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From: Allen Hepner
To: Mike Powell
Date: 2/4/03 5:15PM
Subject: NMRC Release of Report on UNE-P

February 4, 2003

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Federal Communications Commission
Office of the Secretary

The Honorable Michael **K.** Powell

Chairman

Federal Communications Commission

445 12th Street, SW

Washington, DC 20554

Dear Chairman Powell:

The New Millennium Research Council (NMRC) is pleased to provide you with a copy of its most recent report, "What's at Stake at the FCC on UNEs: Ensuring Sustainable Competition".

In this report the NMRC examines whether the current regulatory pricing model known as UNE-P (or Unbundled Network Elements Platform) is promoting investment in advanced telecommunications infrastructure. Specifically, whether the existing regulatory framework is contributing *to* the goal of the 1996 Telecommunications Act-to promote vigorous facilities-based competition while creating incentives for long-term investment in advanced telecommunications infrastructure.

The NMRC has published this report at a very important crossroads for the industry. Your impending decision in the Triennial Review of unbundling obligations of local exchange carriers will have a significant impact upon both the telecommunications industry and the economy as a whole.

This report presents the views of five telecommunications experts, who in their own unique voice offer insightful perspectives on existing UNE rules and their impact for competition and network investment.

The report's authors conclude:

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- UNE-P was designed as a temporary solution to encourage competition.

- It has served its initial purpose and is no longer a sustainable business model.
- UNE-P discourages investment in the public switched network and in broadband services.
- UNE-P seriously inhibits facilities-based competition.
- UNE-P erodes jobs.

The authors note that the FCC can stimulate investment in new and advanced networks, by eliminating rules that restrict local phone companies from competing with the dominant broadband players. Removing unbundling requirements and encouraging competition will encourage the construction of alternative networks so that consumers can have a real choice of provider. This action will also spur investment in and deployment of broadband, enabling more Americans to access advanced telecommunications services.

Yours Sincerely,

Allen Hepner

Advisory Board Member

New Millennium Research Council

www.newmillenniumresearch.org

This report features papers from the following academics and industry researchers: Alliance for Public Technology Policy Director Matthew D. Bennett; TeleNomic Research President Stephen B. Pociask; Eastern Management Group President and CEO John Malone; Competitive Enterprise Institute Senior Policy Analyst Solveig Singleton; and Progress & Freedom Foundation Senior Fellow and Director of Communications Policy Studies Randolph J. May.

Founded in 1999, the NMRC works to foster policy research focused on developing workable, real-world solutions to the issues facing policy makers, primarily in the fields of telecommunications and technology.

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Preface

This report is a project of the New Millennium Research Council (NMRC), which works to foster policy research focused on developing workatle, real-world solutions to the issues facing policy makers, primarily in the fields of telecommunications and technology. The council consists of independent academics and researc hers who are experts in their fields. Both seated experts and invited scholan author NMRC reports.

During the past year, the NMRC has investigated a range of issues related to competitim in the telecommunications industry. The NMRC has also sponsaed a number of round able events in Washington, D.C., and legislative briefings on the subject'

In this report, the NMRC continues its investigatim, examining whether the current regulatory pricing model known as UNE-P (or Unbundled Network Elements Platform) is promoting investment in advanced telecommunications infrastructure. Specifically, whether the existing regulatory framework is contributing to the goal of the 1996 Telecommunications Act—to promote vigorous facilities-based competition while creatin g incentives for long term investment in advanced telecomm unications infrastructure.

The NMRC has published this report at a very important crossroads for h e industry. The Federal Communi cations Commission (FCC) is nearing a decision in the T r i m ial Review of unbundling obligations of local exchange carri ers, a decision that will have a significant impact upon both the telecommunications industr y and h e economy as a whde.

This report presents the views of five telecommunications experts, who in their own unique voice offer insightful perspectives on existing UNE rules and their impact for compelition and network invesbnenl Specifically, that the downturn in the telecommunications industry has been heightend and prolonged by regulation that favors quick entry over sustainable, img-term competition. As John Malone, President and CEO of Easlern Mana gemen t Group writes, *'UNE-P didn't bring* down the *communications* market, but lihe a *stroke delivered after* a fall down a *flight* of *stairs,* it has *kept* the *victim on the* floor.'

- **UNE-P** was designed as a **temporary** solution to enmurage **competitio** n. It has served its initial purpose and is no longer a **sustainable business model**.

As Matthew D. Bennett, Policy Director of the Alliance for Public Technology. ndes, *"UNE's* are a temporary fk In *the short term,* unbundling has *encouraged* a rise in *competition statistics,* but if has done immeasurable damage to *the long-term prospects* for *deploying* advanced services. *It* has *discouraged* network *upgrades* in *urban* and suburban *areas* and *led* to *practically* nonexistent *investment* in *rural* and *underserved* commmilies." Competitive Local Exchange Carriers (CLECs) are now able to compete without the need for UNE pricing. In addition, wireless and cable technologies are taking away customers fran kaditional wireline vdce and data services. Malone writes, *'UNE-P* is *not* a *sustainabl* e *business model.* Companies *built* on *UNE-P have* no assets. no competitive *differentiation, and* no *control* over their future..." This situation can be avoided by switching to facilities-based competitim. CLECs will adapt. *a* revert to the facilities based nehvorks they have abandoned due to UNE-P. Fewer, stronger competitors on a firmer financial footing will provide abundant consumer choices. As Sdveig Singleton, Senia Pdicy Analyst with the Competitive Enterpris e Institute writes, *"Observers* with *little* reason *to butter up* localphone *companies are* calling for unbundling lo be *scaled* back.'

- **UNE-P** discourags investm ent in the public switched network and in broadband services

it is a matter of economic reaiity that telemmmunications networks are capital intensive. and the financial community has no tolerance for investments without reasonable expectations of a competitive return. Despite noble intentions, public policies that promise ubiquity in the deployment of advanced

[1] see our website at www.newmi llenniumresearch.org for copies of me reports and transcripts of me events.

telecommunications capa bility to all Americans do n d drive investment. Stephen B. Pociask, President of TeleNomic Research, writes, *"While* UNE-P was *created* to *jumpstar t comp etition, ironically…it* has *actually disco uraged facilities-ba sed competit ion."* Randolph J. May, Senior Fellow and Directa of Communications Policy Studies at the Progres s and Freedom Fwndation writs. "For iffthe *Commission* chooses [Static *Regulated Compet ition] emb odying* an indefinite *future of 'manage d competi tion', invest ment* in advanced *teleco mmu nica tions facilities* and equipment and innovative new services *will* be impaired.'

The unbundl ing of broad band element s has also directly inhibited the growth of consu mer acces s to high speed Internet services. Singleton writes, "A *realis tic gra sp* of emmm *ic* forces at work beyond the FCC *will* push *the* agency in *the directi on* of scaling back unbundling *for* voice and avoidng it for bmadtan *d…Uncerta in ties* of *consu mer* demand, *espe cially* for bmadtand, mean *that investor s will* need more *reward* lo fake fhe risk." Incumbent local exchang e carriers (ILECs) are positioned to provide such servi ces but the unbund ling of broadband dements such as line-shar ing and packetwitching are preventing faster deployment The ILEC s' Digital Subscriber Line (DSL) services have not teen able to effecti vely compete with cable Internet services, which do not face the sane regulations. As a result, consu mers have fewer broadband chaces and pay higher prices. Pociask notes, "Changes *limiting the extent* of *unbundl ing for* high-speed *Internet* services, as *well* as rules *that provide symmetric al regul atory treatment* of *broa dband investments,* would bring *relief to broadband* investors:

- **UNE-P** seriously inhibits **fac ilities-based competition .**

Incumb ent phone comp anie s are reluctant to invest in advanced telecommunications capabili ties for fear that the FCC will require them to offer the moderni zed netuork to compe titor s at the TELR IC discount. The Commission's sole reliance on UNE resale entry is thus impeding the fadlities-based ampetition that is neces sary to achieve the ubiquitous advmced telecommun ication s deployment that Section 706 of the '96 Act requires. As FCC Chairman Powell has nded, facilities-based competit ion reduces consumers' depfnde nce *on* incumbent networks, provides truly differentiated choice and a redu ndant, more dependable infrastru cture Pod ask writes, "The *fact* is that *UNE pri ces* are being *set* so *low they* have *effect ively becom* e a subsidy *for* CLECs paid by their competitors, fhe *ILEC s."*

- **UNE-P erodes jobs.**

Without a fair return on investment, it becomes increasingly difficult to maintain current workforce levels. In the past 18 months alone, the communications and infor mation techn ology industry has lost more than 500,000 jobs. May writes, "This *stifling* of *invest ment obviously will have* a *continu ing* adverse *impa ct* on jabs in *the already depres sed teleco m and high-tech* sectors and thus on the overall *econo my."* By contr ast, a regulator y environm ent that removes regul atory barriers and enmurages invesbnent can creat e new employment opport unities.

Acmdi ng to a Febtuary 25, 2002, NMRC study, it is estimated that full broa dband deployment would result in the crealion of 1.2 million new jobs. Informa tion technol ogy jobs also pay. *on* averag e, 85% more than other job. *"Withou t* UNE-P, *manufa cturers* and *softw are* companies *will step* in and provide the *produ cts required* of fhe *facilities-ba sed-carrier s.* The *impa ct will cr eate jobs, profit,* and a needed *boos t to* the economy.' (Malone) Greatef investment in a nationwide broadband network (from the release of UNE-P capital) would gen erat e a significant number of high-qualityjcbs.

- **UNE-P** competition **requires investments** by the dominant carriers, **whose** cutbacks not only threaten future **competit ors'** access, but the economy as a whole

Malone writes, 'The uneven playing field created by UNE-P has *motivated* the *incumbe* nt *telephon* e caniers *to* scale *back almost all network* expansion." While the current regulatory framew ork elim inates the economies of scope and scale and discourages investment in more sophisticated netw orks, it enmurages investment in unregu lated servi ces in the U.S. and abr oad. Pocias k notes, *"Fall ing* prices have pmpped up *weak* CLECs, *now* dependent upon subsidized *leasing* and *over crow ded the* market w ith *competit ors,*

making *the whole lot* worse *off.* "The downward trend in pricing encourages shareholders to shift their assets to competitors where the returns are greater, which could lead to higher rates. Singleton notes, "*...the* FCC *needs to pay attention to* forces like *investment incentives* end demand."

The FCC can stimulate investment in new and advanced networks, by eliminating rules that restrict local phone companies from competing with the dominant broadband players. Removing unbundling requirements and encouraging competition will encourage the construction of alternative networks so that consumers can have a real choice of provider. This action will also spur investment in and deployment of broadband, enabling more Americans to access advanced telecommunications services.

The five noted telecommunications experts that contributed to this report representa broad cross section of perspectives.

- Matthew D. Bennett is Policy Directa of the Alliance for Public Technology, a non-profit membership aganization concerned with fostering access to affordable and useable information services and technologies to all people. He educates end advocates for policies that expedite the deployment of advanced telecommunications services to all sectors of society, working with and establishing coalitions to spur involvement in telecommunications issues. Before joining APT, Mr. Bennett served as Senia Associate for Communications and Government Relations at the Alliance for Community Media.

- John Malone is President and CEO of Eastern Management Group, one of the oldest and largest management consulting firms focused exclusively on the communications industry. He provides professional services to leading edge communicatims companies and governmental instihltions worldwide. He and his firm have advised every major telecommunications manufacturer, software company and carrier in North America, Asia, Latin America and Europe John Malone has been professionally involved with the telecommunications indusby fa more than 30 years.

  Randolph J. May is Senior Fellow and Directa of Communications Policy Studies at the Progress and Freedom Fwndation, a market-oriented think lank that promotes innovative policy solutims for the digilai age He examines policies relating to deregulation of the competitive telecommunications industry and the implications of competition fa reform of the FCC. Prior to joining PFF, he was a partner with Sutherland Asbill & Brennan in Washington, DC, specializing in communicatims and administrative law. He has served as Associate General Counsel of the FCC and as a Member of the Administrative Conference of the U.S. He has published more than thirty-five articles on a wide variety of topics ranging from communications law to constitutional theory. He is an adjunct professor of law at George Mason University Schm lof Law.

- Stephen B. Pociask is President of TeleNomic Research, an economic and strategic consulting firm focusing in resesch on Information Technolqly, Internet and Telecommunications markets. Over the past 20 years his studies have been filed with both federal and state regulatory commissions. He has appeared before *the* FCC and testified before Congress on Internet and broadband legislation. Before founding TeleNomic Research, Mr. Pociask served as Chief Economist and Executive Vue President for a DC-Based economic consulting firm.

- Solveig Singleton is Senior Policy Analyst with the Competitive Enterprise Institute, a non-profit public policy organization dedicated to the principles of free enterprise and limited government Ms. Singleton is the former director of information studies for the Cato Institute. She served as vice chair of publications for the Telecommunications and Electronic Media Practice Group of the

Federalist Society for Law & Public Policy Studies from 1996-1999. Her articles have appeared in *The Washington Post*, The *Philadelphia* Inquirer, *The* Wall *Street* Journal, The Journal of *Commerce* Internet Underground, and *Hot-Wired*, as well as academic journals. She is the co-editor of two books. Regulators' Revenge (1998) and Economic Casualties (1999).

The New Millennium Research Council wishes to thank the authors for their time and insight on this critical and timely issue.

February 2003

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Creating a Competitive Future for All

Matthew D. Bennett
Policy Director
Alliance for Public Techndogy

Everythi ng has changed in the world of advance d telecommunications and technology except the need for consu mer access. The new environment is an unknownqurntity with technolog y evolving to a stage never before imagined and a marketplace that has grown enamously, but faces economic uncerta inty. The benefit s for consumers are many, but rmly if the sewices are affordable , accessible and ubiquitous. Today, there are still shortfalls in the reach of broadband and advanced services. The Federal Commun ications Commission is now faced with an extraord inary oppor tunity to promote universal access and widespread deployment and bring all consumers into this exciting telemmmuni cat ions future.

The Commission shoul d not lose sight cl the consumer interest in its Triennial revi ew of unburdiin g obligations (UNE). The god of the Telecommunications Act of 1996, stated in its preamble, is, 'To promote ccmpetition and... encourage the rapid deployment of new telecommunications technologies." In addition, Section 706 cl the Act, which APT took a leal role in crafting, provides regulatory flexibility to encour age deployment of advanced telec ommun ications sewices and remove barriers to infrastructure investment. The current unbundling regime has n d significantly conbiuted to any of these goals, but the FCC now has the chance to bring benefits to all consu mers by creatin g a truly compet itive telecommunications landscape.

To achieve the twin goals of competit im and deployment the Commissirm must take swift action and clear the way for a facilities-based mmpetition model in telecom municatio ns. Today, the UNE regime discourages infrastr ucture investment and creates a resale form of canpetition that has a negative effect on the long-term growth of telecommunications services. By allowing comp etitor s to lease facilities at below-cost rates, there are no incentives for the incumbent io invest in capital-intensive new technologies or fa compet itors to build their own networks.

UNE's are a temporary fix. In the short term, unbundling has encour aged a rise in mmpetition statistics, but it has done immeasurable damage to the long-term prospects for deplo ying advanced servi ces. It has discouraged network upgr ades in urban and suburban areas and led to practically non-e xistent investment in rural and under serve d communities. Competitors using the UNE platform baditionally target lucrative business cust omer s, ignoring millions of Amer ican consumers.

Discouraging infras tructur e investment does n d help cons umers. Crealing false canpetition based on a resale model does not help cmsumers. Continuing the UNE regime in the broadba nd world will not help consu mers. in fact the UNE rules will dramatically slow the arrival of true broadb and sewices; the ubiquitous, two-way connections made possible by technologies such as fiber to the home.

Given the proble ms creat ed by the UNE regime, the Cornmission has a great deal at stake in the current proceeding. The Commission needs to take a new approach, one that values innovation and investment. and not creati on of a competit ion structure that only benefits a small segment of the country.

Encouraging robust facilities-based competitim and deployment of adva nced services requires a regulatory structur e that is flexible and forward-looki ng. Removing outdated rules that only hinder the development of next generation telecommunication services by enacting policies designed to enhance competition and inves tment by both incumbent s and comp etitas is a critical step

Such a regime should include the following principles: (1) Broadband networks and other new investments must be excluded from unbundling; (2) Those elements, such as switching, that are currently available in

aburdan ce in the msketplam should not be included in the list of available **UNEs: (3)** A workatle transition period must be established to ensure services remain available to consumers and competitors are not unduly harmed; (4) Strict performance standards and monitoring devices must be created to ensure service quality and efficient remedies must be available in response to violations; (5) The regulations must be stable across jurisdictions. The Commission alone should formulate the list of dements included in unbundling, while the states continue to possess authority over pricing and performa n m monitoring.

By creating such a forward-looking regulatory structure, one that values investment and deployment of advanced services. the Commissirm can deliver real choices to consumers. Expanding facilities-tared competition will only provide more options at better prices. Additionally, increased investment will improve the fortunes of the telemmmunications economy and create opportunities for new growth and new jabs.

By adopting the pro-consumer principles above, the Commission can encourage deployment and infrastructure investment, allowing consumers to have greater access to Services and applications that bring better and more affordable health care to all citizens, expand educational opportunities f a lifelong learning, enable people with disabilities to function in ways they otherwise could not, create opportunities for jobs and economic advancement, make government more responsive to all citizens and simplify access to all forms of communications technology.

In order to achieve the important **goals** of the Telecommunications Act and provide consumers with real choices and opportunities, the UNE regime must be reformed. Long term growth and development of the telecommunications inhasbucture is critical to our natim's future, but it will not progress as needed if the regulations stifle innovation and discourage investment. Consumers deserve access to every possible form of telecommunications services and the Commission should seize this important opportunity to create a vibrmt telemmmunications future for all.

The Benefits of Dispiadng UNE-P

John Maione
President and CEO
Eastern Manage ment Grcup

When Congress passed legislation, which became the Telecommunications Act of 1996, it set in motion the iagest communications undertaking the world ever witnessed. Thousands of new carriers emerged. erecting massive, robust networks, many of which shamed the older traditional networks of established teiephone companies in efficiency, speed, and ability to deliver new services.

Venture capitalists and Wall Street funded such differentiated business plans predicated on the all too familiar 'better, faster, cheaper'principies of commerce. The new communications age was off and running, and before the roof caved in, venture capitalists were infusing dose to $500 million a day into the industry, not just supporting new carriers, but hundreds of start-up manufacturers and software companies that underpin the indusby. Add to that new debt, and some $2 trillion went to enable the lift-off cl the Teiemmunications Act.

Today, seven years since the Act here is some of what one observes among the charred remains. Two trillion dollars of market cap, a half million telecommunications jobs, and $800 billion in debt have evapwated. Moribund equipment and software manufacturers, whose sales have dried up, are waiting to see what's next. Any carriers with cash are deploying capex dollars in quantities barely capable of sustaining their existing networks; no one is building cut new networks; no company in their right mind provides guidance any more; and yes, UNE-P is here.

UNE-P didn't bring down the communications market, but like a stroke delivered alter a fall down a Right of stairs, it has kept the victim on the floor

Clear and simple, UNE-P is arbitrage. Competitors buy teiephme company facilities for very little money, add a small mark up, and sell uninspired same-old-services fa less than it cost the phone company to construct them in the tint place. What is insidious about UNE-P is that the prices for there unbundled network dement platforms are for the most part chosen by the state regulators with little regard or understanding of what it cost the telephone mrnpany to construct them in the first place. To some it may imk as if everyone wins at this gane (competitors, consumers, state governments) unless, that is, you think that the phone company deserves to win too, which it doesn't

When i was young some bullies pinned me down, took my new Converse sneakers, ran down the street and hocked them for a tidy profit Had they Ripped me a quarter fa my trouble. the arbitrage would hardly have compensated me for the lost investment That's UNE-P.

UNE-P is nd a sustainable business model. Companies built on UNE-P have no assets, no competitive differentiation. and no control over their future (at a moment's ndice the same governme nt who gave UNE-P can take it away). For this reason. and i know from experience, ventue capitalists and private equity firms throw away business plans based on UNE-P faster than a poor auditioner fa American Idol is ushered off the set. Such asset-less companies have no future and there is little chance fa investors to get liquid.

Facilities-based carriers are hurl by UNE-P. There are zero barriers to entry in any market a faciiities-based carrier might otherwise enter, but won't, and no protection in markets the facilities-based carrier has already gone to the trouble to buiid-out. New faciiitiestee caniers can squat buy UNE-P ham the incumbent

telephone company at prices the facilities-based carrier cannot match, and take customers. It's no wonder that the share prices of many facilities carriers today are close to zero.

UNE-P has not generated one dollar of additional revenue for my manufacturer of central office switches. frames, network operating or management equipment software or fiber optic cable. Just ask the hundreds of mmpanies who make Ihem.

So why has UNE-P lasted? The first answer is that every state wants to please its consumers. Holding down phone rates does thai. They also want to report that Ihe state is enjoying the fruits of the Act. That can be done if many competitors are on the scene. Whether the competita is facilities-based or nd, the image is that jobs are being created and the ecommy is benefiting as competitors arrive. Half of ail states have forced down UNE-P rats to such levels that arbitragers cannot stay away.

Now what happens if UNE-P goes away? The FCC's Charmm Powell has made no seaet of the fact thai he doesn't believe UNE-P to be a sustainable business model, or healthy for the industry in the long term. When UNE-P goes away, as it must the industry will be better off fa the effort to rid it. Some carriers. whose businesses have been constructed entirely on UNE-P may sell-off their installed base of Customers to facilities-based carriers Others, who are already largely facilities-based carriers with some UNE-P, may refocus to add more customers on Iheir existing nehvorks. Yet a third UNE-P dependent carrier group may have sufficient UNE-P Customers in given geograp hies tow arrant purchasing new switches, or buying concentrators to back-haul baffic to an existing switch. These options are viable today in the absence of UNE-P Since the price of switches and concentrators have declined substantially within the past year. New small switches can be acquired for under $50 thousand and concentrators sell for under $30 thousand, equating to $50 dollars per line (DS-0) for a cenbal office and $30 per line (DS-0) for a concentrator.

Without UNE-P. manufacturers and software companies will step in and provide the products required of the facilities-based carriers. The impact will creaie jots, profit, and a needed boost to the economy.

The uneven playing field created by UNE-P has motivated the incumbent telephone carriers to scale back almost all network expansion. At the apex of the telecommunications boom, these companies spent more than 30 percent of their revenues on netuork construction and maintenance. Thmks in large measure to UNE-P, these numbers are vastly lower today. Investing in a network makes little sense when it cannot promise a return. Removing UNE-P will elevate construction by the carriers, improve their earnings and creaie a beneficial domino effect for the industry.

The FCC And Telecom Recovery:
A Scorecard For Evaluating the New Rules

Randolph J. May'
Senior Fellow and Director of Communications Policy Studies
Progress and Freedom Fwndation

It is not hyperbole to say that the Federal Communications Commission is truly at an important crossroads. Indeed to suggest anything less wwld be misleading. Acting in three separate proceedngs, the FCC soon will issue new rules that will be touted as reducing regulation of telecommunications and information services. Seven years after the passage of the Telecommunications Act of 1996, real deregulation is coming tm late. The question is: Will it also be too little to spur a recovery in the depressed telecommunications and high tech-sectors?

The three proceedings in which the Commission will issue new rules are: The *UNE Triennial* Review *Proceeding*[2], the *Wireline Broadband Proceeding*,[3] and the Cable *High-Speed* Access *Proceeding*.[4] The *UNE Triennial Review* will determine the extent to which, and for how long, the incumbent local exchange carriers, such as SBC and Verizon, will be required to share every element of their local networks with mpetitors at regulated below-market prices. And the other two, the *Wireline Broadband* and Cable *High-Speed* Access proceedings will determine if telephone and cable broadband service providers will be able to offer their competitive services free from reguiatailymandated capacity sharing requrements and price controls.

In reality, in making the crucial decisions, the Commission will be forced to choose between two competing visions of telecommunications regulation:

Vision 1—Static Regulated Competition —In this vision, communications services are provided essentially in a natural monopoly environment, and this is likely to be the case indefinitely. So the question for regulators is how to continue to shape regulation to guarantee 'mmpetita access' to incumbent facilities and a "level playing field" for all market participants.

Vision 2—Dynamic Deregulation—in this vision, communications services are provided in what is rapidly becoming a naturally competitive environment that encoureges even more competition, investment and innovation. So the question for regulators is how to transition without undue delay to a much less regulatory franework, leaving regulation in place only where necessary for the remaining "pockets of monopoly."

To be sure, the two visions spelled out above may be oversimplified at the margins. But in a very real sense, they do, in fad, describe two divergent paths between which the Commission must chome in confronting the issues in the three major proceedings.

. Randolph J. May is Senior Fellow and Director of Communications Policy Studies at The Progress 8 Freedom Foundation, Washington, DC. The views expressed are his awn. This paper is adapted from a longer version published by The Progress 8 Freedom Foundation entitled, 'The FCC and Telecom Recovery: A Scorecard for Evaluating the New Rules," *Progress on Point Release 10.2*, January 2003.

[2] In *the Matter of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*; Deployment of wireline Services Offering Advanced Telecommunications Capability FCC 01-361, CC Docket No. 01-338, released December 20, 2001.

[3] *Review of the Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, FCC 02-485, CC Docket No. 02-33, released February 15, 2002.

[4] *Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, GN Docket No. 00-185, released March 15, 2002.

In order to evaluate whether the Commission's actions are pro-competitive and deregulatory (that is, cmsistent with the Dynamic Deregulati on Vision) or anti-competitive and pro-regulatwy (thal is, consistent with the Static Regulated Competition Vision). it is useful to have in mind a set of 'benchmarks'. Here are the benchmarks that I propose for the scorecard

- Unbundling And Sharing Should Not Be Required For Newly Installed Fiber Or Other Non-Copper Facilities
- Regardless Of Technology Platform, Broadband Services Shodd Not Be Subject To Unbundling and Sharing Requiremads Or Computer-li-Type Separation Requirements
- Local Switching Should Be Removed Promptly From The Unbundling And Sharing Regime
- Inter-Office Transport and High Capacity Loops Should Be Removed Promptly From The Unbundling And Sharing Regime And "Special Access" Should Not Be Re-Regulated
- A Presumptive Sunset Regima With Competitive Triggers Should Be Established For The Removal Of Copper Local Loops From The Unbundling And Sharing Requirements
- The Commission Shodd Preempt The States From Mandating Unbundling And Sharing Requiremads That Exceed The Scope Of The Federal Obligations
- Elements That Have Been Removed From The Unbundling And Sharing Regime Should Not Be Considered On The "Competitive Checklist" For Evaluating Section 271 Applications

No dcubt, there will be great pressure from outside the Commission, as there always is, for the agency to 'split the baby" among the con lending sides, to let the battle-hardened contestants walk away with their own victories. And there will be pressure from inside the Portals as well for only "incremental" or "moderate" action. After all, if the Commission does, finally, sei Cut determinedly on a truly deregulatory course, it will be decidng that in the future the agency should play a much less intrusive and more modest role than it has in the past. Federal agencies are not by nature immodest in their regulatay ambitions.

So, wheths or not the Commission puts it this straightforwardly, as the Commission makes its choices in the *UNE* Triennial, *Wireline Broadband*, and Cable *High-Speed* Access proceedings. it necessarily will be deciding between the pro-regulatory Vision 1, which leads inexorably down a path of false, not sustainable, competition, or the deregulatory Vision 2, which leads to long–term sustainable competition. In this case, actions that may win accolades if characterized as 'incremental', 'moderate". or 'balanced' almost certainly, in reality, will place the Commission firmly on the Vision 1 path.

And make no mistake. It matters greatly which path the Commission chooses. For if the Commission chooses Vision 1 embodying an indefinite future of "managed competition," investment in advanced telecommunications facilities and equipment and innovative new services will be impaired. This is true for incumbent poviders, whether they are wireline telephone wmpmies or cable companies or whatever, and for new entrants as well, wheths they are wireline, wireless. fiber, or satellite providers. This stifling of investment obviously wiii have a continuing adverse impact on jobs in the already-depressed telecom and high-tech sectors and thus on the overall economy.

There is little purpose here to be served by reciting facts and figures detailing the extent of the telewm meitdown. The Commission surely has in mind the state of the industry. It is enough to quote from the

opening of a November 25 letter to FCC Chairman Michael Powell from Matthew Flanigan. President of the Telecommunications Industry Association:

> [T]he dramatic downturn in the telecommunications sector has led to more than 500,000 job Imses, $1 trillion in corporate debt and nearly $2 billion in market valuation losses in the telecommunications industry alone since 2000. These developments have precipitated an unprecedented slashing of research end development budgets that seriously threatens the future d industry innovation. our global leadership in technology, and in some very important respects, the very security of the United States.[5]

The Commission's part actions implementing the Telecommunications Act of 1996 in en excessively regulatory way surely are not *solely* responsible for the currant telecom meltdown. But they almost certainly have played a *contributory* role.[6] If the Cornmission acts in these proceedngs in a way, judged by the bendmarks set forth in this papa, that is consistent with the Dynamic Deregulation Vision, it mmt likely will play a *contributory* rde in speeding a recovery in the telecommunications and high-tech sectors–to the benefit of consumers and the overall economy.

Back in 1998, in an eloquent *essay* entitled, "Communications Policy Leadership for the Next Century,' then-Commissioner Powell described a dynamic communications industry in the process d being transformed by the rapid technological change brought about by the digital revolution.[7] Chairman Powell sdd: "Policymakers...are fast approaching moments of truth in which we will have to decide whether services similar to thme offered over one medium should be regulated in the same manner es new services offered over another medum—or whether new services should be regulated at all."[8] He asked whether the Commission should allow "traditional wireline telephone companies to take rwt in the rich soil of deregulation to grow innovative services as have Internet service providers?"[9] And he then declared that: "As technology erases the differences between these services, communications pdicy leaders wiii need to reconcile conflicting regulatory approaches in a way that reinforces forward-iwking, pro-competitive approaches and discards *outdated approaches*."[10]

That was 1998, alter the Commission had put in place an overly regulatory and unduly burdensome regime to implement the intended suppmediy 'prc-competitive, deregulatory national policy framework" d the Telecommunications Act of 1996.[11] It would be easy to belabor the point, but, suffice it to say, *that* now. in 2003, the Commission surely is facing 'moments d truth."

The benchmarks set forth above provide a guide f a evaluating whether the Commission's decisions in the three major proceedings–UNE *Triennial* Review, *Wireline Broadband*, and Cabk *High-Speed* Access—meet the minimum requirements necessary to qualify ar consistent with the Dynamic Deregulation Vision. or whether, instead, the Commission opts for the Static Regulated Competition Vision

It is my belief that not only the communications industry, but all of the country's consumers, will benefit if the Commission scaes well.

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[5] Letter from Matthew Flanigan to Michael Powell, FCC. November 25, 2002.
[6] *See* Larry F. Darby, Jeffrey A Eisenach, and Joseph S. Kraemer, 'The CLEC Experiment: Anatomy of a Meltdown, " *Progress on Point* 9.23 (September 2002) (Washington. D.C.: The Progress 6 Freedom Foundation), at 1620.
[7] 50 FEDERAL COMM. L. J. 529 (1998).
[8] Id., at 544.
[9] Id. (Emphasis added.)
[10] Id. (Emphasis added.)
[11] See H. R. CONF. REP. NO. 104-458 AT 113 (1996), *reprinted in* 1996 U.S.C.C.A 124,124.

Fostering Telecommunications Competition: Renters vs. Builden

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FCC Action Expected

The Federal Communications Commissim (FCC) is considering ending a number of onerous regulations thal have discwraged investment and led to job losses in telecommunications ard broadb and sectors. This month, the FCC is expected to rethink its rules f a unbundled network elements (UNEs), those network compo nents that competitive local exchange mmpanies (CLECs) lease from incumbent local exchange compa nies (ILECs). indications are thal the FCC is looking in the right direction for change. One possible change that the FCC is considering is the phasing out of UNE-P. a complete recombination of UNEs *that* form local telephon e services. While UNE-P was creded to jumpstart competition. ironically, as will be discussed. it has actually discouraged facility-based competi tion.

Another possible FCC decision would limit the extent of UNE services based on their availab ility in the market It may be, for example, unnecessary to requir e ILECs to offer a switching element to its com petitor s when some competi tors already own switches. in many markets, switching is abundantly available to even the smallest of carriers. The elimination of just m e element, such as switching, would have the same effect as eliminating UNE-P.

Charges limiting the extent of unbundling for high-speed Internet services, as well as rules that provide symmetrical regu latory treatment of broadb and investments, would bring relief to broadband investors Current regulator y rules require ILECs that build broadba nd infrastru cture to share them with competitor s, and share them at prices thal do not fully com pens ate the ILECs for their investment. This explains why high-speed services are not being deployed as fast in the U.S as they are in som e countries.[12] Moreover, cable operators are not subject Io the same unbundling and sharing requiremenlr, which explains why high speed cable services account for 70% of broadb and services in the U.S.

These changer, if announced by the FCC. would encourage CLECs to build aiterndive networks, and be a boost for consumers and the economy. However, the FCC may not deal with the biggest problem – namely, the fact that UNE prices have been set too low, creating a market of renters, not builders

Background

In ader Io spur competitive entry into the local teleptane market. the Telecommunications Act of 1996 permitte d CLECs to enler and provide local telephone services to cmsumen. The hope was thd these CLECs would eventua lly build their own nehvorks. Becau se building alternat ive networks would take many years, the Act permitted CLECs to reseii the ILECs' services, which allow ed them to provide phme services immediately to consumers. The Act also permitted the CLECs to leas e UNEs from the ILECs' nehuorks. Leasing UNEs would allow CLECs to build portion s of their network, while using portions of the ILECs' netw ork. In theory, this would help migrate CLEC customer s from resale to CLEC-owned netw orks. Over time, con sumers would ben efit from increased mmpetition, as the invis ible hand of market forces would replace the heavy hard of industry reguialion. At least, thd was the thinking.

[12] Stephen P ocia sk, "Putting Broad bandon High S peed," Economic Policy In stitute, Wash ington, DC, 2002

Regulatory Malpracti ce

In setting the prices for these UNEs, regulat ory comm issions often relied on hypothetical Moms-up cost models. These mod els typically exclud ed some overhead costs, ignored regulatory costs, overloo ked actual and prudent investments. missed the recoveryof embedded costs, and under valued the risk of plant obsolescence. Anot her problem regulators created was allowing CLECs to recombin e UNEs into UNE-P service, effectively replicating the resale service called for by the Act, but at half the wst called for by the Act.

The fact is that UNE prices are being set so low they have effecti vely become a subsidy for CLECs pad by their competitors, the ILECs. One study calculated that TELRIC costs would need to be marked up 3.3 times in order to recover the ILECs' sunk costs and risks.[13] Several studies have shwn that UNE prices were so low that ILECs wuld not survive solely as wholesale companies.[14] Another analysis compar ed UNE revenues to retail end-user revenues and concluded that UNEs give the ILECs only 42% of the revenue they would have received from their retail operations.[15] Still another study estimated that it would take twenty years of productivitv-based price reductions to reach the one-time effect of an immedi ate shift to these low UNE prices.[16]

Justifying these artificially low prices as a way to jump start mpetition, regulat ors have continue d to drop UNE prices. Falling prices have proppe d up weak CLECs, now dependent upm subsidbed leasing, and overcrowde d the market with competitors, making the whole lot worse off. And the price reductions cmtinue - last year, several state comm issions made sharp reducti ons to the ILEC's UNE-P rates, including 40% and 45% in California and New Jersey, respectively.

Renters vs. Builden

The result of artificially low UNE prices means that CLECs can lease the ILECs' facilities at rates that are cheap6 than building their own networks. One time facility-based competitors have now adopted the renters' UNE-P model and stopped investing in local telecommuni cations inhasbucture. In short, regulation is subvert ing market forces and undermining those CLECs that took great financial risk to build competitive networks. As the chart below shows. the increase in leaped lines has wme at the expense of CLEC-owned and resale lines. The original premise that CLECs would eventually tran sition to facilities competit ors has not wme true, thanks to artificially low UNE prices.[17]

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[13] Jerry Hausman, "Valuing the Effect of Regulation on New Services in Telecommunications, " *Brookings Papers on Economic Activity: Microeconomi cs*, Brookings Inst itute, Wash inglon, DC., 1997, pp. 1-54

[14] Stephen Pociask, "Competition at Bargain Prices," published as "Two Degrees of Structural Separation,' *America's Networ k*, Vol. 102. No. 24, Dec. 15,1998, pp. 38-42; Stephen Pociask "Structural Separatbn: Consequences for Michigan Consumers, " TeleNomi c Research, May 9, 2001: Staphen Pociask, "Structural Separation of BellSouth Telecommunications and Its Effects an Florida Consumers," Tele Nomic Research, July 31, 2001; and Stephen Pociask, "Addition by Division: How Dividing-up Ameritech Indiana Would Add Costs and Harm Consumes,' TeleNomic Research, May 14, 2001.

[15] Randolph J. May and Larry F. Darby, FCC Comments of the Progress and Freedom Foundation, CC Docket No. 01-338, No. 96-98 and No. 98-147, p. 24.

[16][18] Alfred Kahn, Timothy Tardiff, and Dennis Weisman, 'The Telecom munications Act at Three Years: An Economi c Evaluation of Its Implementat ion by the Federal Communications Commission, " *Information Economics* and Policy, vol 11, 1999, pp. 330-32.

[17] The exception to this point is *intermodal* competition. Cable and wireless providers have now beco me formidable competitors for traditional telepho na services. These providers do not require UNEs.

Summary

As the FCC rethinks its UNE rules, there is a possibility of positive regulatory changes, including limitations to unbundling and phasing out of UNE-P. However, the main problem that regulators have caused – namely, setting UNE prices too low – could remain unresolved. Resolving this problem will be paramount to bringing more intensive facilities competition, as well as increased consumer benefits, telecommunications investment and good paying jobs. These changes would boost economic growth and benefit consumers.

UNE was the Londiest Blunder: From One Network to Many at the FCC

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The Federal Communications Commission's (FCC) proceeding on untundled network elements will lay out the ground rules for the next generation of companies and networks. This is, clearly, a critical role. At the Sane time, the FCC is not, never has been, and cannot be in control of what telephony a broadband looks like two or ten years from now. But the FCC could and did spawn rules that pick who will win and who will lose. Technological innovation, investors, and consumer demand do more to shape the future, but regulators have an unfortunate penchant for handicapping the marketplace. Let's look at how some of these realities affect the unbundling proceeding.

The forces at work in telecommunications are as follows: There's no "killer app' for broadband. Bear Steams recent reports point to the two services presently eroding the power of the former Bell networks (including AT&T), benignly neglected wireless and email. The resale or rebundling of old copper so minutely plotted by Reed Hundt's FCC has not taken center stage after all. All the FCCs tender care of MCI in the 1980's and 1990's could not save MCI/Worldcom. This is a paradox of markets: that legal regimes are everything—because no venture gets off the ground without a baric framework of rights—and nothing, because the faces that operate upon economic actm wtside of the legal regime are so powerful and fast moving.

One implication of this is that the FCC faces hard6 problems in the unbundling proceeding than usually acknowledged. The common view in the press and on The Hill is that the issue of telephone competition is a question of the Few (the monopoly local phone mmpanies) versus the Many (competing local exchange carriers), Big versus little, Monopoly versus Competition. On this view, the FCC faces a simple political force— the incumbent local phone companies' influence The FCC need only figure out what result is likely to be pleasing to the many to do the right thing; that is, to perpetuate extensive untundling to benefit those CLECs that have not built out their own networks.

But anyone with a deeper grsp of economics understands that it is not so simple. A realistic grasp of economic forces at work beyond the FCC will push the agency in the direction of scaling back unbundling for voice and avoiding it for broadband.

- wireless and cable technology means that the spread of competition in business and residential markets, from broadband to voice, need not rely so much on old copper loops.
- Uncertainties of consumer demand, especially for broadband. mean that investors will need mare reward to take the risk.
- Regulation holding down prices in residential areas helps explain the slower expansion of CLECs here as much as (or morethan) difficulties with ILECs.

For those in the press or legislature with little time to grapple with the perplexities of Alfred Kahn's footnotes, here is a red flag that there is more to it than Big versus Little: Observers with little reason to butter up local phone comparies are calling for unbundling to be scaled back. These observers include companies like Corning and the "High-Tech" Broadband Coalition that includes Intel. They want broadband, and they argue that misplaced unbunding can do mae harm than gmd by discouraging investment in new networks. Corning sponsored a detailed study showing that more than 80 percent of incumbent local phme companies' potential investment in DSL will be unprofitable if unbundled and made available to competitors at discounted prices. The High-Tech Broadband Coalition also calls for DSL to be held cut of the unbundling regime.

The concern with unbundling can be expressed in a number of ways, all getting at the same pant Some say that the FCCs generosity in unbundling will delay facilities-based competition. That is, neither the incumbent local phone companies nor newcomers will have much reason to invest in new networks. In other words, the FCC should focus on giving companies reason to build in the future, as much as giving them the means to provide service in the present. One might also call this a dynamic rather than a static concept of canpetition. It is all a way of saying that the FCC nmds to pay attention to faces like investment incentives and demand.

Terms like "facilities-based" and invisible faces don't make good press The arguments and the data are hard to simplify into sound bites. But it is all a reflection of the old dispute between advocates of markets and advocates of government intervention. is more wealth created by taking stuff from the haves and giving it to the have-nots ? Or is more wealth created by making sure that both haves and have-nots have a reason to create it by letting them keq their own gaim? This agedd division explains why seemingly technical issues like the fairness of TELRIC pricing have become so politicized.

The FCC's Notice in the Triennial Review and casual statemends of the Commissicners suggest that the FCC is ready to address some of the hard economic questions here. And they should now have the reams of data and commentary they need to figure out what is really gang on. The D.C. Circuit has told them that simply unbunding every network element that might mst more for a CLEC than an ILEC was not the right legal answer, aligning the law with sensible economics. They have every tool they need to play a leadership role, even if the outcome is not popular in evwy quarter.

This is not a comfortable position for the FCC to be in. The element of discomfort stems from the fact that once again the FCC's rules will indirectly and partially determine winners and losers, as any set of ground rules will if put in place late in the game. (And the agency is definitely late to the game). This time, their action can replace regulatory-favoritism with fair, consumer-friendly market faces. Losers will react as if the FCC had targeted them directly. If the FCC does the right thing, the hard thing, it will not be pretty. But when has gmd economics ever been petty?