Policy Brief

Stanford Institute for Economic Policy Research

The FCC and Local Competition

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The Federal Communications Commission (FCC) recently considered important rule changes regarding local telephone competition. This vote was part of the triennial review of the local competition provisions of the Telecommunications Act of 1996. The provisions govern how incumbent local exchange carriers (ILECs), like Pacific Bell, have to accommodate entry by competitive local exchange carriers (CLECs). CLECs, like Covad Communications, have availed themselves of the market opening provisions that allow them to lease portions of Pacific Bell and other incumbents' local facilities. The FCC determined that these pieces of local networks should be priced at forward-looking costs to mimic the results that would obtain in a competitive market, and that pricing structure was affirmed by the Supreme Court. (See May 2002 SIEPR Policy Brief, *"Supreme Court decision regarding the Federal Communications Commission's Implementation of the Telecommunications Act of 1996"*.) Under the current rules, competitors can lease a set of "elements" (individual pieces of the local network) sufficient to provide service to customers without substantial investment of their own. This collection of elements is termed the unbundled network element platform.

The ILECs continue to argue that the FCC's formula for establishing forward-looking costs, under a pricing model called total element long-run incremental cost (TELRIC), does not provide them with sufficient revenue to cover their costs, and that it is unfair for the commission to require them to lease parts of their networks to competitors at such low prices. One argument they make is that such pricing destroys their incentive to invest in new facilities. On the other side, the new entrants claim that such access is essential to the entry of competitive local telephone services because of the high cost of entry and the anticompetitive behavior of the incumbents absent such rules. They also claim that the pricing is not below cost.

In February, the FCC adopted new rules regarding which pieces of the local networks must continue to be made available under the forward-looking cost rules. The FCC has not yet released the text of those new rules; the commission voted on the order to meet its statutory

April 2003

deadline, but it did not have the details worked out. There is considerable negotiating that will continue until the order is finally released, likely in early May. The analysis in this policy brief is based on the statements released by the commissioners and should provide a framework of what to expect when the actual order is released.

This vote was quite unusual for another reason — the chairman, Michael Powell, was on the losing end. It is relatively rare for the chairman to lose a vote because the chairman is appointed by the president, and two of the other four commissioners are from the same political party and generally vote along with the chairman. In addition, the chairman controls the agenda and generally does not allow items to be voted on until he has a majority. However, in this case, there was a tight legal deadline, and Republican commissioner Kevin Martin sided with two of the Democratic commissioners to outvote the chairman and the other Republican commissioner.

The February decision involved both substance and jurisdiction. The substance involved rules about what should be considered "necessary" for new entrants to be able to compete without "impairment." Jurisdiction involved how much of this would be decided by the FCC and how much would be determined by state public utility commissions. Chairman Powell wanted to continue the strong federal role that began under Chairman Reed Hundt in the Clinton administration. While they agreed on jurisdiction, he disagreed with former chairman Hundt on substance. Chairman Powell believes that federal rules are failing and that the extent of local network facilities that the incumbents are required to lease to entrants under TELRIC should be reduced. His argument is that true competition must stem from new facility construction by the entrants, and that low TELRIC lease prices are stifling the incentive of entrants to make such investments.

The Unbundled Network Element Platform

Most people agree that there would be limited local telephone competition (wireless phones aside) if new entrants had to replicate the entire network of wires (copper loops) connecting each household and business to local telephone switches. But there is substantial dispute about how much of the incumbents' networks beyond the copper loops is required for new entrants to provide competitive services. The most controversial element is switching. Switching, originally done by human operators and later by machines, is now done by computers. Currently, switching is available both as an individual element and as part of the unbundled network element platform (UNE-P). Both unbundled switching and the entire platform are currently priced using the TELRIC formula.

The FCC had to decide whether new entrants' ability to compete will be impaired if they do not have access to switching. Instead of making a concrete decision eliminating unbundled switching, as chairman Powell would have liked, the FCC appears to have given leeway to the states to decide this question. This will lead to substantial litigation as each state's decision is challenged by one side or the other. Because the challenges will be heard in different district courts and likely will have different outcomes, there will be either substantially different standards throughout the country or further litigation as the cases are appealed.

In any case, uncertainty about the rules for the provision of local switching and UNE-P will continue. (Had the FCC issued national rules, there would have been litigation as well, but this litigation would be in a single court and the period of uncertainty would be briefer.) New entrants using unbundled network elements, such as MCI with its "Neighborhood" plan, have begun to capture some customers, but the number is still relatively small. The cloud of litigation that hangs over the FCC decision may slow down competition that relies on the use of the incumbents' networks. Subsequently, depending on the outcome of the cases, use of unbundled network elements and especially the UNE-Platform may cease to be a substantial competitive force.

New Broadband Investment

A second major substantive issue in the ruling involved deregulation of new broadband investment. Broadband in this context mainly means Internet access such as DSL (digital subscriber line) service that competes with cable modem and satellite access services. Incumbent local exchange providers state that they would have no incentive to make substantial risky investments in broadband facilities if they were required to make this new capacity available to competitors at low forward-looking costs. The telephone companies were supported by the High Tech Broadband Coalition, which includes companies from Silicon Valley like Cisco and Intel. The FCC decided in the February vote that the new broadband capacity should be exempted from the network element provisions so long as the telephone company continued to make narrowband capacity available to competitors.

The idea that new capacity should be treated differently than old capacity could raise some interesting incentive questions. Will the older narrowband networks be maintained and promoted? But it also could provide added incentive for investment by both incumbents and new entrants in broadband infrastructure in areas where demand is sufficient to support such investment. Complicating matters is the fact that present-day broadband capacity is provided over the same ordinary copper loops that provide plain old telephone service. Hence, some of the "new capacity" consists chiefly of equipment added at the ends of these wires and at the central office that expands the range of frequencies that can be transmitted on the copper loops. But this part of the decision provides the ILECs with the ability to make wireline investments that distinguish their services from those of CLECs using ILEC facilities.

Another major issue addressed in February also involves broadband. Previously, new competitors like Covad were able to lease a portion of the loop to provide high-speed access (DSL) services while allowing the incumbent to continue to provide voice service over the same line. However, sharing of a common resource leads to problems for state public utility commissions in determining the cost of such an "element." The FCC decided to force the entrants to lease the entire line rather than simply the high-frequency portion of the line. This decision was based on the conclusion that a new entrant is not impaired by having to lease the entire loop to provide service. If this decision stands, it will become more difficult for companies like Covad to compete, because they will have to provide voice as well as data services and to convince customers to switch all of their services on that line away from their traditional phone company.

Implications for the Future

The telecommunications sector went through a period of extremely rapid growth in the period immediately after the implementation of the Telecommunications Act of 1996: Growth in the industry was pervasive; incumbent local exchange providers, new local exchange providers, wireless companies, equipment manufacturers, existing long-distance companies, and new long-haul providers as well as satellite companies all experienced substantial growth and had relatively easy access to capital.

But it is not clear whether this was due to the Act or due to the rise of the new technology, consumer demand for the Internet, and undue investor optimism during the dotcom bubble. At the time all telecom companies were riding high: Local revenues were growing rapidly with the demand for second lines; wireless demand was exploding; and there was the beginning of high-speed access through cable and DSL technology. When the downturn hit, not only did demand for telecom equipment dry up, but the number of wireline connections began to shrink. Presumably this was because of the growing demand for broadband, supplied primarily by cable companies, and the growth of wireless. The current FCC decision does not affect directly the competition from cable or wireless. That means that those sources of competition that have led to substantial consumer welfare gains throughout both the boom and the downturn should continue to grow and provide consumers with benefits.

The interest of consumers and suppliers to the telephone industry lies in cheap and abundant capacity, an outcome best achieved through vigorous competition. In practice, this competition will have to come chiefly from (relatively) unregulated technologies such as cable, wireless, and satellite. These technologies are less vulnerable to the political infighting and judicial second-guessing that has long characterized plain old telephone service. The FCC's decision does little to clarify the regulatory and judicial future for unbundled elements and sends a strong signal that competitors will be less able to use unbundling to compete with the incumbents.

About the Author

Gregory Rosston is the Deputy Director of SIEPR. He is also a Visiting Lecturer in Economics at Stanford University. Rosston's research has focused on industrial organization, antitrust and regulation. He has written numerous articles on competition in local telecommunications, implementation of the Telecommunications Act of 1996, auctions and spectrum policy.

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SIEPR
SIEPR *Policy Brief*
A publication of the
Stanford Institute for Economic Policy Research
Stanford University
579 Serra Mall at Galvez Street
Stanford, CA 94305
MC 6015

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