Is Phone "Competition at the Crossroads?": An Analysis of the Consumer Federation of America's Local Competition Study

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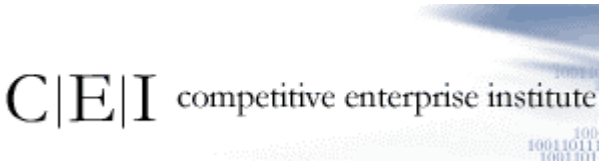


TABLE OF CONTENTS

Preface

This report is a project of the Competitive Enterprise Institute,[1] a non-profit public policy organization dedicated to the principles of free enterprise and limited government, and the New Millennium Research Council (NMRC)[2], established in 1999 to foster policy research focused on developing workable, real-world solutions to the issues facing policymakers primarily in the fields of telecommunications and technology.

In this report, CEI and NMRC continue to explore telecommunications policy issues by providing reviews from noted telecommunications experts to an October 2003 study released by the Consumer Federation of America (CFA) entitled, *Competition at the Crossroads: Can Public Utility Commissions Save Local Phone Competition?*

The CFA study presents a range of arguments for states to ensure that unbundled network elements (UNEs) are made available to competitors of the traditional incumbent local exchange carriers (ILECs). The CFA study concludes that the availability of UNEs has fostered local voice telephone competition and benefited consumers with lower prices. Thus far, the CFA study's findings and conclusions have not been publicly scrutinized by academics or telecommunications experts. Having previously examined the effects of UNEs in the states, the CEI and NMRC undertook this critique to assess the basis of the CFA study claims.

This report presents the views of two telecommunications experts – Solveig Singleton, Senior Policy Analyst for the Competitive Enterprise Institute and Stephen B. Pociask, President of TeleNomic Research, LLC. Each reviews, qualitatively and quantitatively, the CFA study's assertions, claims, and recommendations and provides insightful perspectives on the role that UNEs play in local phone competition, consumer benefits, and network investment.

Ms. Singleton provides a thematic review of the CFA study, focusing on the CFA study's assertions regarding telecommunications investment, network competition, long distance entry by ILECs, and regulatory price controls. Mr. Pociask complements this analysis with a point-by-point critique of the study's quantitative findings and conclusions. Mr. Pociask also provides new data sources to compare and contrast against those provided by CFA.

CEI and NMRC publish this report at a very critical juncture for the telecommunications industry. The Federal Communications Commission issued its Triennial Review Order (TRO) in August 2003 and delegated to the states the complex issues surrounding the availability of UNEs. The TRO provides tight deadlines for states to conduct UNE proceedings and the outcomes will have a tremendous impact on the future of the telecommunications industry. We hope this report provides regulators with more information to make these critical decisions.

The Competitive Enterprise Institute and the New Millennium Research Council wish to thank the authors for their time and insight on these critical and timely issues.

December 2003

[1] To learn more about the Competitive Enterprise Institute, visit www.cei.org.

[2] See our website at www.newmillenniumresearch.org for copies of the reports and transcripts of prior events.

Author Biographies

Solveig Singleton is a lawyer and senior policy analyst with the Competitive Enterprise Institute's Project on Technology and Innovation. Ms. Singleton is the former director of information studies for the Cato Institute. She also 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 in many academic journals. She is the co-editor of two books, Regulators' Revenge (1998) and Economic Casualties (1999). Her undergraduate degree is from Reed College, where she majored in philosophy. She then graduated cum laude from Cornell Law School and worked for two years at a telecommunications law firm.

Stephen B. Pociask is president of TeleNomic Research, LLC and has worked in and consulted for telecommunications and high-tech industries for over twenty years. Mr. Pociask conducts a wide variety of applied economic studies, including those dealing with public policy, regulatory economics, and antitrust issues. He has provided consulting primarily for high tech firms, including those providing high-speed Internet services, local and long distance services. He has appeared numerous times in the media, including Bloomberg News, CNBC, Telecommunications Reports, Telephony, Congressional Quarterly, Americas Network, Network Magazine, and CNET Radio. From 1998 to 2000, Mr. Pociask was Chief Economist and Executive Vice President for Joel Popkin and Co., an economic consulting firm in Washington, DC. Prior to this assignment, he worked eighteen years in the telecommunications industry. He has completed his Ph.D. coursework in economics and has an M.A. in economics from George Mason University.

About the Competitive Enterprise Institute

The Competitive Enterprise Institute is a non-profit public policy organization founded in 1984 and dedicated to the principles of free enterprise and limited government. CEI is nationally recognized as a leading voice on a broad range of regulatory issues ranging from environmental laws to antitrust policy to regulatory risk with nearly 40 policy experts and other staff. CEI produces groundbreaking research on regulatory issues. CEI is actively engaged in many phases of the public policy debate. CEI reaches out to the public and the media to ensure that its ideas are heard, works with policymakers to ensure that the ideas are implemented and, when necessary, takes its arguments to court to ensure the law is upheld. This "full service approach" to public policy helps make CEI an effective and powerful force for economic freedom. Go to www.cei.org for more information.

About the New Millennium Research Council

The New Millennium Research Council (NMRC) was established in 1999 to foster policy research focused on developing workable, real-world solutions to the issues facing policymakers, primarily in the fields of telecommunications and technology. The Council consists of independent academics and researchers who are experts in their fields. Both seated experts and invited scholars author NMRC reports. Over the past few years, the NMRC has investigated a range of issues related to competition in the telecommunications industry. The NMRC has also sponsored a number of roundtable events in Washington, D.C., and legislative briefings on various topics. Go to www.newmillenniumresearch.org for more information.

Executive Summary

On October 7, 2003 the Consumer Federation of America (CFA) released a study entitled, *Competition at the Crossroads: Can Public Utility Commissions Save Local Phone Competition?* The study found that local telephone company arguments for higher wholesale prices for leasing parts of their networks and for reduced access to these so-called unbundled network elements (UNEs) would spell the "end of local phone competition" and "the real savings being enjoyed by consumers across the country." To support its findings, the CFA study disputed three arguments it said are used by the Regional Bell Operating Companies for raising UNE wholesale prices and for restricting the availability of UNEs.

- **Claim 1** – Competition would be stimulated if local incumbents were allowed to enter the long distance market before new market entrants have established access to the existing telephone network;
- **Claim 2** – UNE prices do not adequately reflect costs, and represent a 'subsidy' to competitors; and
- **Claim 3** – Withdrawing access to UNEs will force competitors to make investments in their own facilities and networks.

The CFA study concluded that when incumbents were allowed into the long distance market before local markets were irreversibly open, competition did not take hold; that there was a strong relationship between wholesale costs and UNE prices; and that there was no evidence that reduced UNE availability led to higher investment rates by competitors. Competitive local exchange carriers (CLECs) make investments in those segments where it makes economic sense to do so, the CFA study found.

Thus far, the CFA study's findings and conclusions have not been publicly scrutinized by academics or telecommunications experts. Having previously examined the effects of UNEs in the states, the CEI and NMRC undertook this critique to assess the basis of the CFA study claims. This report presents the views of two telecommunications experts – Solveig Singleton, Senior Policy Analyst for the Competitive Enterprise Institute and Stephen B. Pociask, President of TeleNomic Research, LLC. Each reviews, qualitatively and quantitatively, the CFA study's assertions, claims, and recommendations and provides insightful perspectives on the role that UNEs play in local phone competition, consumer benefits, and network investment.

Solveig Singleton *finds that the CFA study doesn't address telephone company investment after the telecom bubble burst. Instead, it focuses on capital investment after the 96 Telecom Act. She says those investment levels were unsustainable, that regulators should use price controls sparingly, and that basing wholesale prices on a future hypothetical cost model does nothing to finance the building of today's networks.*

"Regulators must recognize that investment follows incentives, and price controls erode incentives," says Ms. Singleton. "The essential problem with TELRIC [is that] the super-efficient network is imaginary and quite subjective. TELRIC price controls and unquestioning unbundling of everything under the sun erode incentives to invest in new wireline networks. The FCC's own data show that CLECs are abandoning their own access lines to piggyback on the old networks."

"For a stark contrast, look at the rates of growth in less-regulated wireless. This is where the real opportunities for investors are and where the real choices for consumers will continue to spread," Ms. Singleton says. Regulators should, keeping in mind how they will transition out of them."

For real competition to occur, Ms. Singleton argues that facilities based competition should be paramount. "If the networks of the future are to be something other than a twisted reflection of legal complexities, competition in building networks is just as important as competition in marketing, pricing, and packaging…Endlessly repackaging the same service offered over the same network will not end monopoly. Real competition happens between real networks."

"The idea behind holding the locals out of long distance was to provide a 'carrot' to tempt them to open their local markets," says Ms. Singleton. To get the "carrot," RBOCs had to open their local markets and were saddled with the "stick" of unbundling, she says. "From a regulatory standpoint, this may have been a necessary transitional measure. But for consumers, it's doubtful that the game was worth the candle." The CFA study, rather oddly, doesn't recognize the tension between consumer interests and regulatory strategy here, she adds.

In any case, the carrot/stick model the CFA study defends is fast becoming outdated, she says. "The long distance market is looking unhealthy as revenues fall. So the longer we wait to let local companies provide long distance, the more likely they will lose interest and find less regulated opportunities."

Ms. Singleton also points out that for the CFA study's argument on TELRIC prices and costs to have any validity at all, the process for measuring costs at the state level should have some kind of integrity. "In practice, wild fluctuations in rates within some states, gross inconsistencies in rates across similar states, and the bizarre technological concepts cooked up in state regulatory proceedings make it unlikely that these costs measures are worth the paper they are printed on. Certainly, investors are not relying on them."

"The CFA study ignores the lessons of the telecom meltdown; sustainable investment requires stable incentives, not regulatory hand-holding of one market segment," Ms. Singleton concludes. ***"It ignores the growth of business competition in local markets from the 1980s, showing that if BOCs do inflate their costs/prices they will be undercut by facilities-based competitors."*** The paper employs a simple-minded definition of competition, ignoring the benefits of competition in building networks and access, she says. Finally, the paper pretends that TELRIC yields an objective measure of costs, as opposed to an artificial construct subject to wild manipulation, she notes.

Ms. Singleton recommends that State regulators should recognize that UNE-P and TELRIC regulations hurt consumers more than they help. ***"It is time to take the next step towards real competition between real networks. UNE-P and TELRIC itself should be phased out, the latter to be replaced first by a more objective measure of costs. Ultimately, both retail and wholesale prices must be deregulated."***

Disputing the CFA study's contention that competition is in trouble, **Stephen Pociask** finds that competition is developing at a robust pace and more regulation is the last thing the industry needs. ***"There are over 153 million wireless subscribers, a number rivaling the total traditional telephone lines provided by the Regional Bell Operating Companies (RBOCs)."*** Competition is also taking shape in the form of tens of million of high-speed connections from cable operators and other broadband providers, he says. ***"These high-speed services permit voice communications, as well as data and video transport services, making them far superior to traditional telephone service."***

Mr. Pociask also points out that the CFA study ignores this competition and focuses on only the market for traditional local voice telephone services. Even given this limited focus, the traditional local telephone market is irreversibly open to competition, he says. ***"This is not, as the CFA would lead one to believe, an ILEC view or an RBOC view, this is the view 48 of 48 state commissions that have independently judged the ILECs to have sufficiently and irreversibly opened their markets to CLECs in terms of interconnection and nondiscriminatory access of the ILECs' facilities."***

Mr. Pociask also disputes the CFA study's three main arguments.

Claim 1. – Mr. Pociask notes that ***the RBOCs have never been allowed to enter an in-region long distance market before that market was fully opened to competitors.*** ***"The Section 271 competitive checklist requires markets to be irreversibly opened first and requires nondiscriminatory access for CLECs before ILECs can enter that long distance market…In all 48 states where Section-271 process could be applied, the ILECs' markets were found to be irreversibly opened."***

He also says there is evidence that ***ILEC entry into the long distance market did increase competition in the local exchange market, after Section 271 approval.*** And in the opposite case, Mr. Pociask finds that there is evidence that ILEC entry into the long distance market did increase competition in that market. ***"Where local telephone companies have been permitted to provide long distance services, the increase in competition has been sufficient to lower consumer prices,"*** he says.

If consumers are benefiting from competition, why does the CFA study argue for more regulation, Mr. Pociask asks. ***"Several studies have shown that the potential benefits from long distance competition exceed the potential benefits of local competition by more than 4 to 1. Oddly, holding back long distance entry, a position that the CFA study appears to favor, harms consumers."*** He concludes there is overwhelming evidence that consumers are saving as a result of the elimination of long distance entry barriers. ***"The CFA report has selectively ignored the studies and facts cited here."***

Claim 2. – ***Mr. Pociask notes the CFA study attempts to prove something different than the ILECs supposedly claim.*** The ILECs' claim that UNE prices do not fully recover their costs, including investment costs. "If, for example, UNE prices only recovered 40% of the ILECs' costs, then the ILEC claim would be true," states Mr. Pociask. "However, if every state set prices this way (recovery of only 40% of costs), then the CFA study response – that there is a strong relationship between wholesale costs and retail prices – would also be true."

Evidence suggests that ***UNE prices are set so low that they represent a corporate subsidy for the CLECs paid for by the ILECs,*** he says. ***"One study calculated that TELRIC costs (the formula used to price network elements) would need to be marked up 3.3 times in order to recover the ILECs' sunk costs and risks."***

"In contrast, regulatory commissions estimate that ILECs can shed only 19 percent of their cost when the ILECs' retail customers are replaced by the ILECs' wholesale services," says Mr. Pociask. This divergence between price and cost leads to an absolute decline in cash flow and earnings for ILECs, he notes. "The CFA study retort for this is that these earnings are based on historically embedded costs, while TELRIC estimates are based on future competitive costs." TELRIC models are full of assumptions that may not reflect real-world realities, such as hurricane damage, network redundancies for security and reliability, and human error, he says. "Economists have criticized TELRIC models and their assumptions for years."

Still, the CFA study believes that UNE prices are reasonable. The CFA study's evidence is also weak, says Mr. Pociask. "They offer data showing that TELRIC costs are roughly aligned to UNE prices. The CFA study shows FCC data on what is supposed to be residential CLEC lines. What the CFA study does not tell the reader is that the FCC does not publish residential CLEC line data separately – it combines residential and small business lines." Accepting that error, the CFA study shows only that TELRIC costs are similar to UNE prices, he notes. "Both price and TELRIC costs can be too low and be correlated. Therefore, the CFA study has not provided any evidence to support its conclusions."

Claim 3. – ***The CFA study finds no relationship between current UNE price and UNE use by CLECs, defying even the laws of supply and demand,*** says Mr. Pociask. "To support this claim, the CFA study pairs and plots, for each state, UNE prices (as a percent of residential retail price) against the percent of total UNE lines in use by CLECs, and not the percent of residential UNE lines in use by CLECs. Similarly, the CFA study pairs and plots, for each state, UNE prices (as a percent of business retail price) against the percent of UNE line use by CLECs, and not the percent of business UNE lines in use by CLECs. Therefore, not one of the seventy-eight data points in the CFA study finds the correct point on both the horizontal and vertical axes." The result is a confusing, meaningless scatter plot that the CFA study uses in finding no relationship between UNE discounting and UNE use by CLECs, he finds.

There is ample evidence that consumers benefit from competition. For this reason, the CFA study should support fair competition and resist efforts (by some) to give an advantage to one competitor over another, he concludes.

Of Languishing Local Loops and Circular Arguments: Critique of the Consumer Federation of America's Telecom 'Crossroads' Study

Solveig Singleton
Senior Policy Analyst
Competitive Enterprise Institute

The controversy over the Federal Communication's Commission's "Triennial Review" of telecommunications regulation has brought a wide range of research offerings. The CFA's study is one of the more recent. It urges states to continue aggressive price controls on wholesale rates (TELRIC) and to perpetuate offerings of the unbundled network platform, the controversial UNE-P. But a careful reading of the study reveals that many of its key arguments are sadly naïve or bizarrely circular.

The states should beware the study's prescriptions. The meltdown of the telecommunications industry is a red flag that past regulatory policies have heavy costs. Unbundling and steep price discounts now bear a weighty burden of proof. It is time to take a new direction towards more competition in facilities and networks.

Describing Investment: The Need for Sustainable Investment and Incentives

One stark oddity of the CFA study is its omission of any discussion of how hard the last couple years' recession hit telecommunications companies. The study does point out that there has been investment in telecom. Indeed, large amounts of money have been invested—and much lost and misdirected. The spate of telecom investment has not proved to be sustainable. As many Wall Street analysts have pointed out, there is serious question as to where the next round of investment funds are going to come from. Both local and long distance revenues continue to fall. TELRIC price controls and unquestioning unbundling of everything under the sun erode incentives to invest in new wireline networks. The FCC's own data show that CLECs are abandoning their own access lines to piggyback on the old networks.

UNE-P, which as many web sites advertise (see, for example, http://a-adt.com/), allows virtually *investment free* entry into telecom offers consumers advantages from price arbitrage and choices in packaging, yes. But these policies are not building the networks of the future. For a stark contrast, look at the rates of growth in less-regulated wireless. This is where the real opportunities for investors are and where the real choices for consumers will continue to spread.

Regulators must recognize that investment follows incentives, and price controls erode incentives. Regulators should use price controls sparingly and with extreme caution, and begin to lay the groundwork for transitioning out of them.

Defining Competition: The Need for Network Competition

If the networks of the future are to be something other than a twisted reflection of legal complexities, competition in building networks is just as important as competition in marketing, pricing, and packaging. The CFA study emphasizes the role the CLECs have played in innovative marketing and cutting prices. But some, like Covad and Allegiance, have also tried to build their own networks. Wireless also offers alternative networks. These competing networks are no more "redundant" than having two grocery stores in the same town; ultimately, this is essential for consumers to see a full range of benefits from competition. Endlessly repackaging the same service offered over the same network will not end monopoly. Real competition happens between real networks.

In the short run, building a competing network is expensive and hard. But it does happen. MCI started as a facilities-based competitor to Ma Bell. In the 1980s, companies like Teleport and Metropolitan Fiber Systems sprang up, building fiber networks to link urban businesses with long distance networks. This network competition sprang up in long distance and business in spite of, not because of, regulation. If competition is slower to come to the residential

market, one might note a key difference between residential and business (and long distance) rates. That is, retail rates in residential areas are often held below cost.

So here are two more recommendations for regulators: (1) Don't forget the benefits of competition between networks, both wireline *and* wireless, and (2) Explore the link between competition and *retail* rate flexibility.

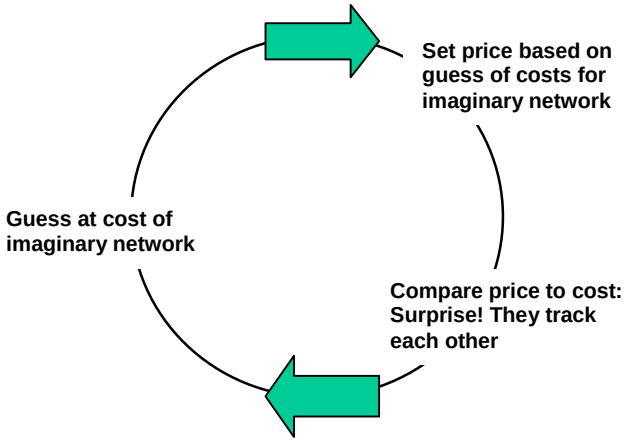
How About a Carrot for Consumers?

Now we come to the issue of local phone company entry into long distance. The idea behind holding the locals out of long distance was to provide a "carrot" to tempt them to open their local markets. To get the "carrot," RBOCs had to open their local markets and were saddled with the "stick" of unbundling. From a regulatory standpoint, this may have been a necessary transitional measure. But for consumers, it's doubtful that the game was worth the candle. Consumers would have benefited enormously from even more long distance competition, whatever the state of local markets. CFA's study, rather oddly, doesn't recognize the tension between consumer interests and regulatory strategy here.

But in any case the carrot/stick model the CFA study defends is fast becoming outdated. The long distance market is looking unhealthy as revenues fall. So the longer we wait to let local companies provide long distance, the more likely they will lose interest and find less regulated opportunities. Remember that telcos wanted to get into cable television, too, and vice versa, but regulators held that window shut far too long. When the window opened, it was too late, and both cable and telcos had one less potent competitor in their traditional markets. Luckily, the telcos and cable are still both interested in less-regulated broadband.

Uses of Imagination in the Economy: CFA on TELRIC Prices and Costs[3]

Suppose you were to give someone a ride to New York for the holidays in your car, and he paid you for gas. But then he only paid you for the amount you would have spent on gas, if you had been traveling along a perfectly efficient, frictionless highway of the future with no traffic. You might well object that the payment was insufficient. TELRIC is a similar economic model—only more problematic; the trip isn't a one-time venture. Likewise, CFA's study offers nice graphs purporting to show that state TELRIC rates follow costs, and, well, so it does—*if, as the study does, you measure costs as the TELRIC regime defines them—as the costs of a hypothetical (that is, imaginary) super-efficient future network, seen through the eyes of state regulators.* A graph of the CFA study's methodology would therefore look something like this:



[3] Some decades ago, Nobel-winning economist F. A. Hayek wrote his famous essay on how prices carry information through markets; the title is usually translated as "Uses of Information in the Economy."

For the CFA study's argument to have any validity at all, the process for measuring costs at the state level should have some kind of integrity. In practice, wild fluctuations in rates within some states, gross inconsistencies in rates across similar states, and the bizarre technological concepts cooked up in state regulatory proceedings make it unlikely that these costs measures are worth the paper they are printed on. Certainly, investors are not relying on them.

Peculiarly, the study also seems to argue that TELRIC prices are inflated, because they are not the bare-bones costs of a bare-voice only network. But is that really what we want a super-efficient future to be? Probably not. The point illustrates, though, the essential problem with TELRIC -- the super-efficient network is imaginary and quite subjective. No one knows what a future super-efficient network will do, what services it will offer, using what equipment and technology, and how it will be priced, much less how much it will cost. And, if we did know, it would have little relevance to the price/cost structure needed to finance the building of *today's* networks.

The CFA study correctly points out the problem with old rate-of-return regulation; giving telcos their historic costs tempts the companies to gold-plate their network, or at least their accounting. But TELRIC errs too far in the opposite direction.

The current thinking is that wholesale price controls in telecom would be improved by paying attention to actual costs. The danger that this would lead to gold-plating today is much lower; wireless competition alone gives local phone companies good reason to stay efficient. Agreeing how costs are to be measured, and tracking them over time, does threaten to get ugly. Ugly, though, is what price controls are. Recognizing this is the first step in moving telecom towards a new consensus on a way out of price controls.

Conclusion

The CFA study ignores the lessons of the telecom meltdown; sustainable investment requires stable incentives, not regulatory hand-holding of one market segment. It ignore the growth of business competition in local markets from the 1980s, showing that if BOCs do inflate their costs/prices they will be undercut by *facilities-based* competitors. The paper employs a simple-minded definition of competition, ignoring the benefits of competition in building networks and access. Finally, the paper pretends that TELRIC yields an objective measure of costs, as opposed to an artificial construct subject to wild manipulation.

State regulators should recognize that UNE-P and TELRIC regulations hurt consumers more than they help. It is time to take the next step towards real competition between real networks. UNE-P and TELRIC itself should be phased out, the latter to be replaced first by a more objective measure of costs. Ultimately, both retail and wholesale prices must be deregulated.

"Competition at the Crossroads:" Assessing the CFA Study's Phone Competition Data and Conclusions

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TeleNomic Research, LLC

Overview

A recent study, "Competition at the Crossroads" from the Consumer Federation of American (CFA), draws some conclusions that are contrary to the findings of numerous studies coming out of academia and prominent "think tanks," a well as contrary to views of industry and financial analysts, the Federal Communications Commission (FCC) chairman and others.[4] The CFA study paints a picture that competition has failed in the industry, and the industry will remonopolize and increase consumer prices.[5] This paper analyzes the CFA study and finds the report to be misleading, subjective and contrary to the interests of consumers. From the start, the CFA study takes positions that are not supported by empirical evidence, makes assertions without proper citation, and then misapplies data to support what appear to be predetermined conclusions. Portions of the CFA analysis are simply erroneous.

What is most puzzling about the report is that it squarely commits the CFA study as pro-CLEC (competitive local exchange carrier) and anti-ILEC (incumbent local exchange carrier). That stance is neither pro-competitive nor pro-consumer, since competition requires that public policies not favor one group of competitors over another. It is puzzling why the CFA study advocates the same views as the CLECs, when CLECs have disproportionately shunned residential consumers, opting for more profitable businesses customers. As a group, the CLECs are no special friend of residential consumers. What is even more puzzling is that the CFA study argues that ILEC wholesale prices and costs should be aligned, an argument if applied to retail prices would justify significant increases in residential telephone prices. These puzzling positions should leave consumers wondering whom exactly does the CFA study support? Competition is not at a crossroads, as the CFA study contends, it is simply the study's arguments that have reached a dead end.

Is Competition In Trouble?

Industry competition has become irreversibly opened. While CLECs provide nearly thirty million lines to customers,[6] this is only one aspect of the competition that is underway, much of it occurring in the absence of regulation. Contrary to the CFA study's claims, competition is developing at a robust pace and more regulation is the last thing the industry needs. There are over 153 million wireless subscribers,[7] a number rivaling the total traditional telephone lines provided by the Regional Bell Operating Companies (RBOCs). Competition is also taking shape in the form of tens of million of high-speed connections from cable operators and other broadband providers. These high-speed services permit voice communications, as well as data and video transport services, making them far superior to traditional telephone service. Consumers now have access to voice-over-Internet services that replace traditional circuit-switched traffic. Besides voice-over-Internet services, other Internet-based services are available online, including call waiting, instant messaging, voice mail, IP teleconferencing, and virtual PBX services. These Internet-based services are replacing all traditional phone services, and sometimes free of charge.

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* Stephen B. Pociask is President of TeleNomic Research, LLC. The views expressed in this report are the opinions of the author. For more information about the company, see www.TeleNomic.Com.

[4] "Competition at the Crossroads: Can Public Utility Commissions Save Local Phone Competition?" the Consumer Federation of America (CFA), Washington, DC, October 7, 2003.

[5] CFA, p. 27.

[6] The CFA predicts this by year's end, see CFA, p. 7.

[7] Wireless subscriber figure from www.CTIA.org on Dec. 4, 2003.

The CFA study ignores this competition and focuses on only the market for traditional local voice telephone services. Even given this limited focus, the traditional local telephone market is irreversibly open to competition. This is not, as the CFA study would lead one to believe, an *ILEC view* or an *RBOC view*, this is the view 48 of 48 state commissions that have independently judged the ILECs to have sufficiently and irreversibly opened their markets to CLECs in terms of interconnection and nondiscriminatory access of the ILECs' facilities.[8] In these 48 cases, not only have the state regulatory commissions agreed, so have the FCC and the Department of Justice (DOJ) that local markets are open and that they do not pose any anticompetitive risks for consumers. However, CFA's study, "Competition at the Crossroads," draws some very different conclusions, calling for a continuance of regulations that, by some accounts, are harming consumers.

The centerpiece of the CFA's study "Competition at the Crossroads" is the attempt to discredit three claims supposedly made by the RBOCs and ILECs.[9] These are:

Claim 1. "The ILECs claim that competition would be stimulated if the Bells are allowed to enter the long distance phone market before new market entrants have real access to the existing telephone network";[10]

Claim 2. "UNE prices do not adequately reflect costs, and represent a 'subsidy' to competitors";[11] and

Claim 3. "Withdrawing access to Unbundled Network Elements will force the CLECs to make investments in their own facilities and networks."[12]

The CFA study lists supposed RBOC claims, though none of the claims are attributed to any particular person or company. It may be easier for the CFA to discredit a claim that has not been made (or is not widely known) in order to draw predetermined conclusions. This raises some serious questions about the objectivity of the CFA study. The next sections consider and analyze the supposed ILEC claims and the CFA study's responses.

[8] In this paper, these facilities are referred to as unbundled network elements (UNEs). The recombination of UNEs into a standalone retail service is referred to as UNE-P.

[9] The CFA study sometimes refers to these as claims made by RBOCs (for example see CFA, p. 4 and 18) and sometimes refer to the same claims as those made by ILECs (see CFA, p. 2). There are four RBOCs and 1,337 ILECs. It would be hard to prove the ILECs have agreed or taken any position unanimously, much less the claims stated here. In fact, some of the claims stated here might also be those made by regulators, academia, consumers, competitive local exchange carriers (CLECs), financial analysts, and others. Therefore, the CFA study commits a logical fallacy called a *hasty generalization*. The proof of this fallacy is that the CFA study offers no citation identifying the source of its claims. Yet, the CFA study proceeds to debunk them as if they were fact. While this paper will discuss these claims and the CFA study 's rebuttal claims, this paper does not accept these as the positions of any party without proper attribution.

[10] CFA, p. 3.

[11] ibid.

[12] ibid.

Supposed ILEC Claim #1:

> **"The ILECs claim that competition would be stimulated if the Bells are allowed to enter the long distance phone market before new market entrants have real access to the existing telephone network."[13]**
>
> **The CFA study finds this supposed ILEC claim to be false and that "when incumbents are allowed into the interLATA long distance market before local markets are irreversibly open, competition does not take hold." [14]**

There are three problems with this CFA study "finding." First, the RBOCs have never been allowed to enter an in-region long distance market before that market was fully opened to competitors. The Section 271 competitive checklist requires markets to be irreversibly opened *first* and requires nondiscriminatory access for CLECs *before* ILECs can enter that long distance market. As previously mentioned, ILECs must first pass a comprehensive checklist administered by the state commissions, and well as meet the approval of the FCC and DOJ. In all 48 states where Section-271 process could be applied, the ILECs' markets were found to be irreversibly opened. Therefore, the CFA study describes an event that has never happened in U.S. telecommunications history. If ILECs have never been granted long distance entry first, then the CFA study cannot observe how these events have stifled competition. Therefore, the study is trying to prove an irrelevant issue and call that issue an *ILEC claim*. It is not clear how consumers benefit from the CFA study's misstatement of these facts.

Second, there is evidence that ILEC entry into the long distance market *did* increase competition in the local exchange market, *after Section 271 approval*. For example, just days before and after the FCC approved Verizon's Section 271 application to provide long distance service in New York, the two biggest long distance carriers announced plans to enter the local market there.[15] Since then, other CLECs have intensified their efforts in New York as well. In fact, in the first six months following Verizon's entry into long distance, 22% of all new CLEC lines added in the U.S. came from CLECs operating in New York. During the same period, the second most active CLEC market in the country was, not surprisingly, Texas -- the second state to remove long distance regulatory barriers. In fact, the FCC concluded, "states with long distance approval show [the] greatest competitive activity."[16] Clearly, long distance competition sparks local competition, which provides additional benefits to consumers.

In fact, econometric evidence confirms that interLATA relief leads to increasing competition in the local telephone service market. An econometric model produced statistically significant evidence estimating that, on average, 291,000 CLEC lines were added in a given state when ILEC long distance entry occurs in that state.[17] This statistical evidence supports the tenet that, once long distance relief was granted, long distance providers, who once benefited from delaying competition by protecting their own markets, were now spurred to compete for local service customers. Thus, eliminating the long distance entry barrier has been an important stimulus for local competition. It is difficult to understand why the CFA study would be opposed to consumers benefiting from competition.

Finally, there is evidence that ILEC entry into the long distance market did increase competition in that market. Where local telephone companies have been permitted to provide long distance services, the increase in competition has been sufficient to lower consumer prices. When Southern New England Telephone Co. (SNET) entered the long

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[13] ibid.

[14] ibid.

[15] FCC approved Verizon's application for entry into the New York long distance market Dec. 21, 1999. For competitive reactions, see "MCI WorldCom to Sell Local Service in New York," January 13, 2000, CLEC-Planet, www.clec-planet.com/news/0001/000113mci.htm; "MCI WorldCom CEO Announces 'All-Distance' Service, Open Access to All Network Services," MCI WorldCom press release, January 12, 2000; and "AT&T Finally 'Enters' Local Market in New York: Clear Evidence of Competition in Local Phone Service," United States Telecom Association press release, December 3, 1999.

[16] See "Federal Communications Commission Releases Latest Data on Local Competition," News Release, FCC, May 21, 2001, p. 1.

[17] "Long-Distance Entry Barriers and Effects on Wisconsin Consumers," TeleNomic Research, Dec. 3, 2001, Appendix A.

distance market in Connecticut in 1994, it cut its rates 18% below AT&T and captured 35% of the market by February 1997.[18] As a result of increased, MCI and AT&T sought to reduce its rates, but only in Connecticut.[19] This demonstrates that entry by a local telephone company into the long distance market can produce lower consumer prices.

A similar result happened when Verizon was approved to provide long distance services in New York. One study of actual residential customer bills showed that when New York customers switched to Verizon, they saved approximately 31.9% on their long distance phone bills.[20] Two other studies concluded that New York consumers have benefited from the increase in competition resulting from Verizon's entry into the market.[21] A survey conducted by a consumer group concluded that SBC and Verizon customers paid less than what "big three" customers paid for long distance services, including basic rates, directory assistance, and calling card rates.[22] RBOC entry into Florida, Illinois, Georgia, and Pennsylvania long distance markets was predicted to yield $200 million dollars of savings to residential consumers in just the first year of competition, according to another study.[23] And another study predicted a 47% price reduction if RBOCs were permitted to provide long-distance services in California.[24]

If consumers are benefiting from competition, why does the CFA study argue for more regulation? Several studies have shown that the potential benefits from long distance competition exceed the potential benefits of local competition by more than 4 to 1.[25] Oddly, holding back long distance entry, a position that the CFA study appears to favor, harms consumers more than it helps them. This position – one that harms consumers - is a puzzling position for the CFA study to advance.

If the CFA study finds that competitors will not respond to market entry, then it must believe that competition does not work and that consumers will not benefit from competition. **Figure 1** (below) shows the coincident timing of Section 271 relief (allowing the RBOCs to enter the long distance market) and the timing of AT&T's offering to give its customers free long distance minutes. The table shows that AT&T is aggressive in its attempts to retain and attract long distance customers in those states where RBOC entry occurs. What AT&T is doing is a positive step for competition and evidence that consumers save when competition is heightened.

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[18] Peter Huber, "Local Exchange Competition Under the 1996 Telecom Act: Red-lining the Local Residential Customer," November 4, 1997, p. vi.

[19] Ibid.

[20] Stephen B. Pociask, "Millions Saved by the Bell," Joel Popkin and Co., Washington, DC, August 2000.

[21] See "Telephone Competition Rings Up Big Savings for New York Consumers," News Release, Telecommunications Research and Action Center (TRAC), Washington, DC, Sept. 6, 2000; and "TRAC Estimates New York Consumers Save Up To $700 Million A Year On Local and Long Distance Calling," News Release, TRAC, Washington, DC, May 8, 2001.

[22] *Consumer Action's Interstate Long Distance Rates Survey 2001*, Consumer Action, San Francisco, CA, Fall 2001. A summary can be found at www.consumer-action.org.

[23] "Projected Residential Consumer Savings," TRAC, Washington, DC, September 6, 2001.

[24] Professor MacAvoy is cited as the source of this estimate in "Economic Effects of SBC's entry into the Long-Distance Market," Texas Perspectives, Inc. (TXP), Austin, Texas, pp. 5-6.

[25] Price reduction and demand stimulation produce high consumer welfare gains from increasing long distance entry, compared to local entry. For three studies on this, see Deregulation and Consolidation of the Information Transport Sector: A Quantification of Economic Benefits to Consumers," Joel Popkin and Company, Washington, DC, September 29, 1999; Economic Impact of Deregulating U.S. Communications Industries, WEFA, Feb. 1995; and "Competition and Consumer Benefits: A Quantitative Assessment of the In-region BellSouth Long-Distance Market, TeleNomic Research, May 29, 2001, p. 17.

Figure 1: A Comparison of AT&T Free 30-Minute Offers and RBOC 271-Approvals

State	AT&T News Releases	RBOC 271 Approvals
Illinois	October 15, 2003	October 15, 2003
Indiana	October 15, 2003	October 15, 2003
Ohio	October 15, 2003	October 15, 2003
Wisconsin	October 15, 2003	October 15, 2003
Minnesota	June 26, 2003	June 26, 2003
Michigan	April 15, 2003	April 16, 2003
Nevada	April 15 2003	April 14 2003
West Virginia	March 19, 2003	March 19, 2003
Maryland	March 19, 2003	March 19, 2003
Washington, D.C.	March 19, 2003	March 19, 2003
Florida	December 11, 2002	December 19, 2002
Tennessee	December 11, 2002	December 19, 2002
Colorado	December 2, 2002	December 23, 2002
Idaho	December 2, 2002	December 23, 2002
Iowa	December 2, 2002	December 23, 2002
Montana	December 2, 2002	December 23, 2002
Nebraska	December 2, 2002	December 23, 2002
North Dakota	December 2, 2002	December 23, 2002
Utah	December 2, 2002	December 23, 2002
Washington	December 2, 2002	December 23, 2002
Wyoming	December 2, 2002	December 23, 2002
Virginia	October 30, 2002	October 30, 2002
New Hampshire	September 25, 2002	September 25, 2002
Delaware	September 25, 2002	September 25, 2002
Alabama	September 25, 2002	September 25, 2002
Kentucky	September 25, 2002	September 18, 2002
Mississippi	September 25, 2002	September 18, 2002
North Carolina	September 25, 2002	September 18, 2002
South Carolina	September 25, 2002	September 18, 2002
Maine	June 18, 2002	June 19, 2002
New Jersey	June 3, 2002	June 24, 2002
Vermont	April 15, 2002	April 17, 2002
Rhode Island	February 19, 2002	February 24, 2002
Arkansas	October 22, 2001	November 16, 2001
Missouri	October 22, 2001	November 16, 2001
Pennsylvania	August 14, 2001	September 19, 2001
Massachusetts	May 14, 2001	May 16, 2001

Sources: FCC and AT&T News Releases

In summary, there is overwhelming evidence that consumers are saving as a result of the elimination of long distance entry barriers. The CFA study has selectively ignored the studies and facts cited here. Moreover, the CFA study has picked a supposed ILEC claim that has not been attributed to any ILEC. Furthermore, the CFA study argues that local competition doesn't work when the RBOCs enter the long distance market first. However, the '96 Act forbids this from ever occurring, and instead, the Act requires that local markets be deemed irreversibly opened to competition before long distance relief is granted. In other words, the CFA study is refuting an event that will never occur. Based on extensive evidence, long distance entry has created huge benefits for consumers.

Supposed ILEC Claim #2:

"UNE prices do not adequately reflect costs, and represent a "subsidy" to competitors."[26]

The CFA study finds that there is a strong relationship between wholesale costs and retail prices.[27]

Once again, the CFA study is attempting to prove something different than the ILECs supposedly claim. First, the ILECs claim that UNE prices do not fully recover the ILECs' costs, including investment costs. If, for example, UNE prices only recovered 40% of the ILECs' costs, then the ILEC claim would be true. However, if every state set prices this way (recovery of only 40% of costs), then the CFA study response – that there is a strong relationship between wholesale costs and retail prices – would also be true. The presence of a relationship between prices and costs does not disprove this supposed ILEC claim. After all, if costs are measured improperly, then setting prices based on these costs will result in the improper measurement of price. This means that both the cost and the price levels are wrong, but they still may be correlated.

How are UNE costs measured and UNE prices set? In setting the prices for UNEs, regulatory commissions almost always rely on hypothetical bottom-up cost models called TELRIC models.[28] The models typically exclude some overhead costs, ignore regulatory costs, overlook actual and prudent investments, miss the recovery of embedded costs, and undervalue the risk of plant obsolescence. Results from these models systematically underestimate wholesale costs, which justify setting lower UNE prices – prices so low that they do not permit the full recovery of the actual costs of deploying and operating the telecommunications network. Regulators have also allowed CLECs to recombine UNEs into a UNE-P service, effectively replicating the resale service called for by the Act, but at half the wholesale price called for by the Act. These two things - reliance on hypothetical cost models and UNE-P- have resulted in wholesale prices that many believe do not fully compensate the ILECs for their costs, including investments.

Evidence suggests that UNE prices are set so low that they represent a corporate subsidy for the CLECs paid for by the ILECs. One study calculated that TELRIC costs (the formula used to price network elements) would need to be marked up 3.3 times in order to recover the ILECs' sunk costs and risks.[29] Another estimated that it would take 20 years of productivity-based price reductions to reach the one-time effect of an immediate shift to these artificially low UNE prices.[30] Four other studies demonstrated that UNE prices were so low that ILECs could not survive solely as

[26] CFA, p.3
[27] ibid.
[28] TELRIC stands for total element long-run incremental cost. The term *hypothetical* refers to the fact that many of these models assume the ILECs operate the most efficient networks possible, one of several assumptions that cause these models to estimate hypothetical network costs below actual costs.
[29] Jerry Hausman, "Valuing the Effect of Regulation on New Services in Telecommunications," *Brookings Papers on Economic Activity: Microeconomics*, Brookings Institute, Washington, D.C., 1997, pp. 1-54.
[30] Alfred Kahn, Timothy Tardiff, and Dennis Weisman, "The Telecommunications Act at Three Years: An Economic Evaluation of Its Implementation by the Federal Communications Commission," *Information Economics and Policy*, vol. 11, 1999, pp. 330-32.

wholesale companies.[31] Another analysis compared UNE revenues to retail end-user revenues and concluded that UNEs give the ILECs as little as 39 cents on every retail dollar they lose.[32] Similarly, studies by the National Regulatory Research Institute estimated that UNE revenues recover 50 percent of retail revenues.[33] AT&T, which has its own CLEC operations, has publicly estimated the recovery to be approximately 55 percent.[34]

In contrast, regulatory commissions estimate that ILECs can shed only 19 percent of their cost when the ILECs' retail customers are replaced by the ILECs' wholesale services.[35] Therefore, when ILECs lose a retail customer to a wholesale customer, they lose more than half of their revenues but shed only 19 percent of the costs. FCC Chairman Michael Powell has noted that UNE-P is priced lower than the law permits:

> "UNE-P is nothing more than a complete use of the incumbent's network, priced by element. This results in a substantially lower price than the statute allows for resale."[36]

This divergence between price and cost leads to an absolute decline in cash flow and earnings for ILECs. However, the CFA study retort for this is that these earnings are based on historically embedded costs, while TELRIC estimates are based on future competitive costs. Of course, the reality is that TELRIC models are hypothetical models, models that assume a network configuration that may not exist. TELRIC models assume the most efficient investment possible, not necessarily the investment currently in use by the ILECs. If CLECs can lease UNEs at the cost of the most efficient network possible, then CLECs are paying less than the ILECs are paying for using the exact same network. This provides CLECs, who need not invest in plant to serve the market, with a network cost advantage financed by the ILECs. Call that a subsidy or not, but clearly it is an advantage given to CLECs at the ILECs' expense.

TELRIC models are full of assumptions that may not reflect real-world realities, such as hurricane damage, network redundancies for security and reliability, and human error. Economists have criticized TELRIC models and their assumptions for years.[37] A recent FCC white paper agrees that TELRIC pricing may lead to significant under-recovery of the ILECs' investment. In a working paper from the FCC's Office of Strategic Planning and Policy Analysis, Mandy and Sharkey find that TELRIC prices will not recover costs as long as the price for future investments decline.[38] The paper shows that raising the TELRIC price by a factor can eventually set prices to where they recover costs. Separately, the FCC Triennial Review Order (TRO) recommends changes to the TELRIC model, changes that would raise UNE prices as well.

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

[32] Jeffrey A. Eisenach and Thomas M. Lenard, "Telecom Deregulation and the Economy: The Impact of UNE-P on Jobs, Investment and Growth," Progress & Freedom Foundation, Progress on Point, Release 10.3, January 2003, p. 10.

[33] See Billy Jack Gregg, "A Survey of Unbundled Network Element Prices in the United States," National Regulatory Research Institute, updated July 1, 2002, Appendix. The author's most recent study (using January 2003 UNE prices) shows that UNE prices have continued to fall, widening the gap between wholesale and retail prices.

[34] "Competition in an All Distance World," AT&T Presentation to NARUC, Nov. 11, 2002, p. 3.

[35] This is sometimes referred to as the percent avoided cost, or the percentage of costs that ILECs avoid when they lose one retail line and gain one wholesale line.

[36] Separate Statement of Chairman Michael K. Powell, regarding Triennial Review Order, Feb. 20, 2003.

[37] For example, see Alfred Kahn, *Letting Go: Deregulating the Process of Deregulation,* Michigan State University Public Utilities Papers, 1998.

[38] David Mandy and William Sharkey, "Dynamic Pricing and Investment from Static Proxy Models" FCC, working paper, Sept. 2003.

Financial analysts have access to the results of these hypothetical cost models and choose not to use them. For the most part, the financial community finds the ILECs' UNE and UNE-P services to be generally unprofitable, making the ILECs a less desirable investment and a greater financial risk for investors. The financial calamity facing ILECs has been demonstrated in reports issued by the investment community[39] and has resulted in downgrades for the ILECs.[40] This finding was expressed by one analyst at Morgan Stanley, which suggested that UNE-P leaves the ILECs with virtually all of their costs but only 60% of their original revenue.[41] Commerce Capital Markets made a similar finding, that UNEs are priced far below the total operating cost of the RBOCs[42] and that UNE-P prices are even less likely to cover costs.[43] Raymond James Financial found that ILECs would be unable to reduce costs to meet revenue losses from UNE-P sales to CLECs[44]

Still, the CFA study finds that UNE prices are reasonable,[45] but a number of studies have found otherwise. A study showed that UNE-P places $38 billion at risk for the ILECs, even if CLECs exclusively use the ILECs' networks.[46] After deducting what costs ILECs should avoid by not being the retailer of the service, ILECs still could lose $23 billion because UNE prices are set below avoided-costs.[47]

Furthermore, the CFA study's evidence is weak. They offer data showing that TELRIC costs are roughly aligned to UNE prices.[48] The CFA study shows FCC data on what is supposed to be residential CLEC lines.[49] What the CFA study does not tell the reader is that the FCC does not publish residential CLEC line data separately – it combines residential and small business lines.[50] Accepting that error, the CFA study shows only that TELRIC costs are similar to UNE prices. However, as stated earlier, if TELRIC costs are too low, then UNE prices are also too low. Both price and TELRIC costs can be too low and be correlated. Therefore, the CFA study has not provided any evidence to support its conclusions.

Interestingly, the CFA study's argument that prices and costs should be aligned is exactly the argument that can be used to increase residential telephone rates. Today, business customer rates are set higher in order to keep residential customer rates lower. This implicit subsidy is used to maintain universal telephone service. CLECs, particularly with the help of artificially low priced UNEs, cream-skim and arbitrage these higher business rates, which undermines the implicit support for universal service and puts residential customers at the risk of higher prices. Aligning prices to costs will reduce business rates, and raise residential customer rates. While the ILECs are the residential consumers' provider of last resort, many CLECs have shunned the residential market. As a result, the CFA study's stance may not be the best one for promoting consumer welfare.

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[39] For example, see "How Much Pain from UNE-P? Analysis of UNE-P Economics for the Bells," UBS Warburg, Global Equity Research, United States, Fixed Line Communications, August 20, 2002.
[40] Robert A. Saunders, "UNE-P Regulating Toward the End of the Industry?" *Telephony Online*, Sept. 13, 2002.
[41] M. Crossman, "No Growth Expected for Bells in 2003," Industry Update, J.P. Morgan Securities, July 12, 2002. The term *Bells* refers to the ILECs that were spun off of AT&T at divestiture (also referred to as *RBOCs* or *Regional Bell Operating Companies*).
[42] Anna-Maria Kovacs, "Status of 271 and UNE Platform in the Regional Bells' Territories," Commerce Capital Markets, May 1, 2002.
[43] Anna-Maria Kovacs, Update, Commerce Capital Markets, Nov. 8, 2002.
[44] F.G. Louthan, IV, "UNE-P: Unlocking the Impact to the RBOCs," Raymond James and Associates, October 21, 2002.
[45] CFA, p. 1.
[46] The Effects of Bargain Wholesale Prices on Local Telephone Competition: Does Helping Competitors Help Consumers?" TeleNomic Research, released by the New Millennium Research Council and the Competitive Enterprise Institute, Washington, DC, June 2003.
[47] State commission set both UNE-P prices and avoided cost discount prices for resale services. Using TELRIC versus avoided cost results in different discounts off retail price for the same wholesale service.
[48] CFA, Exhibit 3, p. 10.
[49] CFA, Exhibits 4 and 5, pp. 11 and 14, respectively.
[50] Actually, the FCC includes business lines with less than four lines on the telephone account.

Supposed ILEC Claim #3:

> **"Withdrawing access to Unbundled Network Elements will force the CLECs to make investments in their own facilities and networks."[51]**
>
> **The CFA study responds to this by concluding that there is no evidence that investment will increase when the availability of UNEs is reduced.[52]**

Defying even the laws of supply and demand, the CFA study finds no relationship between current UNE price and UNE use by CLECs.[53] To support this claim, the CFA study pairs and plots, for each state, UNE prices (as a percent of residential retail price) against the percent of total UNE lines in use by CLECs, and not the percent of residential UNE lines in use by CLECs.[54] Similarly, the CFA study pairs and plots, for each state, UNE prices (as a percent of business retail price) against the percent of UNE line use by CLECs, and not the percent of business UNE lines in use by CLECs. Therefore, not one of the seventy-eight data points in the CFA study finds the correct point on both the horizontal and vertical axes. The result is a confusing, meaningless scatter plot that the CFA study uses in finding no relationship between UNE discounting and UNE use by CLECs. However, the chart is just plotted incorrectly.

In reality, the relationship between UNE price and use is statistically significant and can be easily demonstrated using the same data cited in the CFA study. Because state commissions are frequently revising UNE prices, it is not proper to compare a snapshot of state prices to seven years of UNE use. Instead, a snapshot of state price should only be compared with a snapshot change in UNE demand by CLECs. Using the same sources of data that the CFA study used,[55] **Appendix 1** of this report shows the number of UNE lines added for the states where data is available. By converting this into the percent UNE lines added (representing UNE line growth over the base of all lines) during last year and regressing the data against a snapshot UNE-P prices (also shown in **Appendix 2** of this report), the relationship is statistically significant with at T-statistic of 3.22, exceeding the critical 99% confidence level. In addition, regressing the percentage of UNE lines added to UNE loop prices produces a T-statistic of 3.34. Furthermore, regressing the number of UNE lines added as a function of total state lines and UNE price, produces T-statistics of 3.39 and 3.61, respectively, and an explanatory power exceeding 70%. In other words, UNE prices and UNE use by CLECs are strongly correlated, a correlation that statistically could not have occurred by chance. Therefore, the CFA study's analysis is incorrect. Besides, if economists believe that the demand for wholesale services is downward sloping, then the CFA logic is also intuitively flawed. After all, if UNE use were insensitive to price, then CLECs would not reduce UNE use if prices were doubled.

Some have argued that low UNE prices have hampered industry investment, encouraged CLECs to rent rather then build, and discouraged ILECs to slow investments where they cannot recover costs. As previously mentioned, there is overwhelming data and belief that UNEs are priced below cost. Because CLECs can lease UNEs below cost, CLECs need not take the risk of building their own alternative networks. The ILECs, unable to recover their investment, are also reluctant to invest. **Figure 2** (below) shows that UNE prices are so low that CLECs are now abandoning their own lines for leased lines. It is inconceivable that the CFA study can find this abandonment as a good thing for consumers.

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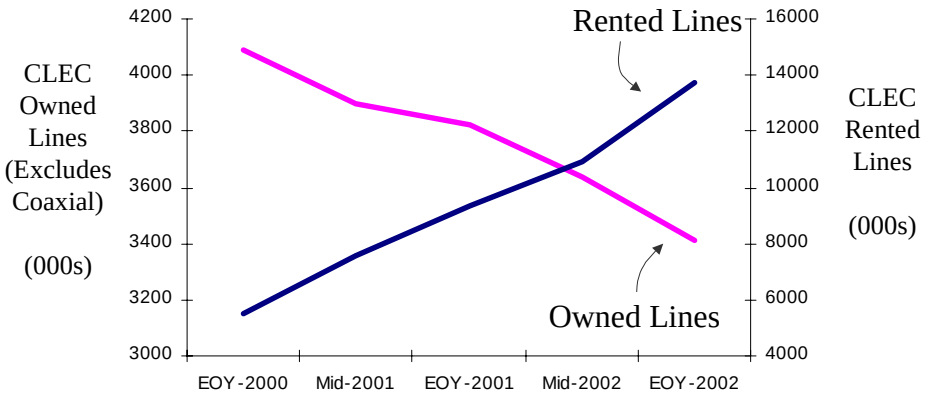
[51] CFA, p. 3.
[52] CFA, p. 3.
[53] CFA. P. 20.
[54] CFA, Exhibit 8, p. 21.
[55] This paper examines that change in UNE use based on the change from December 2001 to December 2002. It uses UNE-P prices effective in July 2002, roughly the mid-point of the FCC data. See "Local Telephone Competition: Status as of December 31, 2002," FCC, June 2003 and earlier FCC local competition reports. Also see Bill Jack Gregg, "A survey of Unbundled Network Element Prices in the United States," National Regulatory Research Institute, updated July 1, 2002.

Figure 2: CLECs Can Rent Telephone Lines for 30% Less than It Costs To Own and Operate Them



As UNE Prices Fall, CLECs Have Begun Abandoning their Own Networks, Much to the Harm of Consumers and the Economy

Source: Stephen Pociask,"Telescam," Pacific Research Institute, 2003.

Regardless of whether limiting the availability of UNEs would lead to a significant increase in investment, low UNE prices are not good for consumers. Low UNE prices create renters, not competitors, as well as destroying the incentives to own and build. Low UNE prices support inefficient competitors and encourage competitors to use the same network they have always had available to them. Furthermore, low UNE prices impede the development of alternative networks, meaning that low UNE rates will lead to impairment and perpetuate regulation. These reasons might be good for advocates involved in the regulatory tussle, but all of these reasons are bad for consumers and lead to a misallocation of industry resources.

How can the CFA study support corporate subsidies that have no apparent benefit to consumers? One study showed that low UNE prices cost consumers ten times more than they benefit, and, based on the consumer price index for local telephone services, there is no evidence that consumer prices have declined as a result of theses subsidies to corporations.[56] The CFA study's pro-business stance is a mystery.

From this report, the CFA study concludes that remonopolization may occur.[57] Yet, the paper errs when it states "the Department of Justice defines a market with 6 or more equal-sized competitors as moderately concentrated."[58] This is not the DOJ definition.[59] The problem with the CFA study's arguments is that they ignore the many intermodal competitors that now compete in the market, including wireless and high-speed cable modem service competitors. The market is less concentrated now than it has ever been, and the CFA study's arguments are reaching a dead end.

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[56] "The Effects of Bargain Wholesale Prices on Local Telephone Competition: Does Helping Competitors Help Consumers?" TeleNomic Research, released by the New Millennium Research Council and the Competitive Enterprise Institute, Washington, DC, June 2003.

[57] CFA, p. 27.

[58] CFA, p.13.

[59] For example 11 equal-sized firms would be considered an unconcentrated industry using a Herfindal-Hirshman Index of concentration. See *Horizontal Merger Guidelines*, U.S. Department of Justice and Federal Trade Commission.

Summary

There is ample evidence that consumers benefit from competition. For this reason, the CFA study should support fair competition and resist attempts (by some) to give advantage to one competitor over another competitor. However, the CFA study does not take a balanced approach to the findings it presents. Instead, the CFA study is fraught with problems. The study makes errors, misstates facts, plots erroneous data, attempts to discredit claims made by no particular party, and concludes findings on market events that have never occurred. Because it appears to make predetermined conclusions, the CFA study lacks objectivity.

APPENDIX 1

FCC Data on Local Competition				
State	12/2002 Total Lines	12/2001 UNE	12/2002 UNE	UNEs Added
Arizona	3,278,290	67,682	77,745	10,063
California	24,174,586	603,103	1,281,292	678,189
Colorado	3,124,180	148,131	153,730	5,599
Connecticut	2,499,908	7,391	42,112	34,721
D.C.	992,094	9,692	47,269	37,577
Florida	11,901,261	376,833	848,818	471,985
Georgia	5,204,294	326,391	454,910	128,519
Illinois	8,596,609	567,893	933,020	365,127
Indiana	3,744,405	78,717	158,277	79,560
Iowa	1,530,809	139,943	144,002	4,059
Kansas	1,494,363	103,017	190,189	87,172
Louisiana	2,542,272	42,008	93,663	51,655
Maryland	3,787,931	57,658	173,784	116,126
Massachusetts	4,501,471	116,675	161,145	44,470
Michigan	6,536,688	627,703	1,153,763	526,060
Minnesota	3,280,929	223,422	307,615	84,193
Missouri	3,482,767	109,806	203,593	93,787
Nebraska	1,006,092	29,023	32,582	3,559
New Hampshire	849,546	14,433	45,913	31,480
New Jersey	6,565,355	93,334	410,070	316,736
New York	12,836,349	2,083,800	2,152,342	68,542
North Carolina	5,230,238	118,446	190,791	72,345
Ohio	7,057,674	121,224	468,521	347,297
Oklahoma	1,934,157	30,217	72,228	42,011
Oregon	2,138,863	75,298	99,339	24,041
Pennsylvania	8,573,098	515,883	612,095	96,212
Rhode Island	671,345	25,581	44,184	18,603
Tennessee	3,474,219	127,542	153,049	25,507
Texas	12,949,056	1,440,485	1,467,770	27,285
Utah	1,269,413	47,570	49,498	1,928
Virginia	4,902,153	271,992	288,416	16,424
Washington	3,960,744	94,453	118,203	23,750
Wisconsin	3,541,341	208,669	351,822	143,153

Source: FCC Local Competition Reports as of December 2001 and December 2002. Only states with insufficient data were omitted from this analysis.

APPENDIX 2

UNE Prices and UNEs Added 2001 to 2002			
State	% UNEs Added	UNE-P Price	Loop Price
Arizona	0.31%	$26.39	$21.98
California	2.81%	$11.58	$9.93
Colorado	0.18%	$19.71	$15.85
Connecticut	1.39%	$22.95	$12.49
D.C.	3.79%	$15.36	$10.81
Florida	3.97%	$17.98	$15.81
Georgia	2.47%	$19.99	$16.51
Illinois	4.25%	$14.82	$9.81
Indiana	2.12%	$16.98	$8.20
Iowa	0.27%	$18.31	$16.47
Kansas	5.83%	$17.49	$14.04
Louisiana	2.03%	$21.96	$17.31
Maryland	3.07%	$20.20	$14.50
Massachusetts	0.99%	$20.28	$14.98
Michigan	8.05%	$13.87	$10.15
Minnesota	2.57%	$20.76	$17.87
Missouri	2.69%	$19.49	$15.19
Nebraska	0.35%	$20.67	$17.51
New Hampshire	3.71%	$19.23	$16.21
New Jersey	4.82%	$12.89	$9.52
New York	0.53%	$15.19	$11.49
North Carolina	1.38%	$19.77	$15.88
Ohio	4.92%	$14.87	$7.01
Oklahoma	2.17%	$19.95	$14.84
Oregon	1.12%	$17.59	$15.00
Pennsylvania	1.12%	$18.19	$13.81
Rhode Island	2.77%	$17.07	$13.93
Tennessee	0.73%	$17.61	$14.92
Texas	0.21%	$19.17	$14.15
Utah	0.15%	$19.69	$16.13
Virginia	0.34%	$18.00	$13.60
Washington	0.60%	$17.10	$14.56
Wisconsin	4.04%	$18.06	$10.90

Source of prices: Billy Jack Gregg, "A Survey of Unbundled Network Element Prices in the United States," National Regulatory Research Institute, updated July 2002. This survey was selected because its time period reflects the midpoint of the time period used to calculate the change in UNE demand.