

Department of Commerce

International Trade Division

Manufacturing Roundtables Proceeding

Written Submission Of the Competitive Enterprise Institute

Regarding the Telecom & High Tech Manufacturing Sector

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About the Competitive Enterprise Institute

The Competitive Enterprise Institute is a nonpartisan policy analysis organization, dedicated to the principles of limited constitutional government and free enterprise. The Institute is a nonprofit educational foundation, concerned with the welfare of consumers and the economy as a whole as opposed to one particular company or industry sector. Solveig Singleton, the author of these comments, is a lawyer and senior analyst with the Competitive Enterprise Institute. Her specialty is telecommunications and e-commerce regulation.

Summary of Comments

Commerce Secretary Don Evans has initiated a federal review to ensure that "the government does all it can to create conditions that allow manufacturers to maximize their competitiveness and spur growth." The Department of Commerce has hosted several "Manufacturing Roundtables" across the country, including one for telecommunications manufacturing in Manchester, New Hampshire on May 29. Corning represented the telecom manufacturers, explaining the harms caused by economically irrational state and federal telecommunications regulations. Such regulations have resulted in massive losses of investment and jobs, and the loss of research and development funding.

These comments further describe the role that regulation has played in the slowdown of the telecommunications manufacturing sector. We address, in particular, the impact of the Federal Communications Commission's regulations concerning unbundled network elements, or UNE's, adopted in proceedings concerning local telephone competition and recently revisited in the FCC's "Triennial Review." These regulations in effect set price controls for the wholesale local telephone carriage market, discouraging efficient investment in that sector. Furthermore, the regulatory regime has been plagued by uncertainty due to litigation and overlapping state and federal jurisdiction. In conclusion, we propose changes to the telecommunications regulatory regime to correct

these problems, including not only specific reform of the telecommunications sector, but an overall program of regulatory reform.

Part I: The Current Crisis in Telecommunications Is Largely Due to U.S. Regulatory Policy, Particularly Policy Regarding UNE's and TELRIC

It is no secret that the telecommunications sector is in crisis and shows barely any sign of recovery. The crisis began with some of the new entrants, known as “competitive local exchange carriers,” or “CLECs.” It has hit the long distance sector hard--Worldcom being the most obvious example--but with Sprint and AT&T's health also wavering. And it has also hit incumbent local exchange carriers. Ultimately, this also affected the manufacturing sector, and still is. The wave of bankruptcies, for example, resulted in the availability of a substantial amount of used telecom equipment being put up for sale. This used equipment still competes with new equipment and holds down prices.

The Department of Commerce has before it a critical opportunity to put markets on a more sound footing. To begin to do so, we must trace the causes of the telecom crash.

Some have blamed deregulation. But this does not hold water. What, exactly, has been significantly deregulated in the telecommunications service sector? Not long distance, as the former Bell companies have been allowed to enter that sector only after a laborious regulatory process and only on a limited scale. Neither retail nor wholesale pricing for local services has been deregulated. Substantial regulations have been added, governing universal service, and, of course, local competition, with a new apparatus of interconnection and unbundling price and access regulation. The Federal Communications Commission has taken some steps in its recent Triennial Review to shelter broadband services from the worst of wholesale price regulation, but this step came after the crash. The fact is, telecommunications remains the most heavily regulated sector of the United States economy—with the possible exception of energy, fraught with its own crisis.

Other observers have blamed “hype” for the telecom crisis, in particular, a giddy optimism about the growth of data traffic. This is closer to the mark, but leaves many unanswered questions. During the late 1990's, regulators and investors were told that data traffic was growing at a rate of four hundred percent annually, when the real figure was closer to one hundred percent. But why were these false representations so readily believed across an entire sector? Why has “hype” not similarly afflicted the grocery business, or package delivery services?

The only remaining plausible answer is this: U.S. regulatory policy encouraged broad, unsustainable investment in telecommunications companies that added no real economic value to the networks. Indeed, the only detailed analyses of the crisis offered by credible industry observers, including Scott Cleland of The Precursor Group,¹ John Wohlsetter of

¹ Remarks of Scott Cleland, Chief Executive Officer, the Precursor Group, delivered at Ivan Seidenberg Luncheon, Ronald Reagan Building and International Trade Center Pavilion Room, Washington, D.C. September 19, 2002.

the Discovery Institute,² Peter Huber of the Manhattan Institute,³ and Commissioner Kathleen Abernathy of the FCC,⁴ have pointed to regulatory policy as a key root cause of what ails telecom.

Which regulatory policy, in particular? The forced unbundling of network elements (affectionately known as UNE's) at steeply discounted prices, that is, total elemental long-run incremental cost, or TELRIC. This regulatory regime brought about managed competition through myriad weak resellers, but eroded incentives to build new facilities and upgrade old ones. The strong potential players in the market, particularly cable companies, were undermined by countless weak ones. The incumbent local phone companies, losing market share to cellular, email, still largely barred from long distance markets, were denied meaningful benefits from upgrading their old networks or trying to make a wholesale business of them. Again and again, regulators sent a message to investors through their words and actions that they would protect weak competitors from economic reality. Ultimately, the economy as a whole paid the price, including the manufacturing sector.

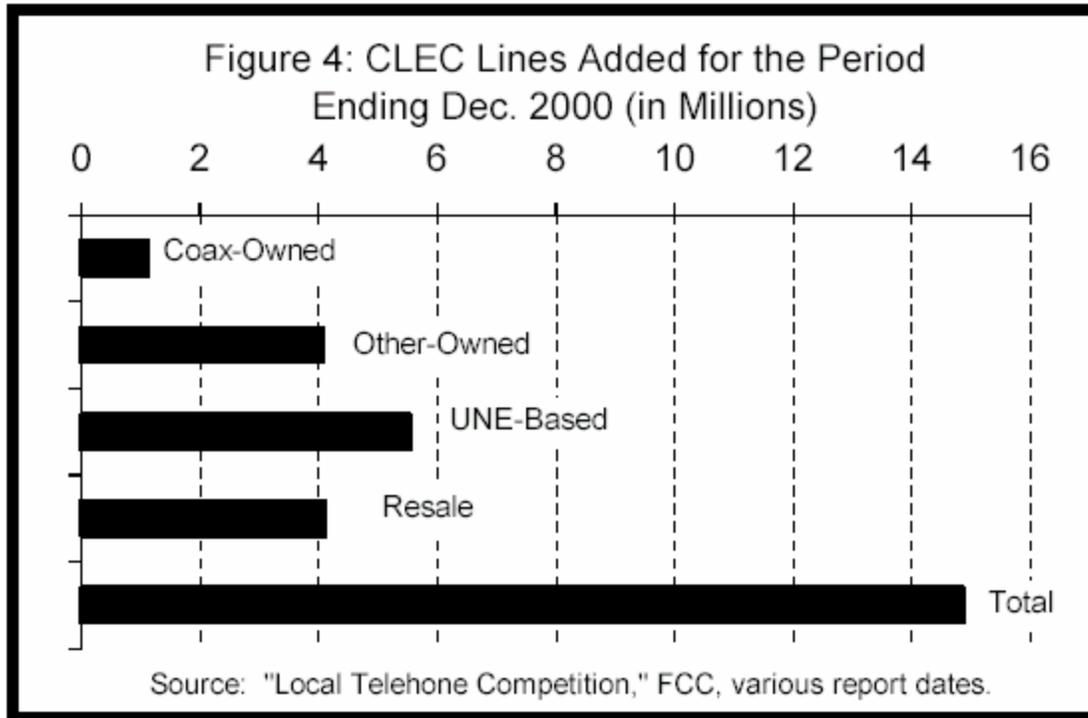
The Competitive Enterprise Institute and the New Millennium Research Council have recently issued a report by economist Steve Pociask empirically confirming the effect of UNE price controls in discouraging the build out of new facilities. The complete report is attached as Appendix A to this document. The data shows that CLECs *are abandoning their own facilities* even as they gain market share.

In the year 2000, Pociask reports, using FCC data, that the combination of CLEC-owned facilities (either by Cable TV coaxial networks or other CLEC-owned facilities) accounted for thirty-five percent of CLEC lines. This is "Figure 4" from the report, showing CLEC-owned lines as compared to leased.

² John C. Wohlsetter, "The Rise and Fall of the Webbers Empire," Guest Comment on NRO Financial, June 28, 2002.

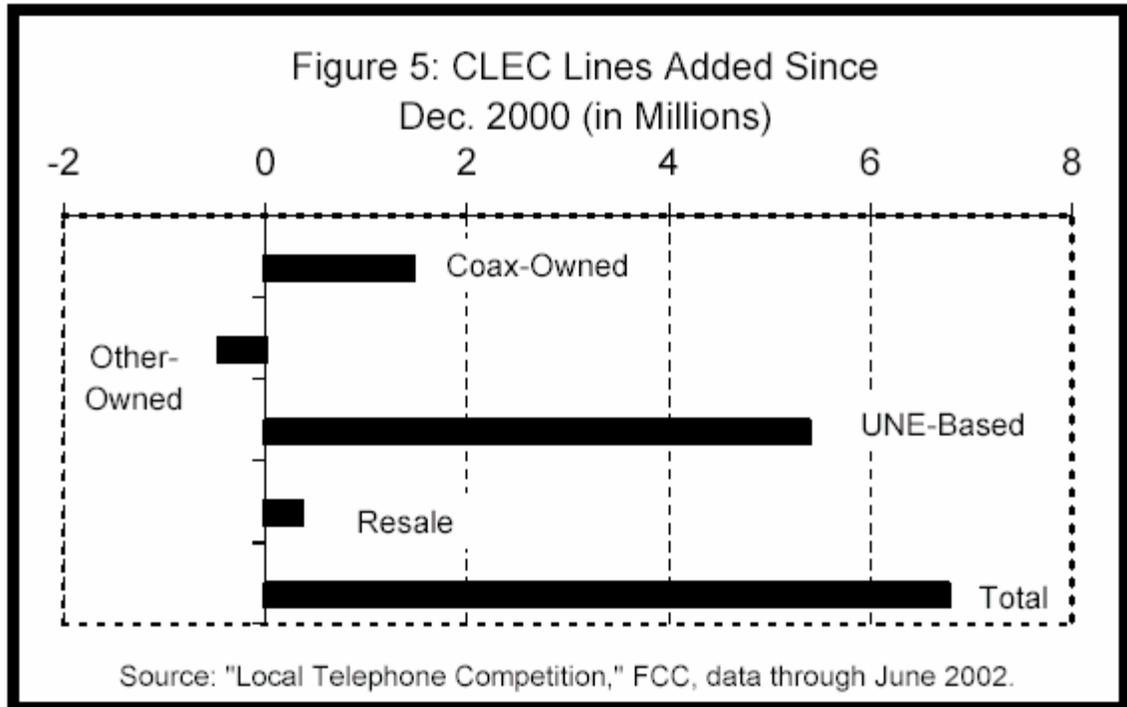
³ Peter w. Huber, "Washington Created Worldcom," The Wall Street Journal, July 1, 2002.

⁴ Comments of FCC Commissioner Kathleen Abernathy, quoted in "Abernathy Describes 'Limited' FCC Role in Wake of Worldcom Woes," Washington Telecom Newswire, July 9, 2002 ("The previous Commission seemed intent on stimulating competition as quickly as possible without regard to the kind of competition that was being promoted and whether it would be long-lasting and beneficial," Abernathy said. 'It was sort of like the overall numbers were more important than long-term sustainability.' As an example, she said, CLECs were given access to 'just about every conceivable element' of an incumbent's network at TELRIC prices. This 'overstimulated' the entry of CLECs who rushed into the market to take advantage of these rates, Abernathy said. When capital markets shrank for the telecom sector, sustaining this many competitors became a problem, she said. 'Telecom by its very nature is very capital intensive,' she said. 'Long-term investment, long-term business strategies take a long time to become profitable. Those prior lessons were sort of ignored.').



State regulators in several states, notably California, however, continued to force the prices CLECs paid to use ILEC networks down, way down. By 2002, the results of this strict price control regime were in; CLECs were abandoning their own networks:

As **Figure 5** shows, the effects of UNE price reductions have been catastrophic. Excluding cable TV facilities, CLEC-owned lines have declined, not just in percentage, but also in absolute terms [citation omitted]. In December 2000, 37% of CLEC lines were UNE-based. Today, eighty percent of all CLEC lines added are UNE-based. Thus, the decline in CLEC-owned lines and the coincident increase in CLEC UNE-P lines demonstrates the stark end of CLEC investment.



There can no longer be any serious question. Strict wholesale price controls in the telecommunications network business are reducing incentives to build out new networks. Ultimately, this will substantially add to telecom equipment manufacturers' difficulties. As we address below, the FCC's recent decision in the Triennial Review has not altered matters much.

Part II. Why the FCC's Decision in the Triennial Review Will Not Substantially Improve the Lot of Manufacturers.

Now we move to the next key set of questions. Has the FCC's decision in the Triennial Review substantially reformed or reversed its anti-growth regulatory policies? The answer, sadly, is no. The decision will prolong negative impact of regulation on the market for telecommunications equipment. This is partly because it effected only a modest federal rollback of price controls in the area of switching and broadband, but partly because the majority of Commissioners took it upon themselves to make the Order the occasion for a most peculiar and misplaced exercise in federalism, rather out of place in putting in place ground rules for modern nationwide networks. The uncertainty that results will affect not only wireline telecom manufacturing companies, is likely to have some partial spillover to wireless, somewhat less to cable broadband, and substantial spillover to telco-built broadband.

Immediately after the FCC announced its plans for unbundling local phone networks, as Chairman Powell pointed out to Congress in his testimony to the Telecommunications and Internet Subcommittee on February 26, capital markets became unhappy. Just how unhappy? In the two days following the FCC's releases, February 20th and 21st, SBC,

BellSouth, Verizon and Qwest lost over 12 billion dollars. Wireless and equipment companies like Nortel and Lucent posted hundreds of millions in losses as well. Any gains by CLECs or long distance companies were slight. A headline in the *Economist* reads, “The FCC Presses Auto-Destruct.” Analysts concluded that the market had reacted to the uncertainty engendered by the FCC’s delegation of key issues to the states. This presents markets with the prospect of further delay and inconsistency, compounded by the risk that the FCC’s decision will be overturned by the courts yet again.

Some of the losses posted following the announcement of the Triennial review have been made up—at least compared to their pre-review value. The real question is, though, how high might the stocks have gone if the review had been more thorough-going in its federal rollback of price controls? It is difficult to tell. But the logic of price controls should at this point be equally difficult to ignore. We now know that price controls in telecom depress investment, and it is time to take this knowledge and act on it.

A second problem with the review is the broad discretion the majority left to state regulators. Chairman Powell and Commissioner Abernathy have repeatedly stressed the importance of certainty, along with deregulation, in helping telecom capital markets recover. Reconciling the need for certainty with calls for “granularity” and close attention to particular geographic markets is not easy. But the majority’s view in the Triennial review seems to neglect the need for certainty entirely. Certainty is a basic requirement of fairness and the rule of law. Without certainty, law cannot serve its most basic function of allowing people to avoid and resolve conflict. Investors cannot make plans. It is that simple. And the certainty that investors need now will not come from the slow machinations of fifty-one state commissions.

The view that delegating key unbundling issues to the states is a triumph of “states’ rights” is mistaken. No consistent or coherent approach to federalism could account for what the FCC has done. Why turn the issue of switching over to the states, but not line sharing? Why a federal rule for broadband, but not UNE-P? There is no rhyme or reason to it. Usually, devolution of power to the states is deregulatory, but in this case it compounds the worst features of regulation. It will impede national markets and national networks.

Several legal scholars have argued that the state commissions are the best place for unbundling decisions to be made, because of their proximity to local markets. Yes, telecommunications costs vary with population density and geography. But there is no correspondence between these features and state lines. And the Telecommunications Act gives the FCC, not the states, the authority to pick UNEs and set the basis for their pricing.

As Commissioner Abernathy has argued, states could serve a role in channeling information to the FCC. Or the states could arbitrate disputes. But telecommunications is an interstate business with national markets. The state commissions have rarely taken the lead in deregulating any telecommunications industry, wireless, the Internet, cable

television, or telephony. Again and again, federal legislators and regulators have stepped in to protect national markets from state intervention.

The failure of the FCC to follow Chairman Powell's lead on federal reform of the UNE regime will not only have an impact on wireline manufacturers. It will also affect wireless, as we already saw following the Triennial Review news release. This is because wireless is the *real* competition for local telcos in the local exchange. But even wireless cannot compete with myriad subsidized CLECs operating below cost. It will also affect telco deployment of broadband, even though broadband is not under the UNE regime, by continuing to starve telco's of capital (the Pociask study describes in detail just to what extent the UNE regime deprives telco's of revenue). It will have the least affect on cable deployment of broadband.

Part III. Conclusion: The Missing Piece of the Puzzle: Regulatory Reform

The Commerce department has announced a plan to restore the health of the manufacturing sector in the United States, including measures such as tax reform and liability reform. One factor is missing so far, however, and that is, regulatory reform. We close with some suggestions as to what an ideal program of regulatory reform would look like.

Telecom-Specific Reforms. An ideal set of reforms in telecommunications regulation would:

- Set a clear federal sunset date for UNE-P regulations, perhaps a year in the future.
- Set a clear federal schedule for rolling back UNE price controls, perhaps three years in the future.
- Establish that healthy competition in telecommunications should mean competing networks and facilities, to give consumers real choices.
- Establish that healthy competition need not entail fifteen new wireline phone companies in every market; it need only mean competition between a few wireline and several wireless carriers.
- Continue with the FCC's reforms of spectrum management, which will turn more wireless spectrum over to the market to be made available to consumers.
- Establish regulatory parity for telephone, cable, and wireless carriers.
- Prevent legacy telephone wireline regulations and taxes, especially universal service taxes and price controls, from spreading to cable, broadband, and wireless.

General Regulatory Reforms. An ideal set of reforms for regulations more generally would include, among other things:

- A review of the role of the states in the telecommunications industry, to determine what role the states should play in making laws that affect consumers nationally.
- A review of the Administrative Procedures Act, the Regulatory Flexibility Act, and other laws passed to help determine which have and which have not been effective in making agencies more accountable.

- A comparative look at the regulatory regimes of other countries, to see how deregulation and privatization have been implemented, and with what consequences.

Sincerely,

Solveig Singleton

Senior Analyst

Competitive Enterprise Institute

1001 Connecticut Ave. NW Ste. 1250

(202) 331-2274

ssingleton@cei.org

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