Effect of Resale on Facilities-Based Competition in the Local Exchange Market

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TCG

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Introduction

Interexchange carriers (IXCs) are seeking through legislation and/or regulation to be able to resell the local exchange and exchange access services of incumbent local exchange carriers (ILECs) with deep discounts from the retail price. AT&T has argued for discounts of 40 percent. In support of its argument that steep discounts are necessary, AT&T announced in mid-1995 that it has ceased to promote resold services in the Rochester area, where Rochester Telephone Company’s wholesale discount is five percent, claiming that this discount is too small to allow AT&T to offer service profitably. At the same time, at least one Regional Bell Operating Company (RBOC) plans to offer discounts that vary, by type of customer, upwards from six percent.¹

As regulators consider the consumer impact of deep discounts for resold local exchange and exchange access services, they should bear in mind the following:

There is a difference between ‘resale’ of ILEC services and simply ‘rebranding’ the ILEC services. Local resale involves the leasing of ILEC facilities or service elements such as loops so that competitive local exchange carriers (CompLECs) can combine those elements with their own facilities. Rebranding involves ‘one-stop shopping,’ where a carrier is simply packaging under its own brand name its own long distance service and an ILEC’s local exchange service, without making any local network investment.

Rebranding could retard the development of facilities-based local exchange competition.

¹Ameritech’s intention to file wholesale tariffs and ICB wholesale discounts was announced November 2, 1995.
Since facilities-based local competition is needed to establish durable alternatives to the existing local exchange monopolies, public policy makers must be diligent in ensuring that repackaging of existing services does not undermine the primary goal of giving consumers a real choice of alternative local exchange carriers.

Any mandated wholesale discount for 'rebranding' risks sending an incorrect price signal and thereby distorting the market.

Facility Resale Encourages Local Exchange Competition: Service Rebranding Could Retard Local Exchange Competition

The rebranding of local service packaged with long-distance service is akin to switchless resale in the long distance market.\(^2\) Since the IXCs do not propose to add value to the ILEC service (they will be reselling minutes of use), this is simply 'rebranding'.\(^3\) It offers convenience to

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\(^2\) The resale industry per se dates to 1976 when the FCC held that AT&T tariff prohibitions on sharing and resale of private line services were unjust, unreasonable and unlawfully discriminatory. *Regulatory Policies Concerning Resale and Shared Use of Common Carrier Service and Facilities*, F.C.C. 2d 262 (1976). The Commission found that resale would rationalize the rate structure and bring rates closer to cost; encourage better management; avoid waste of communications capacity; and create incentives for research and development of ancillary devices to be used with transmission lines; and held that tariff restrictions on resale and shared use were not justifiable on grounds that they protected carrier revenues or rate structures. In 1981, the FCC permitted resale of AT&T's MTS and WATS services, giving resellers greater opportunity to offer universal connections. *American Telephone and Telegraph Company Revisions to Tariff F.C.C. 259, Wide Area Telecommunications Service (WATS); and Regulatory Policies Concerning Resale and Shared Use of Common Carrier Domestic Public Switched Network Services*, 86 F.C.C.2d 820 (1981). The equal access requirements of the MFJ extend to resellers and permitted them to offer one-plus dialing, on an equal footing with facilities-based competitors. All of these decisions broadened the market opportunities for resellers interested in becoming facilities-based carriers themselves, and gave them the opportunity to gain market share as the stepping stone to that goal.

\(^3\) The principle sources of value added by resellers are sales and marketing to end users, customer management, billing and collection. These functions are substitutes for the value added by the local exchange carrier, not additions to the local exchange service as purchased. Admittedly, a reseller might perform these services more effectively or efficiently than the network services provider itself.
customers but does not lead to innovation or significantly improved service quality in the local portion of the rebranded end-to-end service. It does not reduce the ability or incentive of ILECs to discriminate among customers. It does not encourage deployment of disaster-resistant local networks.

In contrast, CompLECs seek to lease local circuits from ILECs, install their own switches, provide value added through redundancy and reliability as well as custom tailored services, billing, and other support, and serve more local exchange customers than they could otherwise do. Facility resale, comparable to resale of private lines by the minute (e.g., Execunet) in the long distance business, does lead to innovation and improved service quality. It puts price pressure on ILECs, and reduces the ability of ILECs to discriminate among customers. It encourages facility construction by CompLECs because the cash flow it generates can finance new investment.

In the short run, local exchange facility resale can further competition. A CompLEC may not be able to make sufficient investment to reach all or even most customers in an area served by an existing monopoly. In that case, the ability to resell the monopolist's subscriber loops and other facilities as part of a local service 'package' enhances local exchange competition. Such resale will be temporary however, because profitable local exchange competition must be largely facilities based; otherwise, the CompLEC is hostage to the less efficient ILEC services. True local exchange competition offering redundancy and price and service choices, must be facilities based, with alternate subscriber loops (whether wireline or wireless).

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4 In 1974, MCI, then a private-line long distance carrier, introduced Execunet which allowed customers to dial MCI's local number, provide a billing number to gain access to MCI's long-distance circuits, and directly dial any telephone in another city where MCI offered Execunet service. Execunet used Bell System Foreign Exchange connections to compete directly with AT&T's Message Toll Service and indirectly with its Wide Area Toll Service -- effectively putting MCI in the switched long-distance business. (It is noteworthy that the FCC initially tried to preclude Execunet and attempted to insist that carriers receive its approval before filing tariffs proposing new services or rates. The U.S. Court of Appeals for the District of Columbia Circuit ruled that the Commission erred in rejecting the Execunet tariff as unauthorized. *MCI Telcos. Corp. v. FCC*, 561 F.2d 365 (1977)).
Significant IXC rebranding at the present time stands in the way of local facilities-based competition. Since subscriber plant construction is costly and time-consuming, while rebranding can be achieved overnight, rebranding will give consumers and policy makers the illusion of competitive choice -- not the reality. By acting as sales agents for the incumbent monopolist, an IXC rebrander can simply entrench the monopolist. The less significant a market, the more likely it is that rebranding will stifle nascent facilities-based competition, but clearly, premature IXC local exchange resale could foreclose entry by facilities-based carriers.

The Impact of Rebranding on Local Exchange Competition Depends on the Price of the End to End Services Offered to Consumers

If local exchange service available to long distance carriers for rebranding purposes is achieved at deep discounts, and the IXCs pass along all or a substantial portion of the savings to customers, CompLECs may be put in a cost-price squeeze. It is possible that the package would be priced below the sum of the two services purchased separately. It is even possible that IXC-packaged retail prices could fall below cost (that is, below the sum of local and long distance service costs). This would have a severe negative impact on facilities-based CompLECs’ ability to compete in the local exchange market. If in the face of such rebranding, facilities-based local exchange competition failed to develop, the possibility of predatory pricing would be suggested. These concerns notwithstanding, it is difficult to argue that there is no cost difference between services offered at retail and at wholesale.
Only Competition at the Wholesale Level Will Bring Wholesale and Retail Prices to Cost

The fundamental economic fact is that only competition will set the ‘proper’ price; regulation simply cannot do that. There is no precedent in the vigorous interexchange resale business for regulatory setting of wholesale price.

There is on the other hand ample evidence of the mischief wrought by wrongly set regulated wholesale prices. One is the six cents per kilowatt hour for purchased power set by the New York State legislature, a price that soon turned out to be more than three times the actual cost of the energy produced by independent (competitive) power producers. Since utilities were required to purchase this power, an artificially high retail price resulted. The harm done consumers would obviously be less in the case where a wholesale price is set too low, but the principle is the same: markets set prices better than regulators, and until there is a significant number of competitive local exchange carriers offering facilities-based service, a cost-based wholesale price for rebranded services can not be set. A competitive wholesale market will produce wholesale prices based on costs of the most efficient provider, which presumably will be CompLECs - including possibly facilities-based IXCs, the very same who today seek deep rebranding discounts.

Therefore, instead of devoting scarce regulatory resources to an issue that affects long-distance marketing strategies and not local exchange competition, state regulators should do everything in their power to hasten the day when two or more CompLECs in every market have successfully created the scale and scope economies that allow them to offer their services for rebranding at

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There would be harm, to the extent that incorrect price signals cause consumers to over consume the service that is underpriced, and divert their purchases away from other goods and services that might have greater utility for them.
substantial discounts.

If legislators or regulators do mandate service resale -- that is, rebranding -- discounts should be negotiated by the interested parties. To prevent discriminatory arrangements, any agreement reached between one reseller and an ILEC should be available to all other resellers. Of course the more LECs are in the market to resell their local services, the greater opportunity IXCs will have to negotiate an arrangement satisfactory to them.

An alternative is for regulators to require wholesale prices to reflect the ILEC's avoided costs. Avoided costs of billing and marketing are relatively easy to assess, although the actual avoided costs would not be the same for all categories of consumers. Net, actual avoided costs should be justified by the ILEC.

Until such time as regulators are satisfied of these costs, and if regulators are determined to set a wholesale price even absent cost justification, the five per cent precedent set by Rochester Telephone Company would seem to offer a reasonable benchmark. The establishment of a wholesale price was part of the company's settlement agreement approved by the New York State Public Service Commission and met the Commission's avoided cost standards, but the nominal wholesale price was not set by the Commission. This discount allowed AT&T to sign up 5000 customers in three months time, and seems to be a reasonable guideline.
Conclusion

Rebranding of local services by IXCs, as distinguished from resale of ILEC facilities, easily could stand in the way of true local exchange competition. Rebranders with the financial resources to combine resold local services with other services that require little or no investment can actually strengthen the incumbent local monopoly, by discouraging alternative distribution facilities. This, combined with their greater historic brand name recognition, would make it difficult if not impossible for a new entrant to attract customers, even if it offered redundancy and diversity through its own subscriber access facilities. Regulators should make every effort to prevent such an outcome, by refraining from intervention in the rebranding marketplace. Regulators should focus their attention on encouraging facilities-based competition, which, when extensive and robust, will offer price and service quality choices to all consumers of LEC services, including the IXCs. The IXCs will then have an opportunity to rebrand a variety of services and will be in a position to negotiate the best possible resale prices.

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