Summary

Local exchange carriers (LECs), and in particular the Regional Bell Operating Companies (RBOCs), are urging regulators, legislators and other policymakers to "level the playing field." By this, LECs mean that the regulatory and legal rules applying to incumbent monopoly local exchange companies should be equivalent for any and all of their actual and potential competitors. In the case of the RBOCs, the symmetry sought includes relief from the currently effective line-of-business restrictions imposed by the divestiture of the Bell System.¹

The justification for these demands is the assertion that competition is rampant, or at least growing fast, so incumbents who compete under regulatory and legal oversight are unfairly disadvantaged.

This argument turns reality upside down. In the first place, the local telecommunications marketplace is more than 99.5 percent dominated by monopoly carriers. They own and control the local telephone exchange network--particularly subscriber loops and switches--which are essential to originate or terminate telecommunications traffic. It will be many years before telecommunications services that are not dependent on the LECs local telephone exchange network are widely available.

In the second place, new entrants must provide superior service at the same or lower prices if they are to build a market presence; regulatory oversight is not needed to force new entrants to behave in the consumer's interest. To assure that they will have the opportunity to do so, regulation of the dominant carrier is essential. Vice President Gore sounded the warning in a speech in Los Angeles on January 11, 1994, saying:

...our quest for equal treatment of competing entities will not blind us to the economic realities of the new information marketplace, where apparent similarities may mask important differences.... A start-up local telephone company is not the same as a Baby Bell [Emphasis added].

Asymmetric market power requires asymmetric regulation.

Rivalry is Limited

The competitive local “playing field” is not level because the LEC competing “teams” are big, mature, heavily and broadly financed, and well known. Against them, at present, only Competitive Access Providers (CAPs) mount any telecommunications competition at all.² CAPs are small, young, narrowly financed and known to a limited customer group. The threat that CAPs pose to the LECs’ local telecommunications monopoly is about as severe as the threat a Little League championship team poses to the World Series champion. As the noted regulatory economist and former Chairman of the New York State Public Service Commission, Alfred Kahn, recently stated on behalf of an RBOC:

The local exchange monopolies of the telephone companies have in recent years been subject to increasing challenge -- by bypass of their facilities via direct link-ups between large customers and long distance carriers; by the entry into every major metropolitan area of competitive access providers, serving mainly concentrated business districts; and by the spread of cellular and other radio-based systems. Few observers would conclude, however, that the process so far has been anything but selective and incomplete.³ [Emphasis added].

Undoubtedly, the potential exists for many communities to see some competitive local telecommunications providers, including but not limited to CAPs. But the reality is that virtually no competition exists in the local marketplace now. The services provided by cellular and other radio based companies are dependent on, and not competitive with, local exchange service, because they rely on the telephone company’s local exchange network to terminate traffic. Similarly, the services provided by resellers are not competitive with local exchange service because they also depend on the telephone company’s networks and do not involve alternate facilities for any part of the transmission. ³ CAPs are legally allowed to pursue only limited market segments, primarily offering local services which LECs do not provide at all or do not provide very well. Therefore, all CAPs together have less than one-half of one percent of the local telecommunications market.⁴

---

² CAPs are also known as AAVs (alternate access vendors), or ALTs (alternative local telecommunications service providers). As the oldest, largest and most successful CAP, TCG provides services in 150 communities in fourteen states and is expanding rapidly.


⁴ Connecticut Research estimates that 1993 CAP industry revenues earned from access charges and switched services are $220.5 million and $31.0 million, respectively. (*Connecticut Research Report on: Competitive Telecommunications,* Connecticut Research, Jan. 1, 1994.) This represents less than one-half of one percent of the $86 billion local telecommunications market.
The limits of competition in the local telecommunications market are described by AT&T, a CAP customer. AT&T, like other long distance carriers, purchases access from CAPs; yet 99.866% of AT&T's access services are still handled by the LECs—that is, by the incumbent monopolists. MCI, another CAP customer, states that 99.6 percent of its access dollars go to LECs. Even though CAPs are expanding, competition for access services is limited and concentrated.

Furthermore, competition for local telecommunications does not generally extend to actual local exchange services. Switched access services for long distance carriers provide only 12% of CAP revenues and most of the local switched service marketplace (i.e., local exchange service) is legally barred to CAPs. Local telecommunications “competition” is now generally limited to private line services between a few buildings in a handful of metropolitan areas (offered by CAPs), or short-distance intralATA toll (offered by interexchange carriers and by some CAPs).

While competition has thrived in the market for interLATA toll services under Federal jurisdiction, the same cannot be said of intralATA toll service under the jurisdiction of the states. This lack of competition is not solely the result of regulatory or statutory prohibitions against competition. On the contrary, 46 states now permit some form of intralATA toll competition. However, none of the states that have legalized intralATA competition have implemented statewide “1+ equal access” dialing. Without “1+ equal access,” consumers must enter additional codes to use the services of someone other than the local exchange carrier. Thus, while a legal barrier to competition may have been removed, technical barriers effectively protect the local exchange monopoly.

According to State Telephone Regulation Report, only 21 states have authorized local competition for private line and special access services. Of these, only Illinois, New York, Massachusetts, and Washington have taken the extra step of authorizing competition in switched access services. Even in the less restrictive states,
competition is localized and generally confined to the business districts of the larger cities.

This situation can change only after all barriers to entry are removed by legislation and/or regulation -- a prospect that is becoming somewhat more likely as the United States Congress considers bills which would amend the Communications Act of 1934. The House of Representatives Energy and Commerce Subcommittee on Telecommunications and Finance is considering HR. 3636. The Senate Commerce, Science and Transportation Committee is considering S. 1822. Both bills promote a national communications and information infrastructure. One means by which these bills seek to accomplish this goal is by encouraging the deployment of advanced local communications services and technologies through competition.

But, even if this legislation is enacted and new local exchange carriers are permitted to provide dial tone and connect ordinary consumers with one another, competitive inroads into the local telecommunications marketplace will continue to be demand driven. Undoubtedly, demand for telecommunications services overall will continue to grow, and all competitors will seek to capture a portion of this incremental market. To meet demand, new local exchange carriers will sometimes use their own or their affiliates' facilities entirely. But, where it is technically feasible and more economical, they will prefer to offer telecommunications services over a combination of their own and the incumbent local exchange carrier's facilities.

Thus the growth of local competition in no way spells the demise of the incumbents. Indeed, incumbents will surely retain market power for the foreseeable future, even as competition thrives. As is illustrated in figure 1, even in the hypothetical case that CAP revenues grow at an extraordinary rate each year, and the incumbent local exchange carriers' revenues grow at only 5 percent per year, the LECs will still have 95 percent of the local market ten years hence!

11. H.R. 3636 is known as the National Communications Competition and Information Infrastructure Act of 1993. It was introduced by Representatives Edward J. Markey (D-MA) and Jack Fields (D-TX) on Nov. 22, 1993.

Figure 1.

CAP Relative Growth Scenario

<table>
<thead>
<tr>
<th>Year</th>
<th>LEC Growth Rate (%)</th>
<th>CAP Growth Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>5</td>
<td>70</td>
</tr>
<tr>
<td>1994</td>
<td>5</td>
<td>60</td>
</tr>
<tr>
<td>1995</td>
<td>5</td>
<td>50</td>
</tr>
<tr>
<td>1996</td>
<td>5</td>
<td>40</td>
</tr>
<tr>
<td>1997</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td>1998</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>1999</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>2000</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>2001</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>2002</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>2003</td>
<td>5</td>
<td>20</td>
</tr>
</tbody>
</table>

NOTE: In 1992 and 1993, CAP revenues grew approximately 40 percent annually and LEC revenues grew 3-5 percent on average.

Even under this “bullish” assumption for the CAP industry, total CAP revenues would barely exceed one-half of the incremental LEC revenues in the year 2003. This hardly suggests level playing fields; in fact, it shows that the sources of LEC future market power are numerous and powerful.
Factors that Give LECs Enormous Market Power

LECs are multi-billion dollar corporations.

The Bell Operating Companies (BOCs), which represent the largest of the LECs, had approximately $84 billion in revenues and $6.8 billion in profits in 1993.\textsuperscript{13}

CAPs, as “upstarts,” had annual revenues of about $250 million in 1993.\textsuperscript{14} Collectively they have yet to report profits.

LECs have access to every consumer.

LECs have ubiquitous networks that can serve all potential consumers.

\textit{CAPs have limited networks.}

LECs have franchised, often free, access to public rights-of-way.

\textit{Many municipalities discriminate against CAPs; CAPs often must pay large fees or make other contributions to obtain access to public rights-of-way.}

LECs generally have “as-of-right” access into any building or tenant premises, at no cost to themselves.

\textit{CAPs must negotiate for -- and generally pay substantially for -- access to buildings or tenants.}

Everyone knows the LECs.

LECs have instantaneous “brand-name” recognition, stemming from 100 years of government-protected monopoly service.

\textit{CAPs are as yet unknown to the vast majority of telecommunications users. CAPs face huge costs to establish consumer awareness or “brand names.”}

\textsuperscript{13} Revenues are based on company year end press releases and profits were compiled by Hancock Institutional Equity Services, a joint venture of Sutro & Co. and Tucker Anthony.

\textsuperscript{14} See footnote 4.
LEC's risk is cushioned by ratepayers.

Because they enjoy monopoly status under Federal and state law, LECs have the legal right to seek and receive rate increases to ensure that revenues cover their costs. LEC shareholders and bondholders are protected from risk, and LEC cost of capital is minimized.

CAPs make all their investment at their investors' risk. CAPs' cost of capital is likely to be higher than that of their LEC competitors. With no guaranteed revenue stream, CAPs must assure that their investment will be recovered under vigorously competitive conditions.

LEC's can cross-subsidize prices for competitive markets.

LEC's have the incentive and the ability to allocate excessive costs to "plain old telephone service," thereby subsidizing the costs of providing competitive services. This enables them to under-price competitive services and stifle competition.\(^{15}\)

CAPs cannot cross-subsidize the price of competitive services with profits earned by monopoly services, for they have no monopolies.

LEC's can offer poor quality to captive customers and subsidize excellent quality for customers of competitive services.

Since CAPs generally are not allowed to provide local exchange services, rivalry cannot discipline the marketplace. Therefore, LECs are free to deliver poor quality service to captive customers so as to subsidize superior quality services for the few customers who do have competitive choices.

CAPs cannot skimp on quality in one market so as to support service quality in another market, because they can't offer a variety of services in many markets. Furthermore, CAPs must provide superior service to compete with the incumbent.

---

15. A "cost study" published by United State Telephone Association (USTA) shows state private line services, which face some competition, are priced below cost ("Potential Impact of Competition on Residential and Rural Telephone Service," United States Telecommunications Associations, July 16, 1993, Attachment "Contribution Analysis").
LECs determine and design network interface requirements.

LECs create the standards that are employed by the entire local telecommunications industry. They learn of the standards first.

CAPs must follow LEC-dictated standards to accommodate users and to gain interconnection to the network. They learn of the standards last.

LECs profit from ratepayer-funded R&D.

LEC customers fund Bellcore, which provides basic and applied research to the Bell Operating Companies and other LECs. These LECs may use Bellcore developments in the competitive marketplace, creating a cost and technology advantage for themselves.

CAPs must either gain equal and timely access to the results of Bellcore research, or compensate for lack of any needed Bellcore information.

LECs control number resources.

LECs control the North American Numbering Plan through Bellcore. LECs assign exchange numbers for their customers immediately as needed, at no cost.

CAPs must buy exchange numbers (in blocks of 10,000) and wait for their assignment.

LECs assign numbers on the basis of a location, rather than on the basis of a customer.

Until number portability is implemented, allowing any customer to keep its telephone number when changing its local carrier, LECs will retain a critical advantage over CAPs in the marketplace.

16. The single potential exception is New York, where the Public Service Commission has approved in principle the assignment of NXX codes to certified carriers. The terms and conditions have still to be worked out. ([Proceeding on Motion of the Commission to Investigate Performance-Based Incentive Regulatory Plans for New York Telephone, Case 92-C-0665, State of New York, Department of Public Service, Issued and Effective on Oct. 4, 1993).]
LECs have advantageous access to customer information.

Proprietary information on customer calling patterns (customer proprietary network information, or CPNI) enables LECs to selectively and inexpensively define markets for competitive, unregulated services.

CAPs or other competitive service providers cannot access ratepayer data useful for determining customer needs on the same basis as the LEC.

LECs can jointly market competitive and monopoly services.

Since rates cover the costs of informing consumers about monopoly services, LECs can pass on to captive consumers institutional advertising costs that benefit their competitive services. LECs can also pass on to captive ratepayers the costs of litigation and lobbying.

CAPs pay for all marketing, advertising, and regulatory/legislative overhead with revenues earned from voluntary customers. By gaming the regulatory process, LECs force CAPs to "invest" in lawyers rather than in the public telecommunications infrastructure.

LECs provide all local services and have access to every customer in their service territory.

All LECs have legal authority to provide all local telecommunications services in their service territories. BOC line-of-business restrictions do not limit their "bread and butter" operations; rather, they prohibit BOCs from entering new businesses that depend on local telecommunications services (and which require new facilities or investment).

CAPs only have authority to provide a few services in a few territories. CAP line-of-business restrictions prevent CAPs from offering all local telecommunications services so as to fully utilize their basic facilities. For example, a CAP may install a switch to provide one permitted service, but because it is barred from providing other services utilizing the switch, its investment is underutilized.
LECs Should "Get Real"!

Given this reality, it is difficult to credit LEC arguments for immediate relief from regulation or line-of-business restrictions. **Facts** do not bolster these arguments. For example, their claims that such restrictions cause them to under-invest in network facilities are certainly spurious. The BOCs' investment in network modernization has been declining since 1982, even though their recovery of depreciation expenses has been accelerating.17

A particularly illogical LEC tactic is to insist that fledgling local telecommunications competitors be regulated by government in exactly the same way that LECs are. For example, LECs often insist in state regulatory proceedings or before the Federal Communications Commission that competitors file tariffs equivalent to those filed by the dominant carrier. They sometimes seek to force these nascent competitors to file financial reports as complex as those needed by the multi-billion dollar incumbent. Regulatory requirements impose substantial costs on competitors and can preclude profitability. By any measure—per customer, per access line or per revenue dollar—the unit cost of regulation to CAPs is far higher than the unit cost to LECs.

Competitors are often forced to divert their resources to fighting these regulatory abuses by the litigious LECs. These tactics also impose costs on the public and on consumers, whose rates cover costs of litigation and regulatory activities by the monopoly.

**Legal restrictions and regulatory requirements should not be the same for monopolists and competitive local telecommunications carriers because the playing field is not level and will not be level in the near future. Competitive local exchange carriers, no matter their capability, cannot gain an instant market presence large enough to threaten the incumbent's core business.**

---

Rather than trying to game the regulatory and legal system with hollow "hype" about level playing fields, the LECs should simply even up the teams' chances--immediately, and completely. If LECs immediately were to eliminate all the conditions that frustrate new entrants in the local exchange marketplace, their claims would be tested in the real world--and quite quickly.\(^{18}\)

Encouraging signs that this real market test may emerge include Ameritech's "Customer First" Plan, which offers full unbundled interconnection, but only in exchange for relief from the MFJ restriction against providing interexchange service. Rochester Telephone Company has made an initial "Open Market" Offer, which does not in fact offer competitors unbundled access to essential network elements.

### What is Fair?

Fair competitive terms are not a new idea in the evolution of telecommunications in the United States. On the contrary, well-established criteria exist to provide for gradual regulatory relief and anti-trust relief as markets become competitive.

Although the MFJ did not anticipate local exchange competition, its restrictions on BOCs entering adjacent markets set the stage for regulation during a transition to such competition. Asymmetric rules and regulations applied to bottleneck carriers (BOCs) and to the non-bottleneck carrier (AT&T). Federal and state regulators gave AT&T more pricing flexibility as its market share declined. The experience in the interexchange markets since divestiture has proven the validity of this approach. \textbf{Gradual regulatory relief as competition grows is the correct model for the local exchange market.}

\(^{18}\) The interconnection arrangements needed to facilitate local exchange competition are summarized by TCG's "Nine Points" initially issued in 1991, and reissued in subsequent years:

1. Central office interconnection arrangements.
2. Connections to unbundled network elements.
5. Equal status in and control over network databases.
6. Equal rights to and control over number resources.
7. Local telephone number portability.
8. Reciprocal inter-carrier billing arrangements.
9. Cooperative practices and procedures.
Congress recognized the importance of market share and market strength in its effort to promote competition in the cable television industry. In 1992, Congress reimposed rate regulation on cable franchises wherever monopolies existed. A cable company, however, is exempt from rate regulation in a particular market once effective competition, defined by market share, exists in that service area.\(^{19}\)

Asymmetric circumstances justify and require asymmetric regulation. Symmetrical regulation is only appropriate for symmetrical circumstances—which clearly do not exist in local telecommunications markets. Therefore, effective competition in the local telecommunications market must be evident before regulatory relief or freedom from the line-of-business restrictions is granted to the incumbent LEC. One element defining effective competition is the number of competitors offering a particular service in a particular market. The other element is the number of subscribers taking the service from a competitor rather than from the incumbent.

Markets must be evaluated in terms of service and geography, for competition in one small portion of a service area should not trigger widespread deregulation or other relief for an incumbent monoplist, which can then leverage its monopoly position elsewhere to compete unfairly in the smaller portion.

The fundamental and unassailable reason to maintain asymmetry in the legal and regulatory environment surrounding market competition is to protect the consumer. With competition, consumers get the greatest benefit of all: choice. With choice comes lower prices and better service at any price. If the historically-favored incumbent firm is unfettered before competition gains a widespread foothold, consumers will never get any choice.

The regulatory relief LECs now seek should come eventually. It should come market by market, for that is how competition will develop.

Even if the local exchange bottlenecks are broadly eliminated, LECs will retain market power. Asymmetric rules will still be needed to assure that competition can thrive until evident and measurable competition exists in local telecommunications services markets. Asymmetric rules are perfectly fair when competitive teams are imperfectly matched. When competition in the local telecommunications marketplace is effective, the rules of the game can be the same for all providers. But not before.

---

19. Under the Cable Television Consumer Protection and Competition Act of 1992, effective competition exists in a particular market where a second multichannel provider reaches at least 50%, and is subscribed to by at least 15%, of the households in its service area.
For Further Information

Gail Garfield Schwartz
Vice President, Government Affairs
TCG
718-983-2892

Don Sussman
Manager, Government Affairs
TCG
718-983-2932

The Unlevel Playing Field is the fifth in TCG's Issue Paper Series.

Other Issue Papers are:

Telco Fiber Fiascos: Will Accelerated Infrastructure Programs Be the Next Nuclear Power Plant Debacles?

The "Pot Bay": Several BOCs Attempt to Obstruct Interconnection...Again

The "Pot Bay": Phase II Ameritech Takes a Step in the Right Direction

Universal Service Assurance: A Concept for Fair Contribution and Equal Access to Subsidies

For a copy of an earlier TCG Issue Paper, contact Christine Grannis at 718-983-2295.