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Today’s telecommunications headlines lament a “breakdown in competition,” and the “remonopolization” of the telecom industry. These reports suggest there are four -factors responsible for the lack of competition in the telecommunications market – the financial woes of the competitive local exchange companies’ (CLECs), limited competitive alternatives for residential customers, the failed business strategies of the interexchange carriers (IXCs) and the consolidation of the Regional Bell Operating Companies’ (RBOCs). The conclusion that should be drawn is in fact quite different. Competition is robust in every sector of the communications market except long distance. The RBOCs are not the dominant players in the data, broadband, Internet and long distance markets and are experiencing significant share loss in the local business voice market. Only in the subsidized residential voice market do the RBOCs remain the dominant provider. Across the country, the competitors share of the local residential market is about 5 percent – it is important to note that they have done this in about half the time it took MCI to gain a similar share from AT&T after deregulation of the long distance industry.

A more complete examination of each of the four factors shows that they have erroneously lead to incorrect conclusions drawn by a backward-looking, voice-centric perspective, and that these conclusions are therefore irrelevant, and in fact are even injurious, to our economic future.

Often cited as evidence that the 1996 Telecommunications Act is not working are the financial woes faced by the competitive local exchange industry. The CLEC industry is indeed undergoing a significant restructure not unlike that which occurs in any industry transitioning to competition. The belief among telecommunications industry analysts is that the recent experiences in the CLEC industry are no different from other evolving industry segments. It can be compared to the railroad, automobile, airline or personal computers. All went through a period of rapid increase in the number of competitors and the subsequent failure or merger of these competitors until the market determined the number of competitors that could succeed. Many CLECs are failing, and the once darlings of the capital markets are having significant problems raising investment capital. Investors are increasingly reluctant to put their money in this and other segments of the telecommunications market, and in the larger technology market without assurances that those they invest in have sound business plans that can generate the earnings growth expected in today's market.

However, while many CLECs have seen their business plans fail, the CLEC industry has seen a growth in revenues of 93 percent year over year. While the recent FCC report shows that CLECs have achieved an 8 percent market share overall nationwide in 2000, up from 4.4 percent in 1999, they have achieved a far higher penetration in the business market. In several wire centers in BellSouth territory, CLECs now enjoy over a 50-percent business-market share, and the number of CLECs operating in our territory, over 300, is increasing. The FCC says that nationwide, business customers make up 60 percent of the CLECs revenues, as contrasted to only 20 percent of the incumbent local exchange carrier (ILEC) revenues. These business customers are high-margin customers, located in highly concentrated business districts.

The CLEC industry sprang up in response to regulatory policy put in place to implement the Telecommunications Act of 1996. The Act has four major purposes:

- To encourage competition;
- To encourage investment in alternative networks;
- To ensure universal service by making subsidies obvious instead of hidden; and
- To increase deregulation.

Regulatory policy to date, however, has focused solely on creating competition by any means possible.

The FCC created a structure whereby the ILECs are required to open their existing networks for wholesale purchase by competitors, either in whole or in pieces. If sold in whole, the network pricing is at a prescribed resale rate (defined as retail less avoided costs such as marketing). If sold in part (unbundled network elements or UNEs), the pricing would be on a cost-plus or rate-of-return basis. The FCC largely ignored the resale pricing provisions, and the UNE prices were set at TELRIC (total element, long-run incremental cost) levels, which were decreed to be forward-looking, most-efficient technology prices – prices that the local exchange companies find hypothetical and inadequate. UNE pricing was designed to jump-start competition by carving up the ILEC revenue stream,[1] and it has worked well in the business market. However, it has not worked in the subsidized residential market. A review of the actual numbers clearly shows why.

Significant competition has developed for the business market in urban locations, like Atlanta, Georgia; Nashville, Tennessee; Miami, Florida; or New Orleans, Louisiana.

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Examining the difference between the retail business rate and the wholesale-unbundled rate – both products of regulation – is instructive. BellSouth's retail business rate in Columbia, South Carolina, for example, is $42.75. This rate was set by regulators intentionally above cost to subsidize local residential rates. The wholesale rate available to competitors is $18.48, also intentionally set at cost. The $24 difference in these rates is available to the competitor as a margin, thereby providing a clear incentive to concentrate on the business market. The picture changes though when we look at rural South Carolina and the competitors' interest in the residential voice customer. The subsidized residential rate in rural South Carolina is $12.70. The wholesale, cost-based rate is $36.91. Competitors are not flocking to pay $36.91 to access a $12.70 revenue stream.

Working from a regulatory structure that clearly enabled them to compete using a business plan of price arbitrage against the ILEC, hundreds of CLECs have flocked to the same urban areas to compete for the same business customers. The CLECs have not sought to serve the residential market despite the fact that 88 percent of all U.S. households reside in ZIP codes "served" by a CLEC. Not surprisingly, there is not sufficient revenue in the limited targeted-customer terrain to sustain them all.

Today, many business customers enjoy new pricing plans and lower rates. For the most part, however, the CLECs have not built modern alternative networks or introduced new products or services. The ones that have, and thus have an ability to distinguish themselves in the marketplace, are the ones that are expected to survive and prosper.

It is a relevant fact that there has been limited competition for the landline residential voice customer, especially those in rural areas. The actual rates outlined above, while specific for South Carolina, are representative of the economics surrounding the non-urban segment of the market. There are no easy financial incentives for competition in the residential landline voice market. The ‘96 Act did not fail in this regard; it just was not fully implemented. The ‘96 Act required that implicit subsidies be made explicit. This has been done only to a very limited extent.

If subsidies were removed, residential rates would have to be permitted to rise to cost. Retail rates would have to be deaveraged to accurately reflect costs, historic jurisdictional cost allocations would have to be removed, access charges would have to be uniformly reduced, and class of service distinctions between geographically separate markets would have to be ignored. Artificially low residential rates, coupled with state-regulatory-imposed retail service standards, currently discourage competitors from serving the residential voice market through or with competitive landline services or networks. Perhaps more importantly, however, they also serve to retard competitive technology’s ability to take hold in the residential market.

Today there are many alternatives to traditional voice transmission. There is E-mail, wireless voice, wireless E-mail, fixed wireless, paging and voice over Internet Protocol. In fact, only one-in-four new connects for telephone service goes to the landline network. The front page of the New York Times on June 12 reported that Microsoft is ready to supply a phone in every computer for computer-based telephony. Cable modems are the dominant residential high-speed Internet access tool today and increasingly are able to accommodate switched voice as an add-on service. By 2003, it is expected that voice landline traffic will be reduced to approximately 45 percent of the total telecommunications traffic. If even a reasonable residential rate were introduced into this environment, the competitive dynamics would explode.

Customers would then choose their technology according to their user needs without the artificial repression of rates or market definition created by regulation.

A third factor cited as evidence that competition is failing is the financial uncertainty of the IXCs. The three key participants in the long-distance market, AT&T, WorldCom and Sprint, are all subject to increasing market pressures despite the fact that the cost of access has declined by as much as 95 percent over the last several years. The long-distance companies say the ILECs prevent them from entering the local residential market. It is not the ILECs, however. It is the economic reality previously noted that discourages them from leaving the safe haven of regulatory protection for the competitive marketplace. Further, their safe haven is increasingly dwindling because there is no longer a discreet long-distance market. Always a creature of regulation, first expressed through pricing subsidies embedded in long-distance rates, then enforced through judicial decree and later codification, long distance is obsolete as a stand-alone market.

This demise did not come at the hand of the ILEC industry nor did it originate with the approval of Verizon's entry into long distance in New York or SBC's entry in Texas. In fact, the FCC found that the RBOCs entry into long distance stimulated local residential competition dramatically in New York and Texas. Ironically, long distance as a stand-alone market was first attacked by AT&T itself, and then killed by Sprint, as a result of their wireless pricing plans that eliminated roaming charges and moved to flat rate nationwide. Wireless pricing, coupled with the substitution of data or E-mail and Internet traffic for long distance voice traffic, makes their earnings growth potential problematic and finds them actively engaged in businesses like cable television, broadband deployment, Internet transport and nationwide wireless.

These new technologies and efforts are expensive and capital intensive, thus creating intense earnings pressures. But make no mistake; this earnings pressure applies to BellSouth and to any company that undertakes the development of a broadband platform. The broadband platform does not exist in the legacy monopoly plant. It must be built and it is expensive. No one company will have the financial capacity to build it all, and no one technology will have the flexibility to meet all of a user's needs. The IXCs, however, have many digital assets, and they are assisted by their national scope and virtual freedom from regulation at the state and federal levels.

The final fact purported to show the demise of competition is due to the consolidation which has occurred in the local exchange industry. True, the seven RBOCs are now four. They have arrived at this point by responding to the incentives currently available to them in the marketplace. The RBOCs still are regulated as if they are a monopoly. With traditional profits subject to regulatory redistribution, billions of available investment dollars are being mandated to build an open-access or open-network platform. (This construction has been mandated under the Act's 14-point checklist, which has now grown to be some 1,800 performance metrics. When calculated for each CLEC operating within BellSouth, this expands to a total of some 4.5 million measurements per month.) Additionally, the RBOCs find themselves in a market position where they trail their cable-company competitors by a 3-to-1 margin in customers for data and future growth-oriented technologies. RBOCs have had to turn their attention to maintaining the margins demanded by the capital markets by taking existing technology and applying it across as many customers as possible to achieve decreasing costs.

Without progressive policy tools, many of which were outlined in the Act but not implemented, the pressure to consolidate to shed costs in the legacy network will continue.

Telecommunications regulation has reaped what it has sown – limited and tentative investment in only one of the four technology platforms poised to deliver the digital economy. The landline, ILEC, public switched network alone is subject to price, service and investment regulation. Policy, driven as it is today by backward-looking residential voice concepts, will continue to severely limit investment and may ultimately not allow the growth in the domestic economy that was foreseen by Congress when it enacted the Telecommunications Act of 1996.

Tomorrow's telecommunications headlines should read, "robust competition in telecommunications stimulates domestic economy and brings unparalleled benefits of advanced technology to all." In order for this headline to become a reality, we must move forward now with the full implementation of forward looking telecommunications policies.