Assessing The FCC's UNE Rulemaking

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Who were the big regulatory winners and losers? It's not as clear-cut as some believe.

Every so often there is a major flurry of regulatory activity that sets the telecom agenda for some time to come. This past August and September was one of those eventful periods.

After a six-month delay following its original February 20 vote, the FCC's Triennial Review on unbundled network elements (UNEs) was issued on August 20. At a high level, the order:

a.) Allows the continued availability of switching to the mass market as a UNE, thus keeping UNE-P open to competitors. UNE-P, which combines all the unbundled elements into a single platform for resale, is the basis for AT&T's and MCI's highly successful local/long distance packaged offerings.

b.) Exempts next-generation broadband networks from UNE requirements.

c.) Eliminates line-sharing for DSL (i.e., competitors renting only the high-frequency portion of a copper loop).

Nine days later, the U.S. Telephone Association and the RBOCs filed petitions with the U.S. Court of Appeals in Washington. The RBOCs seek to overturn the continued inclusion of mass-market switching as a UNE (point **a** above).

Attacking on the other side, attorneys for several competitive local exchange carriers (CLECs) filed a motion on September 25 asking the FCC to reconsider its broadband UNE exemption (point **b** above). If the FCC does not stay execution of the order, the CLECs said they would file suit in federal court.

In a related proceeding, the FCC on September 10 issued a Notice of Proposed Rulemaking (NPRM) with the goal of revising Total Element Long-Run Incremental Cost (TELRIC) rates. The NPRM suggests that TELRIC should be based on actual ILEC network topologies, not theoretical constructs. If this suggestion makes its way into an Order, the result will be higher TELRIC rates—in other words, ILECs will be able to charge competitors more to lease UNEs.

Finally, on a separate local access-related regulatory track, a federal appeals court ruled on October 6 that cable modem systems include a telecommunications service component in addition to (unregulated) information services. As such, the telecommunications services component (unless the Supreme Court overrules) is to be regulated as a Title II common carrier, making it subject to open access (see "Another CLEC Bite At the Apple?" p. 30).

What's going on? Will the new UNE rules stick? What are the implications for the major players? Here are our observations, organized around four basic issues:

Who Won?

The conventional wisdom is that the FCC Triennial Review was a tie: The CLECs won on UNE-P and the ILECs won on broadband.

We agree on broadband, but not on UNE-P. The FCC's ruling to retain mass-market switching as a UNE (and with it, UNE-P) was based largely on a determination regarding the technology for moving subscribers from ILEC to CLEC infrastructure when they change carriers. Specifically, the FCC determined that the current "hot cut" process (in which a subscriber line is disconnected from an ILEC switch and reconnected to a CLEC switch) cannot be handled efficiently and cost-effectively—thus impairing competitors' ability to compete on a level playing field with the incumbents.

However, buried in paragraph 488 of the document is a directive that each state Public Utilities Commission (PUC) must approve within nine months "a batch cut migration process to be implemented by incumbent LECs that will address the costs and timeliness of the hot cut process." So within a year, there will be new processes to address the impairment issue—at which point, switching UNEs may disappear.

The FCC's willingness to reconsider TELRIC rates is another ILEC win. It now looks as though TELRIC rates will be recalibrated upward. (For a critique of TELRIC rates, see our article in *BCR* July 2003, pp. 54–58.)

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A major question: Will the FCC order stand up to the inevitable court challenge?

The bottom line: There will be fewer UNEs over time, and they will cost more. That's hardly a CLEC victory.

Will The New Rules Stick? Part 1: Switching

Whenever an important FCC order comes down the pike, it gets challenged in court. So in evaluating a major new order, it is important to gauge whether the FCC has created a "bulletproof" document that can resist attack. (The FCC is now on Try Three—the first two UNE orders were remanded by the courts.)

Based on our review of the latest ILEC petitions seeking to overturn the switching UNE, we think that the outcome is uncertain. Here is our assessment of the ILEC arguments:

■ **The FCC Can't Reverse Course on Hot-Cuts:** A critical element in the FCC's finding of impairment was the determination that (a) ILECs have serious problems supporting large numbers of hot cuts efficiently, and (b) these hot cuts are expensive, making CLEC self-provisioning of mass-market carrier changes uneconomic.

In response, ILECs argue that this represents a 180-degree turnaround from the FCC's stance on RBOC entry into long distance in different states, where on numerous occasions it certified that hot cuts are being done on an acceptable and non-dis-

Another CLEC Bite At The Apple?

After reading some of the source documents, we believe the October 6 Ninth Circuit *Brand X Internet Services v. FCC* cable modem opinion ("Brand X") has potentially important implications for CLECs.

In *Brand X*, the Court confirmed a prior ruling that cable modem service includes both an information services and a telecom services component. In doing this, the Court vacated an FCC ruling finding that cable modem only constitutes an information service, with no separate telecommunication service component.

If the Court's decision stands on appeal to the U.S. Supreme Court, Title II common carrier obligations would apply to transmission facilities that support cable modem services—though not to basic cable TV. This would mean that the cable multiple system operators (MSOs) would need to separate their information services from their telecom services. The telecom services would then be made available to customers on demand, at tariffed rates that are "just and reasonable," and on a non-discriminatory basis.

In principle, a competitive local exchange carrier (CLEC) could provide broadband ISP information services based on the transport provided by the MSOs, at a price equal to what the MSOs charge themselves. This would give CLECs broadband access without buying UNEs from the incumbent telcos.

The Court ruling also raises the interesting question of cross-platform regulatory equivalence. If cable MSOs are required to provide telecom common carrier transport service, the same should hold true for an incumbent local exchange carrier (ILEC) building a fiber-to-the-home (FTTH) network.

Interestingly, the FCC *Triennial Review* exempting ILECs from FTTH regulatory requirements only covered UNE requirements. It said nothing about common carrier requirements. So perhaps CLECs can use common carrier rules as a lever to gain access to ILEC FTTH buildouts at reasonable rates, even if they are unable to overturn the FCC's *Triennial Review* decision on broadband UNEs.

There are two key questions going forward. The first is whether the U.S. Supreme Court will overturn the Ninth Circuit's ruling. On one hand, the Ninth Circuit is famous for being a quirky group that gets overturned more than any other circuit of the Federal judiciary. On the other hand, the Court did a nice job of addressing the FCC's major argument that cable modem does not include a "telecommunications service" (the FCC argues that "telecommunication services" must be sold for a fee directly to the public—and that cable providers do not sell telecommunications this way). Appealing to the Supreme Court is by no means a slam dunk for the cable companies.

The second issue is regulatory forbearance. If the FCC loses its appeal, it can choose to exempt CATV MSOs (and ILECs) from common carrier obligations. However, there are two vehicles for doing this, each challengeable in court. One approach is the Section 706 exemption (that forebearance is needed to promote the growth of advanced services). However, it will be hard to argue that exemption is needed to foster a cable modem plant that in large part already exists.

More generally, Section 10 of the Communications Act of 1934 allows regulatory flexibility if it is "consistent with the public interest." However, in making such a determination, the Commission would need to make a finding that forbearance "will promote competitive market conditions." If the FCC did that, the CLECs would challenge on the basis that broadband Internet connections to homes and small business is a duopoly, and maintaining that duopoly will not foster market competitiveness.

How will this play out? Stay tuned!□

criminatory basis. Our read? The ILECs have a good point, and the FCC is being inconsistent.

If you eliminate the timeliness factor, the FCC is left with the argument that hot cuts are overly costly, making CLEC entry uneconomic. The FCC may be right, but its logic is not well crafted—the Commission relies on anecdotal evidence on hot-cut costs (why not get complete and accurate data?), and it fails to show how these nonrecurring costs make investment non-economic on a *life-cycle* basis.

We're not saying that the FCC is wrong on the economics—just that they didn't present a tight logic that is defensible against attack.

■ **There are lots of CLEC switches out there already, so there must be no switching impairment:** Courts historically have viewed demonstration of actual CLEC deployment as strong evidence that there is no impairment (and therefore that a particular network element should not be made available as an UNE). However, we think that the FCC did a good job demonstrating that almost all existing CLEC switches are being deployed for business accounts with higher-capacity line inputs; and that net of this, there is minimal mass-market provisioning. So we see this as a strong argument in favor of retaining the mass-market switching UNE.

■ **The FCC can't delegate decision-making authority to the states:** We don't see this as a strong point for the ILECs. In previous TELRIC rulemakings, the FCC set up similar general guidelines and then let each state run individualized TELRIC rate proceedings. The courts blessed this approach; we therefore think they won't have major problems with an UNE analogue.

Net-net, we believe that the ILECs have some good arguments on hot cuts, but weaker arguments on actual deployment and delegation of authority. We wouldn't be surprised to see a remand directing the FCC to demonstrate that high hot-cut costs lead to overly high economic barriers to entry. On the other hand, the DC Appeals court might take a tougher "three strikes and you're out" stance toward the FCC, which would mean a victory for the ILECs.

Will The New Rules Stick? Part 2: Broadband

We also see the broadband issue as being attackable by the CLECs. The FCC's exemption logic goes like this:

a.) There is minimal fiber to the home (FTTH) deployment to date.

b.) ILECs and CLECs have an equal opportunity to deploy FTTH.

c.) CLECs have lower labor and overhead costs—so there is no CLEC impairment. Furthermore,

d.) Section 706 of the Telecom Act permits the FCC to use regulatory forbearance to promote the deployment of advanced telecom services.

Against this, the CLECs can make the following non-trivial arguments:

■ Deploying FTTH is a hugely capital-intensive project that CLECs cannot undertake for the foreseeable future, given the telecom nuclear winter environment and lack of CLEC access to capital markets for years to come. Therefore, the failure to provide FTTH as a UNE will impair competition, triggering the Telecom Act's "necessary" plus "impaired" (N+I) tests (i.e., that a particular UNE is necessary to promote competition and failure to provide it will impair competition).

■ The FCC is being disingenuous when it "adds" Section 706 as part of the UNE tests—saying that while the N+I tests are to be considered "at a minimum," other tests can be added—and then guts the N+I tests by saying that Section 706 is more important.

This violates the plain meaning of Section 251 of the Telecom Act, which requires that UNEs be made available when there otherwise would be impairment of competition.

■ In the Triennial Review proceedings, the FCC applied Section 706 in a manner that conflicts with previous findings. Section 706(b) mandates that the FCC conduct periodic inquiries to determine "whether advanced telecommunications capability is being deployed to all Americans in a reasonable and timely fashion." If the determination is negative, the FCC can "take immediate action to accelerate deployment." An important basis for the FCC's broadband exemption decision in the Triennial Review was the finding that the FCC needed to take action to promote 706.

Unfortunately for the FCC, in its most recent 706 status report (issued in 2002), it said just the opposite—reporting "that advanced telecommunications is being deployed to all Americans in a reasonable and timely manner." So the CLECs argue that the FCC can't now rule that advanced services won't get deployed unless ILECs get a broadband UNE exemption.

Who will win here? We think the CLECs have some good arguments, and that the FCC needs to do a better job of showing why there is no FTTH impairment. Furthermore, the FCC's 2002 "reasonable and timely" finding is a real problem for its *Triennial Review* 706 argument. Therefore, we wouldn't be surprised to see a remand.

In summary, the FCC tried to inject clarity into the UNE debate as a way to foster business decision-making in an atmosphere of certainty. We don't think they succeeded, and we're going to see another year or two of litigation on the issues. It would be particularly amusing if court decisions result in the end of UNE-P and continued broadband UNEs—the exact opposite of the FCC order.

Beyond the litigation, we're seeing a quantum increase in partisanship at the FCC. If/when there is a Democratic administration, we wouldn't be surprised to see major policy shifts at the Commission, based on a 3–2 Democratic commissioner majority. None of this is helpful for telecom players trying to make rational decisions.

Have advanced-service rollouts been adequate? The FCC has come down on both sides of the question

Is A New Grand Bargain Possible?

We can't help thinking that a negotiated settlement would be better for the industry than continued fighting.

In 2000, the RBOCs and key IXCs negotiated a fundamental restructuring of interLATA switched access rates that resulted in lower usage fees and higher fixed fees. The Coalition Alliance for Local and Long Distance Service (CALLS) proposal received fast-track approval by the FCC and helped to resolve a major source of IXC/ILEC conflict.

Can something similar be done here? Possibly. Our general sense is that the fuss about UNEs is misplaced. For the ILECs, the real issue is pricing, not UNEs; and in particular, the concern that they are going to be forced to rent the use of their network at TELRIC rates that generate an insufficient return on investment. If ILECs received adequate compensation for UNEs, the level of concern about being "forced" to provide a particular UNE would drop substantially.

We therefore, think that a logical CALLS-type "grand bargain" might look something like this:

- ILECs would offer a broader set of UNEs, including FTTH.
- TELRIC prices would be revamped to reflect "real world" deployment costs and risk-based costs of capital.
- TELRIC rates would be compared to generally accepted accounting principles (GAAP) costs on existing plant. To the extent that actual costs are higher than (the newly-adjusted) TELRIC rates, a blended UNE rate would be allowed (GAAP costs up to 2003; TELRIC afterwards). This would force ILECs to be efficient in new deployments, while not penalizing them for past inefficiencies blessed by previous generations of regulators.

The situation may be ripe for a "Grand Bargain"

Other Important Takeaways?

Two interesting developments are under-reported, but will have important implications:

- **Move to Micro-Granularity—**In contrast to the first two FCC UNE orders (which designated UNEs on a national basis), the Triennial Review establishes a new regime in which UNE impairment is based on micro-geographic factors, down to the individual building level and dependant on highly geo-specific CLEC self-provisioning decisions. The implementation of these rules is left in large part to each state PUC, reinforcing the likelihood that the final outcome on UNEs will be a patchwork of micro-geographies, rather than broad national mandates. To a large extent, this is due to the DC Appeals Court remand, which attacked the FCC's prior national orders for not having considered geographic granularity.

The implications for telecom competition are profound. During the long distance wars between MCI and AT&T in the '80s/'90s, the general focus was on market segmentation based on national customer characteristics (mostly on the basis of size). Geography was of secondary importance.

With micro-geographic regulation, telecom service providers will need to segment the market by geography as well as customer size, using geo-specific information systems. When service provider telemarketers call prospects (or receive customer calls), they will need to know instantly what types of services are possible/optimal for a customer's specific location, and which services cannot be provided. Micro-granular regulation will result in micro-market segmentation.

- **Profitability-Based Economics—**In previous UNE proceedings, the FCC applied a cost basis for resolving impairment issues—i.e., if there is a higher cost for CLEC provisioning versus ILEC UNE rental, this cost differential is evidence of impairment. This reasoning was rejected by the courts.

In the *Triennial Review*, the FCC decided that the appropriate measure was whether "lack of access to an incumbent LEC network element poses a barrier or barriers to entry, including operational and economic barriers that are likely to make entry into a market uneconomic. That is, we ask whether all potential revenues from entering a market exceed the costs of entry, taking into consideration any countervailing advantages that a new entrant may have."

So cost-based analysis has been replaced by economics-based analysis—something that makes eminent sense.

The issue is how economics-based analysis can best be implemented. We don't like the way the FCC did it—coming up with a laundry list of factors such as market shares, revenues, customer churn rates, bundled service economics—and then telling state PUCs that they should consider these in their individual proceedings. The ILECs are right to point out that this will lead to regulatory balkanization.

As an alternative, we suggest that the FCC standardize the process. To create some standards on UNE pricing rates, the FCC created a TELRIC methodology and then created a cost proxy model that fostered reasonable uniformity across states. It therefore seems reasonable to ask the FCC to create an economic proxy model that considers all revenues and costs that can be used to demonstrate impairment (or lack of it). Otherwise, as the ILECs contend, we're going to have 51 different food fights with minimal commonality□