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ANSWERING THE CALL: AN ANALYSIS OF THE PUC RULING ON LOCAL PHONE COMPETITION

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KEY FINDINGS

- Local telephone competition remains an unmet goal in the United States. The Federal Communications Commission recently released a report in which it was shown that competitive entry into local telephone markets is less than 5 percent nationwide.

- In an effort to loosen the grip Bell Atlantic of Pennsylvania (BA-PA) has on the local telephone market, the Pennsylvania Public Utility Commission voted 4-1 to approve a ruling that calls for substantial changes in the way the local telephone market operates.

- The ruling calls for the structural separation of BA-PA into retail and wholesale operations so that the service delivery functions of the company would be on equal footing with competitors.

- The ruling lowers both access charges (the fee paid by long-distance providers to connect into the local network) and lease rates for unbundled network elements (parts of the network competitors can use in combination with their own facilities to reach customers).

- The ruling caps telephone rates at their current level until 2003. Rural rates cannot go above $16 per month for basic service. The ruling also establishes a fund to keep phone service affordable for all customers.

- The PUC ruling has both short- and long-term implications with the PUC's ruling. Although there are many uncertainties with the ruling that will play out over time, the ruling does bring BA-PA closer to compliance with the Telecommunications Act of 1996.

- Despite the analysis of the Progress and Freedom Foundation, the ruling is a step in the right direction and will benefit Pennsylvania consumers.

INTRODUCTION

The promises for competition inherent in the passage of the Telecommunications Act of 1996 were, at the time of its passage, strong enough to convince consumers that monumental changes were in store for the industry. The local telephone market, long the bastion of monopoly control and pricing, would be de-regulated much like its long-distance companion. Local monopolies, after proving that their markets were competitive, will be allowed to compete in the lucrative long-distance market. The goal of the act was to bring competition to all sectors of the telecommunications industry by promoting this "cross competition".

Three years after the act went into effect, there is little evidence that competition exists in the local telephone market. The Federal Communications Commission (FCC) recently released a report on local competition. Although the report notes that new data shows that competitive local exchange carriers (CLECs) are "becoming more geographically widespread", penetration into the market by these competitors "remains less than 5 percent of the local market".[1]

The FCC report notes that CLECs are acquiring resources to provide telephone services. Incumbent local exchange carriers (ILECs) have increased the number of lines sold to competitors by 1 percent to a total of 2 percent. The number of unbundled local loops (the line from the central office switch to the home or business) tripled between 1997 and 1998, although this increase represented less than 1 percent of all ILEC lines.[2]

The fact still remains that when the typical consumer makes a phone call, they are doing business with a monopoly. What accounts for this slow growth in local competition? Some could say that competition does not happen overnight and that, in the world of de-regulation, three years is a relatively short period of time. Others, most notably incumbents, note that competitors are targeting lucrative business customers in urban areas at the expense of residences and rural or "high-cost" areas. Incumbents also argue that competitors really do not want to get into the local telephone market because it is not as profitable as long-distance service. Whatever the reason, the lack of competition in local telephone persists.

Pennsylvania has moved to remedy this situation. On August 26, 1999, the Pennsylvania Public Utility Commission (PUC) ruled on local telephone competition in the state and severely curtailed the sway Bell of Pennsylvania (BA-PA) has in the state. That ruling has also presumably paved the way for getting long-distance companies into local markets. The purpose of this paper is to detail the elements of the ruling and evaluate the possible effects it may have on the state of local telephone competition.

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[1] "Local Competition: August 1999" A Report by the Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission. (www.fcc.gov/ccb/stats). The report notes that at the end of June, 1999, there remained only 18 of the nation's 193 local access and transport areas (LATA) where CLECs had not obtained the numbering resources to provide services over their own facilities.
[2] Ibid

LOCAL TELEPHONE COMPETITION: A NATIONAL PERSPECTIVE

The Telecommunications Act of 1996 (Telecom Act) established three methods of competitive entry into the local telephone market. First, by using total service resale (TSR), competitors could purchase and then resell ILEC services to customers. Secondly, competitors could lease unbundled network elements (UNE) to use in combination with their own facilities. Lastly, competitors could construct their own networks to reach competitors.[3] Congress expected these methods would sufficiently bring competition into the local telephone market.

The actual implementation of these methods in the local market has yielded few results. The FCC study notes that only 1.7 percent of ILEC lines were provided on a resale basis at the end of 1998. The UNE option represented less than 1 percent of loops at the end of 1998. These early results seem to indicate that incumbents are keeping a tight hold on their services and equipment to the detriment of competition.[4]

The FCC report highlights incumbent dominance in local service revenue. In 1998, incumbents claimed stake to $98 billion in revenue, up from $80 billion five years previous. CLEC revenue totaled $2.4 billion in 1998, an increase of less than $200 million since 1993. The study notes that "even with the most expansive definition of local competition (e.g. resellers, facilities-based, etc.), incumbent companies billed 96 percent of local service revenue despite the growth in competition.[5]

Three years since the passage of the Telecom Act, significant competition has yet to come to the local telephone market. There is competitive growth, no doubt, but it is coming from a very small base and in certain areas of the country, mostly in large cities. For meaningful competition to penetrate all areas, further action must be taken on the part of state legislatures and state utility commissions to foster compliance with the Telecom Act.

[3] Ibid
[4] Ibid
[5] Ibid

LOCAL TELEPHONE COMPETITION: PENNSYLVANIA

The PUC's 1998 data shows that ILECs had a stronghold on access lines in Pennsylvania. Of the 2,733,210 lines serving businesses, incumbents controlled 2,545,541 or 93 percent. Competitive providers held the remaining 7 percent. Incumbents had the lion's share of residential lines as well; over 99 percent of access lines were under the control of 39 companies. Less than 1 percent were held by competitive providers.[6]

Competitive penetration has not only been limited by volume, but by region as well. Of the ten largest CLECs (separated by business and residential access lines), five served customers exclusively in the central and eastern sections of the state. Three were resellers of Bell service, and thus competed anywhere in Pennsylvania. However, the dominance of incumbents, especially in residential service, strongly limited any real competition.

CONTROL OF ACCESS LINES- YEAR END, 1998

Type of Company	# of Business Lines	# of Residential Lines	Total
Incumbent	2,545,541 (93%)	5,582,533 (>99%)	8,127,984 (97%)
Competitor	187,669 (7%)	8,622 (<1%)	196,291 (3%)
Total Lines in Pennsylvania	2,733,210	5,591,155	8,324,275

Breaking this impasse is a daunting exercise in controlling monopolies that have existed under government regulations and have used that as a shield from competition and as a method of tightening their grasp on the local market. However, that is exactly what the PUC attempted with its ruling last week. By a 4-1 vote, the Commission remained true to its commitment of fulfilling the intent of the Telecom Act. As PUC chairman John Quain remarked, "our patience has been tried, our intellect has been challenged, but most importantly, our resolve has been strengthened".[7]

The ruling by the PUC follows a year of battling over competition in the local telephone market in Pennsylvania. It was a year highlighted by the Global Settlement Conference, which aimed at solving the question of competition by bringing concerned parties to the table. It was a year highlighted by the proposed Bell Atlantic-GTE merger, which led to further doubts of true local competition. And it was a year highlighted by the consideration of three Senate bills that aimed to limit BA-PA's ability to dominate the market. The conference failed in its mission, the merger is still pending, and the legislation is now moot. The effects of the ruling are yet to be known. For that reason, it deserves to be examined.

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[6] Jake Haulk and Eric Montarti: "Hung Up: Three Years is too long for Pennsylvania to wait for Local Telephone Competition". Allegheny Institute Report #99-12, August, 1999.
[7] George Strawley: "PUC Approves Plan to Increase Telephone Competition". Pennsylvania State News, August 26, 1999. (http://hotnews,pennli…)

THE PUBLIC UTILITY COMMISSION RULING

The ruling made by the PUC on Thursday, August 26, 1999 will not go into effect immediately. Rather, some of the issues considered in the order must be examined more thoroughly in order for a resolution. The ruling does, however, set the movement to competition in motion.

The PUC ruled on many unresolved issues pertinent to the introduction of competition into the local telephone market. While all of these are important in their own right, the five issues with most significance for competitors to connect into BA-PA's infrastructure and for head-to-head competition with BA-PA are discussed in this section. These issues relate most directly to the objectives of the Telecom Act of 1996. Following a description of these elements, the possible implications for local competition will be analyzed.

Structural Separation of Bell Operations

The ruling separates retail from wholesale functions of BA-PA. This is the first division of a regional Bell by a utility commission in the nation. The logic behind this decision is that Bell is both a supplier and a competitor: under the Telecom Act, it must make its services available to competitors in order for them to reach Bell's customers in the local market. With a separate retail function, BA-PA must follow the same rules that competitors abide by. The PUC feels that this separation would increase competition because the part that maintains access to the network (wholesale) will be different from the part that markets services to consumers (retail).[8]

This part of the ruling comes as a precursor to the proposed Bell-GTE merger, which, if approved, would put Bell Atlantic in control of two subsidiaries with the largest market shares of local telephone service in the state. Structural separation, the PUC argued, is the most efficient tool and the only method to ensure competition under the Telecom Act.[9]

Daniel Whelan, BA-Pa's chief executive officer, lamented this part of the decision by arguing that structural separation "robs Bell of its assets" and "its incentive to invest". He also stated that costs will be driven up and it will be difficult to offer consumers competitive prices.[10]

BA-PA has sixty days to file a restructuring plan with the PUC.

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[8] Rick Stouffer and Dennis Barbagello: "Bell could face Cuts". Pittsburgh Tribune-Review. August 29, 1999.

[9] Pennsylvania Public Utility Commission: Joint Motion of Chairman Quain and Commissioners Rolka, Brownell, and Wilson. Harrisburg, PA. August 26, 1999. Vice-Chairman Robert Bloom was the sole dissenting vote on the ruling.

[10] Ibid

Reduction in Access Charges

Access charges are the fees long-distance companies pay to local carriers to connect calls through the local infrastructure. These fees are often passed off to customers in the form of higher rates. The PUC found that access charges are currently priced substantially above cost, and that to maintain fair competition, access charges needed to be reduced and re-structured.[11]

BA-PA, GTE, Sprint, and other incumbents are affected by the change in access charges. BA-PA is to reduce its charges to $.009 per minute for both originating and terminating local switching. Also, beginning in January, BA-PA must reduce its carrier charge pool by $8.455 million annually. Since the reductions on access charges will produce savings to competitors, they are required to file annual reports with the Commission demonstrating how those savings are being passed on to consumers.[12]

Overall, the PUC ruling reduces the access charges by $78 million. Thus, for example, a call made from Philadelphia to Harrisburg would be lower because competitors could pass savings to their customers in the form of lower per-minute toll rates.[13]

Reduction in Lease Rates of UNEs

The provision in the Telecom Act that permits the leasing of unbundled network elements has been stunted because the elements have been priced at a cost-prohibitive rate. By allowing a CLEC to purchase these elements, service could be provided more cheaply, efficiently, and flexibly. This explains the resistance of incumbents to lease the elements at a "fair" price.[14]

The PUC ruling cuts the price competitors have to pay to lease these elements by 13.59 percent. BA-PA's rates will fall to an average of $14.50 (for two-wire loops) to $16.78 (the statewide average). UNEs that can be used for Internet services, the ADSL and HDSL loop, are to be priced identical to two-wire and four-wire loops, respectively. BA-PA has to provide these services and must demonstrate the technical feasibility of the services.[15]

Corollary to the dollar value reduction in the cost of the elements is the necessity of BA-PA to complete the Operational Support Systems (OSS) test to ensure that BA-PA can quickly and fairly process orders from competitors to obtain the elements. The PUC must approve this process in order to facilitate competition.[16]

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[11] Joint Motion
[12] Ibid. The motion notes that savings are expected to come from direct reductions in standard measured toll rates for residential and business customers.
[13] Wendy Tanaka and Patricia Horn: "PUC Opens the Way to Local Phone Rivalry". Philadelphia Inquirer. August 27, 1999.
[14] Associated Press: "Highlights of Local Telephone Ruling". Pennsylvania State News. (http://hotnews).
[15] Joint Motion
[16] David DeKok: "Local Phone Competition Takes Shape". Harrisburg Patriot News. August 27, 1999.

Lastly, BA-PA must make UNE combinations available to competitors, also known as a UNE "platform". A CLEC must be able to purchase the loop, switch port, switch usage, and transport elements in a combination. This will not only benefit the competitor, but it will cost less for the incumbent than would a recombining of UNEs by the CLEC.[17]

Universal Service Fund

Since the inception of telephone service in the United States, one constant in the ever-changing world of telecommunications has been a commitment to make service affordable to all customers. This commitment has suffered under the strain of poverty, of wiring "high-cost" areas, and of variances in use between different types of consumers. In order to meet these needs, a intricate system of cross-subsidies were established from usage fees on long-distance calls.[18]

In order to keep the rates of "high-cost" areas down, the PUC ruling creates a $30 million universal service fund. This is of particular importance to rural areas in the state, many of which have been left behind in the new telecommunications age. Industry types often refer to this lag as the "digital divide", a system of have and have-nots. Local providers will presumably be able to draw from this fund to offset the costs associated with low-density areas.

Rate Caps

Pennsylvania's telephone companies traditionally operated under a rate-of-return regulation in which rates were based upon capital investments plus a percentage to ensure a profit for the company. In 1993, Title 66 of the Utility Code was amended to allow for a price cap, or "incentive regulation" to be employed. Rather than regulating profits like the rate-of-return arrangement, prices to consumers were to be regulated. This gave companies incentives to cut costs in order to turn a profit.

The price cap regulation, known as Chapter 30 in Pennsylvania, was supposed to lead the way for a broadband infrastructure throughout the state. When BA-PA's plan was approved in 1994, the PUC agreed to allow the company's rates to rise in return for broadband improvements.

As rates climbed, the broadband infrastructure failed to materialize. Unfortunately, the regulatory deal made between the PUC and BA-PA did not work, and BA-PA collected significant profits under its new, higher rates. In fact, research has shown that under the price cap regulation, BA-PA's return on equity was 29 percent in 1997 and 31 percent in 1998. And since the approval of the plan in 1994, Bell's revenues grew at a rate of 3

[17] Joint Motion
[18] Benton Organization: "The New Definition of Universal Service". (www.benton.org)

percent annually, its net income at 5 percent annually. These increases were not, however, rolled back into network modernization.[19]

The PUC ruling caps the rates for dial tone, touch tone, and local usage at the statewide average of $13 to $16 per month through 2003. State consumer advocates fought hard for this provision. A $16 ceiling is to be extended to rural areas, where the costs are typically prohibitive.[20]

Other Parts of the Ruling

The PUC also ruled on several other related issues related to the state of local competition. Calls to Internet connections will be treated as local calls in negotiating for payments that compensate companies that receive the traffic. The eligibility to Lifeline, a program that assists low-income customers with receiving basic telephone service was increased to 150 percent of the poverty level, up from 100 percent. The program provides a $5.25 discount on monthly telephone bills. The PUC also designated a portion of Bell's market competitive: Bell can negotiate pricing with businesses that generate at least $80,000 per year in billed revenue rather than relying on tariffs.[21]

[19] Lee Selwyn, Sonia N. Jorge, and Patricia Kravtin: "Broken Promises: A Review of Bell Atlantic-Pennsylvania's Performance Under Chapter 30". Economics and Technology, Inc., Boston 1998.
[20] DeKok
[21] Associated Press

IMPLICATIONS FOR LOCAL TELEPHONE COMPETITION

Just as the Telecom Act has failed to produce competition in local telephone overnight, it is reasonable to expect that the PUC ruling will not comprehensively address the problems with local telephone competition in Pennsylvania. But it is a step in the right direction. Although there are no tangible results as of yet, there is some movement as incumbents and competitors position themselves for this new regulatory environment. The purpose of this section is to examine the short- and long-term implications the ruling has on local telephone competition.

Short-Term Implications

The immediate future for Bell of Pennsylvania will include a new set of regulations, as well as the promise for new opportunities in the telephone market. First and foremost, BA-PA must submit a plan for restructuring its subsidiaries within 60 days of the ruling. This is the structural separation of its retail and wholesale functions that will put BA-PA on even par with its competitors in attempting to gain access to equipment. It must complete the OSS testing, under the watchful eye of the PUC, in order to ensure that the discounted UNEs are ready to be leased to competitors at a sensible rate.[22]

Another factor in the immediate future for BA-PA may be an appeal of the ruling. Considering the regulations placed upon the company, an attempt to relieve some of the stipulations is probably in the works. Following the ruling, Daniel Whelan made the following statement: "as a matter of public policy, today's decision is bad news. It places Pennsylvania on the radical fringe of regulation, when every other state…is trying to diminish government intrusion and manipulation of the market". Whelan maintained that BA-PA will need time to review its options, possibly meaning that Bell will threaten to pull jobs out of the state, but this remains unclear.[23]

On the positive side for BA-PA, the ruling led to the PUC's approval of the BA-PA merger with GTE.[24] In addition, the ruling may pave the way for BA-PA to sell long-distance services in Pennsylvania, thus fulfilling the goal of the Telecom Act of getting the regional Bells into long-distance.

On the other side of the equation, AT&T stated that it would begin to offer local service in Bell of Pennsylvania's territory so long as there is no delay in the implementation of the order. MCI Worldcom also made clear its intentions to sell residential service within the next year.[25]

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[22] Rick Stouffer: "Next Big Step in Phone Choice Due in Month". Pittsburgh Tribune-Review. August 29, 1999.
[23] Ibid
[24] Rick Stouffer: "Bell Atlantic-GTE Merger Ok'd". Pittsburgh Tribune-Review, November 5, 1999.
[25] Tanaka and Horn

Long-Term Implications

The most pertinent long-term implication of the ruling is that Pennsylvanians will have the opportunity to choose their local telephone service much in the same way that they choose their long-distance provider. With competitors preparing to enter the local market as a result of the ruling's implementation, a variety of choices will soon be available to consumers.

The long-term effect of the ruling on the complex residential market is difficult to assess. There are those who feel that the intertwined cross-subsidy arrangement that keeps residential rates low and connects "high-cost" areas will crumble under a competitive system.

Take for example the analysis of Brad Ramsay of the National Association of Regulatory Utility Commissioners in D.C.: he stated that since telephone service providers "refuse to eat" certain costs of opening telephone networks will pass costs on to consumers. He specifically notes costs associated with leasing UNEs and universal service requirements. However, Mr. Ramsay also notes that the goal of competition is "to drive services to cost".[26]

An aspect that will be helped by this ruling is the packaging of services by companies. Mergers, such as the Bell-GTE union, are happening because consumers are demanding a telecommunications package that includes voice, data, and other technologies coming from one supplier over a broadband cable that allows for the flow of information back and forth at a rapid pace. Competition will speed the arrival of such technologies, much unlike the reliance on regulatory deals like the one in 1994. As a result of the ruling, competitors plan to offer DSL high-speed Internet access.[27]

A final aspect that benefits as a result of the ruling is that by lowering lease rates and providing for a universal service fund, competitors can successfully offer residential service on a much larger scale than before. Incumbents often accuse competitors of "cream skimming", or targeting high-volume (read profitable) business customers at the expense of residences. With UNEs available at a feasible cost and a fund to offset expenses in rural areas, competitors should be ready to take the leap toward residential consumers.

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[26] Alyson Walls: "Long Distance Act isn't Being Felt Here". Pittsburgh Tribune-Review. August 29, 1999.
[27] DeKok

THE PUC RULING IS GOOD FOR CONSUMERS

A recent paper by the Progress and Freedom Foundation argues that this ruling will only set local competition back because it creates "a quagmire in which every step towards de-regulation is matched by a step backwards".

The paper argues that the "structural separation"--which divides Bell Atlantic-Pennsylvania (BA-PA) into wholesale and retail operations--is unfair because it imposes costs upon the incumbent company alone. Three side-effects of the structural separation are cited.

First, structural separation will reduce "incentives to invest in network modernization efforts". What the research fails to note is that BA-PA had the opportunity to undertake network modernization six years ago after being granted permission to raise rates under alternative or "price cap" regulation. In fact, BA-PA's infrastructure investment in modernizing Pennsylvania's broadband infrastructure decreased from 1993 to 1997. Thus, BA-PA had the chance, as well as the funds, to modernize the state, but they failed.

Second, the paper states that the timing of the ruling is wrong and that structural separation may have been a good policy "prior to the implementation of policies at the federal and state level designed to foster competition in the local exchange marketplace" since there is "the actual emergence of competition as a result of these policies". The emergence of competitive penetration, which the Federal Communications Commission has measured to represent a grand total of less than 5 percent of the entire local market, is slow in developing. Even with the broadest definition of local competition (resellers, facilities-based, wireless), incumbent local telephone companies still billed 96 percent of local service revenue. If anything, the PUC ruling was fashionably late.

Lastly, the paper notes that the PUC's separation plan "assumes, at least implicitly, that the incumbents' local network infrastructure will remain a bottleneck facility". The PUC ruling reduces the lease rate on unbundled network elements (equipment competitors need to connect to customers) by 13.5 percent, reducing their cost-prohibitive rate and permitting competitors to purchase them at a reasonable fee. This action breaks the bottleneck, that, until the ruling had effectively kept competitors out of the local telephone market.

The Progress and Freedom Foundation believes that regulated monopolies are treated unfairly and that "overzealous regulatory intervention can slow [competition] down, driving the light at the end of the regulatory tunnel further into the indefinite future". Well, the PUC acted correctly in taking the action that it did. Structural separation--along with rate caps, reductions on UNE lease rates, reduction on access charges, and a universal service fund--ensures that the light of consumer choice and true competition shines brightly on Pennsylvania.

CONCLUSION

Incumbents argued that competitors never wanted true competition and that the Telecom Act was merely a tool of AT&T, MCI, and other competitors to keep the regional Bells out of long-distance service. Competitors argued back that they wanted a piece of the local market in order to bring a packaged future to telecommunications.

This bantering has persisted for nearly three years. Now, Pennsylvania has taken bold steps to ensure that the Telecom Act is executed. By placing stipulations upon Bell of Pennsylvania, the PUC has attempted to target the largest provider of local telephone service in the state so as to facilitate competition. Whether these stipulations will produce the desired end result will not be known for some time to come. There are short-term actions that Bell must take in order to comply with the ruling and the order soon to follow. These actions are coupled with long-term effects that reflect the direction in which the telecommunications industry is headed.

Pennsylvania has been at the forefront of de-regulating its public utilities. Electricity, natural gas, and now, telephone have experienced a competitive environment in the last few years. The former two have seen an increase in selection of suppliers by consumers. The state now waits to see how consumers take to a local telephone market based on competition.