

A Critical Analysis of the Economic Benefits of the 1996 Telecom Act's Local Competition Provisions

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December 14, 2004

The “Theory” Underlying the 1996 Act

- The U.S. long distance sector was competitive by 1996, but,
- Local telecom services were still dominated by “bottleneck” monopolists.
- Therefore, regulators would be required to “open up” the local market through mandated unbundling, allowing entrants an entry toe-hold on the way to facilities-based competition.
- The Bell companies would not be allowed to enter the long distance market until their local markets were “open.”

As a Result, the 1996 Act Had the Following “Market Opening” Provisions

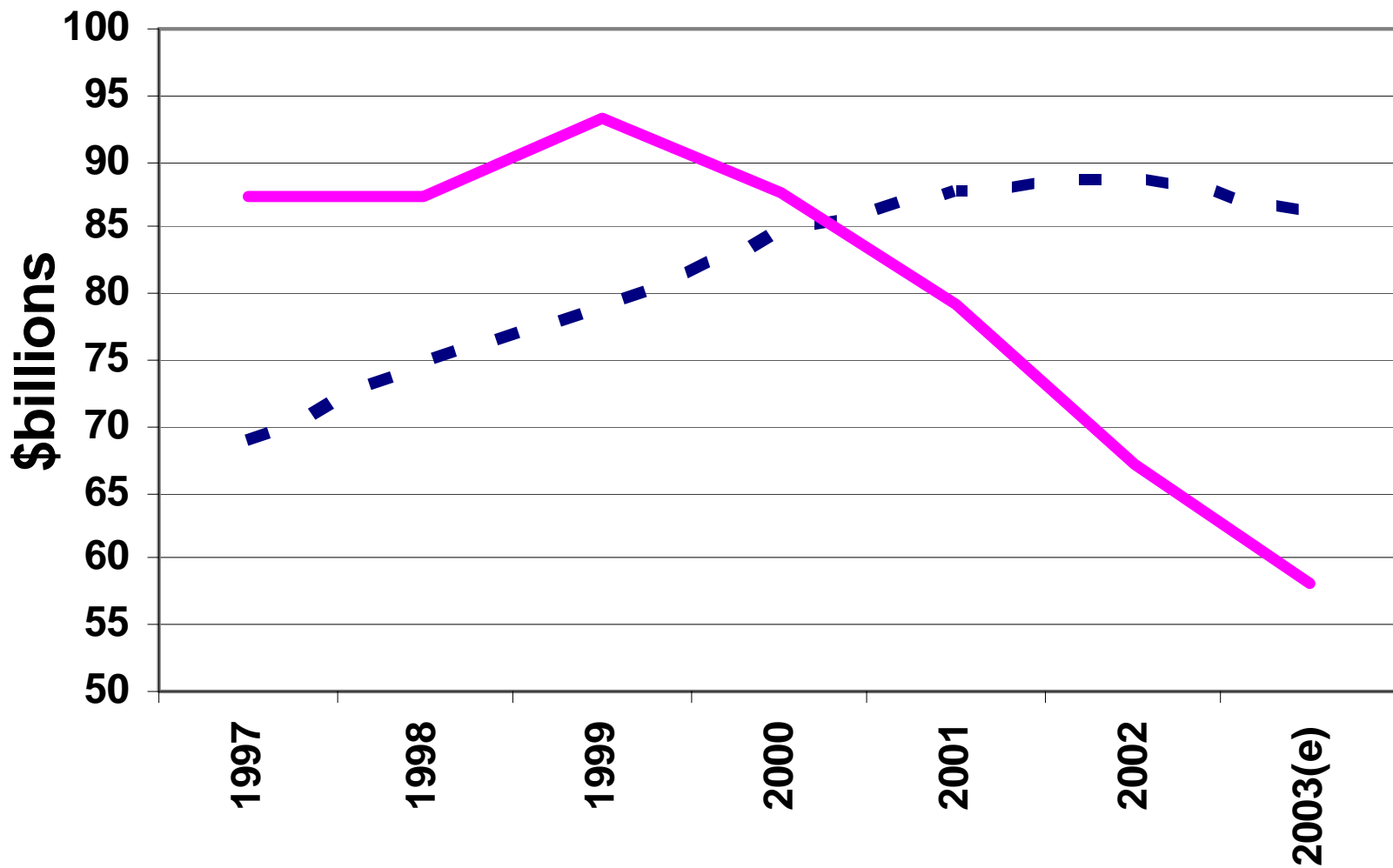
- Mandatory network interconnection at “feasible” points
- Unbundling of incumbents’ networks into “network elements” to be provided to entrants at regulated rates
- Total service resale provided at “avoided-cost” discounts
- Reciprocal compensation for local interconnection on terms to be decided by arbitrations
- The continuation of the ban on Bell Company provision of in-region interLATA long distance in each state until Bell companies have satisfied a “check-list” of market-opening conditions

Under the Act's Assumptions, This Policy Should Have:

- Reduced local rates or increased local service offerings, or both
- Reduced local telecom revenues sharply, given 94 % penetration and an extremely low price elasticity of demand for local lines
- Induced entrants to start with resale or unbundled elements and then slowly build out their own facilities
- Had little effect on long distance rates

So What Is the Evidence?

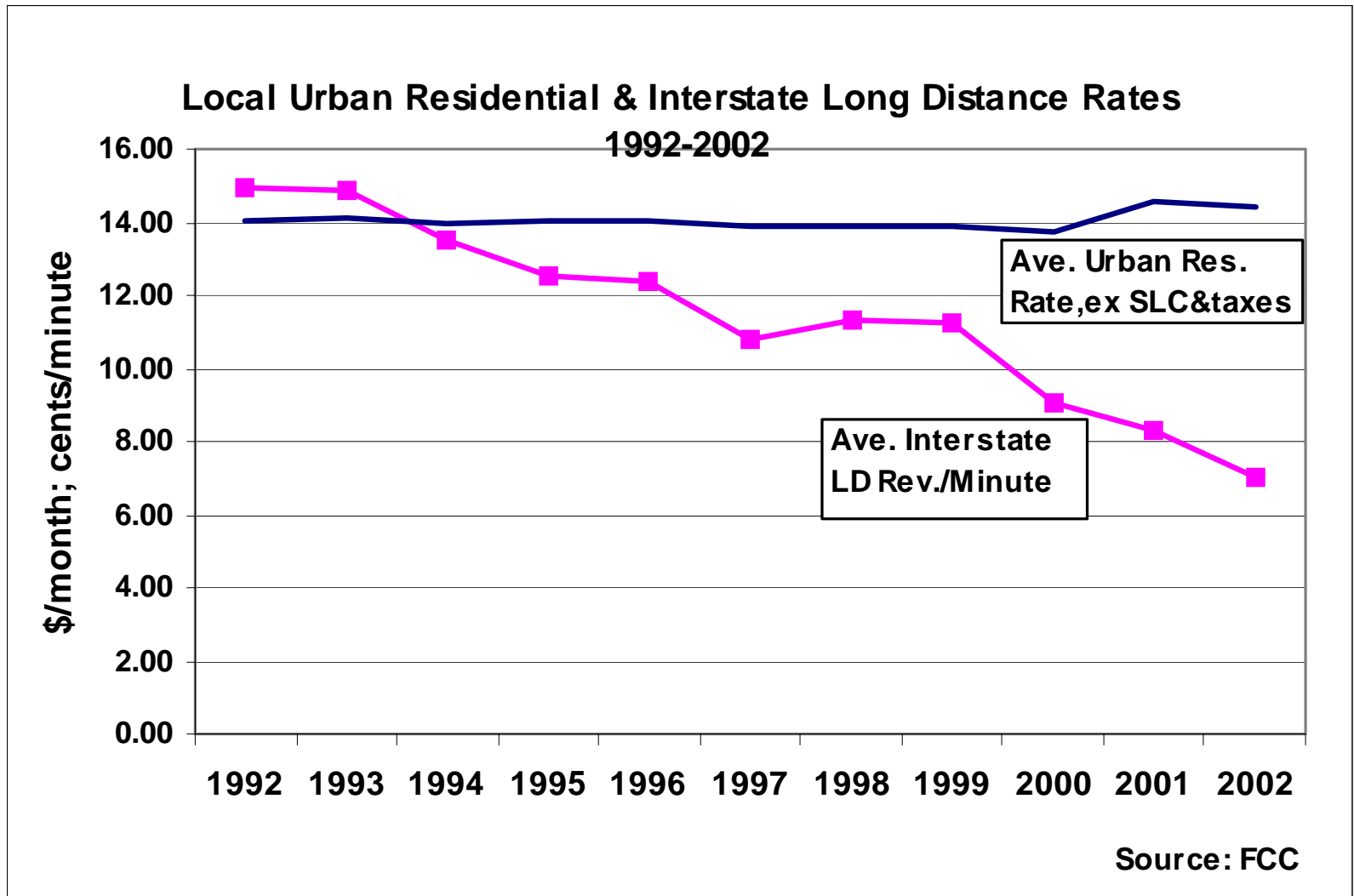
Local and Long Distance End-User Revenues, 1997-2003



■ ■ ■ Local — Long Distance

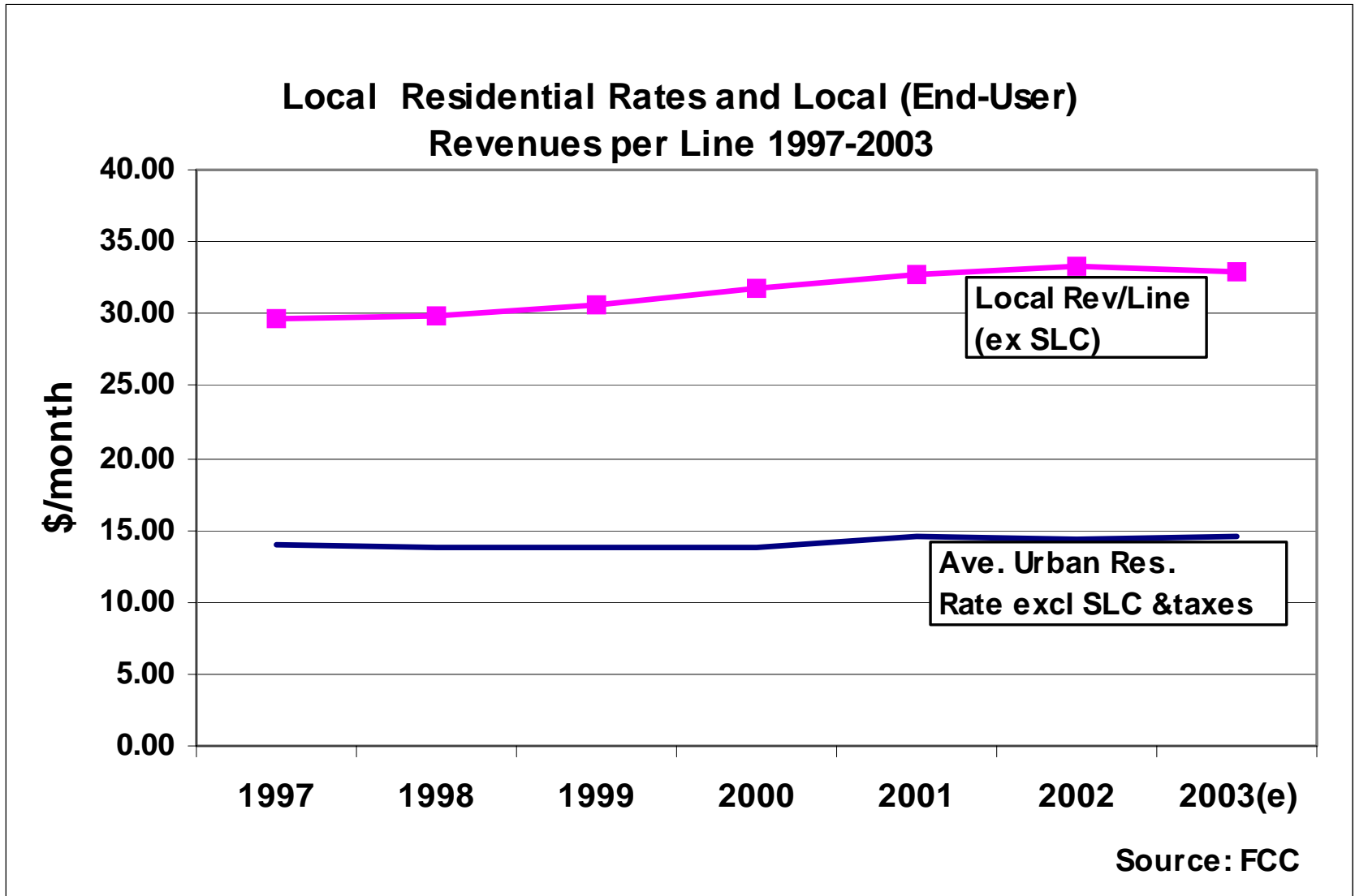
Source: FCC

Local Residential Rates Have Not Fallen, But Interstate Long Distance Rates Have Plummeted

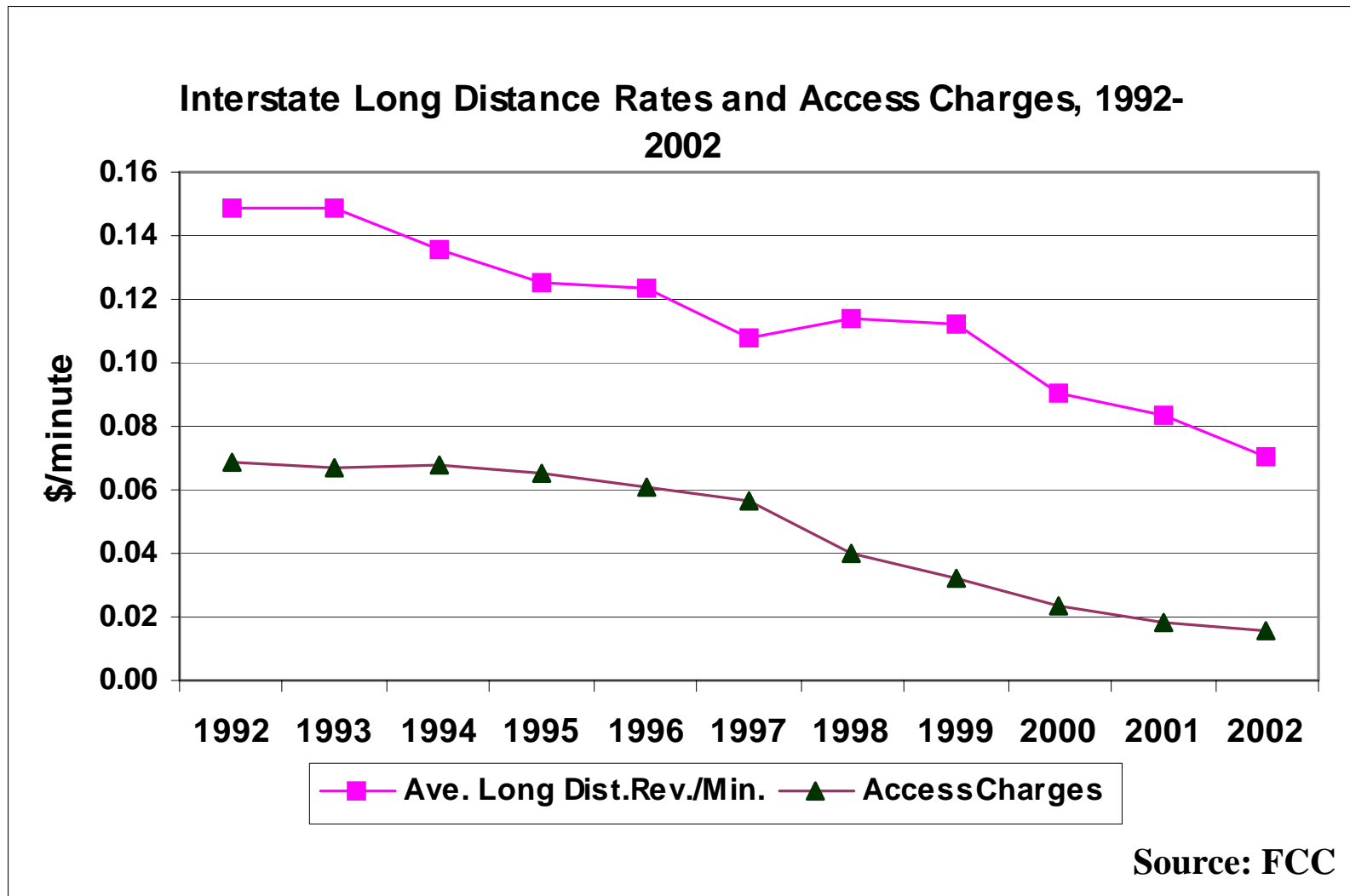


Local Revenues Per Switched Access Line

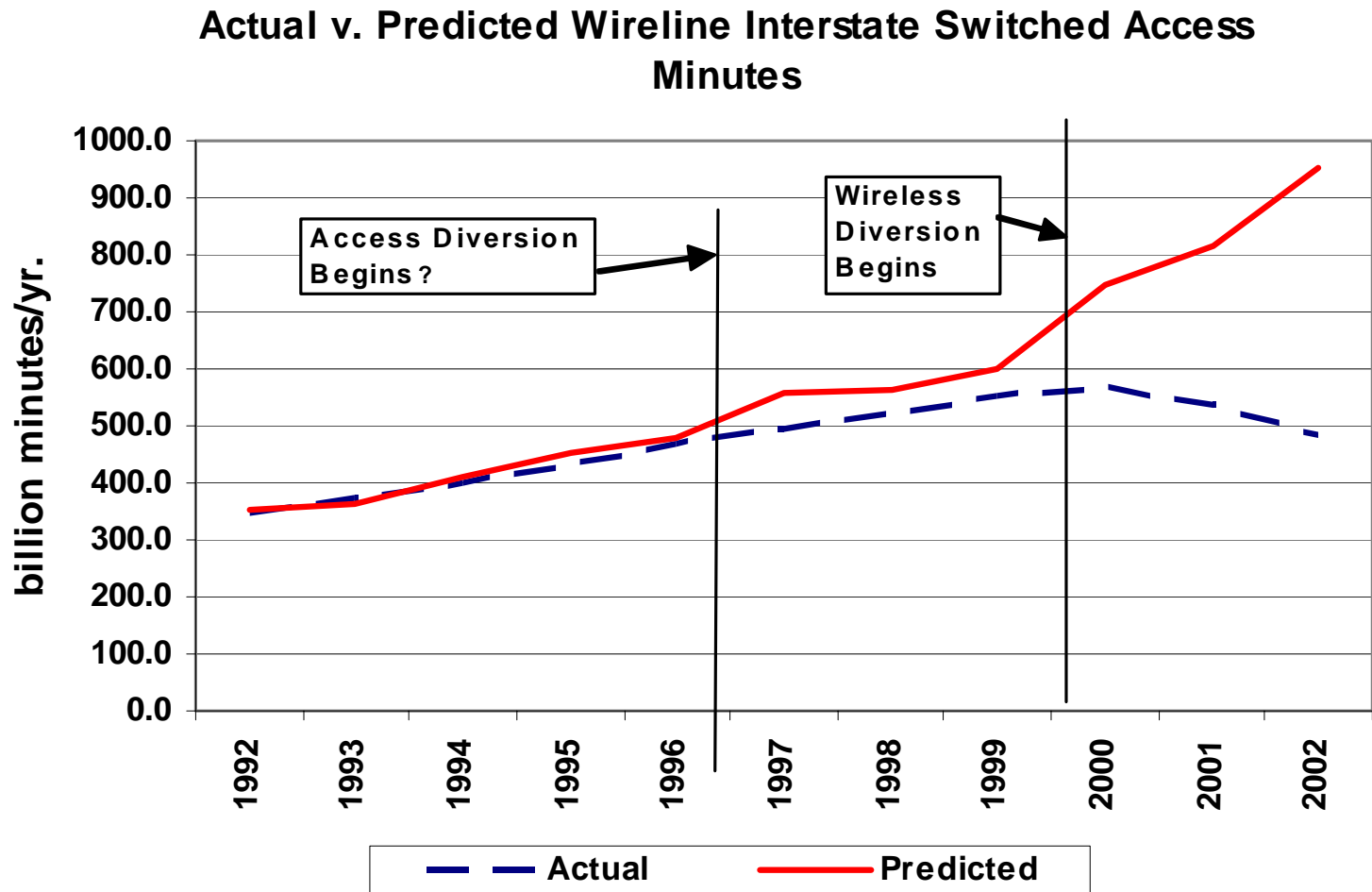
Confirm This Result



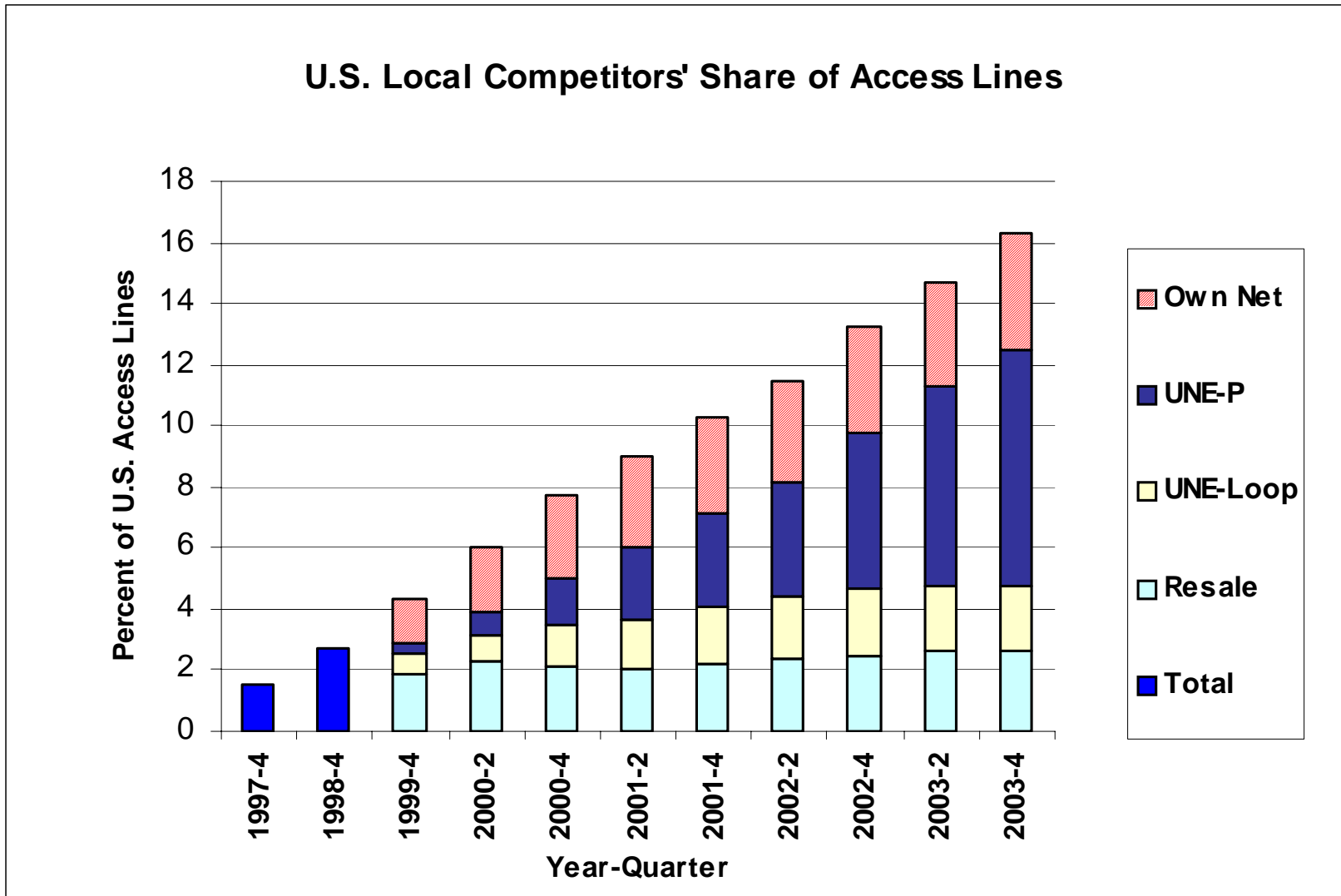
Interstate Long Distance Rates Have Fallen More than Switched Access Charges



Long Distance Competition Also Developed from an Unexpected Source -- Wireless

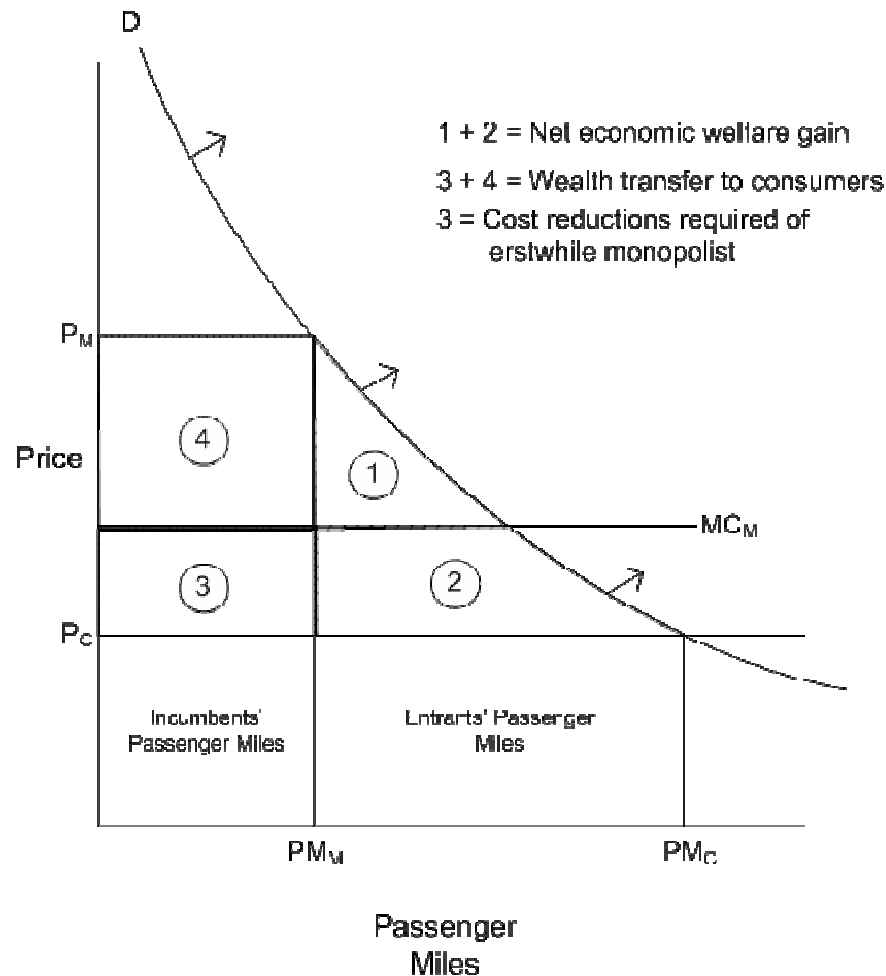


Local Entrants Have Expanded Through the UNE-P, but Have Cut Back on Their Own Lines



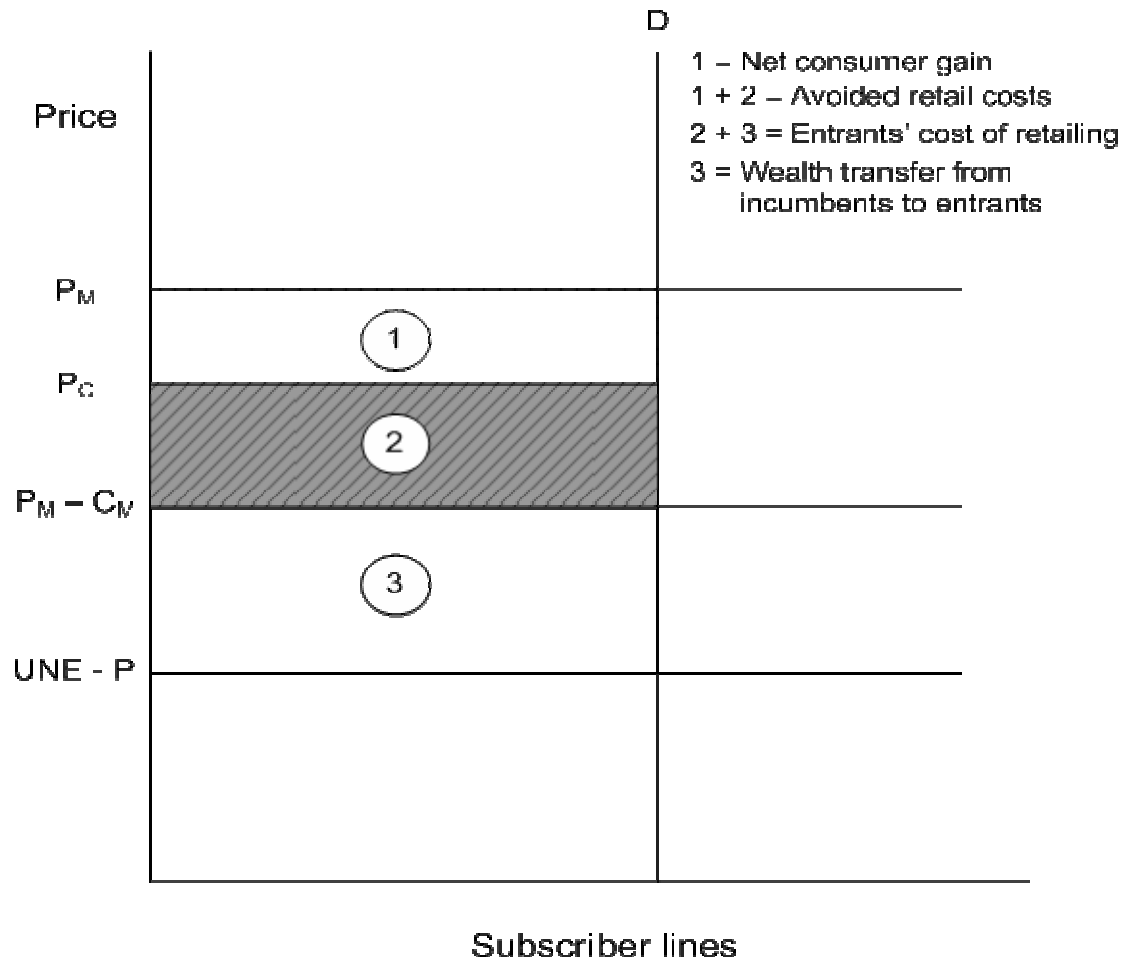
The Benefits from Competition Usually Come from Lower Costs & Prices and Greater Output

Airline Entry



Local Telecom Competition Through Resale or UNE-P Is Different

Entry into Local Telecom Through Leasing of Incumbent Facilities



The Effects of Local Competition on Consumer Prices

- Economides, *et.al.*, (2004) find that the price and (intra-LATA toll) quantity benefits to consumers switching to a UNE-P based CLEC in NY were \$2.28 per month or 11 percent of the local bill
- They find that “quality” effects of switching to AT&T or MCI UNE-P based services raises total benefit to \$3.86 or 19 percent per month
- These results bracket the conventional wisdom that CLECs have to offer 15 percent discounts to induce subscribers to switch
- There is very little evidence that ILECs have been forced to respond with lower local rates

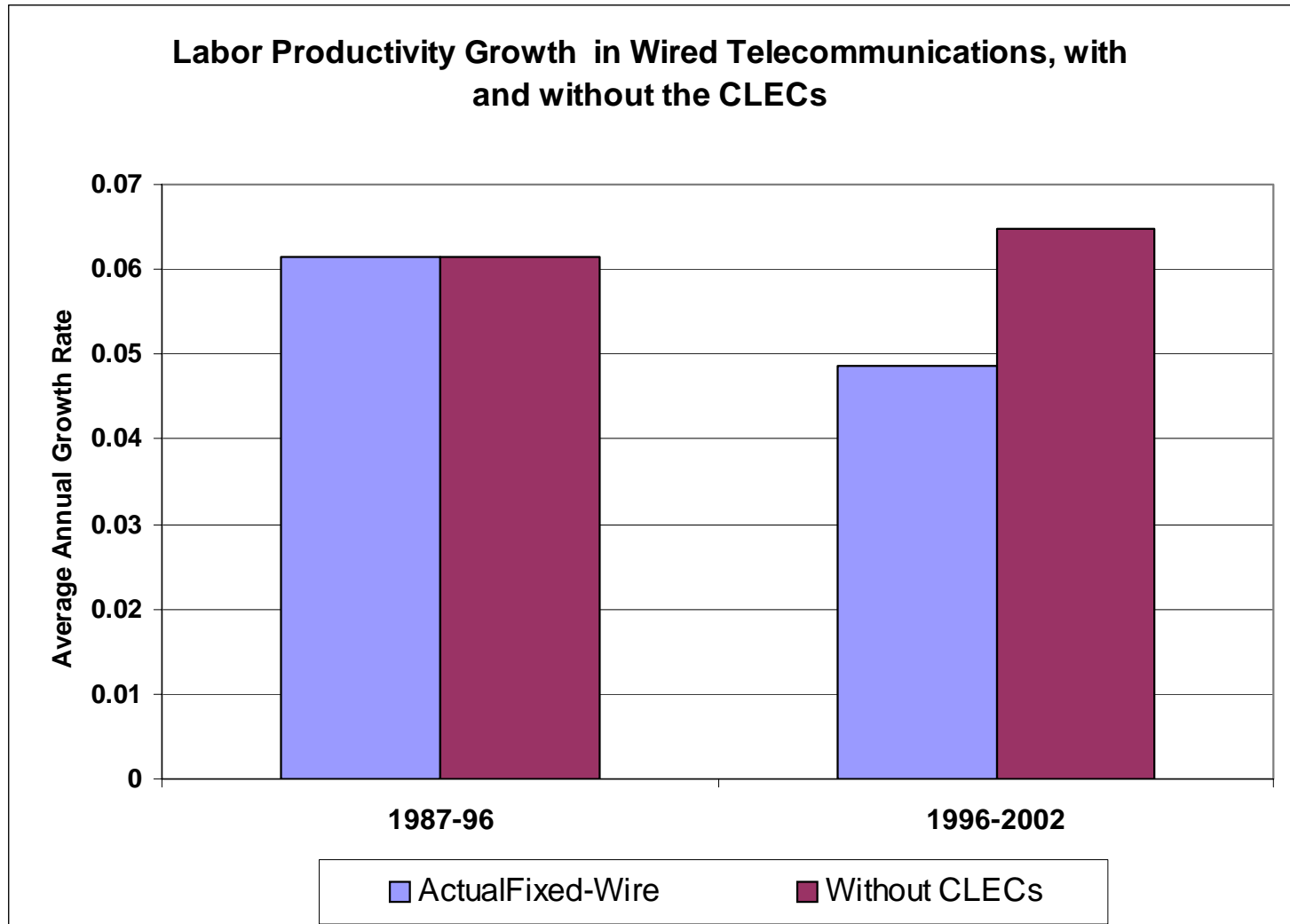
Estimating the Consumer Welfare Gains

- No evidence of innovation by entrants; two-thirds of their lines are simply resold ILEC lines
- Consumers have gained from lower local rates; assume the gain to CLEC subscribers has been 15% of local bill of \$300 per year, or \$45.
- Furthermore, assume that this gain is realized by all 29.6 million CLEC subscribers (including business subscribers) as of 12/31/03.
- Net consumer gain through lower entrants' prices, under these assumptions, is \$1.33 billion per year.
- Reductions in incumbent rates, if they occurred, were likely limited; revenue per line data, shown earlier, suggest a total reduction in local revenues of about \$1.5 billion below trend.

But These Gains Were Achieved at a Huge Cost

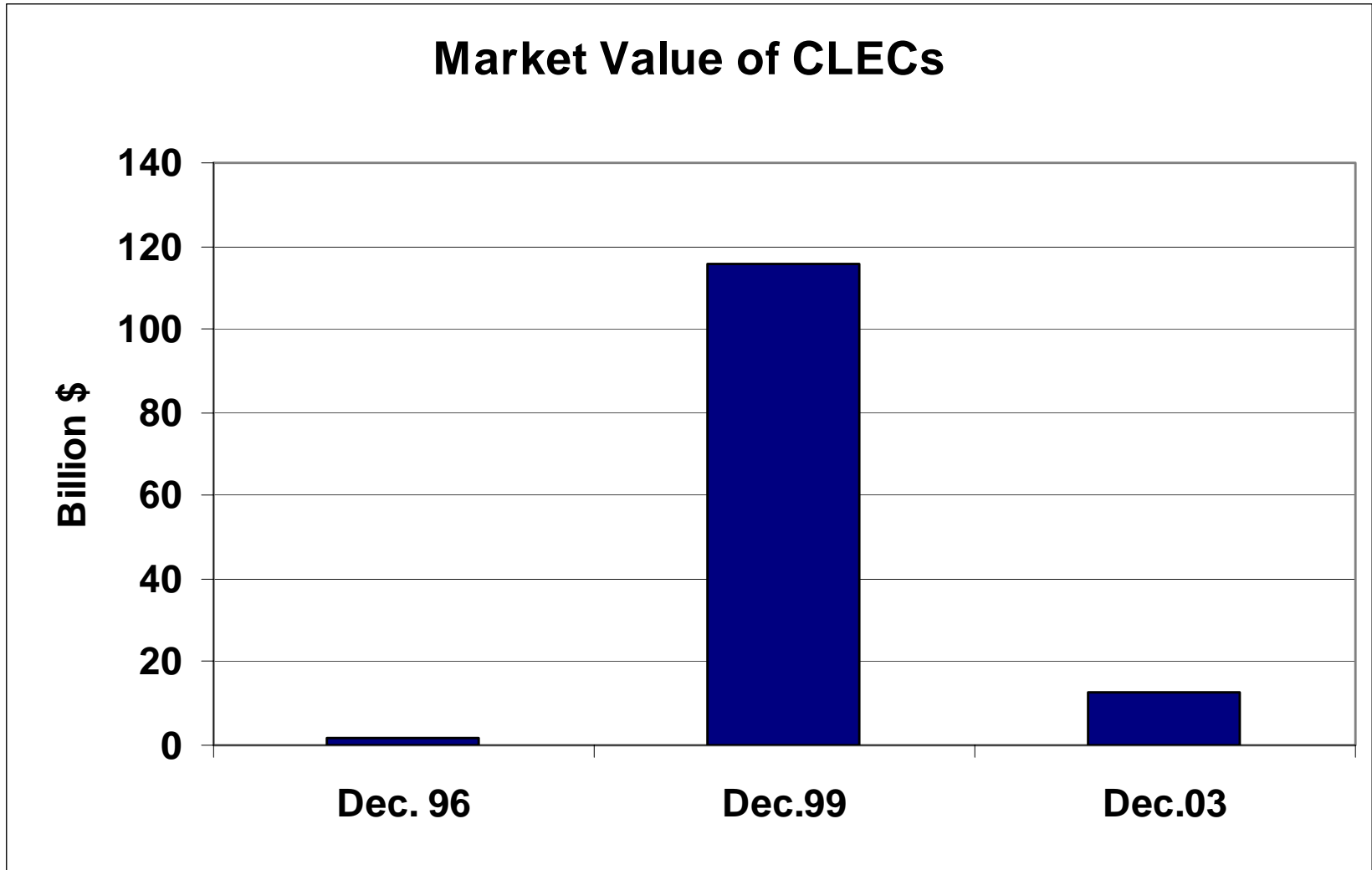
- CLECs invested about \$55 billion *in toto* in capital facilities between 1996 and 2003 [ALTS].
- At a 15% return before taxes, this cap ex requires capital charges of \$8.25 billion per year, assuming an infinite life of assets.
- CLECs' other costs in excess of ILECs' avoided costs must be added to this cost.
- CLECs employed more people per dollar of revenue than ILECs in 2003 despite the fact that they contributed much less in value-added
- These costs reflect losses to the economy unless they are offset by innovative new services or technologies introduced by the entrants

Local Entrants Reduced Industry Productivity

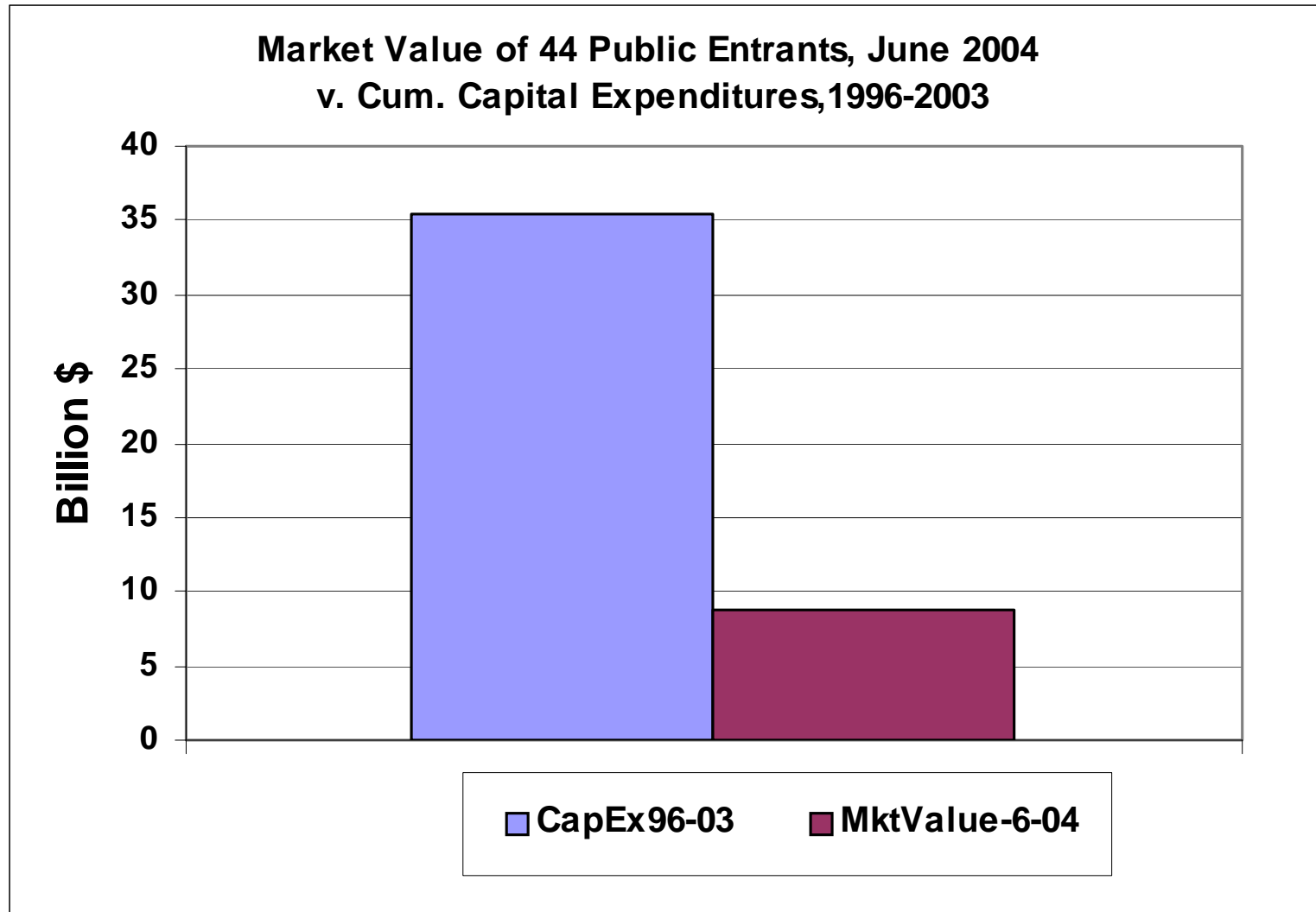


Source: BLS, author's calculation

Of 44 Public CLECs, Only 20 Survive, and Only 7 Have a Market Cap of \$100 Million or More



The 44 Listed Entrants Invested \$4 for Each Dollar of Current Value Left in the Survivors



Source: Company Reports

The Capital Markets Forecast for the Survivors is Very Bleak

- There is little evidence that any of the entrants have a successful business strategy; even UNE-P appears to have been unprofitable for AT&T and others who used it.
- The 20 listed survivors (excluding AT&T and MCI) have a market value of \$1.13 per dollar of 2003 revenues.
- Slow-growth Bell companies have a market value of \$2.73 per dollar of 2003 revenues.
- Therefore, the markets do not view the enormous expenditures by the surviving entrants as “start-up” costs that will be recovered from future growth.

The 1996 Act Also Postponed Long Distance Competition

- Bell Companies did not begin to enter interLATA markets until 2000
- IntraLATA competition was also postponed by the Act
- My results suggest that postponed Bell-Company entry cost consumers about \$20 billion in higher long-distance rates over 1996-2003.

Conclusion

- The 1996 Act's local competition provisions did not create lasting, meaningful local competition
- The consumer benefits from local competition were swamped by the cost of the resources used by the largely-failed CLECs
- The 1996 Act cost consumers dearly by postponing long-distance competition
- Nevertheless, "local" competition is growing through unregulated wireless services and (hopefully, unregulated) VoIP services