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Report: CFA's 'Crossroads' Telecom Study Lacks Objectivity; Fraught with Problems

Misstated Facts, Erroneous Data, Findings on Market Events That Never Occurred Appear to Make Predetermined Conclusions

Washington, D.C., December 9, 2003 -- A new report released today by the Competitive Enterprise Institute (CEI) and the New Millennium Research Council (NMRC) analyzing an October 2003 policy study issued by the Consumer Federation of America (CFA), '*Competition at the Crossroads: Can Public Utility Commissions Save Local Phone Competition?*' finds that the CFA study takes positions and makes claims not supported by empirical evidence and misapplies data to support conclusions. The CFA study paints a picture that competition has failed in the telecom industry, and the industry will re-monopolize and increase consumer prices. The CEI and NMRC report strongly disputes these CFA study claims.

The new CEI and NMRC report, ***Is Phone "Competition at the Crossroads?": An Analysis of the Consumer Federation of America's Local Competition Study,*** is the first to critically review the CFA study and analyze its data and conclusions. Having previously examined the effects of unbundled network elements (UNEs) in the states, the CEI and NMRC undertook this critique to assess the basis of the CFA study claims. Today's report presents the views of two telecommunications experts – **Solveig Singleton**, Senior Policy Analyst for CEI and **Stephen B. Pociask**, President of TeleNomic Research, LLC.

Both authors debunk the CFA study's three main arguments it said were used by the Regional Bell Operating Companies for raising UNE wholesale prices and for restricting the availability of UNEs:

(1) Competition would be stimulated if local incumbents were allowed to enter the long distance market before new market entrants have established access to the existing telephone network;
(2) UNE prices do not adequately reflect costs, and represent a 'subsidy' to competitors; and
(3) Withdrawing access to UNEs will force competitors to make investments in their own facilities and networks.

***With regard to the first CFA assertion,* Stephen Pociask** finds that competition is developing at a robust pace and more regulation is the last thing the industry needs, despite the CFA study's claims. "There are over 153 million wireless subscribers, a number rivaling the total traditional telephone lines provided by the Regional Bell Operating Companies (RBOCs)." Competition is also taking shape in the form of tens of million of high-speed connections from cable operators and other broadband providers, he says. "The Section 271 competitive checklist requires markets to be irreversibly opened first and requires nondiscriminatory access for Competitive Local Exchange Carriers (CLECs) before Independent Local Exchange Carriers (ILECs) can enter that long distance market," says Mr. Pociask. "In all 48 states where Section-271 process could be applied, the ILECs' markets were found to be irreversibly opened."

Rebutting the second CFA claim, Mr. Pociask notes that the CFA study attempts to prove something different than the ILECs supposedly claim. Evidence suggests that UNE prices are set so low that they represent a corporate subsidy for the CLECs paid for by the ILECs, he says. "One study calculated that TELRIC costs (the formula used to price network elements) would need to be marked up 3.3 times in order to recover the ILECs' sunk costs and risks. "In contrast, regulatory commissions estimate that ILECs can shed only 19 percent of their cost when the ILECs' retail customers are replaced by the ILECs' wholesale services," says Mr. Pociask. This divergence between price and cost leads to an absolute decline in cash flow and earnings for ILECs, he notes. "Economists have criticized TELRIC models and their assumptions for years." Still, the CFA study believes that UNE prices are reasonable. The CFA study's evidence is also weak, says Mr. Pociask. "The CFA study shows FCC data on what is supposed to be residential CLEC lines," he says. "What the CFA study does not tell the reader is that the FCC does not publish residential CLEC line data separately – it combines residential and small business lines."

Accepting that error, the CFA study shows only that TELRIC costs are similar to UNE prices, he notes. "Both price and TELRIC costs can be too low and be correlated. Therefore, the CFA study has not provided any evidence to support its conclusions."

With regard to the third CFA assertion, Mr. Pociask notes, the CFA study finds no relationship between current UNE price and UNE use by CLECs, defying even the laws of supply and demand. "To support this claim, the CFA study pairs and plots, for each state, UNE prices (as a percent of residential retail price) against the percent of total UNE lines in use by CLECs, and not the percent of residential UNE lines in use by CLECs. Similarly, the CFA study pairs and plots, for each state, UNE prices (as a percent of business retail price) against the percent of UNE line use by CLECs, and not the percent of business UNE lines in use by CLECs. Therefore, not one of the seventy-eight data points in the CFA study finds the correct point on both the horizontal and vertical axes." The result is a confusing, meaningless scatter plot that the CFA study uses in finding no relationship between UNE discounting and UNE use by CLECs, he says.

Solveig Singleton also points out that for the CFA study's argument on TELRIC prices and costs to have any validity at all, the process for measuring costs at the state level should have some kind of integrity. "In practice, wild fluctuations in rates within some states, gross inconsistencies in rates across similar states, and the bizarre technological concepts cooked up in state regulatory proceedings make it unlikely that these costs measures are worth the paper they are printed on. Certainly, investors are not relying on them."

"The CFA study ignores the lessons of the telecom meltdown; sustainable investment requires stable incentives, not regulatory handholding of one market segment," Ms. Singleton concludes. "It ignores the growth of business competition in local markets from the 1980s, showing that if BOCs do inflate their costs/prices they will be undercut by *facilities-based* competitors." The paper employs a simple-minded definition of competition, ignoring the benefits of competition in building networks and access, she says. Finally, the paper pretends that TELRIC yields an objective measure of costs, as opposed to an artificial construct subject to wild manipulation, she notes.

Ms. Singleton recommends that State regulators should recognize that UNE-P and TELRIC regulations hurt consumers more than they help. "It is time to take the next step towards real competition between real networks. UNE-P and TELRIC itself should be phased out, the latter to be replaced first by a more objective measure of costs. Ultimately, both retail and wholesale prices must be deregulated."

"CEI and NMRC publish this report at a very critical juncture for the telecommunications industry," says NMRC Advisory Board Member **Allen Hepner**. "The Federal Communications Commission's Triennial Review Order provides tight deadlines for states to conduct UNE proceedings and the outcomes will have a tremendous impact on the future of the telecommunications industry."

About CEI and NMRC

The Competitive Enterprise Institute (CEI) (http://www.cei.org) is a non-profit public policy organization dedicated to the principles of free enterprise and limited government. The New Millennium Research Council (NMRC) (http://www.newmillenniumresearch.org) fosters policy research focused on developing workable solutions to the issues facing policymakers, primarily in the fields of telecommunications and technology.

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Editor's Note: A copy of the full report is available on the Web at www.cei.org and at www.newmillenniumresearch.org.