



DEPARTMENT OF JUSTICE

The Section 271 Process: Reflections on The Quest For Local Competition

Address by

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Thank you all for coming here today to take part in this program, as it is a valuable opportunity for all of us to reflect on the opening up of the market for local telephone service, and correlatively, the opportunity for Bell Company entry into in-region long distance services under section 271 of the Telecom Act. It was a little over a year ago that we at the Department of Justice received responses from all interested parties who offered their views about how we should assess applications for in-region long distance entry under section 271. And, going back a little further, it was just fifteen years ago that Bill Baxter, in a profile in political courage, stuck with the United States' antitrust action against AT&T and oversaw a settlement, which, for the first time, made competition the guiding goal in long distance markets.¹ Until that point, the FCC had taken steps to foster competition in long distance markets, but it was not until the AT&T consent decree -- and its divestiture of the Bell Operating Companies from AT&T -- that the industry's market structure was altered to facilitate competitive entry. And with that decree, our nation embarked upon a new journey in telecommunications law and policy that ultimately led to the enactment of the Telecom Act of 1996.

The 1996 Telecom Act did not seek divestiture, say, of the wholesale operations of the local companies from their retail arms, but instead instituted a regulatory regime that would facilitate competition by preempting legal barriers to entry, obligating all carriers to interconnect, and requiring the incumbent local exchange carriers to share their essential facilities with the new entrants. In addition, the Telecom Act contemplated that its market opening measures -- in conjunction with a separate subsidiary requirement -- would break the

¹See United States v. AT&T, 552 F. Supp. 131 (D.D.C. 1982), aff'd, Maryland v. United States, 460 U.S. 1001 (1983).

local bottleneck and pave the way for Bell Company entry into long distance under the process set out in section 271. In so doing, the Telecom Act made clear that our national telecommunications policy called for competition as the guiding force in all telecommunications markets. A bold statement, but, as we all know, one that marked the beginning of a lot of hard work.

Before discussing some of the challenges ahead in bringing competition to the local market and clearing the way for section 271 approvals, I would like to note that, for the first time in our nation's history, there is widespread recognition among all involved -- the state and national agencies, the new entrants, the long distance companies, and yes, at least for the most part, the incumbent local monopolists -- that the future of this industry is competition. This trend towards competition stems from the basic point that more and more, we will see integrated providers of different services, or, as often put in common parlance, "one-stop shopping" for a wide array of telecommunications services, be it local, long distance, Internet access, what have you.² Of course, a local company will be disadvantaged in this regard if it is not in long distance, and likewise, a long distance company will suffer if it is not in the local market. It is this basic premise -- that the long distance and local companies must enter each others' markets in order to provide one-stop shopping -- that will bring the benefits of competition to America's consumers, both in the business and residential sectors. To be sure, the advent of new technologies, such as wireless or cable telephony, also can provide cheaper, higher quality and

²See, e.g., Leonard Kennedy & Christopher Libertelli, *Developments in Local Exchange Competition*, in 15th Annual Institute on Telecommunications Policy and Regulation, at 19 (1997).

different telecommunications options, but those offerings do not appear to be widely available any time soon.

Delivering on the Act's promise of bringing competition to all telecommunications markets is a formidable challenge, especially in light of the promises made by industry while the legislation was under consideration. That being said, I think it is important to recognize just how effective the leaders in the respective agencies -- at the Antitrust Division, at the FCC, and the state commissions -- have been in helping achieve some important progress already. But there is still much work to do, and as all of us recognize, this next year will be critically important as we push ahead to continue the hard work of implementing the Act and start to see increasing signs of what it promises for the future.

Why So Little Residential Competition?

As we approach the Act's second birthday, many are asking -- with greater or lesser degrees of patience -- why we are not seeing more competition for residential consumers. Although there are no simple answers, I believe that there are a few basic reasons for this fact. First, we are still in the midst of reforming our system for providing universal service so that all consumers can continue to enjoy affordable telephone service and not be left behind as competition becomes the driving force in this industry. Second, as has become quite clear, getting the arrangements in place to enable competitors to enter the marketplace takes time and even when they are in place, it still takes time, money, and hard work for competitors to enter. I understand that there are other hurdles as well, such as legal barriers to entry that can stall the development of competition, but, as we don't have all day, let me elaborate on these two.

At the outset, I want to emphasize that although there is a lot of posturing by the affected parties, who may be seeking to position themselves or blame others, we at the Justice Department are focused on the substance of opening up the local market. Put differently, our focus is on the American consumer and in ensuring that Americans can reap the benefits that competitive markets can bring -- lower prices, greater innovation, and enhanced service. In this regard, we agree that Bell entry into long distance will add an important competitor to that market as well as turn up the heat on the long distance companies to compete more vigorously for local customers, but we must first fully and irreversibly open up the local market so that the competitors to the Bell Companies can have a fair shot at winning over local customers; that is what will ultimately maximize the amount of competition in all telecommunications markets. And for those of you who are interested, you can find a detailed explanation of this point in Marius Schwartz's supplemental affidavit filed along with our past two section 271 evaluations.

As the Schwartz affidavit explains, the Department's standard for evaluating section 271 applications does not focus on entry by any particular competitor or any particular market share; nonetheless, Bells have charged that entrants are behaving strategically and withholding from entry when they can to hold them out of long distance. But, if the local market were truly open and the long distance companies were just sitting on the sidelines, we would expect to find the start-up local phone companies -- i.e., the competitors with no base to protect in long distance -- using the Bell's wholesale services and facilities without difficulty. As our filings in the four section 271 applications to date make clear, however, even those competitors have had difficulty getting the necessary wholesale services and facilities from the Bells. And following our standard, if we concluded that a particular local market was fully and irreversibly open, but that

no competitors were entering because of their own business plans, or for strategic reasons in order to game the process, we would support Bell entry into long distance in the interest of maximizing competition.

One important point that is often cited as explaining the lack of interest in competitive entry into the local residential market is that the present rate structure does not encourage new entry. In certain cases, this argument goes, residential rates are actually priced below cost, as they are cross-subsidized from above-cost rates in the business sector. This argument, its advocates point out, explains two phenomena: first, residential customers often will not be profitable to serve; and second, business customers, especially large ones, will be especially profitable. Now, although the cross-subsidization that is presently in place in our regulated system is not quite that simple -- urban rates also support rural ones, for example -- there is something to this point. The Telecom Act, however, has an answer to this dilemma: replace the subsidies presently built into a cross-subsidized and monopolized system with ones that will go to whoever serves the customer -- either the incumbent or its competitors. The FCC and the state commissions are hard at work on this approach and will be forced to make hard choices so that competition can truly become the engine of growth in the future. In some respects, deciding how and when to make the transition to explicit subsidies tests our resolve to bring competition to this industry in the same way that Bill Baxter's commitment to stick with the AT&T lawsuit was tested as he faced critics from every direction, accusing him of overseeing some sort of litigation misadventure.

The most basic reason that we aren't seeing more competition in the residential market is, of course, that the local telephone market has yet to be fully opened in any state in the US and that a local market, even when opened, still takes time, money, and hard work to enter. Some states are closer than others in this regard, but no one has yet set the standard for opening up the local market; or, put in the context of section 271, we have not yet seen an application that we can support. On this point, I want to emphasize that we at the Justice Department believe that it is important to recognize that model once we have an instance in which the standard has been met. Acknowledging a successful market opening effort does not suggest that there is only that one way to go, but it will silence those who question whether the job can be done and provide valuable guidance and inspiration to those Bells seeking to open up their local markets and enter long distance. That reason is why we at the Justice Department are willing to work with the Bell Companies in getting this job done right. We understand that there will be questions along the way and we are ready to answer those questions in advance of an application. While some Bells may wish to litigate those issues where we disagree, we are committed to finding reasonable solutions to the issues raised by the Act and believe that the front door to section 271 authority is open -- it just takes putting the proverbial shoulder to the wheel and sticking with the task. We remain open to offer guidance to any Bell wishing to undertake that effort and will continue to do so as long as there are Bells looking to find the right paths to open their local markets.

The Key Issues To Opening Up The Local Market

After observing the section 271 process in action over the past year, I think it is fair to say that we are getting a handle for what are the most difficult issues in opening up the local market -- and preparing a successful section 271 application. In short, our experience thus far

has highlighted three critical requirements as especially challenging -- (1) getting a pro-competitive pricing structure in place; (2) instituting effective and scalable wholesale support processes that have been "benchmarked" in order to guard against post-entry "backsliding"; and (3) solving the "rebundling" issue. This is not to say that there are not other potential problems, but some problems are easier to resolve than others.

On pricing the necessary wholesale facilities and services, our basic point is that without an appropriate pricing methodology, competitors will be discouraged from entering either because current prices do not allow for efficient entry today or because they are concerned that today's prices will be raised substantially in the future, making entry today a regrettable choice. Accordingly, we believe that our mandate to conduct a competitive assessment of every section 271 application necessitates an inquiry into pricing. This inquiry does not mean that we intend to use section 271 as an opportunity to institute what we think are the "right" prices, but it does mean that we must evaluate both the basic methodology used in a particular state and assess whether that methodology was applied in a reasoned manner. In our filing on the South Carolina application, we explained that the lack of *any* guiding methodology -- let alone a forward-looking one -- would discourage efficient entry; in our filing on the Louisiana application, we commended the Louisiana PSC for its commitment to a forward- looking approach to pricing unbundled network elements, but noted a few areas that diverged from that approach. Specifically, our filing noted that Louisiana's pricing structure did not offer geographically de-averaged prices for unbundled elements or any plan for making such prices available down the road. We understand that the geographical de-averaging of wholesale rates implicates the retail rate structure as well and relates to the need to institute an explicit, competitively neutral

universal service program. Nonetheless, the Telecom Act, as well as sound competition policy, require that these steps be taken.

The second key challenge in opening the local market relates to instituting and "benchmarking" an effective wholesale support process. A basic part of this effort relates to the development of the operations support systems that will enable competitors to switch over and serve those customers presently served by the incumbent. Like the concept of "unbundling" the individual elements of a telephone network, the development of wholesale support systems to assist one's competitors is unprecedented and no easy task. But, like "unbundling," the systems that enable competitors to turn up service for their customers are critical; in California, for example, PacBell failed to process faxed orders in an effective manner and lengthy backlogs of orders resulted, thereby discouraging competitors from entering that market.³ Thus, our evaluation of such systems emphasizes three things: (1) the measurement of wholesale performance before and after entry; (2) the institution of the necessary systems and functionalities that perform at parity with a BOC's own retail systems (or gives a competitor a "meaningful opportunity to compete" if there is no retail counterpart for a particular functionality); and (3) stress testing of those systems, so that we know that they will work as advertised as well as be scalable to foreseeable levels of commercial demand. So far, no one has met all three requirements, but Ameritech did come close, enabling the Commission to chart out a "road map" for a wholesale support system that would meet the checklist standard.

³See MCI v. PacBell, Cal. PUC No. 96-12-026 (Sept. 24, 1997), at 27 (finding that MCI ceased marketing after PacBell built up backlogs of 4,000 to 5,000 orders and that, by PacBell's own admission, it's systems did not offer their competitors resold services at parity).

The final challenge in opening up the market is to facilitate entry through the combining of unbundled elements. So far, we have seen some incumbents devise systems for provisioning individual unbundled elements, but no one has yet demonstrated that they can provide access to unbundled network elements so that they can be combined by entrants in a reasonable and non-discriminatory manner as called for by section 251(c)(3) of the Act. This issue has been complicated, of course, by the ongoing litigation that created some confusion about exactly how to implement this mandate. By default, that confusion has spilled over to the section 271 process, where state commissions, ourselves, and the FCC are forced to determine exactly what section 251(c)(3) requires. In our two recent evaluations of BellSouth's section 271 applications, we explained that a general plan for allowing such re-combining only through collocation was insufficient, especially because BellSouth's proposed solutions raised more questions than they answered. To be sure, this issue has been somewhat of a moving target in the wake of all the litigation that has gone on, but, at this point, at least three things are clear: (1) there is a duty to provide access to unbundled network elements so that they can be combined, even if a competitor wishes to purchase *all* of the individual elements in order to provide telecommunications service; (2) elements must be made available so that they may be combined in a reasonable and non-discriminatory manner; and (3) the exact process by which these elements are to be provided to meet the first two requirements is up for discussion. We at the Justice Department are ready to engage in this discussion and look forward to getting input from the Bells, the state commissions, the competitors, and all concerned so that we can find a solution that will implement the statutory requirement that incumbents provide unbundled elements and allow them to be combined to provide telecommunications services.

In response to our focus on the use of combined elements, some have asked why we think, as we explained in the petition for Supreme Court review of the Eighth Circuit's decision on the Local Competition Order, that combinations of network elements can be one of the Act's most "pro-competitive tools."⁴ In our filing on the Louisiana Section 271 application, we addressed this question, explaining that combining elements in an efficient fashion will be critical to enabling a number of customers -- especially residential customers -- to benefit from some form of facilities-based competition. And while I can't speak one way or the other to the merits of their underlying study, Comptel's recent statements in connection with the ongoing section 271 proceedings in New York made this very point -- that the significance of the recombined "platform" of unbundled network elements is that it provides "a tool for easy entry into the residential market."⁵

Conclusion

I think the experience of the last year in assessing the section 271 applications that have been filed underscores a basic realization about the implementation of the Telecom Act -- opening up the local market is no easy task. The questions involving pricing, wholesale support systems and the combining of network elements are surely some of the most difficult ones raised by the Act and we should realize that we have seen progress on these fronts as well as on the other market opening measures called for by the Act. Based on this and continuing progress, I believe that, within the next year, we should start seeing section 271 applications that deserve to

⁴See Federal Communications Commission and the United States v. Iowa Utilities Bd., No. 97-831, pet. for cert. at 26 (Nov. 17, 1997).

⁵See Communications Daily (Dec. 9, 1997).

be granted -- that is, if some Bells keep their shoulder to the wheel and we, the FCC, and the state commissions provide any necessary guidance. When that day comes, we at the Justice Department will feel a real sense of accomplishment, as it will be a great day for competition. Not only will a deserving application reflect a truly open market in a particular state, it will set the standard for this process and demonstrate that we can -- and must -- use section 271 to maximize competition -- not only to gain another competitor in long distance, but more importantly, to fully and irreversibly open the local market to competition. That's not to say that we will be out of business in a post-section 271 world, but, in all candor, we look forward to a world where the key issue is ensuring reliable, on-going wholesale performance as opposed to facilitating competition in the first place.