Special Access: The Unregulated Monopoly

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March 4, 2009
Special Access: A Brief Regulatory History

- Through the end of 1990, special access governed by “rate-of-return” regulation.
- 1991: the FCC moves large ILECs to price cap regulation.
- 1999: the FCC permitted the BOCs to remove special access services from price cap regulation in areas where the FCC predicted competition.
- 2004: the BOCs have removed the vast majority of their special access offerings from price cap regulation.
- 2005-2008: the FCC permits a series of mergers creating the two largest vertically integrated telecommunications networks in the U.S.
- 2005: the FCC initiates special access rate review proceeding (still pending).
- 2007-2008: the FCC forbears from regulating widening circle of BOC special access services and reporting requirements.
Competition is nearly non-existent
ILECs dominate

Wholesale Interstate Special Access Revenue

<table>
<thead>
<tr>
<th>Year</th>
<th>Others</th>
<th>ILECs</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>$538</td>
<td>$7,492</td>
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<tr>
<td>2001</td>
<td>$811</td>
<td>$10,289</td>
</tr>
<tr>
<td>2002</td>
<td>$199</td>
<td>$10,667</td>
</tr>
<tr>
<td>2003</td>
<td>$443</td>
<td>$10,597</td>
</tr>
<tr>
<td>2004</td>
<td>$664</td>
<td>$10,493</td>
</tr>
<tr>
<td>2005</td>
<td>$933</td>
<td>$10,952</td>
</tr>
<tr>
<td>2006</td>
<td>$997</td>
<td>$11,691</td>
</tr>
</tbody>
</table>
**Overwhelming Market Share: ILECs, already dominant before price flex, have maintained their market share**

Wholesale Special Access Market Share

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>ILEC</td>
<td>92.7%</td>
<td>92.1%</td>
</tr>
<tr>
<td>Other</td>
<td>7.3%</td>
<td>7.9%</td>
</tr>
</tbody>
</table>

Sources: FCC Monitoring Report Table 1.5
Merger Effects

Sprint Nextel 2008 Special Access Spend

Before VZMCI and SBCATT mergers

- AT&T and MCI: 13%
- Other: 10%
- ILEC: 77%

After mergers

- Other: 11%
- ILEC: 89%

…and our biggest alternative suppliers are now controlled by ILECs
Special Access Network Diagram

- **Retail Wireless**
  - VZ and AT&T/BS combined market share: ~60%

- **Tail Circuits**
  - Connect cell-sites to ILEC wire centers
  - Capacity: DS1 (24 simultaneous voice calls)
  - ILEC Market Share: ~95%

- **Interoffice Circuits**
  - Connect wire centers and competitor switches
  - Typical capacities
    - DS3 (672 simultaneous voice calls)
    - OC3 to OC192 (2,016 to 129,024 calls)
  - ILEC Market Share: ~85%

- The largest wireless providers control the circuits their competitors rely on
The Lack of Special Access Alternatives = No Market
Constraints on ILEC Special Access Services

- The FCC lifted regulation of most special access rates in 1999 in anticipation of a competitive special access market.
- This predicted competition has NOT developed.
- Furthermore, the current environment provides strong incentives for the new AT&T and Verizon to charge excessive rates for special access services.
  - ILECs are the largest providers of both special access and retail wireless and long-distance services
  - Strong Incentive to Charge High Costs for Special Access Services
    - Internal Accounting Cost for ILEC
    - Actual Cost for Competitors
The lack of competitive market constraints allows the Bells to post increasingly excessive profits

Special Access - Interstate Rate of Return

<table>
<thead>
<tr>
<th>Year</th>
<th>AT&amp;T</th>
<th>Verizon</th>
<th>Qwest</th>
<th>FCC prescribed</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>40.18%</td>
<td>11.49%</td>
<td>38.14%</td>
<td>11.25%</td>
</tr>
<tr>
<td>2001</td>
<td>56.20%</td>
<td>18.29%</td>
<td>44.70%</td>
<td>11.25%</td>
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<tr>
<td>2002</td>
<td>54.27%</td>
<td>20.79%</td>
<td>57.74%</td>
<td>11.25%</td>
</tr>
<tr>
<td>2003</td>
<td>63.49%</td>
<td>19.47%</td>
<td>65.84%</td>
<td>11.25%</td>
</tr>
<tr>
<td>2004</td>
<td>76.45%</td>
<td>28.43%</td>
<td>75.09%</td>
<td>11.25%</td>
</tr>
<tr>
<td>2005</td>
<td>94.48%</td>
<td>37.48%</td>
<td>109.42%</td>
<td>11.25%</td>
</tr>
<tr>
<td>2006</td>
<td>99.92%</td>
<td>47.73%</td>
<td>132.21%</td>
<td>11.25%</td>
</tr>
<tr>
<td>2007</td>
<td>137.59%</td>
<td>59.07%</td>
<td>175.38%</td>
<td>11.25%</td>
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</table>

Source: FCC Report 43-01, Table I Cost and Revenue, Column (s) Special Access, Row 1915 Net Return divided by Row 1910 Average Net Investment
The lack of competitive market constraints allows the Bells to post increasingly excessive profits.
GAO Finds Limited Special Access Competition in 16 Major Metropolitan Areas (November 2006)

- Independent study concluded that facilities-based competitive alternatives for dedicated access in 16 MSAs “are not widely available.”
- GAO also concluded that in areas granted price flexibility (presumptively competitive), BOCs’ dedicated access list prices tend to be higher or same as prices in areas still under FCC price regulation.
- Recommended that FCC better define effective competition, and consider additional data to measure and monitor competition.
**NARUC NRRI Study (January 2009)**

- Unbiased, independent collection of data
- Analysis of special access markets on many different levels
  - Capacity: DS-1, DS-3
  - Circuit Type: Channel Termination; Transport
  - Prices reported by buyers and sellers
  - Traditional market concentration: HHI
  - Contestable market theory: new entrants generally only operating on fringes
  - Rates of Return; adjusted to account for separations issues
- Claims of lack of data are disingenuous
  - No seller data provided by AT&T and Qwest
  - No buyer data provided by AT&T Wireless and Verizon Wireless
- Robust data collection provides ample evidence to make solid conclusions and recommendations
NRRI Conclusions

- **ILECs have dominant market power for channel terminations**
  - “We do conclude that ILECs still have strong market power in most geographic areas, particularly for channel terminations and particularly for DS-1 services.” Study, p. 84.
  - In the areas surrounding downtown areas, “which can be by far the majority of an MSA, the weight of the evidence says that ILECs retain strong market power, particularly for channel terminations.” Id.

- **Terms and Conditions in special access contracts unreasonably cements market power of incumbents**
  - High rack rates cause buyers to accept restrictive t’s and c’s to get discounts
  - Overly penal t’s and c’s
    - Commitments based on buyer’s current purchases
    - Over purchase penalties are counter-intuitive; large under purchase penalties are too harsh
    - Discounts based on limiting purchase of UNEs.

- **FCC Collocation Criteria for deregulating special access is invalid**
  - Found almost no evidence that competition in channel termination markets is related to the deregulation methodology of the FCC that relies on measuring central office collocations. Study, p. 86.
  - New technologies to date of minimal effect on behavior of existing special access markets
Why the Special Access Monopoly Must be Addressed

Artificially Inflated Special Access Prices Increase Competitor Costs, Reduce Infrastructure Investments and Harm Consumers

- Consumers would benefit from reduced special access costs.
- Infrastructure improvements = greater service options and coverage.
- Faster deployment of wireless Internet broadband services (i.e., WiMax).
- True competition benefits consumers.
- Forcing one competitor (Sprint) to finance another competitor (BOC) distorts competition in the marketplace.
FCC Action Is Long Overdue

- **Special access rate reform**
  - Reset rates to just and reasonable levels
  - Non-competitive services brought back under price cap regulation
  - Apply productivity factor
- **Identify and forbid anti-competitive terms and conditions**
  - Address unreasonable restrictions in Ts and Cs
- **Adopt realistic price flexibility triggers**
Special Access and the Myth of Competition

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The Special Access Problem

- Who is “we”?
  - Enterprise customers, not carriers or competitors
  - Ad Hoc Telecommunications Users Committee
    - 21 corporate users including 9 of the Fortune 100, 19 of the Fortune 500
    - No carrier members, no carrier money
  - We are vigorous advocates of de-regulation for competitive markets
  - We support regulation for non-competitive markets
The Special Access Problem

- Why do enterprise customers care about special access?
  - It’s how we say “broadband”
  - It’s what we buy most often
  - It’s what our networks run on
  - Prices – the 40% rule
The Special Access Problem

So what’s our problem?

1. **Competition**: There isn’t any, for 96% of our locations.
   - Cable service? Only in residential neighborhoods.
   - CLECs? Build arteries, buy capillaries

2. **Regulation**: There isn’t any, where it’s needed.
   - “Pricing flexibility,” not incentive rules (“price caps”)
   - Predictions, not reality, from before the bubble burst
And this little problem...

BOC Rates of Return on special access, 2007

<table>
<thead>
<tr>
<th>Company</th>
<th>Rate of Return</th>
</tr>
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<tbody>
<tr>
<td>&quot;New&quot; at&amp;t</td>
<td>138%</td>
</tr>
<tr>
<td>Qwest</td>
<td>175%</td>
</tr>
<tr>
<td>Verizon</td>
<td>62%</td>
</tr>
<tr>
<td>BOC Average</td>
<td>101%</td>
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FCC Authorized ROR: 11.25%
It’s actually bigger than that

- Special access + information economy = massive ripple effects
  - Macro-economic impact of supra-competitive prices for critical inputs
  - Deadweight loss, decreased consumer and producer surplus
  - Job losses, GDP suppression
What enterprise customers have been doing about it

- Nag, nag, nag
  - Performance Standards Rulemaking – Jan ’02
  - Broadband Regulation Rulemaking – Mar ‘02
  - Broadband Wireline Internet Access Rulemaking – Jul ‘02
  - AT&T Special Access Rulemaking Petition – Dec ‘02
  - ILEC Separate Affiliate Rulemaking – Jun ‘03
  - AT&T Mandamus Petition before D.C. Circuit – Jun ‘04
  - SBC-AT&T/VZ-MCI Merger Proceedings – May ‘05
  - Special Access Rulemaking – Jun ’05, Aug ’07
  - Verizon Broadband Forbearance Petition – Mar ’06
  - “Me too” petitions – Jun ’06 to date
  - ARMIS, cost allocation petitions – Jan ’07 to date
What the FCC has been doing about it
Two Key Events Now Pending

- Appeal of “me too” forbearance petitions
  - AT&T, Qwest, Embarq, Frontier
  - Everything but TDM DS1/DS3s
  - Special access – a single nation-wide market
  - Hope v. flying piggies

- ARMIS/Cost Allocation Forbearance Petitions
  - Because price-gouging isn’t a problem if you hide the data
  - FCC order: compliance plans instead of rules
  - Application for review of Bureau order