Bringing Competition to Local Telephony: The Department of Justice's Perspective

Statement by

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Good morning, Mr. Chairman and members of the Subcommittee. It is a pleasure for me to appear before you today on behalf of the Antitrust Division of the Department of Justice. We are grateful for your support and interest in our work, particularly on the important progress that we have made in bringing competition to the telecommunications industry and in implementing the Telecommunications Act of 1996. I know that many people have focused -- quite understandably -- on the fact that the Act has yet to produce the amount of competition that we would all like to see. We at the Justice Department continue to believe, however, that the Act provides a workable framework that will bring competition to the local market and eventually benefit America's consumers.

As we at the Justice Department, as well as the members of this Subcommittee, well remember, there were lots of critics after the second anniversary of the AT&T divestiture as well, but that experience, like the current one, required hard work before consumers benefitted from a major industry restructuring. So, while most of what people are hearing and seeing is a lot of fighting and complaining, I would like to focus on the real progress now taking place on the ground as well as where I see the local market-opening process going from here.

Before I get into where we are now, I would like to start by going back to the history of bringing competition to long distance. After all, it was that history that helped to establish the Department's role in this current industry restructuring as well as the basic principle that competition, not regulation, should be the driving force of the telecommunications industry in the future. In addition, looking back can help give us all some perspective as we look forward to what lies ahead.

Some Historical Perspective

After Assistant Attorney General Baxter stuck with the AT&T lawsuit under tremendous pressure, and Judge Greene entered the Modified Final Judgment ordering divestiture of the Bell Operating Companies in 1982, there was considerable criticism of the break-up of the old Bell System as the long distance market underwent the painful transition from being part of a regulated system to a competitive market. In 1985, for example, three years after the decision to break-up AT&T was announced, 64% of Americans thought it was a bad idea, 25% a good idea and 11% were unsure.[1] To recollect some of the criticisms leveled at divestiture, let me read a paragraph from a book published in 1986:

> It may yet be, as liberal and conservative deregulation enthusiasts continue to insist, that the long-run benefits of phone industry competition, such as lower long-distance prices and the faster introduction of technological innovation, will quell consumers' anger and that the currently profound confusion will dissipate as the industry begins to stabilize. But long-distance prices have yet to drop significantly amid tepid competition, and besides, well over half of long-distance revenues are generated by businesses, not residential consumers. And while confusion may tend to dissolve with time, the quality of service cannot and will never be restored to what it was during the now fondly-remembered days of matriarchal Ma Bell's reign.[2]

I think that it is fair to say that history has proved that Ma Bell's regulated monopoly for all telecommunications products and services is no longer missed, as few people today fondly look back and wish they had higher long distance prices, lower-quality service, monthly bills to lease a paltry selection of telephones, and no choice for a long distance provider -- let alone no opportunity to earn frequent flier miles with their phone usage. The same commentator who predicted that Ma Bell would be missed also went on to state that "AT&T will find itself alone in

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[1]Steven Coll, The Deal of The Century: The Breakup of AT&T 367 (1986).

[2]Id.

the basic long-distance market by the end of the century"[3] and that "there are few in the telecommunications industry who doubt that [MCI's] day of reckoning is rapidly approaching."[4] Well, MCI is now valued, at least according to Worldcom, at over $37 billion and AT&T is fighting to keep its shrinking market share. So, despite the criticism in the early years, Assistant Attorney General Baxter's fervent belief that competition would benefit consumers of long distance telecommunications services has been proven right. And the hard work that we at the Justice Department and elsewhere contributed to ensuring that the AT&T consent decree worked to benefit American consumers has been well worth it.

Local Competition Taking Root

True to our roots in the AT&T case, the Justice Department's perspective on the present market opening process is that this process is necessary, inevitable, and will eventually benefit consumers, but that it will first require a lot of hard work. Competition was already coming to the local market and, as a result of the initial market-opening efforts at the state level, there was increasing evidence that new technologies made competition possible, if not inevitable. And bringing competition to the local market also promised to benefit consumers. Indeed, once a local market is opened, it will be beneficial to allow the local Bell Company to enter into the long distance market in that state and to bring another important competitor to that market. And that is exactly what the Telecom Act called for. But the Telecom Act also clearly set forth the important principle that the local market must first be opened before the Bell Company is allowed into long distance, lest the Bell not have the incentive to open its market and, as a

[3]Id. at 370.

[4]Id. at 371.

consequence, be the only company able to offer a bundled package of local and long distance services.

In the midst of all of the litigation designed to find a judicial short-cut to complying with the Act, there has been an insufficient appreciation of just how much is happening on the ground. As part of our consultative role under Section 271 of the Act, the Department has pressed for an appropriately tough standard before a Bell can get into long distance and I believe that the Bells are finally getting the message that Section 271 compliance is demanding, but doable. Although a collaborative approach to Section 271 is now being talked about more publicly, the Department has from the beginning taken a very open door policy towards consumer groups, local competitors, state PUCs, the FCC, and the Bells in discussing what we expect from a fully and irreversibly opened local market. We have also laid out our basic standard in filings, speeches, and numerous meetings, so there should be no mystery to this process. And from our experience, we believe that a pro-active engagement in advance of an application will enable the Bells to present stronger Section 271 applications, even if we end up disagreeing about certain issues at the end of the day.

The collaborative nature of the Section 271 process means that, for all involved, there is an important and ongoing role beyond just commenting on applications. From the DOJ perspective, I can tell you that this means we are working not just with Bell Companies, but state commissions, consumer groups, local competitors and any others that are interested in contributing to this market-opening process. Of course, even if a Bell and other interested parties are willing to work with us to determine if the Bell has complied with Section 271's requirements before it files an application, the details of the application still need to and will be

tested through the pre-FCC filing processes held by the state commissions and again at the FCC. Although no state process to date has resulted in ensuring an open market, we are encouraged that the states are taking the Section 271 market opening process as seriously as we do. Two significant efforts that have been underway to date are our collaborative work with the New York Public Service Commission and the Texas Public Utility Commission, both of which have brought considerable expertise to this effort as well as a fervent commitment to open their local markets to competition. As I have said before, this process is not for sprinters, but we are heading down the road towards an open market, and I still believe that this Act can be a great success story, though this success will not happen overnight.

After two years of implementing the Act, it has become increasingly clear what are the most difficult aspects of the market-opening process, and in the case of the Bells, the requirements for entering long distance. In our view, four issues have emerged as particularly challenging: (1) the institution of reliable wholesale support systems to switch customers from the incumbent monopolist to the new entrants; (2) the development of a procompetitive pricing structure; (3) the implementation of a system for performance measurement, reporting requirements, and an approach for guarding against backsliding on prior performance; and (4) the development of a system for ensuring that entrants can serve customers through combinations of unbundled elements. Addressing each of these issues is essential and we are committed to ensuring that these issues -- as well as the other important issues to bringing competition to the local market -- are addressed before we will support an application for long distance entry. Getting these issues solved right is exactly what our collaborative work with the Texas and New York Commissions, as well as with others, has been designed to do.

Encouraging Signs Of What Lies Ahead

The fact that the market is being opened -- albeit more quickly in some places than in others -- seems clear from the fact that entrepreneurs are seizing the opportunity to enter a $100 billion market heretofore closed to competition. Those entrants come in a variety of shapes and sizes and with different business strategies, but the incredible amount of money that is being raised and put into the local telephone business to compete with the local incumbents ultimately will bring consumers the benefits of competition -- lower prices, greater choices, and more innovative and higher quality service offerings. I know that all of us would like to see more competition today, but if one looks closely, and remembers the lesson of the AT&T break-up, I think it is fairly clear that the benefits of bringing competition to a long-monopolized market are real and will come in time.

There are numerous reasons why bringing competition to consumers is going to take time -- the resistance of incumbents to opening their markets, the uncertainty of the relevant local competition rules, the technical difficulty of putting new arrangements in place, the need to reform our system for ensuring affordable universal service so that all customers can enjoy the benefits of competition, and the time necessary to develop new technologies. We are making progress on all of these fronts and, although small at first, I think there are already signs that the Act's vision of competition as the future for the telecommunications industry is fundamentally sound.

The first sign that this Act has set the forces of competition in motion is that investors are lining up to bet on the alternative providers preparing to enter the local market and that these providers are already making headway in putting new facilities into the ground and developing

new technologies to provide telecommunications services. According to a report that detailed the progress made in 1996, competitive local exchange carriers had invested in over forty-seven thousand miles of fiber optic cable that are served by 139 switches.[5] As of a year ago, this report explained that alternative providers were serving almost twenty-four thousand buildings directly. In 1997, the eight largest alternative facilities-based local competitors alone have invested over $1.1 billion into their network, so we can expect increasing future growth of these alternative networks. And Wall Street is betting big that these alternative local providers will succeed; for example, NEXTLINK, a local provider that recently issued an initial public offering of stock, is now valued at over 1.4 billion dollars. Now Wall Street is not always right, and the cost of capital is relatively cheap these days, but the capital markets suggest that the opportunity to serve customers who never before had a choice for local telephone service is a good one that is attracting investors and entrepreneurs to take advantage of an unfolding new world.

Admittedly, the excitement over the new companies springing up has not yet made its way to most residential customers. At the time of the Act's passage, people knew that the new companies that would be just getting up and running would not go immediately into the residential market, but the cable companies suggested that they were ready to be the "second wire" into the home and that they would quickly offer residential customers a choice for local telephone service. That was unrealistic. The fact remains, however, that cable companies are still important potential competitors to the incumbent local telephone carriers and, especially as high speed Internet access becomes another service that they can offer, many residential consumers may yet have the choice of a cable company as a local telephone provider.

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[5]Annual Report on Local Telecommunications Competition, Connecticut Research, Inc. and New Paradigm Resources Group (1997).

The cable companies are well positioned to enter the local market because they are already serving the mass market and, if they can get the technology right, will be able to offer a package of local, long distance, cable, high-speed Internet access, voice mail, paging, and all the telecommunications services that you can imagine. In so doing, they can save on marketing costs -- after all, joint marketing can save them a bundle -- and be able to cut the margins on the individual offerings if a customer chooses them for more than one service.

Although it has taken two years, there are now encouraging signs that the business case for cable entry can be made. Media One, set to be spun off US West, is entering the local telephone market in Atlanta using hybrid fiber optic/coaxial cable, or HFC, technology. This approach enables them to bring a new broadband network into people's homes and, in many cases, to offer a better deal than the incumbent. Media One, for example, is presently offering consumers in Atlanta a basic service plan with caller ID, call waiting, call forwarding, and speed dialing for $24.75/month, which is $7/month less than BellSouth's price. And for those who wish to get two lines, one with the entire array of features, Media One sells that for $36 dollars, which is $14 less than what BellSouth charges. Media One is not the only cable company giving it a go in the local market -- both Cablevision, in New York, and Cox Cable, in California, are rolling out similar offerings. And, from what I understand, electric companies are also starting to get into the act, with Pepco, our local company here in D.C., taking the lead by announcing its plans to offer a high-speed fiber optic network that will provide cable, phone, and Internet access to its customers in Washington, D.C., and Boston Edison working with RCN, a new start-up phone company, to bring local telephone competition to Boston.

In short, the Act's ability to bring the consumer benefits that were promised rests on two fundamental market forces: (1) the development of new technologies, such as HFC or wireless, or more efficient uses of existing technology to provide an alternative to the existing wireline network; and (2) the ability of providers to offer packages of services to customers. Obviously, cable or electric company entry can involve both, but the Act's greatest promise for competition rests with the impending battle between the local and the long distance companies. Before the Act, consumers lived in a world of two separate bills, the long distance market with choices between providers, and the local market with a monopoly provider. The Act put an end to these artificial boundaries and created an environment in which consumers would be able to subscribe to a single provider who could offer both local and long distance.

Although the emergence of a choice for local service has been slower than we all would like, the fundamental logic of the Act is that once the local market is opened, the Bells will be able to compete in both markets and that, if a long distance company wants to have a shot at matching the bundled offering of local and long distance, it will need to be in both markets as well. The key here is that the local market must be opened first so that the long distance companies have a chance at providing local service as well as long distance. Of course, if the local market is irreversibly opened, but the long distance companies have not entered -- for whatever reason -- then the Act properly contemplates that the Bell Companies should be allowed into long distance, both to give consumers the benefit of at least one provider who can offer one-stop shopping as well as to pressure the long distance companies to enter the local market in order to match the one-stop shopping options offered by the local Bell.

From Here To There

The obvious question that many are asking is that if consumers have yet to see many competitive options, how can we be confident that the Act's fundamental framework is sound. I hope that my explanation thus far has been convincing, but I believe that the success of the Act also rests on another set of market forces already taking root.

In explaining how local markets will be opened, a lot of people have focused on the carrots and sticks of the regulatory process, but as importantly, I believe, there are significant market developments at work that, in tandem with these regulatory processes, will ensure that the Bell Companies will fully and irreversibly open their markets to competition. At present, new entrants into the local market are quite rationally going after the most profitable customers — namely, large business customers in urban areas — while not seeking to serve other customers that are unprofitable or at least far less profitable — for example, residential customers living in rural areas. Eventually, after universal service reform is completed, the universal service support now built into the current regulated system will be made available to all competitors, thereby making it profitable for competitors to serve a larger customer base. But, in the meantime, competitors have focused their efforts where the money is — on the large, urban business customers who can be served profitably over a competitor's own facilities or through a local loop unbundled from the incumbent's network. Even with an incumbent's less than vigorous efforts to open its market, many of these customers are already reachable by competitors and will continue to leave the incumbent Bell for the one-stop shopping, lower prices, and other benefits offered by competitors.

In time, the continuing loss of profitable customers will take its toll and force the Bells who are not doing so already to take the long, hard road necessary to open their markets in order to get into long distance. Once they do so, their competitors will be given a fair shot at winning the accounts of all customers and both the local and long distance companies can have at it in a fair fight. Of course, merely opening its local market at the time of long distance entry is not sufficient to ensure that the fight between the local and long distance companies will be a fair one; it is also essential that mechanisms be put in place to keep the market open to competition.

In developing our competitive standard for assessing Section 271 applications, we paid considerable attention to the question of how to ensure that the local market remains open. Accordingly, we have set forth an approach for performance measurement, reporting requirements, and post-entry remedies — regulatory, contractual, and antitrust — to guard against any "backsliding" on wholesale performance. Ordinarily, of course, we would not expect companies to assist competitors in taking away their customers. Thus, we believe that a successful Section 271 application must be premised on a system to measure wholesale performance effectively and to guard against any future deterioration in performance. A number of states have begun to set up such mechanisms, including provisions for liquidated damages, and we encourage more to do so. And the Act also contemplates that the FCC will play a role in this post-entry oversight process as well, as Section 271(d)(6) makes it quite clear that backsliding on the conditions necessary to gain Section 271 authority may warrant the severe punishment of being pulled out of long distance or, for less severe offenses, lesser penalties such as fines or restrictions on future long distance marketing authority. We view this aspect of

Section 271 as very significant and will not hesitate to urge the FCC to rely on it if post-entry developments so warrant.

One important question that many may ask, and that I have been asked before, is what to do about those companies not subject to Section 271 or those that are subject to Section 271 and just don't care about getting into long distance. Put simply, the Act's market opening requirements are not options; they are mandatory. And once we establish a strong track record about what it means to fully and irreversibly open a local market, we will be in an even better position to insist that all companies comply with these standards. State regulators are increasingly considering their options for forcing companies to comply with the Act and we at the Justice Department are well aware that Section 2 of the Sherman Act remains in effect to address exclusionary practices.

Closing Thoughts

Before I conclude, I want to point out a couple of aspects of this market-opening process that will help make this Act a success for residential customers. One important development will be that once the arrangements for getting into the local telephone market are in place — be it collocation arrangements, the unbundling of local loops, the wholesale support systems for switching customers, what have you — it will become far easier and cheaper for companies now focusing on business customers to move on to serve residential customers. Indeed, this is exactly how competition developed in the long distance market and there is reason to believe that the same will be true for the local market.

Secondly, as consumers become more conscious of the opportunity to take advantage of competitive offerings, they will play an important role in encouraging and facilitating

competition. Not only will consumers increasingly learn to shop around for local service opportunities, but individual buildings will begin to create opportunities by helping to create new options. More and more, communities of interest, such as co-ops or neighborhood developments, will be able to take advantage of competitive options for telecommunications services in new and ingenious ways, like aggregating their telephone traffic and offering it to the lowest bidder. We have yet to see many such efforts, but I predict that we will increasingly see these types of innovations in the future.

As we at the Justice Department well remember, the road to competition in long distance was a difficult one and, during those early years of developing systems to support competition and to ensure equal access to the local bottleneck, there was not a lot to cheer about. We got through that transition because people believed that there were no shortcuts and that the hard work would pay off. As a result of those efforts to open up the long distance market, competitors have increasingly entered that market and prices have fallen dramatically -- on average, consumers now pay 60% less, adjusted for inflation, than they did when AT&T was broken up in 1984.[6] And AT&T has been forced to compete for its customers, losing over forty percent of its market share since 1980, and is now offering many consumers a-dime-a-minute long distance phone calls.

When Congress passed the Telecommunications Act two years ago, it did so because it believed that competition in all telecommunications markets would strengthen our economy and ensure that American consumers benefitted from increased choice, enhanced offerings, and better prices. We at the Department believe that Congress made the right choice in enacting the

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[6]B. Douglas Bernheim and Robert D. Willig, The Scope of Competition in Telecommunications 68 (1996).

Telecom Act. We look forward to working with you to ensure that the framework set out in the Act is implemented properly and that consumers receive the benefits of competitive telecommunications markets. I assure you that the Department is very much committed to this goal and is working vigorously to make it happen.