

# Article

## Is Structural Separation of Incumbent Local Exchange Carriers Necessary for Competition?

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*Although competitive local exchange carriers (CLECs) collectively have gained considerable market share since the passage of the Telecommunications Act of 1996, many entrants into local telecommunications have stumbled or failed. Some argue that competitive local telephony will eventuate only if the incumbent local exchange carriers (ILECs) place their wholesale and retail operations in structurally separate subsidiaries. By mid-2001, several states had begun proceedings on mandatory structural separation, and influential members of Congress had introduced legislation mandating structural separation. We show that the most plausible explanation of recent CLEC failures has nothing to do with anticompetitive behavior. We analyze, and reject as unpersuasive, the putative benefits of mandatory structural separation. Such regulatory intervention is unnecessary to prevent discrimination against unaffiliated retailers of telecommunications services. Nor would mandatory structural separation lower wholesale discounts or increase the CLECs' market share. Plausible hypotheses for the CLECs' problems do not require the assumption of anticompetitive behavior by the ILECs. Apart from producing no discernable benefits to consumers, mandatory structural separation would entail a substantial social cost in terms of forgone coordination of investment and production and forgone economies of scope. Moreover, mandatory structural separation would harm consumer welfare and reduce resources for investment by facilitating an anticompetitive strategy by the ILECs' largest rivals, such as AT&T and WorldCom, to raise the ILECs' costs of providing local telecommunications services. Policy makers should reject proposals for mandatory structural separation of the ILECs.*

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## I. INTRODUCTION

When Congress passed the Telecommunications Act of 1996, it said that the legislation’s purpose was to “promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.”<sup>1</sup> Half a decade has now passed. The vision held by some of a radically different market structure for local telecommunications has thus far failed to materialize. Collectively, competitive local exchange carriers (CLECs) are gaining market share and accounted for 8.5 percent of access lines in the United States as of December 31, 2000.<sup>2</sup> The New York Public Service Commission has reported that as of December 31, 2000 CLECs supplied 2.9 million lines in that state, for a market share of 20.9 percent.<sup>3</sup> For the first time, more CLEC lines (52 percent) served residences than businesses (48 percent) in New York.<sup>4</sup> Still, many entrants into the market for telecommunications have gone bankrupt or lost a substantial fraction of their market capitalization, and many telecommunications carriers now face substantial debt burdens.<sup>5</sup> Between the fourth quarter of 1999 and the

1. Telecommunications Act of 1996, Pub. L. No. 104-104, preamble, 110 Stat. 56, 56.

2. Federal Communications Commission Releases Latest Data on Local Telephone Competition, FCC News Release, May 21, 2001, at 1.

3. NEW YORK PUBLIC SERVICE COMMISSION, ANALYSIS OF LOCAL EXCHANGE SERVICE COMPETITION IN NEW YORK 3 (Aug. 2001).

4. *Id.* at 4.

5. *Drowning in glass: The fibre-optic glut: Can you have too much of a good thing? The history of technology says not, but that was before the fibre-optic bubble*, THE ECONOMIST, Mar. 24, 2001 at \*1 (documenting ratio of debt to market capitalization); Gregory Zuckerman & Deborah Soloman, *Telecom Debt Debacle Could Lead to Losses of Historic Proportions*, WALL ST. J., May 11, 2001, at A1. Manufacturers of telecommunications equipment have suffered

third quarter of 2001, at least twelve publicly traded CLECs experienced negative growth in earnings, and many filed for Chapter 11 bankruptcy protection, including WinStar, Northpoint, ICG, and Covad.<sup>6</sup>

The competing explanations for the difficulties encountered by many CLECs are numerous. In particular, however, some argue that the current regulatory strategy (or the current path of “managed competition” adopted in lieu of true deregulation) is not enough and that competitive local telephony will eventuate only if regulators require the incumbent local exchange carriers (ILECs) to place their wholesale and retail operations in structurally separate subsidiaries. In February 2001, the chairman of AT&T, Michael C. Armstrong, publicly advocated such intervention by state or federal regulators or by Congress.<sup>7</sup> By the summer of 2001, regulators in Pennsylvania, New Jersey, and Florida had considered or begun proceedings on the subject,<sup>8</sup> and Senator Ernest F. Hollings, chairman of the Senate Commerce Committee, had introduced the “Telecommunications Competition Enforcement Act of 2001,” a bill that would mandate structural separation of the ILECs.<sup>9</sup>

In Part II of this article, we suggest that faulty business strategies are to blame for many of CLEC failures. Our hypothesis is consistent with empirical evidence that, despite the massive shakeout in the telecommunications sector, some CLECs have actually prospered. Next, we provide anecdotal and empirical evidence that supports our hypothesis. In particular, we review the business strategies of several CLECs and then correlate those strategies with success or failure. Entrants that deliberately built their own networks, carefully analyzing competition and consumer demand prior to entry, were able to increase revenues and continue to attract capital. An overly generous unbundling regime, which rewards CLECs for deferring investment, might be at the root of the CLECs’ problems.

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similar losses in market value. Two of the largest suppliers, Alcatel and Lucent, explored plans to merge in May 2001 due to the downturn in demand for telecommunications equipment, but they ultimately rejected a merger. See Nikhil Deogun, Dennis K. Berman & Kevin Delaney, *Alcatel Nears Deal to Acquire Lucent For About \$23.5 Billion in Stock*, WALL ST. J., May 29, 2001, at \*1; Greg Schneider & William Drozdiak, *Lucent Merger Talks Collapse*, WASH. POST, May 30, 2001, at E1.

6. GST TELECOMMUNICATIONS INC., 1999 SEC FORM 10-K (Mar. 29, 2000); Yuki Noguchi, *Riding Up to the Challenge; 4 Upstart Telecom Companies Are Picking Up Where the Bells Left Off*, WASH. POST, Feb. 28, 2001, at G14; *Covad Makes Filing In Bankruptcy Court In Bondholder Deal*, WALL ST. J., Aug. 16, 2001, at B2.

7. *Speech of C. Michael Armstrong*, National Press Club, Feb. 7, 2001 [hereinafter *Armstrong Speech*]. Available at <http://www.att.com/speeches/item/0,1363,3662,00.html>.

8. Pennsylvania Public Utility Commission, *Global Order of Structural Separation of Bell Atlantic-Pennsylvania, Inc. Retail and Wholesale Operations*, Dkt. Nos. P-00991648, P-00991649, at 222 (released Sept. 30, 1999) [hereinafter *Pennsylvania Global Order*]; Florida Public Service Commission, *Petition of AT&T Communications of the Southern States, Inc., TCG South Florida, and MediaOne Florida Telecommunications, Inc. for Structural Separation of BellSouth Telecommunications, Inc.*, Dkt. No. 010345-TP (filed Mar. 21, 2001); New Jersey Board of Public Utilities, *Request for Proposal to Conduct a Comprehensive Review of the Financial Integrity of Verizon New Jersey*, Dkt. No. TO01020095 (May 8, 2001).

9. S. 1364, 107th Cong., 1st Sess. (2001).

Part III examines AT&T'S alternative hypothesis for failing CLECs and its proposal for mandatory structural separation. According to AT&T, anticompetitive behavior by the ILECs caused the CLECs to fail. Ostensibly to prevent discrimination against nonaffiliated retailers of local service, AT&T and some other CLECs urge regulators to separate structurally the ILECs into wholesale and retail companies. According to its proponents, structural separation would level the playing field between nonaffiliated local retail providers and the ILECs. We explore the meaning of mandatory structural separation, and lay out the purported merits of mandatory structural separation.

In Part IV, we critique AT&T's diagnosis of local competition and its accompanying structural solution. Anticompetitive practices cannot explain certain market and regulatory phenomena. Despite allegations of anticompetitive practices by the ILECs, some CLECs are thriving. Indeed, we demonstrate that CLECs' market share has steadily increased in the past three years. Moreover, during the same time period, state regulators have approved RBOC entry into long-distance services—an event that is not consistent with anticompetitive behavior. Next, we argue that mandatory structural separation is inefficient. Its likely costs would exceed any purported benefits. In particular, we examine several potential efficiency gains associated with vertical integration, including, among others, the coordination of investment and production decisions, accountability for product quality, and the ability to make bundled offerings. Mandatory structural separation would jeopardize each of these efficiencies. We conclude Part IV by explaining why mandatory structural separation is not an efficacious remedy under any diagnosis of the CLEC problems. First, there is no systematic evidence of discrimination. Second, behavioral restraints could prevent discrimination. Third, mandatory structural separation will not lower wholesale discounts to CLECs. Fourth, the experience with structural separation in several other contexts has been unsatisfactory or inconclusive.

Part V explains how mandatory structural separation can serve an ulterior motive: it can advance an anticompetitive strategy of AT&T and others to raise the ILECs' costs of providing local telecommunications services. This strategy of raising rivals' costs would ultimately increase costs for consumers and reduce investment.

Part VI concludes with the recommendation that policy makers reject proposals for mandatory structural separation of the ILECs.

## II. THE PROBABLE CAUSE OF CLEC FAILURES

The primary reason for CLEC failures has been building capacity too rapidly ahead of demand. This phenomenon became known colloquially as the *Field of Dreams* strategy: "if you build it, they will come." Unfortunately for many CLECs, the customers did not come quickly

enough. A May 11, 2001 account on the front page of the *Wall Street Journal* provided a sober assessment of the capacity glut:

Hundreds of upstarts rushed to build state-of-the-art networks to carry the expected surge of demand, and incumbents such as AT&T Corp. and the Baby Bells also awakened to the opportunity, investing billions in their own wireless and Internet businesses. Investors rushed to supply the cash, and Wall Street firms have made \$7 billion in fees by raising debt and equity for the companies since 1995. But the demand didn't materialize as quickly as expected, and the Baby Bells proved to be tough competitors for the upstarts. Today, more than 97% of fiber-optic capacity goes unused.<sup>10</sup>

In 2000, capital expenditures by local carriers increased 39 percent, while the revenues generated from the networks added with this capital reportedly increased only 11 percent.<sup>11</sup> With so much excess capacity, some CLECs exit the market because the market price falls below their average variable cost.<sup>12</sup>

During the thirteen months spanning May 2000 through September 2001, there were at least twenty notable CLEC failures. Table 1 lists the major CLEC failures in reverse chronological order.

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10. Gregory Zuckerman & Deborah Soloman, *Telecom Debt Debacle Could Lead to Losses of Historic Proportions*, WALL ST. J., May 11, 2001, at A1.

11. Tom Fredrickson, *Too many lines, too few callers; Telecom upstarts shelving expansion plans*, CRAIN'S N.Y. BUS., Apr. 23, 2001, at 20.

12. For the derivation of the exit rule, see WILLIAM J. BAUMOL & ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES AND POLICY 156 (Dryden Press 7th ed. 1995).

TABLE 1: MAJOR CLEC FAILURES, MAY 2000-SEPTEMBER 2001

Date	Company Name	Notes
8/15/01	Covad	Chapter 11
8/2/01	Rhythms	Chapter 11
6/2/01	PSINet	Chapter 11
5/21/01	Teligent	Chapter 11
5/14/01	2nd Century Communications	To Cease Operations
4/18/01	WinStar	Chapter 11
3/30/01	Advanced Radio Telecom	Chapter 11
3/1/01	Vitts	Ceased Operations
1/17/01	NorthPoint	Chapter 11
12/30/00	Jato	Ceased Operations
12/27/00	Digital Broadband Communications	