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By Gary Kim and Mitch Shapiro

Down the Rabbit Hole of the UNE-P Debate

The raging debate over the unbundled network element platform (UNE-P) is at times a bit surreal, in large part because it isn't so clear what is fact, and what is fiction. "There are lies, damned lies, and statistics," as British statesman Benjamin Disraeli is quoted in Mark Twain's *Autobiography of Mark Twain*. The difference between fantasy and reality begins there.

Are wholesale providers losing their shirts on UNE sales, as some argue, or making good margins, as others claim? On such arguments the policy framework may swing, but to hear the numbers flung about, you may well feel like Alice in her wonderland: "Dear, dear! How queer everything is today!"

UNE opponents have claimed wholesale operating costs are about \$17 a line, the argument being that when leasing lines to competitors at \$20, each line sold represents a loss.

So if the only conceivable providers of mass deployed access networks are required to keep leasing such lines in the first place, the least that should be done by policymakers is to raise UNE-P rates.

SBC Communications has proposed, for example, that if it really must continue to sup-



Long Distance and UNE-P Revenue Impact, Residential Market

Lost in Net Revenue from UNE-P	\$/Month
Retail revenue/line	38.91
UNE-P revenue/line	19.04
Avoided cost	6.85
Change in net revenue	(12.19)
Gain in Net Revenue from Long Distance	\$/Month
Revenue/line	14.00
Access charges	(2.52)
Wholesale cost of service	(2.80)
Change in net revenue	8.68

Source: WorldCom

Long Distance and UNE-P Impact on Verizon Monthly Residential Revenue, New York Markets

New York Residential Customer Base	Lines
Total residential lines	7,655,000
Loss of local share	23%
Gain of long distance share	40%
Lost local lines	1,760,650
Gained long distance lines	3,062,000
Decline in local net revenue/month	(\$21,462,000)
Gained long distance net revenue/month	\$26,578,000
Net change	\$5,116,000

Source: WorldCom

port UNE-P, it should be allowed to charge \$26 per line, everywhere.

Of course, UNE proponents claim operating costs are \$9 to \$11 a line. And after adding in non-recurring charges and usage-sensitive payments, the typical monthly revenue per UNE-P line is about \$25. "There's plenty of margin there," says Peter Karoczka, InfoHighway senior vice president.

As Lewis Carroll wrote in his famed *Alice's Adventures in Wonderland*: "If there's no meaning in it" said the King, "that saves a world of trouble, you know, as we needn't try to find any."

Obviously, one argument in favor of a wholesale discount is that there are "avoided costs." Sure, the network has to be kept in service, but there are avoided retail billing, customer support and marketing costs, for example, that represent savings for the wholesale provider. The issue is the magnitude of the savings.

UNE opponents claim avoided costs are only about 11 to 12.5 percent per line. UNE proponents say avoided costs actually are 30 to 50 percent of retail costs. The difference represents a positive revenue swing of about \$7 a month, per line.

Lies, damned lies, or statistics? That depends on whose numbers one is willing to accept. Suffice it to say, however, that proponents of the UNE-P regime, including the National Association of Regulatory Utility Commissioners (NARUC), see no "confiscation" of incumbent carrier assets. Quite the contrary, in fact.

"It is wrong from beginning to end," says Carroll's Caterpillar. So say UNE opponents, which argue that current wholesale rates are set at a level that doesn't even cover costs. But a recent study by T. Randolph Beard and Christopher Klein, professors of economics at Auburn University and Middle Tennessee State University, respectively, suggests that EBITDA margins are positive, at \$14.43 a line, with margins of 60 percent.

"UNE-P is the highest margins wholesale product the RBOCs offer," says Joseph Gillan, economic consultant to the PACE Coalition.

And then there's obfuscation. Says the Mock Turtle, in Carroll's tale:

"why, if a fish came to me, and told me he was going on a journey, I should say 'With what porpoise?'"

"Don't you mean 'purpose?'" said Alice.

"I mean what I say," the Mock Turtle replied in an offended tone.

Perhaps that is to be expected when 3,000 lawyers formerly preparing long distance applications now are free to unravel what remains of local loop competition.

UNE-P destroys our incentive to invest, UNE opponents say. That's disingenuous, UNE proponents say. "RBOC capital spending has no relationship to UNE pricing," says NARUC. "The decision to reduce capital spending may have more to do with choice and the company's own business strategy."



To which, one must add an element of absurdity.
"Consider your verdict," the King said to the jury.
"Not yet, not yet!" the Rabbit hastily interrupted. "There's a great deal to come before that!"

Which is something like whining about losing market share,

Annual Change in Local and Long Distance Revenue

	Local Service (\$ mil.)				Long Distance (\$ mil.)			
	Q301	Q302	Chg. in \$	% Chg.	Q301	Q302	Chg. in \$	% Chg.
BellSouth	\$2,991	\$2,893	\$(98)	-3.3%	\$192	\$234	\$42	21.9%
Qwest*	\$2,317	\$2,106	\$(211)	-9.1%	\$633	\$521	\$(112)	-17.7%
SBC**	\$6,666	\$6,158	\$(508)	-7.6%	\$624	\$594	\$(30)	-4.8%
Verizon	\$5,238	\$5,138	\$(100)	-1.9%	\$784	\$853	\$69	8.8%

* voice service only; long-distance revenue does not include any in-region inter-LATA service.

** voice service only.

Source: Broadband Markets analysis of company data

when loss of market share by monopoly providers is not only expected but part of the bargain to gain share in the long distance markets.

Of course, there's always denial.

"I deny it!" said the March Hare. "He denies it," said the King: "leave out that part."

That's a bit like arguing UNE-P is a substitute for, not a stage in a process toward, fuller facilities-based competition. Especially when Public Utility Commission of Texas chairwoman Becky Klein points out that, in Texas, use of the UNE-L platform, which requires facilities investment, is on the rise, while UNE-P, which doesn't require the same level of investment, is declining.

Some would argue that sheer revenue and margin aren't the actual concerns about UNE-P. The "facilities-based" UNE-L, which requires competitor ownership of switching and other facilities, represents only about \$15 a month of revenue for the incumbent, whereas UNE-P represents about \$40 or more monthly revenue, says Karoczkai.

Looking just at the eight million UNE-P lines now in service, the incumbents would lose \$2.4 billion in annual revenue if all those lines were converted to UNE-L, Karoczkai notes. So UNE-P rates aren't the issue. Rather, the fight is about incumbents "hoping everything goes back to retail," says Karoczkai. Retail, in that case, meaning incumbents have all the customers.

Annual Decline in Retail Lines by Category (3Q01 to 3Q02)

	BellSouth	Qwest	SBC	Verizon
Residential lines	-5.7%	-5.2%	-7.6%	-2.4%
Primary	-4.5%	-4.6%	-6.8%	na
Additional	-13.1%	-9.0%	-10.9%	na
Business lines	-4.6%	-5.2%	-7.0%	-5.4%
Total retail lines	-5.3%	-5.1%	-7.4%	-3.6%

Source: Broadband Markets analysis of company data

Lies and Damned Lies

To be sure, there's another argument. A recent research report by UBS Warburg, for example, examined the economics of UNE-P and long distance gains from the standpoint of RBOC (regional Bell operating company) revenue and EBITDA. It concluded that, "for every \$1 in revenue lost to UNE-P based competition, the Bells lose \$0.70 to \$0.85 of EBITDA and \$0.45 to \$0.60 of after-tax operating cash flow (EBITDA less capex)." The report also estimated that "the Bells see a \$1 billion reduction in annualized operating free cash flow for every eight million lines lost to UNE-P," all else being equal.

The UBS Warburg report estimates RBOCs need to add 1.3

long distance subscribers for each retail line lost to UNE-P competition in order to offset UNE-P's negative revenue impact. Since RBOCs currently claim roughly 1.8 long distance customers for every access line served by a UNE-P competitor, this revenue-based ratio might not seem too unsettling for an RBOC executive.

But the report didn't stop there. It also considered the cash flow impact of the long distance/UNE-P trade-off. To breakeven on an EBITDA basis, the Bells need to add 5.4 long distance customers for every line lost to UNE-P. That's the kind of math that can keep RBOC executives awake at night, if the assumptions – and the business reality – are correct.

Those assumptions, though, are hotly contested by firms such as WorldCom. Analyzing the revenue impact of both UNE-P and long distance entry in the New York residential market, for example, WorldCom says Verizon gains \$5 million a month in revenue when UNE-P retail losses and long distance share gains are added up. (See table, page 28.)

Though long distance entry has provided an avenue of revenue growth and a bundle-enhancing tool to help retain customers, it remains far short of providing a full offset for the damage occurring in local service, UNE opponents maintain.

SBC experienced a 4.8 percent (\$30 million) drop in long distance voice revenue in addition to a 7.6 percent (\$508 million) decline in local voice revenue in the third quarter, for example. The long distance decline occurred even in the face of 28 percent annual growth in SBC's inter-LATA customer base. But the revenue gains from this inter-LATA customer growth were more than offset by an 18 percent falloff in intra-LATA toll revenues, which reflected continued erosion of SBC's retail access lines.

Of course, it might be noted that there is scarcely any segment of the telecom business that hasn't suffered declines during the third quarter, in many cases worse than those SBC reports. UNE-P cannot be the cause for all these industry-wide macroeconomic effects.

Granted, there is competition and share loss. That's what happens to monopolists in a newly deregulating market. There is a shift of traffic and "access" revenue to wireless. But the RBOCs own the lion's share of that business, so revenue is simply shifting from the left pocket to the right pocket.

Some long distance traffic also is bleeding away in favor of email and packet-based voice, but that trend hurts the legacy long distance carriers even more than the new revenues picked up by the former RBOCs.

RBOC Line Losses as of 9/30/02

	% of Base Lost		Lines Lost (000)	
	Annual	Since YE00	Annual	Since YE00
BellSouth				
Total lines	-2.7%	-3.6%	696	937
Retail lines	-5.3%	-7.2%	1,291	1,784
Qwest				
Total lines	-4.3%	-4.9%	764	893
Retail lines	-5.1%	-6.2%	875	1,076
SBC				
Total lines	-3.8%	-4.8%	2,335	3,021
Retail lines	-7.4%	-10.2%	4,144	5,906
Verizon				
Total lines	-2.6%	-3.2%	1,703	2,130
Retail lines	-3.6%	-5.0%	2,172	3,068
Total				
Total lines	-3.2%	-4.0%	5,498	6,981
Retail lines	-5.4%	-7.3%	7,924	11,834

Source: Broadband Markets analysis of company data

Long Distance Penetration

	4Q00	4Q01	1Q02	2Q02	3Q02
Long Distance Authorization (% of Access Lines)					
BellSouth	-	-	-	27%	62%
SBC	17%	33%	33%	33%	33%
Verizon	49%	67%	68%	82%	84%
In-Region LD Customers as % of Access Lines					
BellSouth	-	-	-	0.6%	1.6%
SBC	4.8%	8.0%	8.7%	9.3%	9.9%
Verizon	7.1%	11.4%	31.9%	35.4%	15.4%

Source: Broadband Markets analysis of company data





The two leading interexchange carriers have welcomed states' adoption of low UNE-P rates as a way of completing the "book-ends" of deregulation. The RBOCs were supposed to lose local share and gain long distance share. The legacy long distance carriers were supposed to lose long distance share and pick up local share. As slow as the process has been, it is happening according to the expectations policymakers had when they launched the deregulation of the local telecom market.

Wholesale Percent of Total Lines

	Resale		UNE-P		UNE-Loops		Total Wholesale	
	Q301	Q302	Q301	Q302	Q301	Q302	Q301	Q302
BellSouth	2.7%	2.0%	1.9%	5.4%	1.5%	1.5%	6.2%	8.9%
Qwest	0.9%	0.4%	2.6%	2.9%	1.5%	2.5%	5.0%	5.9%
SBC	2.0%	1.4%	3.5%	7.1%	2.5%	3.0%	8.0%	11.5%
Verizon	2.3%	1.8%	3.3%	4.3%	1.8%	2.2%	7.4%	8.3%

Source: Broadband Markets analysis of company data

As of October, WorldCom had used UNE-P to launch local/long distance packages branded "The Neighborhood built by MCI" in 39 states and the District of Columbia. At the end of the third quarter, MCI's Neighborhood local service claimed more than a million customers.

Though active in only eight states, AT&T closed the quarter with more than 1.9 million UNE-P customers and reached the two-million mark on October 16. During the third quarter alone, it added 400,000 units, roughly twice its net adds during the second quarter.

"The Neighborhood" was preceded in June 1999 by a Z-Tel offering of a feature-rich, flat-rated local service with a broad calling area bundled with long distance service for just less than \$50.

Z-Tel's bundled offering also includes a "communications manager" that unifies voicemail, email and provides follow-me functionality. Verizon responded later with a similar "Premium Local Package," which offers "unlimited service, unlimited local directory assistance, plus a choice of four or more" vertical features.

In late September 2001, Verizon announced the release of "Verizon Unified Communications Service" – a messaging service that mimicked Z-Tel's communications manager. So it's hard to argue UNE-P is simply another form of "total service resale," offering no innovations to buyers of telecom services.

Says the Queen of Hearts: "Sentence first – verdict afterward." So some would bury UNE-P before it's had a chance to promote robust local competition and service innovation. "Stuff and nonsense!" said Alice loudly. "The idea of having the sentence first!" **FAT**

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