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“Why Isn’t Local Competition Taking Hold In Telecommunications?”

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The stated goal of the Federal Act is “[t]o promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and to encourage the rapid deployment of new telecommunications technologies.”

Preamble, Pub. L. No. 104-104

Good afternoon. My name is Blossom Peretz. I am the Director of the New Jersey Division of the Ratepayer Advocate. The Ratepayer Advocate represents the interests of all utility consumers -- residential, commercial, and industrial. Our office is a party in all cases where New Jersey utilities and cable companies seek changes in their rates or services. Our office is also responsible for creating policy recommendations to aid in the development of competition.

Thank you for giving me the opportunity to participate in this panel discussion and in Institute of Public Utilities’ Annual Public Policy Conference. I, and other members of my staff, have always found that the benefit of conferences sponsored by the Institute of Public Utilities is

that they give us valuable insights into how regulators and consumer advocates and CLECs and incumbent in other states are grappling with the difficult issues of deregulation and competition. Perhaps our experience in New Jersey will prove equally valuable to you as we confront common problems at this critical point in the transition to what we hope will be a competitive environment.

While customers have had the right to select long distance carriers since the breakup of AT&T in 1984, the promise of the 1996 Federal Telecommunications Act of the entry of competition into the local market has not reached New Jersey. Allow me to give you a brief description of the Garden State. We are the most densely populated state in the union. With 1,100 people per square mile, we are more crowded than India or Japan. At the same time, the latest census reported that New Jersey had a median household income of \$54,226 a year, making us the richest state. Yes, we surpassed Connecticut, where the median income was \$53,106. Our 9 million residents live in 566 municipalities and pay the highest property taxes in the nation. Running through New Jersey is one of the busiest transportation corridors in the country. The state is also a corridor of leading pharmaceutical companies and serves as the back office to many leading Wall Street firms up along the Hudson River. Why then haven't competitors been able to break through the Verizon New Jersey glass ceiling and why haven't New Jersey ratepayers reaped the benefits of the federal Telecommunications Act?

271 Filing in New Jersey

Last month, Verizon New Jersey applied for 271 approval from the state Board of Public Utilities -- our PUC -- on its application to the FCC, which is scheduled to be filed before the end of the year. Verizon New Jersey still provides 99.99% of the underlying residential services, at least 91% of the underlying business services, and some 97% of all local service in its New Jersey serving areas. The vast majority of the “competition” that exists in New Jersey is limited to resale of Verizon New Jersey services and unbundled network elements, and even this largely resale-based competitive share is split up among over 70 CLECs that have been approved to enter our local phone market, but largely have not. Several of these CLECs are major firms with extensive telecommunications experience and billions of dollars of capital.¹

The bottom line is that in my state, there are only 280 residential customers whose local phone service is not delivered by Verizon New Jersey facilities. That’s right: 280 out of approximately 4.3 million telephone lines. By any yardstick you want to use to measure, that is not competition. The utter failure of CLECs to capture more than a sliver of the New Jersey local service market can only be attributed to the extraordinary level of difficulty that entrants continue to encounter in accessing Verizon New Jersey’s network resources.

Our office, the Division of the Ratepayer Advocate, is opposing this 271 application. On October 22nd, we filed a motion to dismiss the filing. The Ratepayer Advocate contends that at this time Verizon’s 271 filing in New Jersey is not in the public interest and urges our Board not

¹ Nationally, the numbers are a bit better. According to the FCC’s most recent Report on local competition, CLECs account for only 5% of all local residential and small business service. It is important to note that this 5% is divided amongst several CLECs, whereas there are currently only three former Baby Bells serving the entire country.

to recommend approval of Verizon's application to the FCC. Verizon's 271 petition fails to meet the public interest standard of the federal Telecommunications Act because the combined effects of the lack of competition in New Jersey's local telecommunications market, coupled with Verizon's ability, upon obtaining 271 authority, to jointly market local and long distance services, will permit the company to become an unregulated dominant monopoly in both local and long distance market.

Unbundled Network Element Rates

The Ratepayer Advocate also maintains that Verizon New Jersey has failed to meet the 14-point competitive checklist that a local operating company must satisfy before it can win approval to provide long-distance service. One of the key 14 points Verizon has not met is nondiscriminatory access to Unbundled Network Elements which includes the price Verizon can charge competitive companies for access to the unbundled network elements essential for local phone service. In 1997, our BPU set the rate at \$16.21 per line a month. A federal judge last year struck down the \$16 fee, ruling it had been set in an "arbitrary and capricious manner." The judge sent the matter back to the BPU, where it is still pending. Hearings have been held and briefs have been filed. We are awaiting a Board decision.

Competitive carriers have stated that they cannot afford to offer local exchange service in New Jersey based on Verizon's unbundled loop rates. This high rate is particularly glaring when one compares the New Jersey rate to forward-looking rates in almost all other jurisdictions. On a state-by-state basis, forward-looking UNE loop rates are generally 20% to 30% below embedded costs. In a 1995 National Exchange Carrier Association (NECA) rating -- which was published

two years before New Jersey set its UNE rate -- New Jersey ranked as the eighth lowest cost jurisdiction in the country for embedded costs, which we should be given our relative small size and high population density. Our demographics should result in relatively low cost construction of network plant. However, when the same ranking is based upon Total Element Long-Run Incremental Costs (TELRIC) unbundled loop rates, New Jersey falls to 20th place. New Jersey is a low cost jurisdiction for the placement of embedded loop plant, but it does not benefit from the same factors for purposes of forward-looking costs. As a result, the forward-looking rate in New Jersey is not reflective of incremental costs and unnecessarily inflates the cost of competitive entry, as to make it economically unviable.

The Ratepayer Advocate believes the current UNE rate is a roadblock to competition. After extensive litigation and review of the testimony, to level the playing field, we have recommended that the wholesale price should be set at under \$10 per line a month instead of \$16.21. Competition, let alone meaningful local exchange competition, cannot occur in New Jersey, or anywhere else for that matter, when the price of the local loop to the competitive carrier is twice what the incumbent prices local exchange service. I believe that lower UNE rates are the key to unlocking competition.

As FCC Chairman Michael Powell said at a press conference just last week in which he stated his resolute commitment to competition, facilities-based competition is the ultimate objective. To quote Mr. Powell, "I believe that other methods of entry are useful interim steps to competing for local service, but Commission policy should provide incentives for competitors to ultimately offer more of their own facilities. This would decrease reliance on incumbent

networks, provide the means for truly differentiated choice for consumers, and provide the nation with redundant communications infrastructure. “

As an aside, let me mention that regulators and advocates in the telecommunications field are not alone in grappling with this issue. As the utility consumer advocate in my state, I am in the midst of the ongoing effort to make sure that deregulation of the energy marketplace will bring consumers energy choice at lower rates alongside advanced technologies. We are, however, confronted with the same obstacle: wholesale energy prices are too high to facilitate competition. High wholesale prices have driven energy marketers from New Jersey, leaving the incumbent utilities to operate free from competition. We call this scenario the unregulated monopoly marketplace. Caught between the incumbents’ high wholesale UNE rates and their low retail basic service rates, telecommunications competitors can’t get into the market and consumers are left without choice.

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The Ratepayer Advocate also contends that Verizon New Jersey has not satisfied another key requirement of the 14-point competitive checklist a Bell operating company must satisfy before it can win approval to provide long-distance service. This is the nondiscriminatory provision of access to operations support systems -- or OSS. The OSS governs the interconnection between competitive telephone companies and Verizon’s local network to provide local service over what is known as the “last mile,” the telephone line to the customer’s residence or business. The FCC has repeatedly acknowledged the importance of nondiscriminatory access to OSS. Before Section 271 approval can be considered, there must be

valid proof that in a competitive marketplace the technology will support a seamless connection. Verizon New Jersey is required to provide evidence of “real commercial data” drawn from *actual commercial usage* after the “phantom” testing of OSS. This has not as yet occurred.

Structural Separation

In addition to lowering UNE rates and providing for real world testing of OSS functions, the Ratepayer Advocate is also calling for a structural separation of Verizon. While structural, or functional, separation is controversial, I and other consumer advocates believe that it is necessary to counter the tremendous advantage incumbent telephone companies enjoy at the onset of competition. Incumbents already have the great majority of customers, brand name recognition, and repeated access to consumers through monthly billing or through customers service or repairs. The advantages of incumbency can also include customer inertia.

Under the Ratepayer Advocate’s proposal, structural separation could be implemented by means of the actual separation of the wholesale and retail operations, or it could be implemented through virtual structural separation featuring stringent accounting safeguards and a strict code of conduct that would be enforced by the BPU, with severe financial penalties for noncompliance.

A code of conduct is crucial to promoting effective competition in the local exchange marketplace. The code of conduct should contain competitive safeguards and consumer protections that would provide a clear distinction between the activities of Verizon as the incumbent local service provider and those of any other Verizon affiliate that competes with other competitive local exchange carriers.

Incumbent phone companies should not be given the additional advantage of being

allowed to market their own inter-exchange services to the detriment of the customer's ability to choose a competing provider. With a structural separation in New Jersey, Verizon's wholesale operation would interact with its retail operation as if it were any other unaffiliated company seeking to provide local telephone service. The goal of structural separation would be to alter the incumbent's incentives so that the wholesale operation seeks to provide the most efficient system, while its retail side designs services and sets prices that accurately reflect the rates it is charged for access to the unbundled network elements. The idea is to put the incumbent's retail operations in the shoes of a competitor, requiring it to order UNEs, set up customer accounts, and pay UNE charges as if it were any other provider. Let's charge Verizon New Jersey retail operations \$16.21 to access the platform. Let's make the retail operation use the same operational interfaces as other competitors and be constrained by the same policies and systems. Let's place upon the incumbent the same onerous requirements and obstacles as are now faced by competitors.

The issue of structural separation goes hand in hand with the issue of UNE rates. The point we have repeatedly made is that if Verizon New Jersey's wholesale operation charges CLECS like AT&T, Sprint, and MCI WorldCom \$16.21 for access to its network, then that should be the price that Verizon New Jersey's retail operation should pay for access to Verizon New Jersey's wholesale operation. That is how we define a level playing field. But, as I've said, the wholesale rate should not be \$16.21 but under \$10.

Verizon has claimed that structural separation in New Jersey would cost \$1 billion while also costing jobs. How can it cost both \$1 billion and cost jobs? Structural separation does not cost jobs. Mergers can and often do lead to job losses. Structural separation can, in fact, spur job creation because, presumably the \$1 billion Verizon will spend will, in part, be to hire additional

employees for the separate retail and wholesale operations, such as accountants, operations managers, technical support personnel, etc.

Once again, the example of energy deregulation provides a useful comparison. Our power utilities in New Jersey underwent structural separation when we deregulated. Their power generation and monopoly transmission and distribution operations were separated. There was no job loss reported. Unfortunately, recent spikes in the cost of energy in the wholesale marketplace have driven energy competitors out of the marketplace. As with high UNE rates in telecommunications, high wholesale energy prices remain a roadblock to competition. But our BPU did enact a strict Code of Conduct for utility energy affiliates which mandates “virtual structural separation.”

So, faced with these obstacles, what is a regulator to do to bring competition to the local telecommunications marketplace while still ensuring that telecommunication services are available and affordable? I would like to use the remainder of my time to concentrate on my vision of how, in the face of the high UNE rates, we can bring competition to all classes of ratepayers - not just the large business customers who are the prime targets for CLECs. My vision is to bring benefits of competition to all ratepayers and that includes all small commercial customers including the mom and pop cleaners and pizza parlors and all residential ratepayers, including low income ratepayers.

Here's my blueprint for competition:

Aggregation

Aggregation of residential and/or small business customers can provide market power in the marketplace - either through private or government aggregation. Aggregation is a simple concept. A group of organizations band together and put out an RFP for utility services, leveraging their numbers to get the best rates. The group can be the AARP or a municipality or a group of municipalities.

Again, please allow me to borrow from energy deregulation. The restructuring of the electric and natural gas systems is opening new opportunities for local government involvement in the energy sector. Most promising, by combining its citizens into one large buying group, a municipal government can facilitate the purchase of cheaper power and reduce rates for residential and small businesses who otherwise might not fully enjoy the promise of the competitive marketplace. Michigan and Massachusetts are models for the promise of energy aggregation. Remember: Big dogs eat first. Using the power and functions of local government to provide lower energy costs for customers provides an option that is non-profit, non-discriminatory, subject to open-bidding laws, subject to the public ethics laws and practices, and subject to local control by consumers who are voters. Consumers who have to make individual choices without information, experience and market power may well be left behind.

If it can be done to deliver heat and electricity, why can't aggregation be used to provide homes with a menu of telecommunication services? It can, and it does. During the past few years, a growing number of smaller cities and municipalities throughout the U.S. have explored, and in

some cases, installed their own telecommunications infrastructures, including modern broadband telecommunications and cable TV networks. Many of these municipalities undertook the project individually, but some have embarked on the project with neighboring towns or in partnerships with telecommunications carriers. In all of these cases, the communities shared common concerns: dissatisfaction with the quality, reliability, cost and lack of advanced technology available from their incumbent telecommunications or cable suppliers or because the telecommunication infrastructure was expensive, outdated, and not due for an upgrade any time soon. The other factor these municipalities shared was a new regulatory environment that facilitated aggregation. Aggregation may not be right for every municipality. But it is deserving of serious consideration.

Convergence

Convergence is my second hope for the future. Convergence is where a utility combines with a company to offer a product or menu of products beyond its traditional services. For example, pursuant to the 1996 federal Act, an electric or gas utility can provide telephone or cable services. This does not require a great leap of imagination. Consider this: your local energy utility already possesses the back office infrastructure to provide telecommunication services. This includes the billing system, name recognition, call centers, service representatives, and, most important of all, customer lists. Power utilities also have poles, antenna towers, land, conduits, rights-of-way and other physical infrastructure. Control of these assets and prior experience place energy utilities at a distinct advantage over new telecommunications providers, which often have limited sources and capital, no name recognition and a lack of familiarity with the local consumer

market, regulatory environment, and business culture. These new entrants either have to build from scratch or negotiate with an incumbent carrier to lease part of its network. The converged company already owns and controls the infrastructure necessary to provide telecommunication services.

Convergence can radically change the shape of the telecommunications industry. While traditional telecommunications and energy utility providers once operated in separate and distinct markets, they are now able to eliminate market distinctions and offer multiple services. While I recognize that there are substantial public policy issues that must be addressed alongside the benefits of convergence of the telecommunications and cable television industries, the Internet and deployment of broadband technology, an overriding concern is that we must remain vigilant about not creating a new “digital divide” and ensure that all consumers, including rural, low-income, community associations, and small businesses, have access to new technologies at affordable rates.

Successful consumer education is also important to enable consumers to understand their options and make effective choices. The 1996 Telecommunications Act has opened the door for all this to happen. It is now up to regulators to provide the environment and incentives for implementation. Just last week, Sempra Energy, owner of the biggest U.S. natural gas utility began installing a fiber-optic cable in a gas pipeline in North Carolina, the first time it has run its “fiber-in-gas” line to offer fast Internet service.

New Technologies

Regulators can provide the economic and regulatory encouragement of opportunities for support of new technologies which will bring new entrants into the marketplace - with new choices for consumers - with affordable technologies - that are consumer friendly and affordable and which will provide competition for standard monopoly utility service.

The recent tragedy of September 11th brought new recognition to the power of the cell phone for communications - both during and after the heinous attacks. As reported earlier this month in The Asbury Park Press, there are plans in place for two companies to offer disposable cell phones for sale next month. The disposable phones now available will only be able to make outgoing calls. But on September 11th, when traditional telecommunication systems were disrupted and local residents and commerce had to find alternative means of communication, the cell phone provided many with instant messaging and connections to family, to voice mail, and E-mail. On better days, the cell phone is also a source of stock quotes, bank accounts, and much more.

An economic revolution is underway. If wireless communications fulfills the new demand for instant mobile communications - what will be the impact on land line communications? What about smart phones? Will you on your drive home begin your dinner? Will smart phones be linked to your home appliances - your security system - your energy controls?

Will energy companies be merging with wireless, will wireless and satellite companies provide telecommunication services as part of our electric power networks? What about automatic meter reading? How about cable modems? What about Internet telephony? The development of an alternative to the reliable landline phone, that is as reliable in tunnels as in

living rooms and offices -- that will combine access to voice, data, and the Internet -- at affordable rates -- will bring competition to the current local exchange marketplace. Consumers will not switch unless the new product offers reliability at affordable rates.

In the energy field we see the emergence and the development of distributed generation technologies such as the fuel cell, micro-turbines, photovoltaic like solar panels, and wind turbines. Distributed energy is environmentally friendly and easy to move and locate at or near the energy consumers' location. It places power on the customer side of the meter. It is energy at affordable rates that can better match supply with demand and perhaps can replace the monopoly energy provider. Distributed generation will bring competition to the energy marketplace.

The emergence of new technologies -- the opportunities for convergence and aggregation -- has begun and we will need regulators who will encourage competition and at the same time protect consumers. Strict codes of conduct must be in place - implemented either through actual structural separation of utility operations and/or strict vigilance of regulators to enforcement of detailed codes of conduct between utility affiliates. Concerns about cross-subsidies, marketing and standards of a level playing field remain critical for incentives for competition.

Again turning to the FCC Chairman, Mr. Powell said at his news conference last week, "Competition in the digital broadband world should come from many platforms. Competition will be both intra-modal and inter-modal. Competition will come from carriers providing choice through similar platforms and interconnection with incumbents. A great deal of competition,

however, particularly for residential consumers, will come from other platforms such as cable and wireless systems.”

Policies must be pro-competition and pro-consumer. Incumbent utilities with monopoly assets should not be permitted to use these assets to gain competitive advantage over new entrants. Regulators must balance the necessary support for emerging technologies - together with support for new incumbents - together with support for consumers, ensuring consumer choice, consumer information and consumer protection.

Conclusion

The fundamental promise of deregulation is that it will provide consumers with lower prices - increased quality of services, new technologies, and more choice. So far we have not reached these goals through the traditional regulatory process - either in energy or in telecommunications. My proposal today is to remain committed to the process of deregulation while we follow the paths of new alternatives. The utility monopoly will finally be shattered not only through low UNE rates -- not only through aggregation -- not only through convergence -- not only through the development of through new technologies. All of these scenarios must happen in tandem.

The 1996 Telecommunications Act opened the lines. Now it is up to regulators to take up that challenge to make sure that the competitive marketplace provides proper incentives and opportunities.

Having opined on all future scenarios, as I return to the real world, as the Ratepayer Advocate for all New Jerseyans, while advanced technologies and convergence may offer the

key to unlocking telecommunications competition, I will be again reviewing the Verizon New Jersey 271 proposal. Let's start first with low UNE rates and a level playing field for the local and long distance marketplace while reaffirming our commitment to reaching all benefits of competition and reaffirming the social goals of the Act.

"It is also time for us to reaffirm our commitment to ensuring that all Americans benefit from the communications marketplace. The new digital economy is being principally defined by its power to unlock markets, to transform retailing and to create unimaginable wealth for a privileged few in our society. But I believe this New Economy must also be defined by its power to unlock the potential of all our people by its power to educate our poorest children, to lift up people in rural and inner-city communities and Native American communities, to empower people with disabilities, and to repair and revitalize the social fabric of our communities."

William E. Kennard, Chairman
Federal Communications Commission
October 18, 1999

Thank you for the opportunity to speak here this afternoon