TELECOMMUNICATIONS & TECHNOLOGY

# THE FCC NOSES UNDER THE BROADBAND TENT AGAIN

*Rent-seeking and public choice put a deregulation success story at risk.*

**BY LARRY DOWNES**

A funny thing happened on the way to deregulating enterprise communications service: it worked.

In the wake of the 1996 Telecommunications Act, which opened local telephone markets to competition from both facilities-based and wholesale providers, the market for dedicated circuits—what became known as "special access"—changed dramatically. As Congress had hoped, non-incumbent providers began building fiber and cable-based infrastructure that was far superior in speed and capacity to the legacy analog services still being offered by incumbent phone companies. That competition accelerated with the dramatic explosion in demand for broadband Internet that followed, creating fast-growing new markets for high-speed digital enterprise services. And then came the mobile revolution, where high-speed special access is increasingly critical to offload the congested cellular infrastructure.

Today, special access is a $40 billion market. Of that, the rapidly dwindling share for regulated incumbent phone companies offering analog service is less than 40 percent, with Internet-based special access now commanding a roughly equivalent percentage of the market. In the 1980s, by comparison, incumbent phone companies controlled 92 percent of the market.

The time has long passed for the Federal Communication Commission to finish the job it started in 1999, when special access was significantly deregulated. But after years of doing nothing, the agency has suddenly reversed course, and now appears intent on re-regulating the sunsetting analog market.

The FCC's renewed interest in special access appears to be motivated in equal parts by the rent-seeking behavior of some legacy customers and, more ominously, to provide cover for the FCC's own goal of regulating the new competitors and their broadband technologies. The open-ended special access proceeding, launched in 2005 but largely dormant until recently, has become yet another front in the FCC's long-running campaign to impose full utility-style regulation of the entire broadband ecosystem.

The agency's change of heart on special access, in other words, has little if anything to do with correcting its long-neglected oversight of what's left of the legacy market. Instead, it reflects a dangerous confluence of purely parochial interests. The current FCC and the special interests are working together to undo the regulatory success of the Clinton-era FCC. But as we'll see, they are doing so for very different, and ultimately conflicting, reasons.

### WHAT IS SPECIAL ACCESS?

Special access refers to wholesale business arrangements between network operators and other enterprises to transmit voice and data traffic. As the FCC defines it,

> Special access … encompasses dedicated transmission services for voice and data traffic that do not use local switches. This service is used by "businesses and competitive providers to connect customer locations and networks with dedicated, high-capacity links.

**LARRY DOWNES** is an Internet industry analyst and project director of the Georgetown Center for Business and Public Policy's Evolution of Regulation and Innovation Project. His latest book (co-authored with Paul Nunes) is *Big Bang Disruption: Strategy in the Age of Devastating Innovation* (Portfolio, 2014).

PHOTO ILLUSTRATION BY DAVID HERBICK, CELL TOWER BY PHANTHIT/THINKSTOCK, NET BY TEREX/THINKSTOCK

Historically, competitive local exchange carriers (CLECs) relied on special access leased from incumbents to supply or supplement capacity for resale to their own business customers. Businesses also use special access to manage internal communications. And special access has become an essential component of mobile networks, where it provides "backhaul"—connection to the core network—for mobile traffic. These dedicated connections increasingly make up the "middle mile" of the broadband Internet.

Like other aspects of the communications industry transformed by the broadband revolution, the special access market is evolving rapidly. Cable, fiber-optic, and high-speed Ethernet loops deployed by a growing range of companies are quickly displacing the legacy analog technologies of traditional phone companies. Switched networking technology simply can't handle the speeds necessary for exploding Internet traffic, especially for mobile backhaul. Gigabit Internet will never run on these antiquated circuits, which average speeds of only 1.5 Megabits per second.

New competitors with new technologies have long since arrived. Already, wholesale special access services offered by companies including Level 3, Time Warner Cable, Comcast, and Cogent have taken significant market share. Even Google is getting into the special access business. CLECs, which once relied almost exclusively on incumbents for special access connections to fill gaps in their own resale offerings, are increasingly self-sufficient, as are mobile network operators.

While incumbents still offer dedicated service on their legacy networks, that part of the market is fading fast. It is technically obsolete and too slow by at least an order of magnitude for any but the most marginal users.

## SNATCHING REGULATORY DEFEAT FROM THE JAWS OF MARKET VICTORY

This technical revolution has for the most part been taking place outside the FCC's authority or interest. In 1999, the FCC largely deregulated the analog business, letting the market determine price and terms in areas where there was clear competition. The 1999 order, approved under Chairman William Kennard, recognized "the development of competition in the marketplace" and aimed to free the incumbents to "compete more efficiently" in local markets where competitive providers had already emerged, particularly following passage of the 1996 Telecommunications Act.

Since 1999, competition has only intensified, with new competitors using new broadband technologies to meet the needs of new and existing wholesale customers. By 2013, facilities-based competitors were offering unregulated special access in 95 percent of all U.S. census blocks, covering 99 percent of all U.S. businesses—a remarkable story of policy success.

But even as competition flourished, the FCC never finished the deregulation of the incumbents' services, accelerating the obsolescence of the switched network. Not that the agency didn't try. As far back as 2005, noting complaints from both the incumbents and their customers about the formulae the agency used to evaluate the reasonableness of prices, the FCC initiated a review of its "pricing flexibility rules." Today, after 10 years and with over 50 filings by the FCC alone swelling the proceeding's docket, the agency has yet to complete that review.

Instead, even as the market moved forward with increasing speed, the agency has recently taken significant steps backwards. After years of relatively little activity and utterly no data collection in the proceeding, the FCC's Wireline Competition Bureau inexplicably reversed course in 2012, re-imposing price regulations.

That abrupt change came largely in response not to deteriorating market conditions, but rather to pressure from two special interests: (1) CLECs who resold special access circuits leased from the incumbents along with their own facilities, and (2) mobile carriers, who had grown to rely heavily on incumbent phone networks for wireless backhaul as consumer demand for mobile broadband services exploded after 2007 with the rapid adoption of smartphones.

Both groups had taken advantage of the improving price and performance of broadband technology to build their own network capabilities. These users also found they could more easily acquire supplemental capacity from new and unregulated broadband providers than from the incumbents.

The increased competition, however, put significant downward pressure on prices in some local markets, leading resellers and mobile operators to regret having entered into long-term contracts with the incumbents. Those contracts locked in regulated prices and other terms that seemed attractive at the time but became increasingly less so.

The two groups implored the FCC to free them from their obligations or otherwise rewrite the agreements on their behalf before their expiration, and the 2012 decision by the agency to suspend pricing flexibility signaled at least partial victory for the special interests. Meanwhile, the agency initiated a vast data collection effort aimed, once and for all, at determining the true competitive dynamics of the enterprise market.

The re-imposition of price regulations flew in the face of acknowledged market realities, bowing to transparent rent-seeking behavior from the resellers and mobile operators. At the very least, suspending longstanding pricing flexibility before collecting and analyzing current market data to determine if the policy was still working seemed to many at the time to be putting the cart before the horse. As dissenting Commissioner Ajit Pai put it, channeling Lewis Carroll, "Sentence first—verdict afterwards." But the FCC promised to complete its review quickly, and to replace the suspended price flexibility rules with a more enlightened regulatory regime.

Easier said than done. Following nearly two years of negotiations, notably with the Office of Management and Budget, the agency was finally given permission in late 2014 to proceed with its data collection, but only in a scaled-back capacity. The FCC's initial preference for two years' worth of data was cut by the OMB to one specific year:

2013. For that year, the FCC mandated that both purchasers and suppliers of special access services submit data they hoped would provide a snapshot of the state of the market.

The data collection effort was not completed until mid-2015, with considerable doubt even then as to the usability of the databases the agency compiled. And despite complex safeguards established for review of the proprietary information submitted, even authorized parties were unable to see the information until the end of 2015. These continued problems forced the agency to once again extend the comment period, now pushed well into 2016.

What was intended in 2005 as a rational sanity check on longstanding deregulation—one designed with clearly defined parameters and timeframes—has devolved into an open-ended review of an undefined but fast-changing subset of the broadband market. The agency, quite simply, has failed to pursue a fact-based review as promised, and has failed to conduct the review either quickly or comprehensively. Its process, especially since 2012, has been neither open nor transparent. And even so, it seems clear the FCC has failed to ask the right questions or collect the right data.

### HIDDEN AGENDAS: RENT-SEEKING BY CUSTOMERS

Meanwhile, continued efforts by special interests to turn the proceeding to their advantage are wreaking havoc on this dynamic market. In October 2015, the agency announced a new investigation into a key subset of long-term special access contracts between incumbent providers and their business customers. This despite the fact that, at the time or since, the agency had failed to perform any analysis of the data it had compiled on the state of the market in 2013, nor provided effective access to those data to anyone else.

The inescapable meaning of this provocative act was that the agency was bowing to pleas from long-favored CLECs and mobile operators, some of whom are now largely relying on their own equipment to meet their needs and offer unregulated, all-digital special access services. Given the rapid changes in the market, these enterprises apparently regret making long-term contractual commitments to the regulated providers. They now want the FCC to rewrite terms and prices on their behalf, to the detriment of the incumbents, who are both their suppliers and competitors in the emerging market.

The FCC's stated goal in opening this investigation is unrelated to the 2005 proceeding's goal of revisiting the flexible pricing formulae. Rather, the new investigation is aimed at determining whether certain contract terms constitute "reasonable practices" and, if not, how the agency should amend them.

As is typical for agreements between large businesses, the specific terms and conditions are not publicly disclosed at the insistence of both buyers and sellers. But not surprisingly, the Broadband Coalition, a trade group of companies that traditionally resold analog services under the protection of the FCC, cheered the investigation.

"Consumers and business customers are demanding more broadband choices," the group said in a statement, adding:

> They want the freedom to choose their own service provider. But in markets controlled by large incumbent providers who charge monopoly-era rents, archaic lock up tactics in the terms and conditions to which their customers are subject are hurting competitors who want to bring new affordable options to the marketplace.

How so? The Broadband Coalition and other potential beneficiaries of the re-regulation of analog special access argue that exclusive contracts and contracts that require pre-defined levels of committed purchase are inherently "bad for competition" and somehow negatively affect consumer choice for broadband service.

But there is no basis in either law or economics for such unsubstantiated claims. Output or requirements contracts, as they are known, have been standard forms of merchant-based commerce since the beginnings of capitalism. Their formation and interpretation are among the first subjects taught to law students in first-year contracts courses. Their origins may be old, but their mechanics are hardly "archaic."

Such contracts represent a hedge by both buyers and sellers against an uncertain future, where supply and demand may change in ways that affect each contracting party's interests. Entering into such contracts allows both parties to invest long-term resources in their respective production and sale of the goods subject to these contracts, secure in both price and availability over a defined period of time.

Over the course of such agreements, one or both parties' predictions of market prices will likely prove inaccurate. But that hardly means all such contracts are inherently unfair. Indeed, the formation of any contract presumes that one party has made a better prediction of value than the other.

In the fast-changing special access market, it now seems that enterprise customers who committed to long-term requirements and exclusive purchase when the regulated terms were attractive regret their decision in light of better and perhaps cheaper alternatives from a growing list of providers offering high-speed, Internet-based special access using digital network technologies.

That one party's prediction of supply and demand proved inaccurate has never been understood to be the basis for a court to modify or rescind such agreements. Nor should it be for a regulator long absent from the field. In any case, no serious economic analysis of the costs and benefits of such agreements would simply begin and end by comparing contract price to market price in the final years. Over the full period of the agreements now being reviewed, and taking into account opportunity costs of investment decisions made in connection with them, the buyers may well come out ahead—perhaps far ahead—of the sellers.

As with all such agreements, existing output contracts will naturally expire on their own terms. Meanwhile, the business prospects for non–Internet Protocol (IP) services are decaying as fast as their old copper networks. Cable and fiber-based services are indisputably the future of the market as broadband traffic

continues to explode and higher speeds are demanded by businesses and consumers alike.

That future is coming up fast in the rear-view mirror of the regulated providers. Perhaps as much as half of the special access market has already moved to a growing set of competitors (including companies in the Broadband Coalition) offering faster connections and IP-based solutions.

In particular, Sprint and T-Mobile have dramatically reduced their dependence on the incumbents, deploying fiber-based backhaul to the vast majority of their cell sites. T-Mobile claims, for example, to have installed fiber at 50,000 of its 54,000 locations. And middle-mile providers such as Windstream, Level 3, and XO Communications, which once depended on capacity leased from incumbent phone companies at rates overseen by the FCC, are investing in their own faster connections, cherry-picking the most attractive markets.

Given the lack of serious analysis and the secrecy typical of business-to-business commercial arrangements, it's hard to know precisely how many crocodile tears are being shed here. But the invocation of consumer harm from such agreements is both unsupported and entirely gratuitous.

Whatever the true motivation of the complainants, the FCC's decision to investigate could prove a pyrrhic victory. While one FCC official told the *Wall Street Journal* that this new investigation "will take at least a few months," the likely reality, given the pace of the 2005 special access review, is that it will drag on for years. By then, the current set of "tariff pricing plans" subject to the review will have expired or become irrelevant, or both.

If anything, the expanded review will simply slow down rather than speed up the transition of incumbent analog suppliers to more competitive digital offerings. The Broadband Coalition claims to want the latter, but given their own entry into the IP-based middle-mile market, presumably what they really want is the former. Perhaps that's what was behind their complaints all along.

## HIDDEN AGENDAS: REGULATORY EXPANSION FOR THE FCC

The FCC's rationale for the 2005 proceeding was to determine just how successful its 1999 actions had been in fostering new competition, and to determine whether it was time at last for further deregulation. But it was clear from the scope and scale of the 2012 order's reporting requirements and the 2015 investigation that the agency has other plans for the information it has at last collected.

The FCC, like the market's current participants, knows that special access is rapidly moving from regulated rate-capped analog circuits to all-digital technologies offered by a wide range of high-speed competitors—competitors that are notably outside of its jurisdiction.

Well beyond the clear signs of regulatory capture, the FCC's awakened interest in legacy special access services advances its own top priority: to force its way into the role of "regulatory cop on the beat" for the broadband ecosystem, despite explicit congressional prohibitions to the contrary. The agency is putting all service providers on notice: it intends to remain an active participant even in markets that are unarguably competitive and growing more so.

The link between cause and effect here can be found in the February 2015 misnamed "Open Internet" order, whose considerable legal sleight-of-hand is now being challenged in the D.C. Circuit Court of Appeals.

*The FCC's interest in legacy special access services advances its top priority: to force its way into the role of "regulatory cop on the beat" for the broadband ecosystem, despite congressional prohibitions to the contrary.*

In the 1996 Telecommunications Act, Congress denied the agency jurisdiction over the Internet, in particular the broadband data services offered over mobile networks. Faced with multiple court decisions affirming that reality, including a case directly on point from the U.S. Supreme Court, the Commission majority attempted an audacious end-run in its 2015 Open Internet Order. They simply redefined "the Internet."

In a provision noteworthy for its brazenness, the Open Internet Order purports to change the meaning of "the public switched telephone network," over which the agency maintains regulatory power, to mean both the public switched telephone network and the Internet.

A central term of the 1996 Act, which the agency and the courts had long understood to distinguish old analog technology from new digital replacements, was suddenly and implausibly redefined to erase that distinction. "The public switched telephone network," the majority wrote, now includes any "service" that "uses" IP addresses.

Coupled with the "reclassification" of Internet-based information services in the 2015 Open Internet Order as "telecommunications services" subject to any and all of the public utility provisions of the 1934 Communications Act, the redefinition of "public switched telephone network" flings open the door to potential rate regulation of all special access providers—large and small, old and new, national and local, fixed and mobile.

If the FCC's legal and linguistic gambit survives, it magically extends the FCC's full public utility jurisdiction from fast-fading analog services to broadband ISPs, mobile networks, and most

anyone with a website or Internet service. That includes, of course, IP-based special access services. With a stroke of the pen, the 21st-century digital network turned out to be the same thing as the 20th century analog network, but only because the agency needed it to be.

So where the agency felt constrained in 2005 and again in 2012 to limit its special access oversight to the former Bell companies whose analog services it continued to regulate, that constraint has now been removed. The FCC's renewed tinkering with the regulated special access market seems to be little more than a dress rehearsal for future regulation of new cable and fiber-based competitors, all of it considered and applied at the same leisurely pace we've seen with the 2005 order.

The long-dormant special access proceeding, initiated a decade ago to consider further deregulation of analog services in light of growing competition from better and cheaper digital alternatives, has come full circle. Its endgame, ironically, may not only be the re-regulation of legacy wholesale services, but new regulations aimed at the emerging IP-based market. Such regulation would supplement other features of the FCC's expanding public utility agenda, giving it complete authority over all forms of broadband access, wholesale and retail.

## RESCUING COMPETITION

The FCC's suspiciously enthusiastic rediscovery of special access is the latest in a series of recent efforts by the agency to put its nose under the broadband tent, hoping to sneak the rest of its body inside. It joins similar bait-and-switch proceedings, including the collection of so-called "net neutrality" orders, the municipal broadband order, the mobile data roaming order, and a rumored upcoming proceeding regulating the privacy practices of broadband providers.

But beyond the self-interested goal of giving the FCC newfound relevance in the digital age, it's hard to see any benefit in these expanding efforts to re-regulate the communications industry.

As I explained in my recent book with Paul Nunes, *Big Bang Disruption*, markets undergoing dramatic change in response to disruptive technological innovation are ill-suited to detailed regulatory oversight. Under such dynamic conditions, the ability of industrial-era regulatory institutions to solve even legitimate market failures is highly limited and fraught with potential unintended harm. While the pace of change in the market accelerates, regulatory change proceeds at a constant or declining speed. Despite what may be the best of intentions, the regulators simply can't keep up.

Worse, as new forms of competition emerge to dynamically transform the structure of industries, the regulatory process remains static at best. Regulatory intervention unintentionally applies drag, the result of obsolete legal levers and industry insiders using their influence to slow down rather than speed up proceedings, entirely for self-interested short-term benefits.

No more compelling evidence of the danger of this folly is needed than the on-going special access proceeding itself, which has ground on for over a decade, failing at every stage to demonstrate either relevance or the ability to enhance—rather than damage—both emerging and legacy services. Even if new technologies and competitors were not providing sufficient market discipline to maintain effective competition in special access, the agency's failure to collect and analyze the data it needs to understand the dynamics of the market makes clear the danger of expanding or even maintaining the agency's role in regulating it.

Instead, the special access proceeding has become a deeply cynical enterprise, with layer upon layer of subterfuge and misdirection. CLECs, mobile network operators, and other buyers of incumbent special access services have seized the opportunity to improve their own competitive position as both buyer and now seller (rather than reseller) of enterprise wholesale services. But in the process, they have aligned themselves, knowingly or otherwise, with the agency's self-interested effort to carve out a leading role for itself as regulator of the entire broadband ecosystem.

The special interests are playing with fire. The agency may be supportive for now of their efforts to hamstring the incumbents, but it may only be to enhance the FCC's larger agenda of establishing regulatory primacy of broadband access from end to end—a goal that could intentionally or otherwise harm the continued growth of the competitive market for enterprise services. The special interests involved may quickly find their own special access offerings subject to new and unhelpful scrutiny from the agency.

In the absence of congressional authority to regulate the Internet directly, the FCC has become adept at playing one set of interests off another, even as those interests play the agency for short-term advantages. But in the long run, every participant in the Internet ecosystem seems destined to feel the withering scrutiny of the FCC. That is the real danger deeply buried in the special access proceeding.

Self-styled consumer advocates cheered loudly when the FCC tried to assert its authority to "prophylactically" protect the Open Internet from hypothetical dangers in 2008, 2010, and again in 2015. But by now it should be clear to even the most naïve Internet activist that the FCC is hardly a benign occupying force. It cannot be counted on to efficiently or unobtrusively ensure corporate interests don't somehow ruin the greatest engine of innovation of this century, while leaving everyone else—consumers, edge providers, smaller carriers, and middle-mile competitors—in peace.

The special access proceeding unintentionally reveals just what kind of policing the FCC really has in mind as the Internet's regulatory cop on the beat. In sharp contrast to the engineering-driven multistakeholder process that has so far driven the unprecedented success of digital technology, the agency's approach is neither enlightened nor modern. Nor, it seems, is it based on sound economic principles or analytic practices. R