

Regulatory Source Associates, LLC

Anna-Maria Kovacs, Ph.D., CFA
617-661-4666
akovacs@regulatorysource.com

Kristin L. Burns, Ph.D.
781-621-8371
kburns@regulatorysource.com

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TELECOM REGULATORY NOTE

Triennial negotiations—headed to a train-wreck?

- On one track, the Triennial negotiation process appears to be making great progress. On another, it seems to be in danger of a train wreck. Two agreements have been signed and lots of offers have been announced, all either Region-wide or nation-wide (which in practice must be region-wide since no RBOC can sign for all RBOCs). But some state commissions are demanding that agreements be filed for approval. That raises lots of risks to the negotiations, above all the risk of conflict between region-wide economics in the deals vs. state jurisdiction that must focus on economics within the state's own borders. What this means for investors is that it is too soon to get very excited about the deal-making.
- Two actual agreements have been announced, by SBC (SBC-\$25) and Sage and by Qwest (Q-\$4) and Covad (COVD.OB-\$2). All four RBOCs and Z-Tel (ZTEL-\$2) have announced various Region-wide or national offers and AT&T (T-\$18) is announcing its own offer today, a proposal that would give it a multi-year transition from UNEP to UNE-loop. Qwest held a meeting for 50 CLECs yesterday and is negotiating with MCI (MCI.V.PK-\$17). All of that is enormously positive for the “negotiate rather than litigate” request the FCC made of the industry.
- Perhaps necessary from a legal perspective, but dangerous nevertheless to this process is that some states are asking companies to file their agreements. This is not because the states disapprove of the negotiation process—as far as we can tell, most state commissioners like it. Commissioner Nelson of Michigan, Chairman of NARUC's Telecom Committee, encouraged parties to participate in negotiations in Michigan even before the FCC made its own request. The problem is, as we have pointed out in the past, that the legal status of such agreements is very unclear.
- Both California and Michigan have asked SBC and Sage to file their agreement under sections 251 and 252 of the Telecom Act and Kansas has asked for an explanation of why it should not require them to do so. Sage has made it clear

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from the start that it considers the confidentiality of its agreement a key requirement, and as a result the companies have so far resisted filing it with any state. The states have indicated that confidentiality of some parts of the agreement is a possibility, but cannot guarantee it absolutely. Beyond the confidentiality issue, of course, is the question of what such a filing implies in terms of obligations on the RBOC---an issue that goes beyond this agreement, this RBOC, and these states. Thus, these SBC-Sage filing requests may well dampen, if not shut down, the negotiation process, by forcing the RBOCs to make only such agreements as they are willing to extend to all parties. Those kinds of agreements, in turn, may be less appealing to CLECs because they cannot be responsive to the CLECs' individual needs.

- The perspective of the states who require filing is that they have an obligation under sections 251-252 of the Telecom Act of 1996 (Act), as well as under their own state's legislation in some cases, to require the filing of negotiated interconnection agreements. With such a filing comes the potential for the state to approve or disapprove as well as the possibility that the agreement, in whole or part, becomes available to other parties. There is even the possibility that a state could stretch that initial set of obligations to impose TELRIC---i.e., before the Triennial is vacated on June 15th, can a state approve an agreement that is not consistent with the pricing standard that has been deemed to be "cost-based"? There is, above all, the problem that a Region-wide agreement such as the SBC-Sage deal could be disrupted if at least one state disapproves of the terms for its own state. In other words, the agreement balances terms across the whole Region, but each state has jurisdiction to approve only for its own state---it would have to look at it through the lens of its own state's view of public interest, just and reasonable pricing, etc. An agreement that may make economic sense at a price averaged across thirteen states might make no sense if a major state ruled that the price has to be changed for its state.
- The perspective of some CLECs is that they have a right under the Act to opt into such agreements, or parts thereof, that they find desirable. Their position is that a refusal by SBC to file would be like the past refusal of Qwest to file some of its agreements, something the FCC ruled to be in violation of the Act. At the same time, the perspective of other CLECs (or even the same CLECs) is that they need deals that work for their specific circumstances. It would not be to the advantage of a small CLEC to force the RBOCs to create generally available deals that have high prices for low volumes, for example, if that CLEC can get a better deal by throwing other items on the table that the RBOC might not want to make generally available but may agree to do for one party. Thus, the CLECs are divided both on the legal issue and the practical issue, with some CLECs wanting an individual deal but dubious about its legal status, others believing that they will do best if they can opt into a deal cut by a more powerful CLEC, and yet others believing that the individual deals are both legal and desirable.

- The RBOCs have yet to articulate a unified legal position on the relationship of the deals they are offering vis à vis sections 251-252. While SBC is trying to keep the Sage deal private, SBC itself has made a separate open offer to all CLECs that would be effective from June 15th to the end of 2004, which it has agreed to treat as a 251-252 obligation, subject to state jurisdiction, as long as the CLECs accept that deal by June 15th. Qwest and Covad have reached a line-sharing agreement, which has not been filed, but which Qwest has said it would file if asked to do so (thus, this deal is presumably exempt from our train-wreck concerns, because it would be filed if that is necessary to preserve it). Qwest is engaging in negotiations with MCI under the auspices of a mediator, and held a meeting for 50 CLECs yesterday to discuss the negotiation process with them and encourage others to enter negotiations. Verizon (VZ-\$38) has made an offer to negotiate with individual CLECs a three year deal that it outlined in general, in which pricing is dependent on terms such as usage and geography (state and zone). BellSouth (BLS-\$26) put an offer on the table that would increase UNEP prices from their current levels in stages.
- In essence, if they agree to comply with requests like those of California and Michigan, the RBOCs will open the door to a whole slew of obligations to which they may no longer be subject once the D.C. Circuit vacatur of the FCC's Triennial Review Order takes effect, or even under the Triennial itself. While that Order is in effect till June 15th because of the extended stay, the RBOCs' UNEP obligations under the Triennial will be lifted after that point unless the stay is extended. The FCC probably will put some sort of interim patch in place until it can rewrite the rules, but the patch and final rewrite are unlikely to include a seven-year obligation like the SBC-Sage deal, or even a three-year obligation like the Verizon offer. The issue is not just the length of the term. These offers would make UNEP available throughout the RBOC's entire Region, while the Triennial itself made provision for UNEP to be eliminated from portions of each state as the RBOC demonstrates lack of impairment. The average price opens the rural zones to competition in states where those areas were priced too high for competitors in the past. There is tremendous value for the CLECs in being able to market their product across a whole Region without fear that their coverage will actually either have large holes in it or will require self-provisioning. In other words, if SBC opens itself to making the Sage deal—or even just the UNEP portions of it—available to all CLECs, it will be committing itself (and its RBOC-siblings by setting a precedent) to obligations that go further than anything that would be required of it even if the Triennial were upheld by the Supreme Court. It is getting a price that averages out Region-wide above the current TELRIC rate in exchange, but the FCC's TELRIC proceeding is headed toward raising that rate anyway.

- If they file their agreements, the companies also create the possibility that a single state's demand for revision will disrupt the entire multi-state contract. Assuming the CLECs like the deals they are signing, this is a risk for them as well as for the RBOCs. For CLECs who are heavily dependent on UNEP for their existence, that risk is much more severe than it is for the RBOCs, for whom UNEP is one factor out of many that determine revenues and earnings.
- The train wreck toward which all this seems to be headed is between the legal obligations of various parties and practical realities. From a practical perspective, the concept of "negotiate rather than litigate" makes tremendous sense. As Sage and Covad have demonstrated, CLECs as well as RBOCs have something to gain from and can reach commercial agreements that are tailored to the parties' specific business plans and needs. Z-Tel put a national plan on the table a few weeks ago and AT&T is doing so today. MCI is engaged in negotiation with Qwest. In essence in each of the actual or proposed deals, the CLECs are agreeing to a somewhat higher price and the RBOCs are agreeing to extend their unbundling obligations beyond what is required even under the Triennial. For both RBOCs and CLECs, there can be an advantage to a Region-wide or nation-wide agreement or which averages terms--including price--across the whole Region. For both parties there can be an advantage in tailoring the deals to the specific needs of the CLEC that is involved in a specific deal. Unfortunately, it is not clear at this point whether the law is consistent with such deals. At least some state commissions believe they are obliged to oversee such agreements. If they do, they cannot do so on a Regional or national basis. In fulfilling their legal obligations, some states may find themselves forced to destroy deals that all parties involved believe are advantageous.

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