EXECUTIVE SUMMARY

As we approach the 10th anniversary of the Telecom Act of 1996, it is appropriate to take stock of the state of the competitive carrier sector. Overall, the competitive sector is making itself over and transforming its business model to capture the opportunities by the march of digital technology innovations. As carriers change their models to include wireless, broadband and IP-based voice delivery, the CLECs are once again threatening incumbents and the established order by the deployment of innovative technologies. Despite the demands of day-to-day turbulence, carriers continue navigating the landscape. While mergers, acquisitions and bankruptcies narrow the playing field, evolving technologies allow competitive carriers to broaden the scope of services and delivery methods that reach customers and meet increasing competition from a surprising set of brand new providers.[1]

Facilities-based competitive carriers continue to cope with a number of immediate operational challenges. In addition to declining revenues, carriers have had to adjust to rising operating costs, owing, in part, to the elimination of UNE-P as a deployment strategy and the expense of attracting new business in the face of intensifying competition. The sector has been joined by entirely new kinds of carriers: MSO's are providing digital telephone and VoIP services – over their own lines. These next-generation CLECs are utilizing lower-cost technologies to price down the market, further squeezing the top-lines of traditional, facilities-based CLECs. In addition to these new players and top-line drains, competitive carriers struggle with capital expenditures and costs, striking the balance between necessary expense and sacrificed margin – all while jockeying for position in an industry that is fighting the persistent reality of consolidation.

Revenues

Revenues, perhaps the most watched barometer of possible success, are essentially flat for the competitive telecom sector. Specifically, as shown in further detail in this report, revenue among the CLECs decreased by 0.1% from 2004. This slight decrease, however, masks some good news: Despite significant unit price suppression, overall revenues have not suffered severe decline; sales growth is largely offsetting unit price decline.

[1] eBay-Skype, Google and Microsoft, to name a few.

Access Lines

Access line counts evidence overall business growth. Competitive access lines have increased by 10.5% in 2005. For as turbulent as the market is, the overall pie continues to grow. This is a positive indicator for the industry: Despite changes to the industry, perhaps even because of them, customers seem to be capitalizing on increased competition, and lower prices, and are migrating to competitive carriers to provide telecommunications services.

Switches

While the number of switches remains stable across markets in 2005, the composition of the switch distribution has changed. Where there were only TDM circuit switches, NPRG has found that between 8% and 12% of competitive carrier switches are now softswitches. With the migration to softswitches, carriers are realizing new operational efficiencies which, likely will be reflected in the bottom line.

Consolidation

This year has seen some of the most significant consolidation in the larger telecommunications industry. The CLEC space has not been left out. Carriers are, without a doubt, being more selective of their acquisition targets, choosing to merge with companies that bring depth to localized networks, rather than an increase in the breadth of network reach. It has been a year of notable consolidation within the sector, ranging from the SBC-AT&T and Verizon-MCI mergers, to the McLeodUSA and Birch Telecom bankruptcies. NPRG expects this consolidation trend to continue throughout 2006 and 2007, ultimately resulting in the further rationalization and strengthening of the surviving competitive carriers.

Consolidation should lead to considerable competitive opportunity. When one looks at the increasing number of access lines and the migration to lower-cost softswitches and other new technologies, the carriers who remain after the continuing consolidation are likely to prosper. Nonetheless, the surviving carriers will not look like the carriers who emerged with the Telecom Act of 1996. NPRG will continue to cover the changes in the industry and is building the new *Competitive Carrier Report* to capture the evolution of the competitive carriers.