

COMMENTS FOR CPUC – JUNE 2005

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These three papers present the telecom industry as a set of capital-intensive service businesses. In that regard, they essentially “get it right”; although it is somewhat surprising that they rarely make this approach explicit. The papers do make it clear that we need to consider both the network, including incentives for investment, and the variety of services and the characteristics of those services, including prices.

Although there is this implicit common starting point, the papers then move in differing directions. I’ll describe some of their contributions. The first paper, by Professors Fine and Figueiredo, takes a rather nifty approach. They compare and contrast the regulatory—and deregulatory—histories of several industries, ranging from railroads to cellular telephony. They classify types of deregulation by whether they were “delayed and partial” or “timely and complete”. Intriguingly, the other possible combinations—such as “delayed and complete” are not represented, although some may want to move cellular telephony to that category.

To me, the most interesting aspects of this paper are the parts of the story that are left out or covered only in the notes. In general, Fine and Figueiredo focus on the important points. But I would like to have seen more coverage of the past costs to the public of the botched parts of banking deregulation and the future costs of the public takeover of the airline pension obligations. Furthermore, for the purposes of

this proceeding, the most interesting statements are on the last page of the text and in two of the last three footnotes.

To start with the concluding section:

“If wireless and cable broadband networks obtain and retain substantial market share and compete vigorously with the traditional copper-based networks of the incumbent phone companies, then the time would be ripe for comprehensive deregulation.”¹

But that is a big “if”. In other words, if there were no problem, we would no longer need to regulate. Probably we can all agree with that.

Now, on to the footnotes. Notes 48 and 50 in the version I received state:

“It is important to note that [we] have not considered how the fact that many of the ILECs own a wireless provider affect [incomplete]”²

and

“The ownership structure in the telecommunications sector is somewhat complex. Most major incumbent local exchange carriers not only own the copper networks in the ground, but also hold large ownership positions of both long distance and wireless carriers. This ownership structure is unlike any other industry we have studied. In essence, one substitute that challenges the traditional phone carriers is actually owned by the traditional phone carriers. Our paper and our theory are silent on this complex ownership structure, though policymakers will need to consider how this affects legislation and regulatory decisions. We leave this to future academic work.”³

Here I agree with the authors. I just would have preferred this be the opening paragraph of their paper rather than the final note.

¹ Fine and Figueiredo, page 28.

² Ibid., fn 48 on page 31.

³ Ibid., fn 50 on page 31.

Next, I shall jump to the NRRI paper. Rosenberg and McGarvey lay out the many dimensions of what has been regulated at the state level and the importance of maintaining at least some aspects of that regulation. They start with the overall view that:

“It would be extremely unwise to completely dismantle state regulation without assurance that meaningful competition is firmly established.”⁴

They provide an excellent summary of the current situation on page 3 and lay out a clear set of goals on page 4, so I shall avoid repeating those parts here. Instead I want to highlight one of their “regulatory functions”, specifically the market monitoring function.⁵ The need for this monitoring and its related information gathering and analysis tasks becomes more important with the introduction of new services, new freedom in pricing and bundling, and so on. I think it unlikely that states attorneys general will provide satisfactory substitute for the public utilities commissions in this area.

For the remainder of my time, I shall focus on three specific areas—resale, anti-competitive behavior, and information needs in a competitive marketplace—contrasting the views of Dr. Hazlett (and sometimes of the other authors), on one hand, with my own views, on the other. Then, I shall end with a brief summary.

⁴ Rosenberg and McGarvey, marginal note on page 2.

⁵ Ibid., pages 11-12.

Resale

It is instructive to look at resale in detail. Hazlett makes a distinction between regulation-mandated resale and input-driven resale, showing the contrast between wired local service resale based on UNEs, on one hand, and wireless MVNOs, on the other. He then draws several interesting, but unwarranted, conclusions based on the differences between the two cases.⁶ One source of his errors is possibly his forgetting to include the ILECs successful entry into long distance by means of the very same resale they so strongly argue against.

It is useful to note here that virtually all of SBC's inter-LATA traffic here in California, whether interstate or intrastate and regardless of whether the service is branded "SBC long distance" or not, goes over networks owned by others. Take the "extreme", but common, case of an in-state inter-LATA call from an SBC subscriber here in the Bay Area to another SBC subscriber in Stockton or Los Angeles. Even for its own brand of long distance, SBC leases capacity on the networks of other carriers to carry this traffic. This fact was somehow ignored in the ILECs arguments that such behavior in local markets was tantamount to being un-American, as carriers should rely on their own networks.

So what is it that does distinguish the cases? In mobile and long distance there are reasonably competitive markets so a reseller seeking capacity, switching, and other services can negotiate with several possible suppliers. That this is not the

⁶ This argument shows up in several places, but particularly at pages 31-32.

situation in local is a more powerful explanation of the ultimate failure of UNE-based resale than any of the explanations proposed by Hazlett. When the dominant ILECs fought the rules and terms of trade to the death in the courts, the resellers had no alternative source of supply.

Anti-competitive behavior

Fine and Figueiredo say it is difficult to detect when predation exists, that economists disagree on how effective it is, and cite Posner on why—if it were to be a problem—the antitrust authorities would (or should) take care of it.⁷ Let's be realistic here.

There are two types of predation—one is lowering prices below costs and the other is raising competitors' costs.⁸ There is ample evidence of both in telecom, and this is concrete evidence that at least some of the markets are not as competitive as Hazlett and the ILECs claim. Furthermore, this alone could provide much of the justification to continue regulation at the state level. To help us understand this phenomenon, I want to review the basic economic “facts of life” of local and long distance service. First, the ILECs claim they lose money on local service. For just a moment let's take this claim at face value. Second, the ILECs fought for the right to enter long distance despite its being reasonably competitive. There are likely to be few

⁷ Fine and Figueiredo, fn 7 on page 29

⁸ See, for example, the special issue on non-price predation of *Journal of Reprints for Antitrust Law and Economics*, Vol. 16, No. 2, 685-705 (1986).

opportunities for super-normal profits in that market. How can these two facts be true, especially since the three biggest ILECs are among the most profitable corporations in America? The short answer is “vertical features”. Having the exclusive rights to 80 to 90% of the residential subscribers in their regions allows the ILECs to sell features (and bundles of features) at many times their incremental costs. This dynamic explains many of the anti-competitive tying arrangements in the industry as well as much of the market segmentation. My favorite here is the ILECs threat to cut off DSL if a customer even thinks of switching to a competitive local carrier. SBC’s DSL subscribers are required to keep their traditional voice service despite the fact that there is no valid technical requirement that prevents voice and broadband from being provided separately. (The precise wording on their DSL web site is “SBC local service and one year term required.”⁹) This also has the effect of reducing the likelihood of any effective competition from technologies such as VoIP.

Information needs of a competitive market

Additional evidence of lack of competition comes from the prevalence of deceptive pricing, pricing that fails to disclose all its components and additional fees, or—at least—pricing without full disclosure except in tiny footnotes. To give but one example, again from broadband, SBC is currently offering residential “Express” DSL service for what appears to be \$14.95 per month to new DSL subscribers. (This

⁹ See web page at: http://www02.sbc.com/DSL_new/content_new/1,,18,00.html

may be what Hazlett is referring to when he states: “Moreover, retail discounting has occurred simultaneously with the acceleration in DSL growth.”¹⁰ What is not clear in the advertising, but is buried in the middle of a 15-line footnote, is the fact that this price will be increased to an unstated amount after the first year.¹¹ The exact text is: “At end of term, then-current monthly rate applies”. The typical consumer has no idea of what that means. In fact, neither this expected price nor the now-current rate is stated in the promotional material. This problem of lack of disclosure is made worse by the statement “Additional requirements, restrictions, and charges apply, including monthly Federal Universal Service Fund (FUSF) cost recovery fee.” Nowhere on the DSL offering page or on the page to which this statement is linked is the actual level of that “fee” disclosed.

These practices are inconsistent with competitive markets.

Conclusion and advice for the CPUC

At this point, I want to make it clear that I do not somehow think the ILECs are all bad or that all regulation is automatically good. To provide some background and *bona fides*, I am the author of the study showing that state regulation of CATV actually led to increased prices in those states with PUC-like regulation of cable prices

¹⁰ Hazlett, page 24.

¹¹ SBC web site, *op. cit.*

when compared to the other states.¹² But again here there was a difference as CATV at that time was regulated at as many as three levels—federal, state, and local.

So what should the role of PUCs be, given that we all agree the industry is in transition? I would stress two specific roles. The first, as I mentioned, is discussed rather nicely by NRRI, but should be given more prominence. Regulators should develop and enforce rules designed to let consumers (residential and business) understand what they are buying and how much they will have to pay. The current situation is a disgrace. My guess is that literally almost no one in this room can completely and adequately explain every line item on a current telephone bill to a reasonably well-educated Californian.

The second is that we need to face up to the fact that the telecommunications and information needs of the public are changing. It is no longer sufficient to have a goal of a telephone in over 90% of California homes. Whether one is seeking information for schoolwork or to help in a job search, broadband access is becoming a necessity. But at the same time, the U.S. has dropped to 16th in broadband penetration.¹³ Two of this morning's papers have made it clear that consumer benefits increased greatly when the introduction of PCS enabled the number of wireless competitors to increase from two to approximately five in most geographic markets. So why should we be satisfied with the so-called "duopoly" in broadband?

¹² Yale M. Braunstein, "Economic Effects of State Regulation of Cable Television," in H. S. Dordick, ed., *Proceedings of the Sixth Annual Telecommunications Policy Research Conference* (Lexington, 1979).

¹³ ITU data, Jan. 1, 2005. Available at: www.itu.int

Intelligently reforming industry structure and practices can have a big payoff in this area. These are goals to which I hope we can all subscribe.