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April 6, 2006

The Honorable Ted Stevens, Chairman
The Honorable Daniel K. Inouye, Co-Chairman
The Honorable Trent Lott, Member
Committee on Commerce, Science, and Transportation
United States Senate

Dear Mr. Chairman, Mr. Co-Chairman, and Senator Lott:

At the committee's March 30 hearing on "Competition and Convergence," Chairman Stevens posed two followup questions for all witnesses to answer. Since that time I have also received some additional questions from Senator Lott and committee staff. To keep things simple, I'll address all of the followup questions in this letter.

Chairman Stevens' questions

"I also want to ask you another question…If you were drafting this bill what would you include in it that would help promote competition and what would you include that would force consumer prices down? We say that promoting competition is designed to bring it down. So, it may be there's one answer for that double question, but I don't think so. What would you include to promote competition and what would you include to force the prices down, really, bring them down?"

The most important thing Congress can do to promote sustainable competition is to adopt policies that facilitate the creation of multiple conduits through which customers can obtain a variety of voice, data, video, and other services. As I mentioned in my testimony, two of the most significant opportunities are (1) removal of video franchising as a barrier to competitive entry, and (2) continued movement toward a market-based spectrum policy that will make more spectrum available for wireless services. These measures will help ensure that multiple conduits are available to as many consumers as quickly as possible.

Experience suggests that we can usually expect competition to generate substantial price reductions and quality improvements. In cable TV, for example, 20 years of economic research consistently demonstrates that prices are 15-20 percent lower, and the number of

channels is larger, in markets with two wireline video providers.[1] Competition in long-distance telephone service substantially reduced long-distance rates, even after accounting for long-distance access charge reductions mandated by the Federal Communications Commission.[2] The explosion of competition in wireless communications, triggered when Congress made an additional 120 MHz of spectrum available in 1993, led to several years of double-digit reductions in the per-minute price of wireless service.[3] More recent years have seen significant new wireless services and features, such as camera phones, Internet access via PDAs, and wireless broadband cards. In all of these examples, the principal and most effective form of competition consists of entrants who made substantial investments in building their own networks.

Competition can benefit consumers even when it does not generate price reductions.

If a monopoly is providing only a low-priced, low-quality service, and many consumers would prefer a higher-priced, higher quality service, then competition might increase prices while simultaneously increasing quality. Consumers, however, would be better off as a result. Competition ensures that consumers receive the combination of price, quality, and innovative new services that they would most prefer.

Alternatively, if a regulated monopoly is selling one service at a price that is below cost and selling other services at prices that exceed costs, then competition may lead to a price increase for the service sold below cost, coupled with reduced prices for the services sold at prices that exceed costs. Consumers who used only the below-cost service might be worse off as a result of competition, but the consumers who had been over-charged for other services would be better off. Overall consumer welfare would increase, because prices would more accurately reflect the actual cost of service. This is essentially what has happened in long-distance telephone service, where substitution of the federal subscriber line charge for excessive per-minute access rates increased overall economic welfare by between $8 billion and $15 billion annually between 1985 and 1992.[4]

In short, we should be cautious about an exclusive focus on price when quality is important to consumers or when regulation has held some prices below cost. Even in those cases, however, competition can lead to price reductions for some services.

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[1] Jerry Brito and Jerry Ellig, Public Interest Comment on Video Franchising, submitted to the Federal Communications Commission (Feb. 13, 2006), pp. 7-11, available at http://www.mercatus.org/pdf/materials/1539.pdf.

[2] Jerry Ellig, "Intercarrier Compensation and Consumer Welfare," *University of Illinois Journal of Law, Technology, & Policy* 2005:1 (Spring), pp. 98-99.

[3] Robert W. Crandall and Jerry A. Hausman, "Competition in U.S. Telecommuncinations Services: Effects of the 1996 Legislation," in Sam Peltzman and Clifford Winston (eds.), *Deregulation of Network Industries: What's Next?* (AEI-Brookings Joint Center for Regulatory Studies, 2000), pp. 102-105.

[4] Jerry Ellig, "Costs and Consequences of Federal Telecommunications Regulations," *Federal Communicaitons Law Journal* 58:1 (Jan. 2006), pp. 53-54, available at http://www.law.indiana.edu/fclj/pubs/v58/no1/ElligPDF.pdf.

Senator Lott's questions

1. "I know this committee has spent a lot of time talking about video competition, but what can we do to ensure there is healthy competition in the voice marketplace?"

In the most general terms, the best way Congress can ensure healthy competition in voice service is to ensure that multiple conduits capable of delivering multiple services (including voice) are available to consumers. (I elaborated on this point in answering Chairman Stevens' first question.)

One additional, significant barrier to competition solely in voice service is the fact that many states still require incumbent phone companies to sell basic local service at a regulated price that is below the incremental cost of service in many markets. In Texas, for example, Robert Crandall and I found that only about 5 percent of the four largest incumbents' residential lines are sold at prices that cover long-run incremental costs.[5] As a result, new competitors have had to find a way to compete against incumbents who are forced by regulation to sell local service below cost in many places. Some temporarily succeeded by convincing regulators to force the price of the unbundled network element platform even further below cost than the regulated retail price of local telephone service. Sustainable competition, however, came only from competitors who could introduce a lower-cost technology (such as Voice over Internet Protocol), offer a quality attribute that wireline phone service could not match (such as the portability offered by wireless), or sell a package of services at a price that covered the cost of the whole package (as cable, wireless, "broadband service providers," and facilities-based competitors using only some of the incumbent's network elements have done).[6]

Congress could arguably prohibit states from setting rates for local telephone service below cost, because such price regulation interferes with the federal goal of promoting competition in telecommunications. However, Congress may be understandably reluctant to interfere with state regulation of local telephone rates. The next best option would be for Congress to support, or at least avoid undermining, any FCC initiative to increase or deregulate the federal subscriber line charge, which helps bring the price of local telephone service closer to cost.[7]

There are, of course, some very rural markets in which cost-based pricing might make voice service more expensive than policymakers feel is desirable. Federal universal service policy is intended to promote affordability in these markets. The most important thing Congress can do to promote competition in high-cost markets receiving universal

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[5] Robert W. Crandall and Jerry Ellig, "Texas Telecommunications: Everything's Dynamic Except the Prices," Texas Public Policy Foundation Research Report (Jan. 2005), available at http://www.texaspolicy.com/pdf/2005-01-telecom.pdf.

[6] *Id.* , pp. 117-118.

[7] The FCC has discussed increasing or deregulating the federal subscriber line charge in its proceeding on intercarrier compensation, discussed in Ellig, *supra* note 2, pp. 116-118.

service support is to make the support competitively neutral, and structure the support so that it creates incentives for continuous improvement and cost reduction. Universal service programs should have goals that are defined explicitly enough to guide the design of the programs. They should also have performance measures that identify how well the programs are accomplishing the goals that Congress established.[8]

2. "I have some real concerns about any provider cherry picking the wealthiest neighborhoods in my state while leaving the rest behind. There has been a lot of discussion about this in the context of franchise reform. Is there anything Congress can do to protect all consumers?"

Incumbent monopolists frequently allege that competitors will "cherry pick" as a justification for preventing entry or imposing costly requirements that will raise competitors' costs. A common justification for requiring new entrants to serve all markets served by an incumbent firm is that "cream-skimming" in the most lucrative markets would erode the profits that subsidize prices in less lucrative markets. The less lucrative markets may be higher cost, or they may consist of consumers who buy only a basic service package. According to this theory, if the new entrant takes the "cream," the incumbent will have to raise prices to its remaining customers, or perhaps even discontinue service to the unprofitable customers.

Whatever the merits of the cream-skimming argument in theory, there are two practical reasons that it is not applicable to contemporary cable markets.

First, the cream-skimming theory requires that some customers pay prices that are below the incremental cost of serving them. These are the customers in danger of paying higher prices or losing service if the incumbent loses some of its profits from the more lucrative customers. I know of no economic studies showing that cable companies currently sell video, broadband, or telephone service to any subscribers at prices that fail to cover the incremental costs of serving those subscribers. As long as prices cover the incremental costs of serving a subscriber or a group of subscribers, they make a contribution to covering the fixed costs of the cable system. These customers may be *less* profitable than other customers, but they are not *un*profitable. As a result, there is no reason for the cable company to stop serving them just because it loses some of its more profitable customers. Indeed, if the less profitable customers are willing to pay a price that covers the incremental cost of serving them, then new entrants would also eventually extend service to them, and competition would likely lower their cable rates too.

Second, the theory that the incumbent deprived of the "cream" will raise prices to other customers makes sense only if regulation effectively constrains the prices these

[8] Additional ideas on improving the effectiveness of universal service programs can be found in a series of comments that Mercatus Distinguished Visiting Scholar Maurice McTigue and I have filed in the FCC's proceeding on management of universal service programs. These are available at http://www.mercatus.org/regulatorystudies/article.php/1509.html.

customers pay. But cable rates are effectively deregulated, because 90 percent of subscribers purchase “expanded basic” service, whose price is not regulated.[9]

An incumbent unconstrained by regulation will charge whatever price it believes the market will bear (taking into account concerns such as its reputation for fair dealing and the possibility that a higher price might attract competition). Such an incumbent is already charging its customers the most profitable price. A cable incumbent that lost customers to competition and then tried to increase prices on remaining customers would see its profits fall even further. Since cable rates are effectively unregulated, it is unlikely that cable companies are using profits from lucrative markets to subsidize the prices paid by customers in less profitable markets. Therefore, no consumers are harmed if new competitors are permitted to serve only part of the incumbent cable company’s customers. Because noncompetitive portions of the jurisdiction will not see higher rates as a result of competition elsewhere, there is no reasonable justification for forcing new competitors to serve the incumbent’s entire territory.

On the whole, I believe that concerns about “cherry picking,” “redlining,” and “cream-skimming” in cable stem from an inappropriate analogy with telephone service. Historically, regulation has forced phone companies to sell basic local service to many consumers at a price that is below the incremental cost of providing the service. Urban consumers, business customers, and long-distance users were over-charged to provide this subsidy. Cable companies, on the other hand, do not face effective rate regulation that would force them to sell to some consumers at prices below incremental cost. Therefore, the conditions that lead to cherry-picking are simply not present in cable.

The principal effect of requirements intended to prevent “cherry-picking” would be to prevent or delay entry by new wireline cable competitors.

Committee staff questions

“You have stressed the importance of encouraging competition unfettered by regulation, but is it sometimes necessary to treat similar services differently? For instance, satellite providers don’t pay a franchise fee but they don’t use the rights-of-way either. Is there a problem with those types of distinctions?”

Firms that use the public rights-of-way to provide communications services should pay fees that promote efficient use and management of the public rights-of-way. The appropriate fee depends on what kinds of costs the firm’s use of the rights-of-way imposes on the public, in terms of congestion on poles, excavation of streets, and similar factors.

Since satellite does not impose these costs, it would be inappropriate to charge satellite a franchise fee. For similar reasons, it would not be appropriate to charge wireless firms a franchise fee if they used some of their spectrum to provide video services. This does not

[9] Federal Communications Commission, *Report on Cable Industry Prices* (2005), p. 3.

amount to treating a competitor differently. Rather, the competitor is simply not charged for using something that it does not use.

Having said that, I would also like to point out that the wireline video providers probably have a legitimate complaint about franchise fees. It is likely that the current maximum 5 percent franchise fee is quite excessive, compared to the costs that cable companies, broadband service providers, and telephone companies impose on the public when they use the rights-of-way. Out of approximately 175 local governments that filed comments in the FCC's video franchising proceeding, only three reported franchise fees substantially different from 5 percent.[10] Data on the actual costs imposed by cable firms' use of public rights-of-way are sketchy, but a study of Berkeley, CA, found that these costs amounted to only $30,000 annually.[11] Other potential video entrants, such as incumbent phone companies and electric utilities that could use broadband over powerlines to transmit video, already have arrangements to use the public rights-of-way for other purposes. The additional costs they might impose on the public by adding video services are likely small.

Firms that do not use the public rights-of-way should not have to pay local governments for something they do not use. However, the excessive franchise fees paid by cable, telephone, and electric utilities most likely distort competition, and they surely increase consumer costs. Since franchise fees represent an increase in marginal costs, it is likely that they are passed right through to consumers.[12] The pro-consumer solution is to find a way to reduce franchise fees so that they reflect the actual costs that the franchisees create for the public when they use the public rights-of-way.

On a more general level, these two questions ask whether policymakers should seek to "level the playing field" by removing artificial distinctions between competitors created by public policy. The "level playing field" is an attractive metaphor that appeals to our sense of fairness. But not all "level playing fields" affect consumers equally.

One can level the playing field either by imposing all of the regulations and requirements faced by each competitor on all, or by removing most of them and then making the remaining ones competitively neutral. For example, Congress might change existing law so that all voice, data, and video services pay a 5 percent franchise fee to local governments, make contributions to the federal universal service fund, *and* pay the federal government some upfront fee before they can enter the market (as the wireless firms must do when they purchase spectrum). The playing field might be level, but

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[10] Montrose, CO, White, SD, and Esopus, NY each charge 3 percent. See Jerry Brito and Jerry Ellig, "Video Killed the Franchise Star: The Consumer Cost of Cable Franchising and Proposed Policy Alternatives," SSRN Working Paper (March 2006), p. 18, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893606.

[11] Thomas W. Hazlett, "Cable TV Franchises as Barriers to Video Competition," George Mason University Law and Economics Research Paper Series 06-06, p. 17, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=889406.

[12] For a more detailed explanation, see Brito and Ellig (2006), pp. 17-18.

consumers would pay substantially more for these services than they do now. Alternatively, policymakers could level the playing field by:

> (1) requiring that local governments charge voice, data, or video service providers a franchise or other fee no greater than the costs that their use of the public rights-of-way actually imposes on the public,
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> (2) funding universal service through a phone-number-based charge, and
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> (3) making a large quantity of spectrum available for flexible use, which might result in less revenue from spectrum auctions but would substantially increase competition and consumer welfare.

From a consumer perspective, this second "level playing field" is much preferable to one in which all companies bear every burden currently borne only by some.

Finally, I strongly suggest that a fully "level playing field" should *not* be a prerequisite before policymakers allow new competitors to enter a market. One of the benefits of competition is that it helps reveal artificial advantages or disadvantages that public policy confers on some competitors, and it creates incentives to eliminate them. Competition, therefore, is an important tool that helps policymakers identify when the playing field is *not* level and find a pro-consumer remedy.

I hope these answers will prove useful to committee members and staff, and I would be happy to provide any further information you think would be useful.

Sincerely,

Jerry Ellig
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