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April 24, 2006

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

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

Subsequent to the committee's March 30 hearing on "Competition and Convergence," Senator DeMint posed several followup questions, in addition to those sent earlier by Chairman Stevens and Senator Lott. This letter answers those questions.

1. *You've said that you want more telecom regulations reviewed under the antitrust standard, but what about the FCC's current 'public interest' standard? What's wrong with that?*

The public interest standard is so broad that it allows the FCC to make virtually any decision and consider virtually any factors, regardless of their effect on consumer welfare. This means, for example, that the FCC could approve an anti-competitive merger if it decided that such a merger would further some other objective, such as enhanced national security, ease of regulatory administration, or three commissioners' own personal vision of what the communications industry should look like. Historically, the FCC has used the public interest standard to adopt spectrum allocation policies that hindered competition by making it impossible to reallocate spectrum to another use without FCC permission. Until the 1970s, the FCC suppressed cable television in order to promote broadcasting – another exercise of the public interest standard that harmed consumers.

This potential problem arises not just when FCC decisions are explicitly made under the public interest standard, but whenever legislation gives the FCC leeway to depart from consumer welfare as the guiding principle. The longstanding battle over the Unbundled Network Element Platform, for example, occurred not because of FCC decisions under the public interest standard, but rather because the FCC opted to push the communications industry toward a particular vision of competition under legislative provisions that gave the FCC more leeway than antitrust principles would have allowed.[1]

The consumer welfare standard that guides antitrust law would help ensure that consumer interests are paramount, rather than just one set of factors to take into consideration. Congress could ensure that decisions about communications regulation are made under a consumer welfare standard in one of two ways: (1) Revise the Communications Act to replace the public interest standard with a consumer welfare standard, or (2) Move some or all jurisdiction over communications services to the antitrust agencies.

2. *If we reviewed more telecom regulations under an antitrust standard, would there be a danger that we would return to a monopoly like we had during the era of Ma Bell? What about the dangers of a duopoly?*

"Duopoly" simply means that there are two competitors rather than one. Extensive research shows that duopoly in communications is much better for consumers than monopoly.[2]

A possible danger of duopoly is that the two firms might collude on prices or other terms of service. Thus far, experience with duopoly in cable TV, broadband, and telephone service suggests that two competitors can be expected to compete vigorously. Two decades of economic research find that the presence of a second wireline video competitor reduces rates by 15 percent or more. A Government Accountability Office case study found that markets in which new Broadband Service Providers compete with the existing cable and phone companies tend to have rates for video, Internet, and telephone service that are often lower than similar markets without such competition.

The idea that even two firms would compete vigorously makes some sense, because the costs of these networks are largely fixed, and so the firms face strong pressures to cut prices or offer other inducements to acquire or retain customers. In any case, overt collusion would be illegal under the antitrust laws.

Prior to the 1960s, Ma Bell was a monopolist because the company owned the only phone lines that customers could use to make local or long-distance calls. Customers served by local phone companies not owned by the old AT&T still had to use AT&T's long distance lines if they made long distance calls. Competition was also simply illegal,

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[1] *United States Telecom Assn. vs. Federal Communications Commission*, No. 00-1012 (March 2, 2004): 7-11, 19, 24.

[2] Cable franchising issues are examined in great detail in 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), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893606, and Thomas W. Hazlett, "Cable TV Franchises as Barriers to Video Competition," George Mason University Law and Economics Research Paper Series 06-06, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=889406. For information on Broadband Service Providers, see Government Accountability Office, *Telecommunications: Wire-Based Competition Benefited Consumers in Selected Markets* (2004).

until MCI started offering long distance services contrary to law and then repeatedly won its court appeals in the 1970s when the FCC tried to put an end to competition. Replicating this monopoly today would require one company to own all of the conduits through which voice, data, and video could flow to the consumer – telephone wires, cable, satellite, wireless, and power lines (once broadband over powerlines is widely deployed).

While some companies own multiple competing conduits (phone companies that own wireless, for example), the idea that all conduits would fall under the ownership of a single company is simply fanciful. I doubt such a combination would be economically sensible from the company's point of view. Even if it were, the mergers necessary to make such a combination possible would not likely be approved (unless the "public interest" standard permitted some other factor to override consumer welfare considerations).

3. *Is it possible for Mr. Cooper to come up with a number that determines how many competitors are needed to have a "competitive marketplace" in telecom?*

Not with any degree of accuracy.

The relationship between the number of competitors, their market shares, and the competitiveness of markets has been studied extensively by scholars for 50 years. This research reveals that there is no simple rule of thumb that tells us how many competitors, or what level of concentration, makes a market "competitive."

Recent studies on the relationship between concentration and prices have produced a wide variety of results that depend on the facts and circumstances in the industry studies. Some empirical research on railroads, for example, finds that two competitors are sufficient to produce the results one would expect in a competitive market.[3] Across a variety of industries, a number of studies find a positive relationship between concentration and prices, but not all do.[4] Laboratory experiments find that four sellers are usually enough to produce a competitive market outcome.[5] In general, the results seem to vary across industries and with the type of information buyers and sellers have.

The DOJ/FTC Merger Guidelines reflect the fact that there is no simple or mechanical relationship between the number of competitors and the competitiveness of the market. The guidelines indicate that mergers in more concentrated markets face a heightened level of review, but such mergers can still be legal.[6] The antitrust agencies try to take

[3] Paul A. Pautler, "Evidence on Mergers and Acquisitions," *Antitrust Bulletin* 48:1 (Spring 2003), pp. 181-82, and references cited therein.

[4] Pautler (2003), pp. 189-95.

[5] Pautler (2003), pp. 200-01.

[6] See Section 1.5, Concentration and Market Shares. A copy of the guidelines is available at http://www.usdoj.gov/atr/public/guidelines/horiz_book/toc.html.

into account all relevant facts and circumstances in determining whether a merger would reduce competition and harm consumers.

Two fairly reliable findings in the economics literature are highly relevant to current communications debates:

> **1. Duopoly is much better for consumers than monopoly**. Studies on competition in cable television, natural gas, and railroads, for example, find that the presence of a second competitor reduces prices significantly.[7] This suggests that a pro-competition policy, rather than a policy aimed at creating regulated monopolies, is the appropriate way to promote consumer welfare.
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> **2. Free entry promotes consumer welfare, regardless of the number of competitors.** Studies of the wireless industry, for example, find that making more spectrum available for wireless communications (one measure of the openness of entry) tends to lower the price of wireless service, independently of any effect on market concentration.[8] Policies to remove barriers to entry -- such as video franchising reform and market-based spectrum allocation to make spectrum more widely available – could deliver big consumer benefits.

4. *Mr. Comstock advocates re-instating common carrier rules in order to bring about more competition. Isn't getting wrapped up in Title II of the Communications Act what every carrier is trying to flee from? Are common carrier rules appropriate anymore? What effect would imposing common carrier regulations on* <u>*all*</u> *carriers do to competition, innovation and growth?*

The discussion at the hearing skipped back and forth between three different kinds of "common carrier" obligations: the obligation to interconnect with other communications providers, the obligation to let competitors use monopolized facilities, and the obligation to let customers access whatever content they wish at no additional charge ("net neutrality.") All three types of concerns could be addressed under antitrust law and antitrust precedents.

The choice is not between common carrier regulation or allowing carriers to manage their networks in whatever arbitrary way they see fit. The choice is between common carrier regulation (which has, traditionally, had a deadening effect on incentives for innovation) and making carriers operate under the same competition and consumer protection rules that apply to the rest of the economy. Federal Trade Commission Chair Deborah Platt Majoris made essentially this point when she recently noted that the FTC has jurisdiction

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[7] For cable, see studies cited in my testimony. For railroads and natural gas, see sources cited in Pautler (2003), pp. 181-82 and 191-92.

[8] Thomas W. Hazlett and Roberto E. Muñoz, "A Welfare Analysis of Spectrum Allocation Policies," AEI-Brookings Joint Center for Regulatory Studies related Publication 04-18 (Aug. 2004).

over broadband (cable modem and DSL) as a result of the FCC's decision that broadband is an information service.[9]

5. *Dr. Ellig and Mr. McSlarrow: Should cable companies be relieved of their existing franchising obligations? If so, when?*

Yes. As soon as possible.

In addition to keeping competitors out, local franchising also often imposes costly obligations upon incumbent cable companies. Some of these costs get passed through to consumers. The local cable franchise embodies an anticompetitive quid pro quo: cable companies get to exercise some market power, and in exchange they agree to spend some of the profits to provide free or below-cost services that local officials want. Indeed, obligations to provide free or below-cost services may be a way that local governments evade the statutory 5 percent cap on franchise fees, because they can demand services in-kind instead of asking for a higher franchise fee.[10]

When addressing cable franchising, one factor that Congress might want to consider is the level of franchise fees. Federal legislation caps franchise fees at 5 percent, and most local authorities charge 5 percent. Widespread wireline video competition could attract a sizeable number of consumers away from satellite, which does not pay franchise fees to local governments. As a result, local governments could experience a revenue windfall if the franchise fee remains at 5 percent. One study estimates that a revenue-neutral franchise fee would equal about 3.7 percent.[11]

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
Senior Research Fellow

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[9] Lynn Stanton, "FTC Chairman Claims Jurisdiction over DSL, Cable Modem Providers," *Telecommunications Reports* (April 20, 2006).

[10] See Brito and Ellig (2006) and Hazlett (2006).

[11] George S. Ford & Thomas M. Koutsky, Franchise Fee Revenues After Video Competition: The "Competition Dividend" for Local Governments, (Phoenix Policy Center, Bulletin No. 12, Nov. 2005), p. 8.