



Dial “C” for Competition

By **Nicholas Economides**

The telecommunications industry has been blessed by very significant technological changes and innovation that have cut costs dramatically. Technological innovations have driven down costs of essential inputs to telecommunications services, such as computing, information storage, and transmission. And such costs are expected to keep decreasing for many years to come. Digitization, the integration of telecommunications services, and the widespread adoption of the Internet have created very significant business opportunities and many new products and services.

And yet consumers – both business and residential – have not reaped the full benefits of the cost reductions and the innovations. Historically, in many industries, the creation and enhancement of competition have made it possible for consumers to reap the benefits of technological innovation. But in a network industry, such as telecommunications, services are produced by combining different elements and components of a far-flung network. Here, consumers can benefit fully only when the markets for each of the constituent parts of the network are competitive.

If a service requires components A and B, but only the A market is competitive while the B market is monopolized, consumers will never receive the full benefits of innovation. Instead the company that monopolizes the B market will reap these benefits. Unfortunately, in the telecommunications sector, while the long-distance market is effectively competitive, the local market isn't. And this state of affairs represents a failure on the part of regulators.

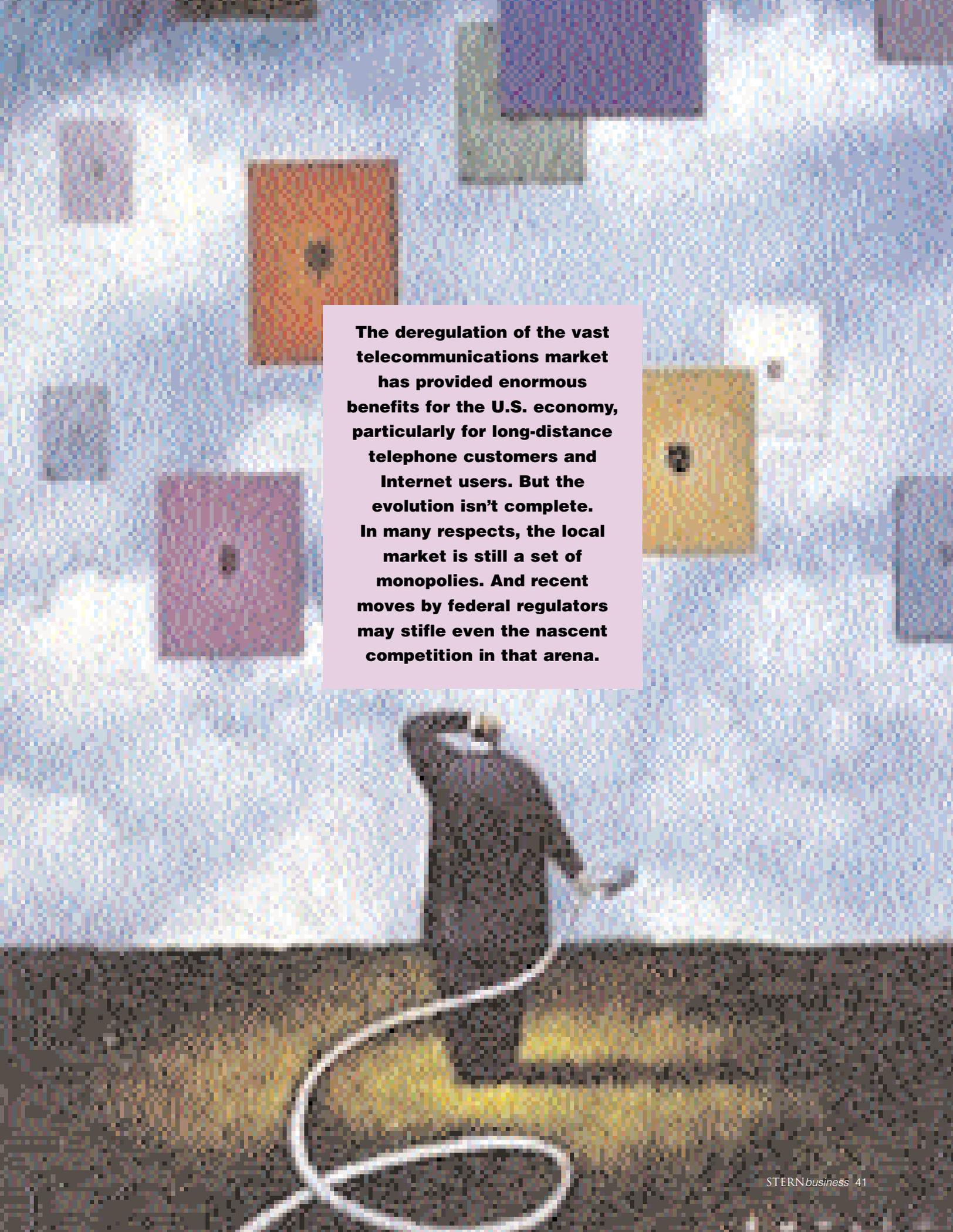
There are three crucial requirements necessary to expand, enhance, and maximize competition. The first crucial requirement is to create new markets, whenever possible. But what can be done for markets or components where it does not seem possible or economically feasible to have effective competition in the foreseeable future? This state of affairs accurately describes local telecommunications markets. These markets, in the absence of regulatory intervention, remain monopolies for the “Baby Bells” that were created by the breakup of AT&T in 1981. If left unregulated, the monopolists in these markets would effectively restrict sales and reduce the variety of offerings. And even worse, since long distance calls pass through local wires in

their origination and termination, local monopolists would also absorb the benefits that consumers could get from long distance. It is evident therefore that the monopoly power of the incumbent local monopolists needs to be restricted and contained from spilling over and distorting other markets. This is the second crucial requirement.

The third requirement is the creation, fostering, and enhancement of competition whenever possible, even if that means occasionally creating artificial environments that imitate competitive markets. These artificial environments can serve as incubators, fostering the conditions that help competition flourish over time. The way that long-distance service developed in the past 20 years provide an excellent example of this theory working in practice.

Competitive Balance

The long-distance market has been the big success story in telecommunications in the past quarter-century. Consumers have benefited tremendously from the long distance competition that started with the breakup of AT&T in 1981. Several competitors, like MCI, created their own networks, and hundreds of



The deregulation of the vast telecommunications market has provided enormous benefits for the U.S. economy, particularly for long-distance telephone customers and Internet users. But the evolution isn't complete. In many respects, the local market is still a set of monopolies. And recent moves by federal regulators may stifle even the nascent competition in that arena.



resellers entered the field. In the 22 years since deregulation, prices of long distance calls have decreased by a factor of five to ten. Today, they are falling at an annual rate of between 10 and 20 percent. Low long distance prices, especially for bulk data transmission, have allowed the Internet to grow and become both ubiquitous and affordable.

But the success of competition in long distance service was not immediate. For several years, entrants did not have their own networks, and were simply reselling long distance minutes they bought in bulk from AT&T. Regulators created an environment in which AT&T was required to sell in bulk, and in which AT&T was forced to allow entrants such as MCI and Sprint to interconnect with the AT&T network. The regulators forward-looking policies ultimately delivered remarkable benefits to consumers as long distance providers aggressively cut prices to gain market share.

In contrast to the overwhelming success of competition in long distance, competition in local service ranged from minimal to lukewarm for a number of years. Since the beginning of 2002, competition in local service has increased significantly. However, some federal telecommunications regulators, including FCC Chairman Michael Powell, seem intent on changing regulations in ways that are likely to eliminate competition. And regulators have already taken steps that strengthen the market power of incumbent monopolists in the provision of high bandwidth (“broadband”) Internet services. The immediate consequence will be price increases in broadband Internet service.

But why not replicate the long distance success story in creating local competition? And does it make any sense that federal regulators are facilitating higher Internet prices when all

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agree that the Internet is an engine for growth?

Congressional Intent

To understand these issues we need to go back seven years. As part of an effort to jump-start competition in local telecommunications, Congress passed the Telecommunications Act of 1996 (“1996 Act”). Among other things, the 1996 Act required that public telecommunications networks to interconnect, and that incumbent monopolists, such as Verizon, lease to entrants all parts of their local telecommunications network at cost. Entrants were to be allowed to choose which parts of the network they wanted to lease, and barriers to entry were eliminated. Broadly speaking, the key Congressional mandate to regulators was to encourage telecommunications competition in every dimension!

The 1996 Act recognized that the modern telecommunications network is a network of interconnected networks. For example, a typical long distance call may pass through three networks. A call from New York to Los Angeles passes through the Verizon network at its origination, through AT&T in its long distance transmission, and through PacBell’s network when it terminates at its destination. This means that each one of these three networks can add to the price a consumer pays for a long distance call. And here’s the rub. Even as the long distance transmission market

has become competitive, the end-to-end call can still be expensive because of its origination and termination parts. Although the origination and termination parts are small in distance (often called “the last mile” from the network to the customer’s location) they can add significantly to the price of a long distance call since they are monopolized.

The rules of network access define the success of local competition. And the Federal Communications Commission (“FCC”) did set up elaborate rules that define the parts of the network that can be leased, as well as the cost basis for these components. However, the rules for implementing the 1996 Act have touched off six years of litigation dealing with everything from the meaning of the word “cost” and the right measure of cost, to whether AT&T technicians installing equipment in a Verizon building can use Verizon’s bathrooms. This near-constant litigation created tremendous uncertainty in the industry, delayed entry in local telecommunications markets and contributed to the downturn of the telecommunications sector.

In the last year and a half, litigation has subsided. Moreover, as part of their efforts to gain regulatory approval to provide long distance service, local telephone monopolists such as Verizon effectively lowered prices for leases on parts of their networks. As a result, competition in local telecommunications mushroomed. Responding to better prices and plans with better assortment of services, millions of customers changed providers of local service. Slowly, but surely, the model established by Congress for telecommunications is working. Consumers (and businesses) are saving money, have more choices in providers, and

can choose from a wider range of more innovative services.

The past few years have been not particularly good ones for the telecommunications industry. The dot com bubble popped, and major players like WorldCom and Global Crossing went bankrupt. But amid the gloom, the emerging competition in local telecommunications should have been heralded as a big success story and embraced by regulators. Instead, the FCC in February 2003 upheld the network access rules that fostered local competition by the thinnest of margins – a 3-2 vote. Significantly, FCC Chairman Michael Powell was in the minority – i.e. he lobbied against the pro-competitive rules. Now the FCC is considering starting hearings aimed in re-evaluating (read: increasing) the cost at which the local telecommunications networks are to be made available for leases. Such a cost increase would likely stop the emerging local competition in its tracks.

Logging On

Competition in local telecommunications is also essential for the inexpensive provision of broadband Internet connections to small businesses and residences. The 1996 Act allowed entrants, such as Covad, to lease and use high frequencies of the copper wires of local networks to provide broadband Internet service. This Digital Subscriber Loop (“DSL”) service became one of the two most popular ways for a broadband Internet connection. The other Internet broadband connection is through a cable modem that uses the coaxial cable of cable television.

Broadband data connections to the Internet are crucial for Internet growth. Most web sites’ content and structure are optimized for a broadband connection. The transfer of video, pictures, and digitized music

are extremely difficult without such a high-speed connection. Broadband penetration is growing. But despite the wide recognition of the importance of the Internet as a major engine of growth, the United States lags behind a number of countries, including South Korea and Hong Kong, in broadband Internet connections.

Under the circumstances, one would have expected that regulators would try to lower the price of broadband Internet connections, and thus encourage more rapid expansion of the Internet. Here again, the FCC came up short. In February 2003, the FCC decided to allow incumbent monopolists of local telecommunications networks to charge any price they want for the portion of the network used to provide DSL service. The immediate consequence will be higher Internet connectivity prices and slower growth of the Internet in the U.S. This is possibly the most damaging decision for the Internet that the FCC could take short of formally imposing regulation on the Internet.

In its decision on broadband last February and in its general approach to telecommunications, today’s FCC seems to disregard the importance of fostering competition in local telecommunications, as well as the benefits that competition will bring. It seems as if the FCC has lost its faith that the success of competition in long distance can be replicated in local voice telecommunications as well as in broadband Internet service. Even worse the FCC seems to have forgotten that Congress through the 1996 Act directed it to encourage competition.

The results of the loss of faith in competition are likely to be highly detrimental to the U.S. economy. Consumers have benefited and will continue to benefit from the opening

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of the local telecommunications network to the tune of tens of billions of dollars. But changes contemplated by the FCC in the network access rules or the methodology of cost calculation can easily wipe out these benefits. Even a tiny reduction in the growth of the U.S. economy precipitated by a slowing of the growth of the Internet as a result of the February 2003 FCC decision will result in additional tens of billions of losses.

It is truly ironic that when the European Union as well as a large number of countries around the world have fully subscribed to the competitive vision of telecommunications as first understood, tried, and proved successful in the U.S., the federal U.S. regulator is abandoning it.

The competitive vision for the telecommunications sector was and is correct. Time will show that those who adopt it will end up with more efficient telecommunications infrastructure, lower prices, more abundant choice of services, and higher economic growth. It is a pity that the U.S., having led the way, may now be on the verge of reversing course.

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