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Working Party No. 2 on Competition and Regulation

ROUNDTABLE ON THE IMPACT OF SUBSTITUTE SERVICE ON REGULATION

---United States---

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IMPACT OF SUBSTITUTE SERVICES ON REGULATION

1. This paper discusses the impact of "substitute" services on regulation and on antitrust enforcement in the telecommunications sector. It then discusses some issues relating to substitute services that have arisen in postal service regulation, and concludes with a very brief note on trucking and rail competition.

Telecommunications

Introduction

2. Competitive services in United States telecommunications markets started to take shape during the 1970s when Microwave Communications Incorporated (MCI) began offering long distance services using microwave technology. Prior to that, AT&T had a monopoly on the provision of long distance telecommunication services and a near monopoly on local service. Since then, innovation and a changed regulatory structure have combined to create an environment characterized by widespread competition. For example, the widespread adoption of wireless services has given rise to increased inter-platform (wireline vs. wireless) competition. As a result of such competition, some wireline consumers have "cut the cord" and chosen to use only wireless services.[1]

3. More recently, companies using Internet Protocol (IP) based applications have further changed the competitive landscape. For example, cable operators using IP-based applications are now offering both video and voice services to their subscribers. Similarly, phone companies, also using the IP-based applications, are beginning to offer both voice and video programming to their customers. In addition, a number of companies, using existing broadband platforms, are offering IP telephony services to residential customers. Some IP telephony offerings give users the capability to place calls to, and receive calls from, other broadband subscribers and telephone subscribers via the use of traditional public switched telephone network facilities.[2]

4. Broadband Internet access today is being provided by a number of entities using different transmission platforms, such as cable, wireline, wireless, and satellite. Utility companies have also entered the broadband Internet access market through a new platform, called broadband over power-lines (BPL), which uses electric power lines as a transmission medium to provide high-speed communications; BPL made its commercial debut in 2003. Two widely used wireless technologies that use unlicensed spectrum, WiFi and WiMax, are providing wireless broadband access in many cities and towns, and in many educational, civic, and commercial institutions and buildings across the United States.

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1 Federal Communications Commission, Ninth Annual Commercial Radio Communication Services (CMRS) Competition Report, FCC 04-216, p. 88 (2004).

2 FCC, Availability of Advanced Telecommunications Capability in the United States, Fourth Report to Congress, p.25 (September 2004). An Internet application called Free World Dialup provides free peer-to-peer communications to its subscribers capable of exchanging voice, video, or text with other Free World Dialup subscribers without relying on traditional public switched telephone network.

5. In media markets, cable operators, which initially provided services that were complementary to terrestrial, free-over-the-air, broadcast services, are increasingly facing competition from Direct Broadcast Satellite (DBS) operators. A decade ago, cable operators served almost 100 percent of the nation's multichannel video distribution (MVPD) subscribers, but by June 2004, cable's share of all MVPD subscribers had declined to approximately 72 percent. Almost all consumers in the United States have the choice between over-the-air broadcast television, a cable service, and at least two DBS providers.[3] Moreover, competition in the video delivery market is expected to intensify as phone companies enter this market using IP-based video distribution applications and fiber to the premises (or fiber-to-the-curb or fiber-to-the-node) platforms.

Effects of Substitute Services on Regulation

6. In general, a more competitive landscape with widespread availability of substitute services in both telecom and media markets will increase consumer choice, increase the quality of service, and lead to lower prices – changes that are evident in the U.S. market.[4] These changes have also affected many aspects of telecom and media regulation including rules governing market entry and tariff (price) regulation. A modest degree of inter-platform competition between cable and telephone companies was anticipated by the Congress when it enacted the Telecommunications Act of 1996. Rapid deployment of broadband platforms and IP-based applications and related substitute services, however, has ushered in a new era of increased competition and has resulted in the need for a re-evaluation of existing regulations.

7. The Federal Communications Commission (FCC) has several open regulatory proceedings where the Commission is seeking comments on services affected by inter-platform competition. The FCC, for example, is seeking comments on issues relating to services and applications making use of IP, including but not limited to voice over IP (VOIP) services (collectively, "IP-enabled services"). More specifically, in this proceeding, the FCC is seeking comments on the impact of IP-enabled services on the communications landscape and the Commission's regulatory role in this changed landscape, as well as the proper regulatory treatment of these new IP-enabled services.[5]

Selected Recent Regulatory Decisions

8. On a number of occasions, in response to greater availability for consumers of substitute services, the FCC has adopted rules that foster competition and rely more on market forces as opposed to rules that are generally more intrusive in nature, e.g., tariff regulations and market entry rules. The following are some examples from recent FCC decisions.

9. *MVPD Competition and Determinations of Effective Competition.* In the Cable Television Consumer Protection and Competition Act of 1992, Congress directed the FCC to evaluate competition in the MVPD market at the local franchise market level and determine whether there is a continuing need for regulation of basic cable service prices at the local level. The Commission has received several petitions from cable operators claiming that competition from other MVPD operators, including DBS operators, is now substantial and exceeds the threshold set by Congress for a determination of "effective competition"

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3 Federal Communications Commission, Eleventh Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, p.3 (rel. February 4, 2005).

4 One provider of IP telephony services currently offers 500 minutes the customer may use to call anywhere in the United States for $14.99. See Federal Communications Commission, Availability of Advanced Telecommunications Capability in the United States, Fourth Report to Congress, p.25 (September 2004).

5 Federal Communications Commission, IP-Enabled Services, Notice of Proposed Rulemaking, WC- 04-36, pp. 2-6 (rel. February, 12, 2004).

required for deregulation of basic cable rates. The Commission is required to examine the level of competition from other MVPD operators on market-by-market basis by comparing competing MVPD operators and cable operators' penetration and service offerings. In many markets, the FCC has found that there was sufficient competition to justify a finding of effective competition. In those areas, the FCC has decided in favor of deregulation of basic cable service.[6]

10. Inter-platform Competition and Unbundling Requirements. The FCC in its Triennial Review Proceeding has determined that the incumbent local exchange carriers do not have to unbundle certain broadband elements, including fiber-to-the-home (FTTH) loops in greenfield situations, broadband services over FTTH loops in overbuild situations, the packetized portion of hybrid loops, and packet switching.[7] The Commission based its determination with regard to these elements on a number of factors including inter-platform competition between cable companies and telecom carriers for broadband services. The Commission found that the cable companies have made significant inroads in providing broadband services to the mass market. The Commission also found that limiting the unbundling obligations imposed on incumbent local exchange carriers would remove disincentives to the deployment of advanced telecommunications facilities in the mass market[8] The Commission later extended its FTTH decision and determined that certain fiber-to-the-curb (FTTC) deployments,[9] and fiber loops deployed to predominantly residential multiple dwelling units (MDUs),[10] would be treated in the same way as FTTH loops.

11. The Commission also has eliminated other unbundling requirements in order to give the Bell Operating Companies increased incentive to deploy broadband services and compete with cable providers in order to "increase competition and benefit consumers."[11] Specifically, the Commission granted the

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6 We note that in 2004 alone the Commission made a finding of effective competition in more than 250 geographic markets. *See,* various Media Bureau "Effective Competition Orders" posted at FCC's website.

7 Federal Communications Commission, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147 (2003). Packet switches allow carriers to provide advanced services over fiber networks.

8 *id*

9 *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Order on Reconsideration, 19 FCC Rcd 20293 (2004) (treating FTTC deployments as FTTH deployments where the fiber deployment is not farther than 500 feet from each customer premises reached from the serving area interface).

10 *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Order on Reconsideration, 19 FCC Rcd 15856 (2004) (treating fiber deployed at least to the minimum point of entry (MPOE) of MDUs that are predominantly residential as FTTH loops for unbundling purposes, irrespective of the ownership of the inside wiring).

11 *Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C.§ 160(c)*, WC Docket No. 01-338, *SBC Communications Inc.'s Petition for Forbearance Under 47 U.S.C.§ 160(c)*, WC Docket No. 03-235, *Qwest Communications International Inc. Petition for Forbearance Under 47 U.S.C.§ 160(c)*, WC Docket No. 03-260, *BellSouth Telecommunications, Inc. Petition for Forbearance Under 47 U.S.C.§ 160(c)*, WC Docket No. 04-48, Memorandum Opinion and Order, 19 FCC Rcd. 21496, 21511 para. 31 (2004).

regional Bell operating companies forbearance from rules that would impose unbundling obligations under section 271 of the 1996 Telecommunications Act (which governs the regional Bell operating companies' entry into long-distance markets) for elements including FTTH loops, FTTC loops, the packetized functionality of hybrid copper-fiber loops, and packet switching to the same extent the Commission determined that these facilities need not be unbundled under section 251(c)(3) – the statutory unbundling provision at issue in the Triennial Review Proceeding.[12]

12. Local number portability. In November 2003, the FCC extended local number portability requirements to wireless providers requiring wireless operators to provide for porting both to other wireless carriers and to local wireline carriers. In general, local number portability (LNP) refers to the ability of users of telecommunications services to retain, at the same location, existing telecommunications numbers when switching from one telecommunications carrier to another. The Commission concluded that enabling wireless subscribers to keep their phone numbers when changing carriers would enhance competition between wireless carriers as well as promote competition between wireless and wireline carriers. LNP had a direct impact on wireless competition where operators embarked on an aggressive customer retention effort to minimize switching among carriers which was made easier by number portability.[13] Also, as a result an increased number of wireline customers have switched to wireless service because they were able to port their numbers to their new services provider.

Impact of Substitute Services on U.S. Antitrust Law Enforcement in Telecommunications

13. Telecommunications markets in the United States are undergoing constant change as a result of consolidation, evolving regulatory requirements, technological advances and efforts by providers to meet consumers' demands for faster, higher quality or easier to use services. In analyzing proposed mergers or potentially anticompetitive conduct, the antitrust agencies are mindful that these changes need to be factored into any determination. Many of these changes have resulted in the emergence of "substitute" services. For example, technological advances that lead to improved services, or lower the cost of providing services, can increase competition by allowing the development of new providers or the expansion of existing providers in adjacent areas into markets served by local incumbents. Such changes can alter market definitions, add new participants to markets or change the competitive significance of mergers or conduct. It is also possible that newer technology may lower the cost and time for entry thus eliminating concerns about the consolidation of existing providers. The Antitrust Division of the U.S. Department of Justice (DOJ), as described below, has wrestled with these issues in past investigations and is currently analyzing large combinations between local landline incumbent providers and traditional long distance companies that the parties allege are necessary because of the extensive upheaval the industry is undergoing.

14. The DOJ recently considered a merger involving the first and second largest providers of paging services in the United States. The U.S. paging industry has undergone significant consolidation, multiple bankruptcies and a rapid decline in the number of units in service. In 1999, there were 45 million paging units in use, but at the time of the investigation, that figure had dropped to less than 12 million and was projected to shrink further. The parties to the merger alleged that the appropriate market to examine in our analysis was broader than just paging services, because customers were substituting from paging to other wireless services at a dramatic rate. The DOJ found that there was evidence suggesting that many users were replacing their pagers with mobile wireless telephony services, such as cellular or PCS services; however, it then considered whether there were classes of pager users for whom these services were not an

12 *See id.*

13 Federal Communications Commission, Ninth Annual Commercial Radio Communication Services (CMRS) Competition Report, FCC 04-216, p. 69 (2004).

adequate substitute. A small percentage of paging customers, including some hospitals and emergency responders, did not consider cellular or PCS to be adequate substitutes because of differences in price or quality, including network reliability or the ability to penetrate buildings. The DOJ eventually concluded that even for users who said they could not totally switch to mobile wireless telephony services, there were sufficient alternative options, including other national, regional or local paging companies as well as the ability of some customers to self-provision. Based on these findings, the DOJ did not challenge the proposed merger. The DOJ also noted that some customers were moving to wireless local area networks that in part replaced freestanding paging systems. The DOJ concluded that over time this technology could increase competitive pressure on paging companies.

15. The DOJ is currently evaluating two mergers involving incumbent local telephone providers acquiring long distance companies. The major local incumbents in the U.S. (known as Regional Bell Operating Companies or RBOCs) currently offer long distance services as well as local services, each having received regulatory approval to offer such services nationwide. Each RBOC has been very successful in selling bundled local and long distance services within its region. The traditional long distance carriers began providing local service after passage of the 1996 Telecommunication Act; however, they have not been very successful in obtaining customers for this service. The proposed mergers raise potential concerns in a variety of telephony areas affecting both businesses and consumers, and the DOJ is devoting substantial resources to evaluating these transactions.

16. The parties to these mergers have argued to the DOJ and FCC that these transactions will not substantially lessen competition because of the tremendous changes in the industry that have resulted in increased competition. In particular, they point to the proliferation of e-mail and cellular and PCS phone usage, the entry of cable companies into providing telephony services and the offering of Voice Over IP services ("VOIP") by other providers. In analyzing these assertions and determining the appropriate markets and related market shares, the DOJ will examine the price and quality of these alternative services and the way these services are sold and used. For example, customers who purchase VOIP may pay less for these voice telephony services than the prices set by incumbent providers with circuit-switched networks, but need to purchase broadband services to be able to use the service. The DOJ will also examine whether these alternatives are attractive or available to all classes of customers or users located in different geographic areas. In the U.S., not all cable companies currently offer telephony services, and some areas are not served by cable companies. In addition, businesses, which demand higher levels of reliability and security, may not find wireless services to be adequate substitutes for wireline services. Among other information, the DOJ will be gathering data on the extent to which customers are relying on these services to totally replace landline services and how changes in the price of traditional services are impacting customers' choices. Finally, the DOJ will need to evaluate the impact regulation has on competition in the markets of concern, including the results of deregulation in some geographic areas, any differences in regulation imposed on incumbents and substitute providers and uncertainty created by legal challenges to existing regulation.

Postal Service Regulation and Substitute Services

17. The United States Postal Service (USPS) and the Postal Rate Commission (PRC) are the two federal executive branch institutions with governmental responsibilities in the postal sector. The USPS has characteristics of both a governmental agency and a business enterprise. It has statutory authority to provide for the collection, handling, transportation, and delivery of mail matter. Rates and classifications for domestic postal services are generally developed through a process that involves the USPS, the Presidentially appointed Governors, and the PRC. Briefly, in order to institute proposals for changes in rates and classifications, the USPS must first seek recommendations from the PRC, which provides

opportunities for the public to participate in rate proceedings. The PRC conducts hearings and issues recommendations to the Governors, who then vote on the recommendations.[14]

18. The PRC has responsibility for evaluating proposals for changes in domestic postal rates, fees and mail classifications proposed by the USPS. It issues recommended decisions to the Governors of the USPS. Further, the PRC investigates complaints of substantial national scope concerning postal rates and services. Complaints can be filed by interested persons, which in the past have included competitors, mailers, mailer associations, and individuals.

19. The role of substitute technologies – in particular diversion of traditional postal services to newer technologies – has arisen in postal regulatory proceedings. Diversion was cited as a justification for a recommendation on classification and fees for "qualified business reply mail" (QBRM) service, which consists of a high-volume reply mail service, used primarily in connection with consumer remittances. The PRC explained its recommended fees and classification provisions for the service as follows:

> "The recommended new fee categories for QBRM will allow fees that are aligned more closely with costs than existing fees, and therefore more fair and equitable to QBRM mailers. The Commission notes that BRM volume has decreased substantially over time. This may have occurred in part because firms that would otherwise use BRM have been deterred by a non-cost based fee structure for QBRM that made its use uneconomical. Adopting a more cost-based QBRM fee structure may spur volume. Because such mail pieces are often related to bill paying, greater usage may aid the Service in staving off electronic diversion. Improvements in QBRM pricing and costing are therefore quite important, and the new structure is desirable from the point of view of both users and the Postal Service." PRC Op. & Rec. Dec., Docket No. R2000-1, vol. I, at 557.

20. Substitution and new technologies have also arisen in complaint cases filed with the PRC. In response to a complaint brought by United Parcel Service challenging the USPS's provision of Post E.C.S., an all-electronic service, the Commission questioned the USPS's argument that electronic services were necessarily outside the scope of the Commission's authority to make recommendations on domestic postal classification changes:

> "The Postal Service's primary argument for dismissal of the Complaint on the merits is that Post E.C.S. necessarily is a "nonpostal" service because it lacks a physical relationship to the network with which the Service transmits hardcopy mail from senders to recipients. The Service observes that the Commission, the Governors, and reviewing courts have evaluated the "postal" character of services by reference to functions performed in the hardcopy postal network - i.e., collection, acceptance, processing, handling, transportation and delivery of tangible mail pieces. As an "unbundled completely electronic service," the Service argues, Post E.C.S. lacks a relationship to any of these physical functions. Therefore, the Postal Service concludes, "Post E.C.S. does not fall within the definition of 'postal services' as defined by the courts, the Commission, and the Governors." Motion to Dismiss at 15. The premise of the Postal Service's argument is largely correct, but the conclusion it urges does not necessarily follow. It is true, as the Service claims, that "[a]bsolutely none of these [judicial and other] authorities has concluded that completely electronic services are'postal' in nature[.]" Id. at 8. However, analogous claims could be made with respect to the legal status of First-Class Mail transported by air prior to 1955, or messages received in post offices by telegraph prior to 1970. As the decisions described in the footnotes illustrate, the Postal Service's adoption of new technologies into its operations can generate controversies that the body of pre-existing legal authority

[14] 39 U.S.C. § 3625. The Governors' authority to make changes to the Commission's recommendations is restricted, though it can and has modified PRC decisions with a unanimous vote.

cannot resolve. This is the current state of the controversy with respect to any end-to-end electronic service offered by the Postal Service, such as Post E.C.S." PRC Order No. 1239 (Docket No. C99-1).

21. Ultimately, the PRC dismissed the UPS complaint as moot, so it never reached closure on its authority over electronic services in that docket. Since the issuance of Order No. 1239, the PRC has initiated a rulemaking to define "postal services" to include "the delivery of letters, printed matter, or packages weighing up to 70 pounds, including acceptance, collection, processing, transmission, or other services supportive or ancillary thereto." Nevertheless, the PRC is also proposing a rule to require the USPS to provide cost and revenue information on "nonpostal" services.

Rail/Trucking Competition

22. The U.S. regulated railroads, beginning in 1887, with the implementation of the Interstate Commerce Act. With the construction of a national highway system and the advent of competitive motor carrier transportation, the U.S. regulated motor carriers with respect to both entry and rates. Regulatory asymmetry was a big part of the federal government's decision to regulate trucks in the 1930s. According to Alfred Kahn's classic "Economics of Regulation", this was one of only two primary impetuses for the Motor Carrier Act of 1935: "We have already cited the major consideration motivating the imposition of this comprehensive set of public utility-type controls on a highly dispersed and competitive industry -- the belief that unregulated entry and price competition had resulted in poor service. The other side of the coin is that the Act was passed and has been enforced with the explicit purpose and effect of protecting railroads against the intensified competition of motor carriers and protecting motor carriers from one another."[15]

23. In 1980, the U.S. deregulated trucking; for highway carriers, entry and rates were set by the market. On the rail side, in response to a failing railroad industry the U.S. in 1980 (Staggers Act) gave the Interstate Commerce Commission authority to exempt from regulation rail movements that were truck competitive, e.g., boxcars and TOFC/COFC (trailer on flatcar and container on flatcar). Regulatory asymmetry did not play a major role in 1980; rather, a widespread consensus formed that both the rail and trucking regulatory regimes were inefficient and needed overhauling, and that competition should be relied upon where possible.

[15](vol. II, p. 14).