

THE LIMITS
OF CHOICE IN
CALIFORNIA'S RESIDENTIAL
TELECOMMUNICATIONS
MARKET

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Why "Competition" is Failing
to Protect Consumers

BRIEF

TURN (The Utility Reform Network)

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California consumers have experienced an ongoing stream of rate increases following the California Public Utilities Commission's decision to lift price caps, with the most recent increases for basic service likely to cost consumers over \$100 million per year.

"Pricing freedom" for telephone companies has turned into a travesty for consumers.



In August of 2006 the California Public Utilities Commission (CPUC) found that the states' four largest telephone companies¹ "no longer possess market power" based on "the demonstrated presence of competitors" throughout their service territories.² As a result, the CPUC has proceeded to dismantle almost all aspects of telecommunications regulation in California. Most significantly, the CPUC granted the state's dominant incumbent local exchange carriers (AT&T, Verizon, SureWest, and Citizens/Frontier) "broad pricing freedoms concerning almost all telecommunications services, new telecommunications products, bundles of services, promotion, and contracts."³

However, instead of price competition, California consumers have experienced an ongoing stream of rate increases, with the

most recent increases for basic service likely to cost consumers over \$100 million per year. "Pricing freedom" for telephone companies has turned into a travesty for consumers, and the "competition" identified by the CPUC has turned out to be a myth.⁴

In order to investigate the outcomes of the CPUC's deregulatory policy, TURN commissioned a study of market conditions in California. This study, *The Limits of Choice in California's Residential Telecommunications Market*, clearly demonstrates that contrary to CPUC assumptions, consumers have extremely limited choices of telephone service providers and that the "pricing freedom" granted to the incumbent telephone carriers has resulted in an ongoing stream of rate hikes driving prices sky high.

A SAMPLING OF RATE INCREASES SINCE PRICE CAPS WERE LIFTED BY THE CPUC

AT&T

Basic Service.....	26%
3-minute local toll call.....	163%
Caller ID.....	62%
Call Waiting.....	86%
Non-Published Directory Listing.....	346%
Directory Assistance.....	226%
Returned Check Charge.....	276%

Verizon

Basic Service.....	13%
3-minute local toll call.....	188%
Directory Assistance.....	171%
Returned Check Charge.....	121%
Inside Wire Maintenance.....	66%
Call Waiting.....	29%



RATE INCREASES DEMONSTRATE MARKET POWER

The CPUC's decision to remove the price cap framework that had previously protected consumers from market power was driven by the conclusion that “competition” would protect consumers. In other words, the market would self-regulate, and no firm would impose arbitrary rate increases on consumers. The CPUC accepted the conclusions of telephone company experts, such as Dr. Robert Harris, an economist who testified on behalf of AT&T California (formerly known as SBC).

Dr. Harris told the CPUC:

One of the reasons I'm confident in making the recommendations that I'm making to this Commission (i.e., to remove price caps) is that I'm firmly convinced that the stupidist thing SBC or Verizon could do was think, oh, we got some pricing flexibility now. Let's start jacking up local service rates.⁵

However, this is precisely what has occurred. Most recently, AT&T California and Verizon, the state's two largest telephone service providers, implemented, respectively, 23% and 13% increases for basic service rates. These rate increases alone are likely to cost California consumers more than \$100 million per year. These most recent rate increases come on top of other increases by AT&T California and other large telephone companies. Price increases of the magnitude implemented by AT&T California and other telephone companies are not consistent with a “self regulating” market where competition protects consumers.

This ongoing stream of price increases should be a wake-up call to the CPUC that self-regulation has failed to deliver the consumer protection that price-caps had previously provided.

*I was worried that I was going to be cut off
from my doctors, from my family, and my elderly parents.* ~Howard Vincini

PRICE INCREASES AND THE LIMITS OF CHOICE

The TURN study finds that market competition is failing to protect consumers. Not surprisingly, given the rate increases that have been imposed by telephone companies, the study finds that wireline telephone service has unique characteristics that are difficult to substitute for alternative voice technologies such as wireless services or voice over Internet protocol (VoIP) services. Because there are limits on consumers' ability to choose, telephone companies have found it profitable to "jack up rates."

Wireless Service Does Not Constrain Local Service Rates

The study finds that numerous factors contribute to the ability of telephone companies to increase rates. For example, the CPUC, in deciding to lift price caps, relied heavily on the conclusion that wireless mobility services are a close substitute for wireline telephone service. The study finds substantial evidence that this is not the case.

- California has one of the lowest rates of wireless-only households in the nation. Only 9% of California households have cut the cord and gone "wireless-only." The overwhelming majority of California households continue to purchase local telephone services provided over wireline facilities.
- Wireless substitution for wireline services is now recognized by the Federal Communications Commission as a niche-market phenomenon that affects a relative few households.
- The report analyzes data from recent surveys regarding telephone usage conducted by the Centers for Disease Control and Prevention, and demonstrates that there are statistically significant factors that make it more likely for a household to rely on wireline telephone service. These factors include:
 - Age of household head
 - Race of household head
 - Size of the household
 - Home ownership
 - Marriage
 - Presence of individuals with health problems
 - Presence of individuals with a disability
 - Higher income levels

This analysis demonstrates that many consumers will not find it easy to substitute wireless for wireline service. Thus, the presence of wireless service providers will have limited impact on price increases for wireline service. If it is easy to substitute wireless for wireline services, why do telephone companies raise their rates?



CLEC Competition has Evaporated

The CPUC, when deciding to lift price caps, identified competitive local exchange carriers (CLECs) as an important source of competition.⁶ The report finds that CLEC competition has declined dramatically since the CPUC issued its decision—there are now over 50% fewer CLEC lines in service compared to the peak of CLEC operations. The two largest residential CLECs, MCI and the legacy AT&T, merged with Verizon and SBC (now known as the new AT&T). Given this decline in competition, it is not surprising to find residential rates rising.

Cable Alternatives Have Significant Limits

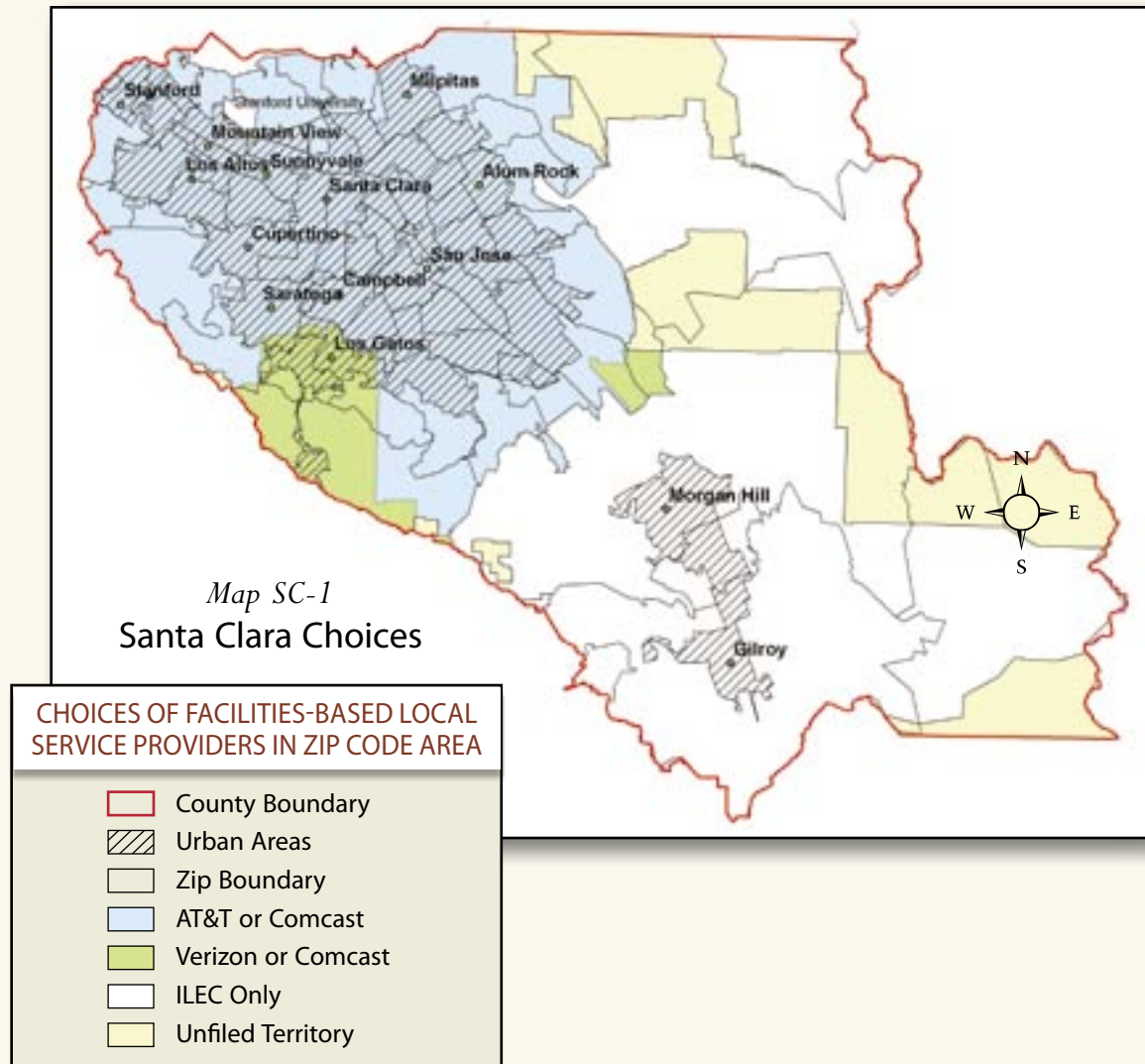
The report also finds that while some cable television companies have begun to offer voice telephone services, there are substantial limitations on the ability of these services to constrain telephone company price increases. These limitations include the fact that:

- Not all cable companies sell voice services, and other cable companies that do sell voice services may not have these services ubiquitously deployed in their service areas.
- Those cable companies that sell telephone service have varying policies regarding how they sell those services:
 - Most cable companies that sell voice services offer only packages of voice services that combine local, long distance, and vertical features. These service packages are priced well above stand-alone local service rates, and eliminate consumers' ability to find à la carte alternatives to local telephone company services.
 - Most cable companies promote the purchase of service bundles that combine video programming, high-speed Internet access, and voice services. These bundles have prices that typically start at \$100 per month, and up.

These factors reduce consumers' ability to choose alternatives to their local telephone company's service. If consumers have limits on their ability to choose alternatives, price increases are more likely.

Market Maps Show Limited Choice

The report conducted research to identify the choices that California consumers can make among alternative providers of wireline telephone services, and found that most Californians are likely to have two choices—service available from their local telephone company (either service packages or à la carte options), or service available from their local cable company (typically a service package). The report studied these alternatives in nine California counties, where nearly 50% of California's population resides.



The results shown in the map above are typical of findings in the report.⁷ In and around urban areas, cable voice services are available, giving consumers one alternative to the local telephone company, while those consumers residing outside of urban areas are less likely to have any choice at all. This map also shows that consumers in the urban areas in the southern portion of Santa Clara county continue to face a monopoly—no cable voice services are available. This low level



of choice inhibits price competition. Furthermore, if consumers do not want voice packages, or do not want to purchase an expensive bundle from the cable company, then consumers have little ability to substitute for telephone company services as their rates rise.

The report also reviews other services identified by the CPUC, such as voice over Internet protocol (VoIP) services provided by independent firms like Vonage. The report finds that these services have substantial limitations, and have experienced limited adoption by consumers. These limitations prevent VoIP services from effectively constraining telephone company rate increases.

CONCLUSIONS

The evidence evaluated in the report quantifies the lack of competition in the market for local telephone services in California. Many California consumers face a market with only one alternative to their local telephone company—this “choice” is not sufficient to provide consumer protection. Economists refer to this market structure as a duopoly. The report indicates that duopoly markets have not been observed to perform well from the standpoint of encouraging price competition and protecting consumers. The performance of the duopoly in California’s residential telephone service market—an ongoing string of rate increases— indicates another market failure.

As the old saying goes, “the proof of the pudding is in the eating.” If market competition is working, why the ongoing stream of price increases? Why have the main rivals to the local telephone company, the cable companies, increased rates following telephone company rate increases? Observed pricing behavior on the part of local telephone companies and their cable rivals does not reveal evidence of price competition. Rather, pricing reflects the actions of firms that recognize that consumers have little choice, resulting in dramatic rate increases for many California consumers.

In light of these findings, it is clear that the elimination of price caps is failing to protect California consumers. Unless corrective action is taken, consumers will pay prices that reflect the exercise of market power, leading to the undesirable outcomes of excessive prices, undue discrimination, and the unwarranted transfer of income from consumers to the providers of local telephone services.

*Wireless? My father, who is 91 years old?
My father doesn't understand wireless.*

~Bishop Aurea Lewis

POLICY RECOMMENDATIONS

As the last threads of price protection for basic service rates for most consumers will be removed in early 2011, it is imperative that the CPUC take action to reinstate reasonable price caps for local service rates. As the CPUC's decision also permits, beginning in 2011, geographic deaveraging, i.e., local telephone companies will gain the ability to target specific communities with basic service rate increases, it is imperative that this provision of the CPUC's decision also be reversed. The continuing market power identified in the companion report, combined with local telephone companies' ability to geographically target rate increases, can only increase the harms already experienced by California consumers.

The following actions should be taken:

- It is imperative that the CPUC take action to reinstate reasonable price caps for local service rates. The price caps should, at a minimum, constrain basic rate increases to no more than the rate of inflation.
- The geographic deaveraging provision of the CPUC's decision must also be reversed. The continuing market power identified in the companion report, combined with local telephone companies' ability to geographically target rate increases, can only increase the harms already experienced by California consumers.
- In addition to a price cap on basic rates, LifeLine rate increases should be reversed, and a uniform, affordable, LifeLine rate should be established statewide. The continued affordability of basic telephone service to low-income households is a pressing issue given the economic crisis that is gripping California.
- Finally, the CPUC should more closely monitor market outcomes associated with pricing, service quality, and the delivery of advanced services.

Market forces are failing to deliver the benefits that the telephone companies promised the CPUC as it made its decision to lift price caps. It is time to reestablish an effective regulatory framework that will protect consumers and ensure that high-quality telecommunications services are available to all Californians at reasonable rates

ENDNOTES

1. AT&T California, Verizon, SureWest, and Frontier.
2. D06-08-030 at 117.
3. D.06-08-030 at 1.
4. After TURN's competition report was completed TURN obtained access to a previously unreleased white paper prepared by the CPUC's Staff entitled "Market Share Analysis of Residential Voice Communications in California," California Public Utilities Commission Communications Division – Policy Branch Staff White Paper, December 2008. In this paper the CPUC Staff calculates that between June, 2005 and June, 2007, market concentration increased in California for wireline voice services, wireless voice services, and broadband services, measured either separately or on a combined basis.

The CPUC's finding is startling, as it shows that even if one assumes that a wireline telephone, a wireless telephone, or a broadband connection are perfect substitutes for one another, market concentration has increased, not decreased. Economic

theory links higher market concentration to a greater likelihood of market power. The CPUC Staff study finds that market concentration, as measured by the Herfindahl-Hirschman Index, results in concentration measures well above the Department of Justice's standard indicator for highly concentrated markets.

To conduct its analysis, the CPUC Staff had access to proprietary data that was not available to TURN or our researcher. However, it is clear that the analysis performed by the Commission's own staff supports TURN's findings that because of the limited choices available, competition is not sufficient to protect California consumers from market power.

5. From Dr. Harris' oral testimony. See, CPUC01-#220620-v1-R0505005_013006_Vol_2, at 364.
6. D.06-08-030 at 265 and 268.
7. The report studied voice service choices by Zip Code area in nine California counties: Alameda, Fresno, Humboldt, Los Angeles, Madera, Sacramento, San Bernardino, Santa Clara, and Shasta.

*We need to get the public part of this process back on the table.
There is no public in the Commission.*

~Charles McGee





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