ECONOMIC NOTE

Montreal Economic Institute

May 2004

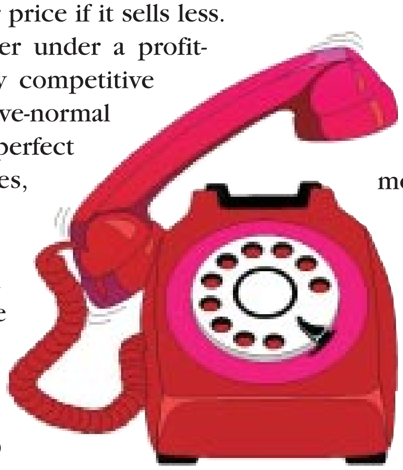
Do we still need to regulate telephone services?

The Canadian Radio-television and Telecommunications Commission (CRTC) argues that there is not enough competition in the telecommunications industry. In a public notice issued last December, it suggested imposing artificial handicaps on the former telephone monopolies to enable new providers to enter the market.[1] In a more recent public notice, dated April 7, 2004, the CRTC suggested extending these handicaps to the new field of Internet telephony. This is consistent with the antitrust and competition policies that the governments of western countries started adopting in the late 19th century, but it is not supported by contemporary economic analysis.

Two views on competition

There are two economic conceptions of competition.[2] One is based on the model and the ideal of "perfect competition", in which there are so many small competitors that none can individually influence the market price. At the far end of this spectrum, a monopoly can charge a higher price if it sells less. Prices will be higher, and quantities lower under a profit-maximizing monopoly than in a perfectly competitive industry: this is why a monopoly earns above-normal profits for a similar level of risk. Under perfect competition, or so the argument goes, consumer welfare is improved.

In this approach, there was one case in which monopoly was deemed to be unavoidable and where, therefore, regulation (or nationalization) was warranted: the case of so-called "natural monopolies". A natural monopoly is an industry (or firm) in which, because of wide-ranging economies of scale, the average cost of production decreases until market demand is entirely satisfied. If a firm is a natural monopoly, however, it can outcompete all others. The state, the theory argued, must prevent such a monopoly from charging a higher price than the price that would prevail in a perfectly competitive market.



The second conception of competition is more realistic, and more important in contemporary economics: more than an end-state, competition is viewed as a process where entrepreneurs have to make guesses about the future and engage in risky investments. In this perspective, concentration may indeed limit consumer gains in the short run, but increase them even more in the longer term. The market itself is better equipped than government entities to determine which degree of concentration is in the best interest of consumers.

A new entrant will sometimes face high investment costs, but breaking into the market remains possible if there are no legal barriers. Indeed, one surprising fact is that most, if not all, real monopolies are legally protected, or run by the state – like electric utilities, for example, or the Canadian Wheat Board. In a market without such barriers, competition is an efficient process. Competition does not need to be "perfect" (in the real world, it cannot be), but the absence of perfection is not sufficient reason to regulate it.

Competition in telecommunications

The telecommunications sector has long been regulated, mainly by the CRTC since 1976. The CRTC has protected regional telephone monopolies such as Bell and Telus, deemed to be natural monopolies, until the 1990s, when it started allowing some regulated competition. The former regional monopolies are still subject to price controls and are required to lease their facilities, at regulated tariffs, to new competitors that are less heavily regulated.

[1] The former telephone monopolies are called "incumbent local exchange carriers", or ILECs, in bureaucratic jargon, while the new providers are called "competitive local exchange carriers", or CLECs.

[2] For further discussion, see Appendix 1 at http://www.iedm.org/uploaded/pdf/may2004appendix1.pdf.

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Following this partial deregulation, the CRTC now argues that there is not enough competition. This conclusion is based on an end-state vision of perfect competition – for example, on the observation that 95% of local wirelines are supplied by the former protected monopolies.

According to its December 2003 public notice, the CRTC aims to increase competition by imposing artificial, and anticompetitive, constraints on former monopolies that are now operating in competitive markets. The CRTC suggests requiring them to price their own retail basic services (say, access to a local loop) at 25% over estimated cost, while they are obliged to sell the same services to their competitors at wholesale prices of cost plus 15%. In other words, the CRTC wants to force the former monopolies to give their competitors a margin guarantee. The second type of restriction the CRTC wants to force on the former monopolies is a 10% cap on the discounts it offers on bundled services (for example, local and long-distance service with Internet access), plus limits on the discounts offered on high-volume and long-term contracts.

The static view in which competition is measured by the number of firms does not take account of competition for *the market, as opposed to competition* in *the market.*

More generally, the CRTC wants to prohibit the former monopolies from using targeted pricing. This competitive technique exists in many sectors; for example, airlines offer different prices for return flights requiring a Saturday-night stay in order to charge more to business travellers. Actually, the CRTC itself has always imposed price discrimination in favour of residential users as opposed to business users. Economic theory shows that this sort of price discrimination is economically justified when high (fixed) investment costs have to be included in prices.

Even if there is not a large number of competitors in a given sector of the economy, what counts is potential competition. This can come from new entrants or from firms that offer substitutes in "other" markets. The static view in which competition is measured by the number of firms does not take account of competition *for* the market, as opposed to competition *in* the market.

This distinction is important. Firms can compete in the same market (phone companies, for example), or try to gain entry to new markets (cable companies that offer telephone services, for example). Where the line is drawn between different markets depends on which goods and services consumers consider easily substitutable, and this remains arbitrary. But for any given "market", there is competition among the suppliers already *in* the market, and between those firms and suppliers from other industries who compete *for* the market. Competition for the market maintains a competitive process even when competition in the market seems limited.

Unless one adopts the CRTC's static, end-state view of competition, there is no question that substantial competition exists in telecommunications.

Consumers, not producers, define markets. They may regard things produced by very different technologies (snail mail and fax, for example) as close substitutes, and they may also regard things produced by similar technologies (scanners and digital cameras, for example) as distant substitutes. However, in telecommunications, rapid technological change does play a crucial role.

Unless one adopts the CRTC's static, end-state view of competition, there is no question that substantial competition exists in telecommunications, as indicated in Table 1. New competitors have a 20% share in long-distance calls. In a number of large urban areas, they supply 10% to 20% of local business lines. In certain urban markets, their residential penetration is much higher than aggregate data suggest. In low-density residential markets, the lack of competition is due to the price ceilings that the CRTC still imposes on all suppliers. Moreover, even in markets where competition *in* the market seems soft, there is a lot of competition *for* the market, from suppliers with new technologies (or existing technologies used differently) like Internet telephone ("voice over Internet protocol", or VoIP), cable telephone and, of course, cellular phones.

The CRTC's current regulation of telecommunications as well as its proposals for more regulation reflect a poor understanding of the nature of competition and economic efficiency. On this issue, professor Donald McFetrige of Carleton University writes: "It is seldom the case, perhaps never the case, that inhibiting competition increases competition."[3] If regulation does not prevent it, competition will increase by itself. It is likely that phone companies, cable companies, Internet-based competitors, and perhaps even electric utilities will soon offer the same telecommunications and broadcasting services. For example, Rogers Communications, whose Rogers Cable subsidiary is the largest cable company in Canada, recently announced its intention to compete with phone companies by offering VoIP services. Vonage and Group Telecom have just launched VoIP service on the Canadian residential market. AOL Canada has announced that it will also join the fray.

[3] Donald G. McFetridge, *Comments on Public Notice CRTC 2003-10,* Brief to the CRTC, January 30, 2004, p. 9.

Table 1

PARTIAL LIST OF EXISTING AND IMMINENT COMPETITORS IN THE CANADIAN RESIDENTIAL LOCAL TELEPHONE MARKET

COMPANY	STATUS AND LOCATION SERVICES	SERVICES
	Major actual competitors allowed by the CRTC	
Telus	ILEC in B.C. and Alberta CLEC in Ontario and Québec	All services as ILEC
Sasktel	ILEC in Saskatchewan	All services as ILEC
MTS	ILEC in Manitoba	All services as ILEC
Bell Canada	ILEC in Ontario and Québec	All services as ILEC
Aliant	ILEC in the Maritimes	All services as ILEC
AT&T Canada	CLEC in major centres in Ontario and Québec	Bundle of long-distance and local access
Eastlink	CLEC in major centres in the Maritimes	Bundle of voice, data and cable TV
FCI Broadband	CLEC in the Greater Toronto Area	Bundles of local access, long distance and data
360networks/ Groupe Télécom	CLEC in 17 major centres across Canada	Local access and long distance VoIP with Vonage
Microcell	CLEC in Calgary and several cities in B.C.	Wireless networks providing local access
Primus	CLEC in major cities in Ontario and Québec	Bundle of local access and long distance VoIP
Sprint/Call-Net	CLEC in a number of cities in Ontario	Bundles of local access and long distance
Videotron Telecom	CLEC in Québec	Local access
	Major announced or expected competitors	
Rogers	Ontario, New Brunswick, Newfoundland	VoIP
Shaw	Western Canada	VoIP
AOL Canada	Canada	VoIP
Vonage	Canada	VoIP

ILEC = incumbent local exchange carriers (the now competing former monopolies)
CLEC = competitive local exchange carriers
VoIP = Voice over Internet Protocol

Sources: Quigley (2003); Financial Post, February 13, 2004, and April 13, 2004.

The latest public notice published by the CRTC in April compounds problems with the existing regulatory framework by suggesting that it be extended to VoIP. Not only is this contrary to the trend in the U.S.,[4] but it would add to the competitive handicaps imposed on the former monopolies. For them, VoIP would be regulated, while new competitors (many of which are large companies) would be free to offer service as they choose at unregulated prices.

It should also be noted that one problem is the obstacles to entry raised by the foreign ownership restrictions in telecommunications. Eliminating those restrictions would allow new competitors to obtain financing more easily on international capital markets and would thus further intensify competition. Offering a protection package to new competitors, as the CRTC is doing, is, on the contrary, anti-competitive.

[4] For more on the American example, see Appendix 2 at http://www.iedm.org/uploaded/pdf/may2004appendix2.pdf.

Richard Posner, a well known American economist who is now a federal judge, wrote three decades ago:

> Communications is a contemporary example of an industry undergoing rapid technological changes that are apparently opening up a host of new competitive opportunities... The most pernicious features of regulation would appear to be precisely its impact on change – its tendency to retard the growth of competition that would erode the power of regulated monopolists. To embrace regulation because an industry is today a natural monopoly and seems likely to remain so is to gamble dangerously with the future.
> *(Natural Monopoly and Its Regulation)*

Conclusion

This criticism of regulation (which states that, even if markets are imperfect, regulation may be even more imperfect) has been one of the main achievements of economic theory over the past 50 years, especially through the Public Choice school of economics (developed under the impetus of James Buchanan, the 1986 Nobel laureate in economics). The main conclusion is that regulation, as it is in the real world, does not serve the public interest but is used by organized interests against competitors.

In the field of telecommunications, the CRTC protected monopolies against entry when it should not have, and it now grants privileges to their competitors while there are no more economic reasons to do so.

The CRTC is a powerful and entrenched bureaucracy. The intensive lobbying that the CRTC's power generates suggests that the anti-competitive privileges it grants have considerable value for recipients and that extensive resources are wasted in trying to obtain those privileges. Economists call this phenomenon "rent seeking". This means that the social cost of the CRTC's regulation of telecommunications is probably very large.

In the field of telecommunications, the CRTC protected monopolies against entry when it should not have, and it now grants privileges to their competitors while there are no more economic reasons to do so. Even if it could be argued that telephone services were a natural monopoly before the development of the new telecommunications technology, this is not the case any more, and it seems that the CRTC no longer has any reason to intervene in this sector. A good economic case can be made for a real and complete deregulation of telecommunications in Canada.

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