

The Benefits of Effective Competition

In sectors of the telephone industry where competition has been successfully introduced (e.g. long distance), consumers have gained many benefits. Perhaps the most obvious benefit is that most consumers are paying lower rates as a result of the downward pressures exerted by competition. However, this decline in prices is not the only benefit enjoyed by consumers. As competition has intensified, it has provided increasingly widespread benefits to the public as a whole.

Competition has provided consumers with increased choices, strengthened the nation's infrastructure through increased diversity of supply, and encouraged technical and marketing innovations. While one can reasonably debate the exact extent to which competition has driven down toll prices, competition has unquestionably allowed consumers to save money on their phone bills. Of course, customers who shop carefully, and those who use long distance the most have gained the most benefits. But it is fair to say that long distance competition has benefitted almost everyone.

It is also clear that competitive entry and lower rates have not been at the expense of the incumbent carriers. During the period when AT&T's market share declined from nearly 100% to roughly 50%, its profits remained strong, because market share "losses" were offset by increased demand for long distance services, improving technology and increased efficiency. The competitive process contributed to rapid traffic growth, by encouraging volume discounts and by increasing customer awareness through intensive advertising. Declining toll prices further stimulated demand, which allowed AT&T and other carriers to benefit from increased economies of scale. In turn, this led to additional efficiency increases and cost reductions, which led to further reductions in prices. Local Exchange Carriers (LECs) like Bell Atlantic have shared in the bounty, because they collect "access charges" from AT&T and other long distance carriers for the use of their local networks in originating and terminating long distance calls. This growing revenue source has helped the LECs generate strong profits in recent years.

Achieving Effective Competition

It is sometimes assumed that a market is competitive if it contains multiple competitors. However,

the mere presence or absence of multiple firms does not determine whether the benefits of true competition are being achieved. *Effective* competition is only achieved when a market is free of substantial barriers to entry and exit and when no firm or consortium of firms has enough market power to maintain prices at highly profitable levels. Both buyers and sellers must view price as a given. All participants in the market must behave as if market prices are unaffected by their own decisions regarding how much they should purchase or produce. If the dominant firm can maintain prices at highly profitable levels, competition is not yet effective.

Market dominance and the ability to exercise market power--not the mere presence of alternative suppliers--are the key issues in deciding whether or not effective competition has emerged and regulation can be relaxed. The logical first step is to evaluate relative market shares. If the incumbent continues to enjoy an overwhelmingly large market share it would not be appropriate to assume that competition is effective, or that deregulation is appropriate.

Economic theory demonstrates that there is generally a direct relationship between market share and market power: i.e., the larger its market share, the greater a firm's ability to exercise market power and earn excess profits and/or pursue strategies for sustaining its dominant position in the market. In the extreme situation, a firm like Bell Atlantic (which currently controls nearly 100 percent of the market) has great market power, allowing it to earn monopoly profits except to the extent this is precluded by regulation. Bell Atlantic's extremely high market share translates directly into a high degree of market power and the ability to maintain very high profit margins. Of course, even if its market share declines somewhat, it will continue to retain a high degree of market power, particularly since customer allegiances are often slow to change.

If future examinations of market conditions indicate that Bell Atlantic's market dominance has eroded substantially, a review of other factors would then be appropriate, including the extent to which barriers to entry and exit have diminished, the extent to which customers consider the offerings of different firms to be close substitutes, the willingness of customers to change suppliers in response to price and quality differences, and so forth. The appropriate regulatory response at that time would depend upon the results of this examination. Once Bell Atlantic's market power has been sufficiently eroded by competitive pressures, it may be appropriate to deregulate portions of its operations, or to modify the form of regulation.

Policy makers at both the state and federal level have taken steps to move telecommunications markets towards effective competition; however, that doesn't necessarily indicate that the transition to effective competition is close to being achieved or that regulatory

protections should be removed. Unless and until Bell Atlantic's market power is greatly eroded, the continued regulatory oversight provided by the BPU and the FCC provides vital protection for customers.

Potential Obstacles to Residential Local Competition

In adopting the 1996 Telecom Act, Congress removed legal barriers to competitive entry and imposed mandatory unbundling and other requirements which are intended to accelerate the transition to a more competitive market. However, many technical, regulatory, and economic barriers remain which impede competitive entry into New Jersey telephone markets.

In the case of facilities-based carriers, the most prominent barrier to entry is the enormous cost of installing new facilities. Given the existence of an entrenched incumbent LEC with a ubiquitous system and deep pockets, building a competing network is a risky venture that few carriers are going to undertake. Because the economic barriers to entry remain so high, and there is little prospect for the rapid and immediate emergence of multiple facilities-based local networks throughout New Jersey.

To a lesser degree, many of the same difficulties exist for resellers and carriers that rent unbundled network elements (UNEs). Potential competitors face considerable uncertainty about how quickly they will be able to woo customers, gain market share, and achieve adequate economies of scale. Substantial investments must be made before customers can be gained, yet enormous uncertainty exists concerning which customers a new carrier will be able to attract, and how difficult it will be to retain their loyalty.

For these reasons and others, new entrants are likely to start off by installing facilities that are limited in scope and are targeted at specific markets (e.g. areas where large business customers are densely concentrated). This reduces the scale of their investment, and allows a more focused business plan. However, once a carrier has entered the market, it will have an incentive to expand. Carriers that initially target business customers will eventually find it profitable to also serve residential customers, just as airlines find it most profitable to serve leisure travelers as well as business travelers, despite the fact that leisure fares are much lower than business fares.

A competitive carrier can reduce its risks by expanding its customer base to encompass a larger, more predictable income stream. Furthermore, it can benefit from improved economies of scale if it serves a larger target market, including residential customers. Accordingly, one can logically anticipate that competitive carriers will eventually expand to serve residential customers, unless the additional revenues gained from those customers are too low to cover the additional costs incurred serving them.

In view of the limited extent to which competitors are currently serving residential customers in New Jersey, and considering the relatively low level of the existing residential local rates, some may question whether Bell Atlantic's rates are too low to attract competitors.