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Ex Parte

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: Petition of Verizon New England Inc. for Forbearance Pursuant to 47 U.S.C. § 160(c) in Rhode Island, WC Docket No. 08-24; Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in Cox's Service Territory in the Virginia Beach Metropolitan Statistical Area, WC Docket No. 08-49

Dear Ms. Dortch:

My name is Everett M. Ehrlich, and I am President of ESC Company, an economics consulting firm. I have previously served as the Undersecretary of Commerce for Economic Affairs (in the Clinton administration), as the Chief Economist and head of strategic planning of Unisys Corporation, and as the Senior Vice-President and Director of Research of the Committee for Economic Development. I have attached a copy of my biography to this letter

Verizon now has two petitions before the Commission regarding forbearance from certain regulatory obligations, including unbundling requirements, in the state of Rhode Island and Cox's Service territory in the Virginia Beach Metropolitan Statistical Area. Verizon has asked me to review two comments that have been submitted to you concerning these petitions (*An Analysis of Verizon's Petitions for Forbearance* by QSI Consulting of O'Fallon, Missouri, and the *Declaration of Michael D. Pelcovits* in the matter of these two petitions), and to comment as well on the broader issues regarding competition in the telecommunications markets at issue.

In summary, I will make the following points:

- The QSI study is based on the premise that competition from UNE-centric CLECs limits the prices that companies such as Verizon or Cox charge for voice, data, and television. Given the

extensive facilities-based competition for these services from cable, wireless, and other sources, that is extremely unlikely;

- Pelcovits' view that wireless voice and data do not compete with wireline is at odds with available evidence;

- Pelcovits' apparent view that there is a "cable-telco duopoly" ignores competition from wireless as well as other sources that enable retail customers to obtain all the services they seek without ever doing business with the supposed "duopoly."

- Even if there were only two firms – "telco" and "cable" – considered in the Commission's analysis, it should not alone be a cause for economic concern. There are exceptions to the traditional "Nash-Cournot duopoly" model on which QSI and Pelcovits rely, which include, among other things, cases where there are product dynamism and high fixed costs, as is the case here.

The QSI "Impact Study"

The QSI Study presents estimates of the cost burden QSI associates with the granting of forbearance. The model that generates these results is not presented, and is described only in the most general terms. But what drives the numerical results is QSI's assertion that UNE-centric Competitive Local Exchange Carriers provide a check on the prices that Verizon (and its cable competitors) can charge. (See p. 16, "In the current marketplace, CLECs provide a disciplining force to retail prices.") Moreover, QSI claims that even when they *do not exist*, the possibility that UNE-centric CLEC's *might one day exist* is enough to limit the prices that Verizon and its cable competitors charge. (See p. 16-17, "Even though CLECs actual market share may not be large, *the potential for CLEC entry*…creates downward pressure on retail telecommunications prices…).

The QSI study gives virtually no empirical evidence to support this underlying hypothesis. Instead, it goes on at some length regarding the "Dominant Firm – Competitive Fringe Pricing Model," in which companies at the periphery of the market limit the behavior of "dominant" firms at the market's center. In fact, on pages 19 and 20, QSI argues that eliminating UNE-centric CLECs would "facilitate

tacit coordination or collusion" among the remaining firms. QSI makes no attempt to reconcile its claim that peripheral CLECs are able to discipline market prices with its decision to ignore competition from wireless carriers, which provide for more than peripheral competition, and under QSI's own theory would also have to be considered.

Consider those portions of Rhode Island that are served by Cox and are the subject of one of Verizon's petitions. As far as I am aware, there are now *no* UNE-centric CLECs providing services to residential customer in that territory (or, if there are such entities, their presence is *de minimis*). But, according to QSI, the *possibility* that a UNE-centric CLEC might *one day* decide to enter that territory leads to savings of $77 per year per household, which represents an increase from existing rates of about 5 to 6 percent. About 15 percent of this $77 total comes from increases in the price of residential video, even though none of the CLECs cited in their study offer a video service using UNEs that the range of channels, high-definition, and other services that most consumers purchase from cable, fiber, or satellite providers. (On page 23, QSI states that "CLECs such as Cavalier in Virginia are now offering video services over copper loops." But Cavalier's website (cavtel.com) makes no mention of video-over-copper services, but instead mentions a recent agreement for Cavalier to resell DirecTV services.

So, in QSI's model, companies such as Verizon or Cox -- both having made massive investments and competing with each other in all three segments of "bundled" service, both with large fixed costs (meaning that profit can be achieved only through high levels of system yield), both trying to capture customers in a period when high-speed broadband is finally achieving mass market penetration -- both charge their customers less than they otherwise would as a result of their competition with each other entirely because *nonexistent* competitors selling services that *they do not now sell* might one day enter their service territory using Verizon's own facilities obtained on an unbundled basis – and not just any facilities, but the dated copper plant rather than next-generation fiber -- and, in the words of the report (page 18), "…force(s) other firms to compete more aggressively and may undermine their ability to coordinate;" QSI goes so far as to call these nonexistent UNE-centric competitors "mavericks."

A far more likely alternative is that Verizon and Cox compete with each other, often offering some combination of superior services (for example, Cox offers Internet connections of up to 20 Mbps, and Verizon's FiOS product offers up to 50 Mbps) and lower prices, driven by their efforts to capture

market share and spread their fixed charges over a large user base. UNE-centric CLECs then find their place underneath this pricing umbrella, but likely have little influence over it. If that view of the world is more likely, then the damages estimated by QSI, particularly in the mass market, evaporate.

The Pelcovits Declaration

Pelcovits' Declaration is essentially about one issue – whether wireless services are a substitute for wireline services. He concludes that they are not. But Pelcovits has both misread the evidence and failed to understand the context in which to place it.

For one, Pelcovits has used phone number porting as a proxy for wireline-wireless competition. This is at best a weak measure. For example, we know, from Pelcovits' own submission, that about one-third of users between 18 and 29, one-third of renters, and almost two-thirds of households with unrelated adults and no children have abandoned wireline for wireless. But the total number of phone numbers ported to wireless from wireline in the U.S. – 2.2 million – is only about one-ninth of the total number of households that have made this transition. What is far more likely, therefore, is that users with both wireline and wireless service subsequently abandon wireline after a period of comfort-building with wireless.

Moreover, if a large number of users have both wireline and wireless phones, then the two are obviously in competition every time the user reaches for one or the other – *using* one of the two services instead of simply *having* both services. Here, there are obvious signs of wireline-wireless competition. For example, the Nielsen Company reports that the average wireless user used 45 percent more minutes than a wireline-only user but had a bill only 10 percent larger. Thus, users with more extensive telephone use have learned how to lower their bills by substituting wireless for wireline service.

Pelcovits then argues that non-price factors may govern the substitution of wireless for wireline and, therefore, they are not effective substitutes. (See p. 10, "If the customers switch between wireline and wireless access but *not* in response to price changes, then wireless is not a close substitute and cannot prevent the exercise of market power in the wireline market."*)* This is also a remarkable statement. For

example, consider the substitution of the automobile for the horse and buggy. The two are patently and obviously substitutable, yet market price was only one of many factors that led to the replacement of livery animals with the internal combustion engine. Yet had the horse and buggy been regulated, Pelcovits would not have regarded the advent of the automobile as reason enough to abandon that regulation, because while horse and buggy providers would have lost market share, they would have even greater "…market power over the remaining customers in that market." (See page 13). Moreover, were the Commission to adopt this view, it would in effect be disregarding all future innovation in its markets, as innovation typically permeates the market through terms other than price alone.

Pelcovits proceeds to make the strange claim that, as wireless service makes further inroads against wireline service, the two become *less* competitive with each other. (p. 14, "Indeed, it is very likely that the households that remain attached to the cord are less likely … (to respond to)…changes in the price of wireline service….) In essence, Pelcovits argues that the Commission should overlook any obvious evidence of success that wireless has had at wireline's expense, or any further success it may enjoy, because incremental future success will be harder to achieve. In one swoop, Pelcovits has tried to make any positive evidence of substitution irrelevant.

In an effort to strengthen the previous argument, Pelcovits draws an analogy to the competition between generic and name brand drugs. He notes that after the introduction of a generic drug into a market, the "brand name drug producer responds…by raising the price of its branded drug." By way of this analogy, Pelcovits has taken the position that generic drugs have not been an effective constraint on the monopoly power exercised by patent-protected pharmaceuticals because the *remaining* brand-name market is "inelastic" – generics would fail the test Pelcovits constructs! Pelcovits, therefore, would see the introduction of generic drugs as a reason to increase – not eliminate – the regulation of brand name competitors.

Retail Choice

Pelcovits then focuses extensively on wireless' weakness in the area of broadband (pages 16-19). He concludes that wireless is not an effective competitor for wireline broadband.

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Several things should be said. First, on page 7 of his Declaration, Pelcovits argues that, using his standard ("demand substitution"), "voice and data services would not be in the same market." So his discussion as to whether wireless is an effective competitor to wireline for broadband should be moot, as he has already said they do not compete. But, as should be obvious to Pelcovits and to all users, they *do* compete. Nielsen recently reported that "43 percent of data card users say they most often use their data card at home, and 59 percent of data users say they might swap out their home ISP in favor of data card access. Clearly, Internet access is the next frontier of wireless substitution." (*Call My Cell: Wireless Substitution in the United States*, the Nielsen Company, 2008) So wireless and wireline devices are obviously in competition today, and that competition will only accelerate with the deployment of more advanced wireless broadband technologies. For example, Verizon and other wireless providers are now, or will soon be, deploying 4G technology – including Long Term Evolution (LTE) – that may offer rates of up to 50-60 Mbps downstream.

Second, even if Pelcovits was right and wireless broadband was slower than wireline broadband, he has missed the larger point completely. The point is not whether wireless can get broadband or WiMax can get television or DirecTV can make phone calls. The point is that users understand that voice, data, and television are all overlapping services, and that they can put them together in any number of ways -- the real boundaries of markets are not as cut-and-dried as Pelcovits depicts them.

The reality is that, in each of these overlapping segments, the so-called "cable telco duopoly" faces formidable competitors. Wireless phones already have about one-fifth of the market, and time is on their side. WiMax has major investments behind it and is expanding rapidly. DirecTV and Dish are obviously competitive with cable or telco-based television programming.

The fact that no one of these competitors competes in all three realms does not mean that they are not effective competitors. In fact, telephone and cable companies must compete with *all* of them – there exists retail choice through which users can find a viable alternative to wireline for each component of bundled service. How can there be a "duopoly" if I can subscribe to WiMax, a mobile phone company, and DirecTV or Dish Network, get competitive products, and not spend a cent on a Verizon or cable product?

These services all compete, in the classic definition of the term – what one does affects the other. If WiMax makes inroads against bundled broadband, or some users drop wireline phone service for wireless, then satellite television has a *greater* competitive opportunity, because the rationale of "bundling" by the cable-telco providers has already been undone. Telephone and cable companies compete with all three of these alternatives at the same time. And this competition will only deepen in the future, as WiMax gains popularity and 4G technology improves; as QSI states in footnote 60, on page 24, "…the pressure of potential competition…is equally important when evaluating Verizon's petitions," and this is where future competition will be most profoundly felt.

Finally, the Commission should note that there is a major inconsistency between Pelcovits' Declaration and the QSI study. QSI argues that the mere potential for entry by UNE-based CLECs disciplines the prices of wireline service. If that is the case, then how can we avoid the conclusion that the presence of ubiquitous wireless telephones has an even greater effect? The unavoidable conclusion is that Pelcovits is wrong.

The Misapplication of Duopoly Theory

So there is much more competition in the information services market for voice, data, and television than the description put forward by Pelcovits. But even if there were not, the fact of a market dominated by two firms – a "duopoly" -- is not *prima facie* evidence of uncompetitive or monopolistic behavior.

QSI and many others have talked about the economic model of "duopoly," in which there are only two producers of a good. In 1838 Augustin Cournot concluded that were these two firms to incorporate the other's reactions into their pricing decisions, they would end up with a joint optimization of profits that would deprive the public of its maximum economic welfare. Over a century later, John Nash used the mathematics of game theory to describe a process by which the two "Cournot-type" competitors learned to co-operate against the welfare of consumers by limiting output and raising prices.

The existence of both "cable" and "telco" providers of integrated information services – voice, data, and television – in most markets, has been the basis for charges that these competitors act in the way

the "Nash-Cournot" duopolist would. Indeed, the Commission itself has assumed that so long as there are only two dominant firms in a market, they must constitute duopoly.

I believe this is a misapplication of duopoly theory. First, as discussed above, a competitor does not need to be in all the segments in which a telco or cable company operates in order to be an effective competitor to them. In fact, as discussed above, segment-by-segment competitors can mount an even more effective, synergistic challenge to the idea that a consumer is better off by "bundling" the three services.

But, more importantly, I believe that the Nash-Cournot model has been applied uncritically in this instance. First, the Nash-Cournot model assumes that the product in question is a homogeneous one. That is why the duopolists can collude in the first place – they are selling the same thing. If they do not compete on the basis of price, then there are no remaining dimensions on which they can try to outdo each other, and they can effectively divide the market.

In the case of information services, this assumption of the model does not hold. The product is incredibly dynamic; we need not belabor that point. Thus, even if the "duopoly" were to agree to "reach an equilibrium where prices are higher and output is lower," (QSI, page 20) they would still be innovating rapidly and would be competing to offer the fastest, most reliable, and otherwise most highly-valued product on the market. The steel "oligopoly" of the 1950s could refrain from price competition because steel was steel. Does the Commission believe that "connections" are "connections?"

Second, unlike the Nash-Cournot "duopolists," the companies in question have enormous fixed costs. Like "natural monopolies" of a previous era, the greater the number of users over whom they can spread those costs, the better their ability to lower prices. The Nash-Cournot firms have costs that rise, not fall, as they offer more product (so-called "rising marginal costs"), and that is why they have incentives to refrain from lowering prices – because rising costs make selling more output self-defeating, and competition does not press them to do so regardless. But the high fixed costs of cable and telco systems create the opposite dynamic – the more they can sell, the greater the units over which fixed costs can be amortized, and the greater the opportunity to lower prices, increase profits, and attract new customers.

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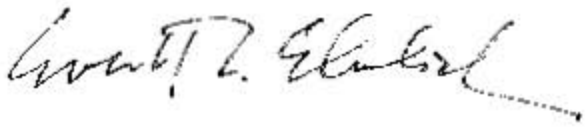
Third, over the last several years, cable and telco providers of broadband have been able to draw customers of dial-up and DSL by offering sometimes-staggering improvements in quality. But in the future, this pool of "easy" switching will have dried up. Thus, these providers will have to innovate more rapidly and compete more aggressively to rationalize their systems.

When these factors are considered, and when the presence and prospect of wireless competitors in all aspects of this market are considered, there is ample reason to consider whether or not a "duopoly" model should be applied to markets dominated by cable and telco providers and the absence of competition *assumed*. Instead, the Commission should consider empirical evidence regarding prices, products, and penetration to reach a fact-based determination.

I appreciate the opportunity to have made these points to the Commission, as well as any consideration they may be given.

Sincerely,



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