

Market Power and Price Increases in the DSL Market

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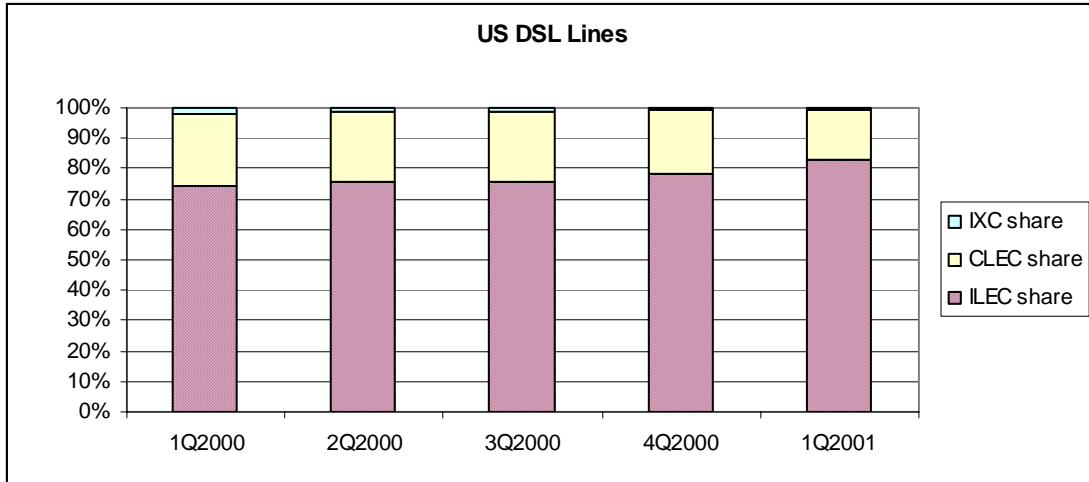
OVERVIEW

This paper discusses the current state of competition in the DSL market. Two competing bills are under consideration in Congress. One, the Internet Freedom and Broadband Deployment Act of 2001 (HR 1542, sponsored by Representatives Tauzin and Dingell) would eliminate the requirements for incumbent local exchange carriers (the ILECs or "Baby Bells", companies such as SBC Communications and Verizon) to share their facilities with competitors wishing to provide broadband services via DSL over their local loops. On the other hand, the American Broadband Competition Act of 2001 (sponsored by Representatives Cannon and Conyers), makes it clear that the provisioning of broadband services is subject to the provisions of the antitrust laws.

All parties agree that competition in local broadband telecommunications is severely limited, but the provisions in the Tauzin/Dingell bill do not address the key problems. For example, ILECs control almost 95% of the telephone market in California, as measured by lines, and 90% of the residential DSL market nationwide. The practices of the ILECs restrict the ability of other carriers to enter and compete. These practices have included maintaining unreasonable delays in the provisioning of local lines and collocation facilities and charging ISPs a wholesale price for DSL that is unjustifiably high. The ILECs attempt to counter these charges by arguing that the residential broadband market is not just for DSL but must include cable modems, satellites, and other broadband technologies. Given the presence of these competing technologies, they say, the market is competitive and the ILECs should be freed of obligations to provision lines and share their infrastructures. Laying aside for the moment that this claim is inconsistent with the philosophy underlying the Telecommunications Act of 1996, recent pricing practices and economic logic together demonstrate the fallacy of their claims. For example, in February 2001, SBC/Pacific Bell raised its monthly rates for residential ADSL in California from \$39.95 to \$49.95. This would not be a rational move in a competitive market.

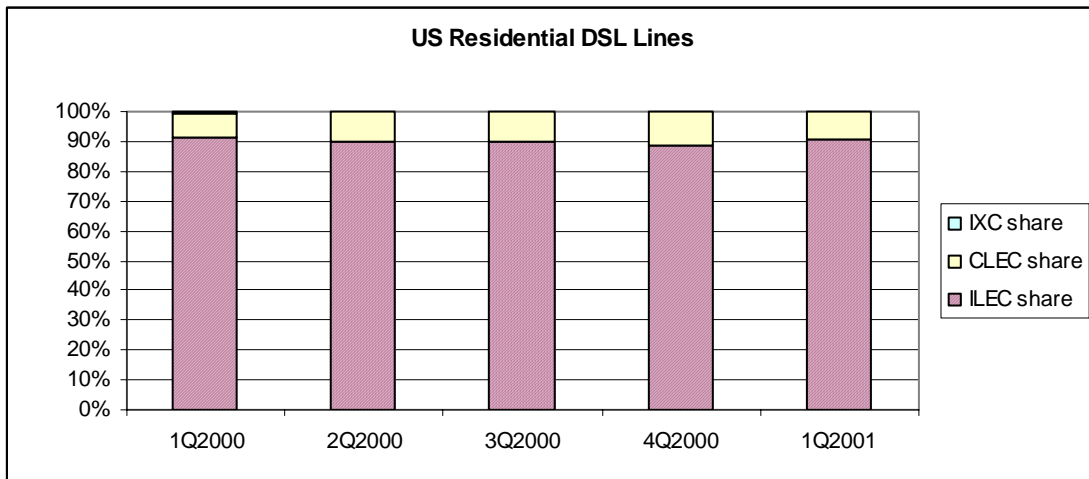
OVERALL DSL MARKETSHARE

I believe that it is useful to look at recent trends in the DSL market to understand the dominant role of the ILECs. Over the past year the ILECs share of the DSL market has increased from just below 75% to 83% while the competitive local exchange carriers' (the CLECs) share has declined from 23.7% to 16.2%. (These numbers come from TeleChoice: the remaining share of the market is served by inter-exchange carriers.)



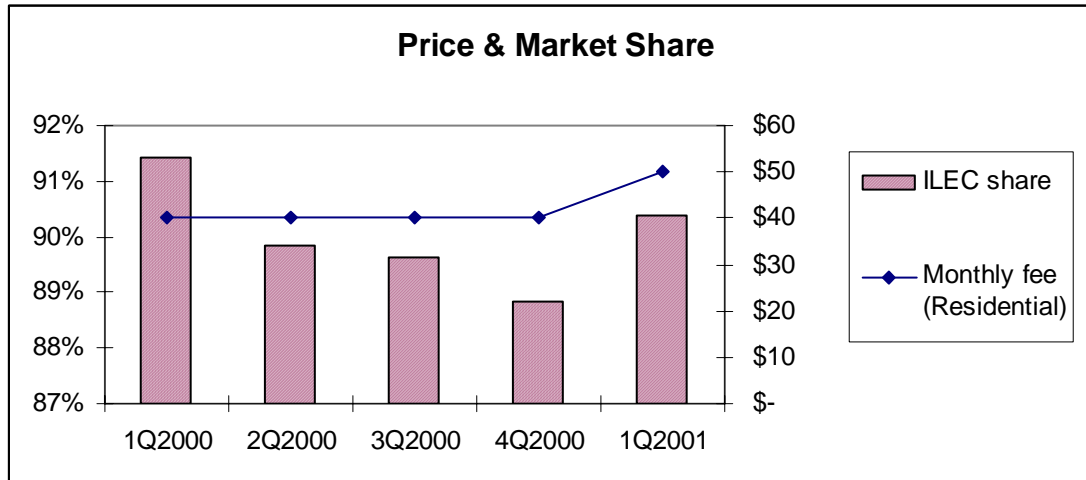
RESIDENTIAL DSL MARKETSHARE

During 2000 the CLECs did manage to increase their share of the residential market slightly, although their residential market share fell slightly in the first quarter of this year, probably due to the withdrawal of Northpoint. However, it is important to note that at no time did the CLECs share of the residential market surpass 11%. Furthermore, we should understand that these market share trends were not the result of a static market. During this period the total number of DSL lines grew by 286% and the number of residential lines grew by 314%. In fact, these market share results leads one to wonder why the ILECs are so interested in driving the CLECs from what little share of the market they have.



RELATIONSHIP BETWEEN MARKETSHARE AND PRICING

I have combined the ILEC's market share data and the monthly fee charged for residential DSL service in California on one chart to highlight that SBC/Pacific Bell's price increase occurred at the same time the ILEC's share of the market increased. I realize that this one fact in isolation does not prove that SBC/PacBell took advantage of reduced competition to increase its rates. Nevertheless, we would not expect to see such a relationship if the broadband market were as competitive as the ILECs claim. (In a competitive market one would expect a price increase to be accompanied by a drop in market share.)



CONCLUSION

The ILECs offer DSL services in both retail and wholesale markets. One result of this is that the ILECs determine the cost of the key input for one group of their competitors. Some ISPs combine DSL service offered by an ILEC with their connection to the Internet and sell the package to residential and business subscribers. As the ISPs usually have only a very small share of the DSL market, they feel pressure to meet the ILECs price for the combined service. However, when the wholesale-retail margin is set artificially low, the ISPs are at an unfair disadvantage to the vertically-integrated ILECs.

The ILEC's near-monopoly control of the local loops was recognized in the line sharing and unbundling requirements of the 1996 Telecommunications Act. Although these provisions are criticized as unfair and burdensome, they are both appropriate and consistent with previous remedies seeking to guarantee access to "bottleneck" facilities.

Nevertheless, some argue that the presence of economies of scale supports the need to treat the provision of telephone-network-based broadband services differently from traditional voice services. Broadband services should be relieved from the line sharing and unbundling requirements, according to this argument. One should not accept this line of reasoning without detailed supporting evidence as it ignores the realities of the DSL market. First, the argument for economies of scale is inconsistent with the recent price increases unless one includes an explicit acknowledgement of presence of monopoly power in the setting of prices. Second, there is the issue of the "shape" of the underlying cost functions. The question should not be whether scale economies exist, but at what market share or size do they occur. It is important to remember that, while economies of scale arguments have been used to justify the monopolies in local telephone service in the past, the modern approach is to encourage new technologies and competitive entry wherever possible. Unfortunately, the Tauzin/Dingell bill embodies a return to the past.

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