Chapter 6

On thinking about deregulation and competition

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The first problem in thinking about regulatory reform is to know what this term means. The central issue of regulatory reform used to be whether or not we should deregulate. Today, the meaning of regulatory reform has become much more clouded: The question of whether one should re-regulate comes up as often as whether one should deregulate further.

In the telecommunications industry, however, the debate still centers on how regulations should proceed from here. By focusing on the part of the telecommunications industry that I know best, the interLATA interexchange market, I will try to review the important issues that every regulator must confront when contemplating how to reform regulation.

My perspective is that of a person who works primarily on problems of company strategy. Although my roots are in industrial economics, the perspective of an economist on competition and my perspective as a person who works with companies on strategy are different enough to affect the view of regulatory policy and reform.

I find there are three problems that obscure how regulators and other observers evaluate the rationale for reform of telecommunications regulation. First, the model of competition is often inadequate; second, most regulators have a flawed conception of company strategy, radically different from the one held in industry; third, regulators have the wrong priorities when they assess the benefits of deregulation. I will briefly touch on each of these three areas and use the interLATA market as a case study for how these problems have colored the debate about the future reform of regulation in that market.

With regard to models of competition, discussions of regulatory reform among policymakers often draw on a model of competition that has a long tradition in economics. The model rests on two variables. The first, seller concentration, takes into account the number of competitors and their degree of concentration. By this measure of competition, the interLATA interexchange market is highly concentrated in comparison with the average of all industries. The second variable, barriers to entry, is not universally accepted as a part of the model of competitiveness. For instance, some economists do not believe that there are any barriers to entry. Those who believe in barriers to entry, as I do, tend to view them in relation to the cost of replicating the position of industry leaders; thus, they are generally concerned with economies of scale, learning curve effects, and those sorts of things. Again, if we regard the interLATA market in this way, the barriers to entry appear to be high. The cost of replicating AT&T's position would be very large – in the billions of dollars.

As a consequence of adopting this model, policymakers spend an inordinate amount of time trying to define the industry. This is because seller concentration and, by inference, competition are a function of where the industry's boundaries are drawn.

From my viewpoint as someone working in company strategy, this image of competition is much too narrow. Seller concentration and barriers to entry are significant, but only part of the story – and in telecommunications only a small part of the story. Another model of competition is what I call the industry structure model. The idea is that the competition is broader than mere rivalry and barriers to entry. There are instead five major forces of competition: those two plus the bargaining power of buyers, the bargaining power of suppliers, and the threat of substitute products and services. These five forces determine demand and supply elasticity facing firms in an industry.

If we look at the interLATA interexchange market through this new lens, we reach a strikingly different conclusion than if we limit our view to the traditional lens of seller concentration and barriers to entry: The interLATA market is an intensely rivalrous industry. Why? Because the forces that drive rivalry in an industry are much more numerous than seller concentration alone. One important industry characteristic is its tendency toward intense rivalry. In this industry there are enormous fixed costs as a proportion of value added. There is also significant excess capacity. Moreover, we find high barriers to ever retiring capacity from the market – that is, high barriers to exit, to use terminology starting to become more common.

So we find competitors with high stakes in the market, with conflicting goals, and with tremendous cost pressure to cut price and/or add service to fill up capacity. Not surprisingly, they are locked in a vigorous struggle. The competition is enhanced by the fact that networks are competing. Companies with networks having varying technological capabilities can be readily redeployed to offer different kinds of services. Thus rivalry, far from being low as would be predicted in a highly concentrated industry, is actually intense and likely to remain so for the foreseeable future.

As for buyers, this industry traditionally neglects them, assuming that they are powerless. In a regulated world, they were. But in the deregulated industry, buyers are enormously powerful, very price sensitive, and quite sophisticated. Thousands of consultants advise companies on how to lower the telecommunications costs by buying better. Even grandma in Peoria can easily and cheaply switch from one provider of services to another with simply a phone call or a letter. Some shared tenant services merge the bargaining power of even relatively small business customers. The reasons why the buyers are sophisticated, why they care about this product, why they can buy efficiently, why PBX, the machines of the future, are going to enable them automatically to route these cost services are firmly embedded in the logic of the buyers' businesses. That is not going to change.

As for barriers to entry, it is difficult to replicate AT&T's position, but one does not have to do that. In this industry there are many less expensive ways of getting into the industry, including leasing excess transmission capacity and building regional facilities. Large amounts of excess transmission capacity will be the rule, which means potential entrants with access to customers will be able to lease this capacity from hungry providers who have no other use for it. Even replicating AT&T's national network is within the reach of several corporations. The capital spending budgets per year required to build a national fiber network are not out of line with what a Fortune 100 company would spend on capital investment. Barriers to entry are therefore not invincible. To the contrary, they are relatively low in some segments, and hence a company can slowly build a broader position.

Effective substitutions are taking place – the most significant being that the buyer backward-integrates, providing his own telecommunications capacity or at least a piece of the overall capacity. This is likely to happen more and more, and not simply for reasons of cost, but so that the buyers can obtain improved service and responsiveness in their telecommunications networks.

If, then, you take an old, narrow view of industry structure based on seller concentration and barriers to entry to replicate AT&T, you end up wringing your hands about regulatory reform. But if you look through the new and broader lens of the determinants of industry competition, the conclusion is resounding: Get on with deregulation. What are we worrying about? We have an industry structure that fundamentally supports active competition.

I mentioned earlier that the second problem with regulatory reform is how regulators think about strategy. Economists have not been very interested in strategy until lately. Their usual position is that the environment has driven strategy; that is, companies have maximized within constraints set by the environment. There is not much that a company can do; it is a passive actor in the environment. Most writers have also viewed strategy narrowly and assumed that it was heavily driven by costs. Further, the test of strategic position has been correspondingly narrow, measured primarily by market share. One's strategic position is fully reflected in one's market share. Again, industry definition becomes crucial. What the relevant market is, is of central importance. This conception of strategy by regulators is abetted by the fact that in regulated industries, companies tend to adopt homogeneous strategies. When many variables are regulated, companies do not have many degrees of freedom. They all follow the same strategy. So regulators start believing that all companies are alike, and they all approach the competition in the same way.

If we review the business strategy literature and analyze the experience of other companies, however, we discover that unregulated industries are heterogeneous. The essential issue in strategy is competitive advantage. How can one company gain a sustainable advantage over another? Competitive advantage is rich in character. It involves not only cost, but also what I call differentiation, or the ability to provide superior service and value and command a price premium.

In creating strategy, firms also have myriad possibilities for choosing competitive scope, or the breadth of their strategic target; for example, whether to stay in a niche or whether to offer a full line of services, or create an arrangement in between the extremes. It is clear from the research on strategy that high share does not equal highest profit. It is also clear from the research on strategy that high share does not equal lowest cost or even competitive advantage.

The airline industry provides an example. United Airlines has had the highest share, but they are nowhere near the lowest cost producer. Nor does United have the best quality product. United has a poor strategy and is being punished for it in the marketplace. American Airlines and Delta, with lower market shares, are the differentiated competitors and earn much higher returns. Continental is the low cost producer.

Relating this to the interLATA market, once again the old view of strategy and how it is measured turns us to handwringing: AT&T is dominant, and we should worry. With a broader conception of strategy, however, we find that AT&T's market share is not a good indicator of its competitive advantage. Indeed, Sprint's commercial, which showed that over a Sprint circuit you could hear a pin drop, went straight for AT&T's jugular. It showed that AT&T's service quality and the quality of transmission are not an advantage, nor is its breadth of services.

What about cost? AT&T has a big depreciated network, but AT&T's competitors have brand new, low cost capacity coming on stream. AT&T is racing to catch up and eventually will have the same kind of capacity itself, in which it will have to invest current dollars as well. So here is an industry where the leader, AT&T, does not have a compelling competitive advantage, but is indeed struggling to maintain its position.

My conclusion, already obvious, is that we should get on with deregulation. The price cap concept is unnecessary. Either it will not make any difference or it will turn into a great morass of trying to calculate things that are impossible to calculate – for example, the costs of an individual service where you compete network to network. There is the risk that we will find ourselves in an expensive mess where only the lawyers will be the winners.

As for the benefits of deregulation, many regulators think of them primarily in terms of prices. The perspective is of static efficiency and price–cost margins. Will AT&T rip off poor grandma on the farm? Much evidence in economics, however, suggests that these are not the first order of problems in thinking about deregulation.

There are essentially two main benefits of deregulation. The first is of strategic heterogeneity. Deregulation allows firms to choose different strategies, to offer different bundles of service, to have different mixes of cost and differentiation. That kind of variety is enormously beneficial from an economic standpoint. The second and even more important benefit of deregulation is in promoting dynamic efficiency of progressiveness or innovativeness. Research compellingly indicates that innovation is what really matters, not the price–cost margin. And yet, we concentrate on the price–cost margin and ignore how regulatory changes might affect innovation. Given the breathtaking technological changes in this industry, the real action is obviously in innovation; and so regulators must figure out how to ensure that innovation takes place.

What general conclusions can we draw? The issues I have raised are endemic to all regulation. They exist in electric power, energy, airlines, and a host of other sectors. The tendency is strong to view competition narrowly and inadequately when we assess how to deregulate, and whether and how to continue doing so. Regulators should use the same competitive model as other companies do, and should have a realistic view of competition as other industries do. By taking accurate readings of the health of competition, regulators can encourage and celebrate strategic heterogeneity. They must allow companies to take different approaches and not create policies that force them to adopt the same strategy. Finally, regulators need to think first and foremost about how they might affect innovativeness and technological progress.

As one who works with companies on strategy, I have found that it is easy to underestimate the time it takes for regulated entities to adjust their behavior to reflect competition. Having worked with many regulated entities as they entered a new era of competition, I know that the barriers to adjustment are enormous. They involve an entire generation of management brought up with different rules who are terribly uncomfortable with the new rules. Such problems add years to making strategic adjustments, and hence the behavior of companies will lag behind reality for a while. In such a setting, where behavior lags behind reality, we cannot afford to use these old-fashioned measures of competition and market power. Regulatory reform must be guided by the new realities, not the comfortable, understandable old ones.