

## **The Pacific Research Institute's Telecom Policy Seminar Post-Event Report with Speaker Summaries October 2005**

Few states have as much potential for strong telecom regulatory reform as California. With the recent redrafting of industry framework rules, local lawmakers have been handed a prime opportunity to foster significant marketplace growth and new competitive technologies. However, a growing information gap between Sacramento and Silicon Valley threatens these prospects, as some legislative priorities conflict with a robust rollout of telecom investment in California. If a stronger initiative is not taken to address this issue, the Golden State will fail to capitalize on the latest trends of industry convergence and innovation, to the detriment of both business and consumers.

To help bridge this divide, the Pacific Research Institute (PRI) brought together influential state policymakers and high-tech entrepreneurs for a special one-day telecom policy retreat in Santa Clara on October 11, 2005. Participants discussed the major challenges in state telecommunications policy such as current regulatory reform ideas, municipal Wi-Fi, broadband deployment, and industry investment. Attendees also heard from a host of speakers including George Gilder, famed technologist and author of best-selling *Wealth and Poverty*; Dr. Robert Crandall, Senior Fellow at the Brookings Institution; Dr. Ronald Rizzuto, Professor of Finance at the University of Denver; Dr. Debra Aron, Adjunct Professor at Northwestern University; and Greg Stein, Executive Vice President of Laffer Associates. Following the daytime seminars, guests were treated to a private dinner conversation with California Public Utilities Commissioner Susan Kennedy and remarks from newly-appointed Commissioner John Bohn.

This one-day event raised awareness of the failed telecom government policies of the past, and helped generate ideas for positive change going forward. In distributing this post-event summary, PRI aims to continue facilitating positive discourse concerning local telecom issues as well as help industry decision-makers find the junction between fueling economic growth and meeting government goals.

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## **George Gilder – Editor-in-Chief, *Gilder Technology Report***

George Gilder is Editor-in-Chief of the *Gilder Technology Report*, a prominent monthly technology investment newsletter. Mr. Gilder shared a number of thoughts on fostering effective telecommunications policy with seminar attendees, including:

- **Government should not attempt to “solve” telecom problems. Instead, it should create opportunities.**
  - Mr. Gilder noted that the key issue with current government oversight of the telecom industry is that there currently exists a “regulatory maze” of municipalities, state standards, and federal rules that delay telecom services, stifle investment, and raise costs for both businesses and consumers.
- **The United States does not need an “industrial policy” to foster growth in the telecommunications industry.**
  - Some have suggested that the U.S. should follow the heavy-handed regulatory paths of South Korea and Japan, which have higher broadband deployment rates. Mr. Gilder suggested that, instead, our nation has a golden opportunity to dismantle our “anti-industry policy” of red-tape and bureaucracy that stifles innovation in video programming, broadband, and other services. Mr. Gilder recommended that the federal government establish “free zones” so companies no longer have to go to public authorities to ask permission to complete rudimentary business transactions or deploy new services.
- **Government has many opportunities to strengthen the telecommunications industry.**
  - Government can be a good steward for telecom growth by working on the demand side of the market as a customer, and adopting advanced communications for government services. As lawmakers, public officials can also create a low-entropy environment that would facilitate high-entropy entrepreneurship via better franchising policies, rights of way rules, environmental laws, and launching pilot projects for new technologies like Broadband over Power Lines (BPL). Finally, as a financier, government can cut the swelling tax burden of the telecom industry, which is the third highest for any industry in the nation, trailing only alcohol and tobacco companies.
- **The definition of “innovation” is a monopoly.**
  - The first person or company to come up with a new idea always has a monopoly in the beginning. It doesn’t matter that the Telcos used to be monopolies – that’s a sunk cost. We need to proceed with policy from where we are now.

## **Dr. Robert Crandall – Senior Fellow, Brookings Institution**

Dr. Robert Crandall is a senior fellow at the Brookings Institution, where he has worked since 1978. In his presentation, Dr. Crandall explained how government can work to create a stronger telecommunications sector, including:

- **To improve broadband deployment for tomorrow, we must first understand why our policies don't work today.**
  - By December 2004, the United States lagged behind eleven other nations in broadband penetration. Besides varying consumer demand levels, the most striking difference between the nations was the DSL penetration rate, in which the U.S. came in eighteenth overall. Dr. Crandall explained that this was largely due to egregious federal policies that burdened DSL technology with the same facility-sharing rules that governed wireline telephony.
- **Economic regulation should only be considered for a select few industries.**
  - Dr. Crandall stated that if an industry 1) produces an essential service, 2) is dominated by durable, sustained monopolies, and 3) is not subject to rapid technical change, then they can be economically regulated. Water, gas, and electricity are examples of such goods, not the vibrant, ever-evolving telecom industry, which faces strong competition across various sectors – video, voice, and data.
- **Regulating market competition has failed in the telephone industry, and would bring the same problems to the broadband market.**
  - Forced facility-sharing policies for telephone companies under the 1996 Telecom Act led to lower labor productivity, reduced incentives to invest, and produced little net economic gain from the resulting competition. Since many of the smaller carriers that benefited from these rules were less efficient than the sharing incumbents, the net loss to the economy was greater than \$8 billion a year.
  - Requiring line sharing in the broadband market would also disrupt current investment for the benefit of a few. Incumbent Bell companies slowed down fiber-to-the-home (FTTH) high-speed Internet network deployment until the FCC ruled out broadband network sharing in late 2003. As the Bells now take major risks to deliver video programming over billions of dollars of new technology, more red tape and bureaucracy would be inappropriate at this time.

## **Dr. Anna-Maria Kovacs – President, Regulatory Source Associates**

Anna-Maria Kovacs is founder and President of Regulatory Source Associates, which provides investment professionals with analysis of federal and state regulation of the telecom and cable industries. Dr. Kovacs discussed how entrenched interests are preventing the next wave of advanced communications technologies.

- **Government policies are discouraging telephone company entry into the video market.**
  - As the communications market converges, telephone companies face growing competition in the voice market from lightly-regulated, VoIP and cable providers. Companies like SBC and Verizon are attempting to enter into the video programming market alongside the cable companies, but it's been an uphill battle. The procurement of thousands of local franchise agreements, combined with the dearth of market competition, and the billions of dollars required for a fiber network make the proposition risky and unattractive. As long as municipalities control the local video market via franchise agreements, it will be unlikely that consumers will see additional competition.
  - Responding to a question as to why the telephone companies did not take an earlier opportunity to invest in network upgrades, Dr. Kovacs explained that their managerial decisions were distorted by federal regulations. With the passage of the Telecom Act, the Baby Bells were required by law to share their landlines and other facilities with competitors, pouring billions into building and maintaining parts of their network that they were forced to lease at artificially low prices. At the same time, cable companies were free to spend a similar amount of money on fiber network upgrades.
- **Limited government will foster new video market competition.**
  - A state-based or national-based video regulatory authority could facilitate easier entry into the market by new competitors. Under current rules, new entrants have to spend years lobbying tens of thousands of municipalities for local franchise agreements, which are drafted to heavily favor the incumbent cable company.

## **Dr. Jeffrey Eisenach – Chairman, CapAnalysis**

Dr. Jeffrey Eisenach has more than 25 years of experience in economic analysis of legal and public policy issues, and served in senior policy positions at the Federal Trade Commission (FTC) and the White House Office of Management and Budget (OMB). Dr. Eisenach discussed regulatory lessons for the future with seminar attendees, including:

- **Government should not try to solve problems that do not exist.**
  - In their attempts to expand regulatory power and authority, state and federal lawmakers perpetuate certain myths about the telecom sector. These myths include
    - 1) There is not sufficient competition in the telecom marketplace.
      - Government data shows that in fact, there is plenty of competition for telecom services. The continuous deployment of new, affordable technologies like VoIP, Instant Messaging (IM), cellular and wireless have created an industry supermarket for most consumers; it's really up to individuals to shop around for the best deals.
    - 2) Government must solve the problem of broadband access with muni Wi-Fi.
      - There is no crisis with broadband deployment – the U.S. has the highest rate of facilities-based competition for broadband in the world. Government controlled Internet access jeopardizes taxpayer dollars and undermines millions in private investment, and does little to bring sustained lower rates and greater reach of access to consumers.
    - 3) There is a problem with Internet network interconnection.
      - The federal government does not need to create a new policy to force interconnection among Internet service providers (ISPs). The handful of interconnection issues that have erupted in the past were resolved effectively in a private and timely manner.
    - 4) The universal service system is working.
      - The universal service system is an unwieldy \$6.5 billion program that is rife with corruption, waste, and abuse, and is only helping a small number of people at an enormous cost for all. Expanding universal service to include universal broadband or VoIP would be a mistake; government is incapable of redistributing money or technology in any meaningful way.

## **Dr. Ronald Rizzuto – Professor of Finance, University of Denver**

Ron Rizzuto is Professor of Finance at the Daniels College of Business at the University of Denver. Dr. Rizzuto shared with attendees his analysis of municipal broadband networks, and why they have failed to serve the public interest. These reasons included:

- **Municipal broadband networks are poor investments from a utility standpoint.**
  - None of the muni networks have generated incremental revenue for the city, and though they may cause a reduction in rates for consumers, they are not sustainable in the long term. Municipal business plans are unrealistic, setting prices at artificially low rates to the detriment of all residents; the private sector is more effective at understanding consumer demands and investing in new technologies.
- **Handing over control of Internet access to government is risky.**
  - Dr. Rizzuto explained that municipal decision makers often fail to look at the complexities of network cash flow, such as capital costs, whether revenues can cover operating costs, and debt service. Many of the city plans for broadband are overly optimistic, such as Dubuque, Iowa, which predicted it would take 75% of the broadband market after only two years. The city of Chaska, Minnesota projected capital costs of \$535,000, but their actual costs ran up to \$853,000. Philadelphia, Pennsylvania last year touted ambitious plans to begin construction this February on a wireless network that would only cost \$10 million, and would be free for residents. However, construction is still pending, costs have overrun to \$18 million, and many residents will be charged a monthly rate for service.
  - As replacement capital is non-existent in government networks, there is usually cost shifting in the form of increased community taxes, escalating debt levels, and reduced network investments, so as to give the illusion of cable rate savings. Some municipalities also “loan” money from other utilities to cover their deficits, usually without charging interest.
- **The City and County of San Francisco may be taking more risk than they think with their wireless broadband network plans.**
  - San Francisco public officials are aggressively pursuing a public-private partnership to build a single city-wide network, but the 1996 Telecom Act may force them to open up their market to allow competition. Lessons from market intervention can be learned from cross the Bay, as the city of Alameda borrowed \$82 million to build a broadband network that now only serves 7,000 residents.

## **Dr. Debra Aron – Adjunct Associate Professor, Northwestern University**

Dr. Debra Aron is an adjunct associate professor at Northwestern University, and director with LECG, a global expert services firm providing testimony and studies to governments around the world. Dr. Aron explained to seminar attendees why legislating consumer protection rules in the telecom industry can be hazardous for both businesses and consumers:

- **There is a major difference between legal rights and prescriptive rules.**
  - Dr. Aron explained that legal rights establish boundaries and principles that businesses should follow. However, prescriptive rules act to delineate how specifically the legal principles are to be implemented in the business place, governing how companies conform to law.
- **Prescriptive rules, such as those contained within the California Telecommunications Consumer Bill of Rights, are based on dubious assumptions.**
  - For micro-managing prescriptive rules to enhance consumer welfare, all of the following assumptions must be true: 1) companies do not have sufficient incentives to protect consumers; 2) general consumer protection laws such as those against fraud and anti-competitive behavior are insufficient to limit bad business practices; 3) regulators are superior at identifying the best ways to meet consumer needs than the marketplace, and thus know what consumers need more than they know themselves.
- **Implementing prescriptive rules in the California telecom industry are costly in many ways.**
  - Dr. Aron discussed how prescriptive rules limit diversity in the marketplace, and may result in approaches that are not desired by consumers. Prescriptive rules also underestimate the strength of competitive marketplace forces, whereby the ability of consumers to take their business elsewhere provides a strong incentive for businesses to satisfy demand and effectively convey important information in a user-friendly manner. Dr. Aron's analysis of former Commissioner Carl Wood's revised 2003 version of the Consumer Bill of Rights shows that it would have cost \$3.86 per customer per month to implement the rules, and a loss of over 11,000 jobs statewide.
  - The loss of consumer welfare from a decline in use of telephone service, due to higher prices, should also be considered in debates over Bill of Rights-type legislation.
  - Telephone companies already spend lots of money on focus groups and consumer research to improve the design of monthly bills, and to make their services user-friendly.

## **Greg Stein – Executive Vice President, Laffer Associates**

Mr. Stein is Executive Vice President of Laffer Associates, an economic research and consulting firm that provides investment-research services to institutional asset managers. Mr. Stein shared his analysis on the challenges facing reform of California's New Regulatory Framework (NRF), the state-based rules that govern the telecommunications industry:

- **By delaying industry deregulation, California policymakers place jobs and the local economy at risk.**
  - Despite burdensome state rules, telecom companies are a major contributor to local jobs and the economy. The telecom industry employs more than 340,000 Californians, which generate roughly \$1 billion in state income tax revenue each year. Mr. Stein estimated that the opportunity cost from delaying deregulation for the California telecommunications industry is more than \$100 million per month in lost economic activity.
- **The telecom marketplace has changed, jeopardizing current government policies.**
  - The California Public Utilities Commission (CPUC) has been ineffective and inefficient in helping the neediest Californians connect to basic telephone service through its universal service programs, costing Californians more than half a billion dollars a year. While NRF and programs like universal service add costs for industry, new affordable technologies like VoIP and cellular telephony are overtaking the market, and state regulators need to draft new regulations that reflect these trends. As a 2004 CPUC study found, the growing popularity of VoIP may cost California more than a billion dollars in lost funding for the state's universal service system. Incumbent carriers like SBC and Verizon may simply abandon their copper-wire telephone network, or be pressed into bankruptcy under the crushing weight of state regulatory demands.
- **Change must happen at the CPUC.**
  - With the current Uniform Regulatory Framework (URF) proceedings, Mr. Stein suggested that strong leadership and initiative must come from the California Public Utilities Commission. Regulators should implement a new regulatory regime that facilitates new growth and industry investment, as well as reaching government goals in an efficient manner. Mr. Stein suggested that state universal service programs be non-specific to technology and price. He also suggested eliminating the municipal bureaucracy that hampers telecom deployment through rights of way issues, cable franchise agreements, etc.

## Speaker Biographies

### **George Gilder – Editor-in-Chief, *Gilder Technology Report***

George Gilder is Editor-in-Chief of the Gilder Technology Report, a prominent monthly technology investment newsletter. He is also a Senior Fellow at Discovery Institute where he directs Discovery's program on high technology and public policy.

Born in 1939 in New York City, Mr. Gilder attended Exeter Academy and Harvard University. At Harvard, he studied under Henry Kissinger and helped found *Advance*, a journal of political thought, which he edited and helped to re-establish in Washington, DC after his graduation in 1962. He later returned to Harvard as a fellow at the Kennedy Institute of Politics and editor of the *Ripon Forum*. In the 1970s, as an independent researcher and writer, Mr. Gilder began an excursion into the causes of poverty, which led to his best-selling *Wealth and Poverty* (1981).

Mr. Gilder's latest book *The Silicon Eye* (2005) travels the rocky road of the entrepreneur on the promising path of disruption, and celebrates some of the smartest-and most colorful-technology minds of our time. In *The Silicon Eye*, Gilder shares his insider knowledge of Silicon Valley and illustrates how the unpredictable mix of genius, drive, and luck that can turn a startup into a Fortune 500 company.

Mr. Gilder is a contributing editor of *Forbes* magazine and a frequent writer for *The Economist*, *The American Spectator*, the *Harvard Business Review*, *The Wall Street Journal*, and other publications.

### **Dr. Robert Crandall – Senior Fellow, Brookings Institution**

Dr. Robert Crandall is a senior fellow at the Brookings Institution, where he has worked since 1978. Mr. Crandall was the former deputy director of the Council on Wage and Price Stability during the Ford and Carter administrations. He was also a former faculty member at the Massachusetts Institute of Technology and the George Washington University. He has been a consultant to the Environmental Protection Agency, the Antitrust Division of the Federal Trade Commission, and the Treasury Department. His interests include industrial organization, antitrust policy, regulation, the auto industry, competitiveness, deregulation, and environmental policy. He has published widely, and his articles have appeared in *Regulation*, the *Journal of Economic Perspectives*, and the *American Economic Review*.

**Dr. Anna-Maria Kovacs – President, Regulatory Source Associates**

Dr. Anna-Maria Kovacs is founder and President of Regulatory Source Associates, which provides investment professionals with analysis of federal and state regulation of the telecom and cable industries. Dr. Kovacs has followed the telecommunications industry for over twenty years, as either an analyst or consultant. Her undergraduate degree in Economics and English is from Boston University. Her Ph.D., from Harvard University, is in Comparative Literature with extensive work in Economic History. Her MBA is also from Harvard. Anna-Maria is a CFA.

**Dr. Jeffrey Eisenach – Chairman, CapAnalysis**

Dr. Jeffrey Eisenach has more than 25 years of experience in economic analysis of legal and public policy issues, and has served in senior policy positions at the Federal Trade Commission (FTC) and the White House Office of Management and Budget (OMB). He has also served on the faculties of Harvard University's Kennedy School of Government, Virginia Polytechnic Institute and State University and, currently, at the George Mason University School of Law. In 1993, Dr. Eisenach co-founded The Progress & Freedom Foundation, a non-partisan, non-profit think tank focused on issues affecting the high-tech sector of the economy. He has authored or co-authored numerous filings before the Federal Communications Commission and other regulatory agencies, as well as filing comments in the Tunney Act proceeding in the Microsoft litigation. He has testified before Congress on numerous occasions. He remains a member of the board of directors of The Progress & Freedom Foundation and serves on the Executive Board of Advisers of George Mason University's National Center for Technology and the Law.

**Dr. Ronald Rizzuto – Professor of Finance, University of Denver**

Ron Rizzuto is Professor of Finance at the Daniels College of Business at the University of Denver. His specialty areas are capital expenditure analysis, mergers and acquisitions, and corporate financial planning. Dr. Rizzuto has extensive consulting experience in evaluating the financial viability of new technologies (video, voice, and data), and on the economics of telecommunications overbuilds. In addition, he has co-authored two books, *Costs, Benefits, and Long-Term Sustainability of Municipal Cable Television Overbuilds* and *Managing by the Numbers*. He has published numerous articles and essays that have appeared in scholarly and professional journals and books. Dr. Rizzuto holds a B.S. in Finance from the University of Colorado and an M.B.A. and Ph.D. in Finance and Economics from New York University.

**Dr. Debra Aron – Adjunct Associate Professor, Northwestern University**

Dr. Debra Aron is an adjunct associate professor at Northwestern University, and director with LECG, a global expert services firm providing testimony and studies to governments around the world. At LECG, Dr. Aron has been engaged in regulatory economics and policy matters, merger analyses, and antitrust analyses, with specialty in the communications industries. Dr. Aron has served as an expert witness in numerous matters relating to the appropriate regulatory posture regarding the development of competition in local telecommunications markets, the development of competition and investment in broadband markets, the pricing of local telephone service, interconnection, determination of forward looking costs under the Telecommunications Act of 1996, limitations of liability, and Universal Service. One of her primary fields of consulting expertise is pricing strategy, and she has conducted a number of price restructuring projects in cellular telephone markets. Dr. Aron holds a Ph.D. in economics from the University of Chicago, and is a former National Fellow of the Hoover Institution, and Faculty Research Fellow of the National Bureau of Economic Research.

**Greg Stein – Executive Vice President, Laffer Associates**

Mr. Stein is Executive Vice President of Laffer Associates, an economic research and consulting firm that provides investment-research services to institutional asset managers. Mr. Stein is responsible for developing and maintaining client relationships, establishing partnerships with associations and government agencies, and providing public policy evaluations in support of special projects. Mr. Stein's resume includes more than 12 years of public policy and campaign experience at the local, state, and federal level, and most recently he managed a trade association in San Diego. He served two members of the House of Representatives with responsibility for issues ranging from the economy and taxes to foreign affairs, trade, and defense, including work as the key staffer responsible for the Telecommunications Act of 1996. Mr. Stein earned his undergraduate degree in Political Science from the University of California at San Diego, and is a 2006 MBA Candidate at the UCLA Anderson School of Management.