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TESTIMONY

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Before the Senate Committee on Commerce, Science, and Transportation

October 17, 2007

"Consumer Wireless Issues"

Mr. Chairman and Distinguished Members:

Thank you for the opportunity to appear here today and testify on consumer wireless issues. I am a senior research fellow at the Mercatus Center, a research, education, and outreach organization affiliated with George Mason University and located a short Metro ride away on the Arlington, Virginia campus. The Mercatus Center's mission is to bridge academics and policy: we conduct interdisciplinary research in the social sciences that integrates practice and theory.

My own research focuses primarily on the causes and consequences of regulation, primarily "economic" regulation of network industries like telecommunications. During the past several years, I have published several studies examining consumer issues in wireless telecommunications—particularly the itemized "add-on" charges that appear on consumers' wireless bills. The two most relevant studies I have attached as appendices to this testimony.[2] Between 2001 and 2003, I also served as deputy director of the Office of Policy Planning at the Federal Trade Commission. While the FTC does not exercise jurisdiction over telecommunications, this experience familiarized me with the general economic concepts used to analyze the kinds of consumer protection issues under discussion today.

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[1] The views expressed in this testimony are solely my own and are not official positions of the Mercatus Center or of George Mason University.
[2] Jerry Ellig and James N. Taylor, "The Irony of Transparency: Unintended Consequences of Wireless Truth-in-Billing" *Loyola Consumer Law Review* 19, 43 (2006), available at http://www.mercatus.org/publications/pubID.2494/pub_detail.asp; Jerry Ellig, "Costs and Consequences of Federal Telecommunications Regulation," *Federal Communications Law Journal* 58, 37 (2006), available at http://www.mercatus.org/publications/pubID.1229/pub_detail.asp.

Consumer wireless issues involve two types of proposals that are conceptually distinct: regulation of specific contract terms and regulation of disclosures. To understand the effects of regulations mandating specific contract terms or disclosures, three questions need to be answered:

1. Is there a systemic problem that regulation might solve?
2. How effective are alternative solutions?
3. What are the likely unintended consequences of new regulation?

1. Is there a systemic problem that regulation might solve?

A systemic problem is a widespread problem created by the existing "rules of the game" under which wireless companies compete. This kind of problem should be distinguished from other sources of consumer complaints that cannot be readily remedied by new regulation, such as ordinary misjudgment or human error, misunderstanding, sloppy execution of corporate policy, technology that does not quite yet do what people would like it to do, or bad-faith actions that are already prohibited under existing rules. These other types of problems are either self-penalizing in competitive markets or can be dealt with via enforcement of existing regulations.

Contract terms

In competitive markets, the bundle of contract terms offered to consumers tends to be the combination that consumers are most willing to accept, given all the relevant costs and tradeoffs. That does not mean some consumers will not wish that some contract terms were different. As consumers, we always want more for our money, and since we are all different, a standardized contract will not always please everyone. But when competition exists, competitors have strong incentives to find out what combination of contract terms will best satisfy most consumers, and offer tailored contracts when they can identify substantial groups of consumers who prefer something else.

The wireless market is undoubtedly the most competitive of all telecommunications markets. The Federal Communications Commission's annual wireless reports amply demonstrate this.[3] There are multiple competitors, the vast majority of Americans have a choice of three or more, average revenue per minute of use has steadily declined, subscribership and usage have steadily increased. "Churn" rates between 1.5 percent and 3.0 percent per month imply that the typical wireless carrier can expect to lose about one-third of its customers every year.[4] Given the extent of competition, it is unlikely that regulation of specific contract terms can significantly increase consumer welfare.

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[3] See, e.g., Federal Communications Commission, *Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services,* WT Docket No. 06-17 (Adopted Sept. 26, 2006), available at http://fjallfoss.fcc.gov/edocs_public/attachmatch/FCC-06-142A1.pdf. [Hereinafter "FCC Wireless Report."]

[4] Id. at 65.

A critic seeking to dispute this contention might characterize wireless communication as an oligopoly -- that is, a market with a small number of competitors. Despite the fact that it ends in "-poly," the term implies nothing about the relationship between the number of competitors and consumer welfare. The relationship between the number of competitors, their market shares, and the competitiveness of markets has been studied extensively by scholars for 50 years. This research reveals that there is no simple rule of thumb that tells us how many competitors, or what level of concentration, makes a market "competitive."

Recent studies on the relationship between concentration and prices have produced a wide variety of results that depend on the facts and circumstances in the industry studied. Some empirical research on railroads, for example, finds that two competitors are sufficient to produce the results one would expect in a competitive market.[5] Across a variety of industries, a number of studies find a positive relationship between concentration and prices, but not all do.[6] Laboratory experiments find that four sellers are usually enough to produce a competitive market outcome.[7] In general, the results seem to vary across industries and with the type of information buyers and sellers have.

The DOJ/FTC Merger Guidelines reflect the fact that there is no simple or mechanical relationship between the number of competitors and the competitiveness of the market. The guidelines indicate that mergers in more concentrated markets face a heightened level of review, but such mergers can still be legal.[8] Similarly, the FCC states in its 2006 wireless report, "We note that market structure is only a starting point for a broader analysis of the status of competition based on the totality of the circumstances, including the pattern of carrier conduct, consumer behavior, and market performance…."[9] Examining the totality of the circumstances, the FCC concluded that wireless is effectively competitive in both urban and rural areas.[10]

Disclosures

Economists like to say that well-functioning markets require well-informed consumers. This shorthand statement can generate significant misunderstandings. Information, like anything else, is a scarce commodity that requires resources to produce and disseminate. Expecting *all* consumers to have *perfect* information is an ideal that neither competitive markets nor enlightened government regulation can achieve. Fortunately, that is not necessary for competition to work reasonably well.

For competition to function well, it is sufficient that *enough* consumers have *sufficiently good* information to understand the material contract terms *that are important to them*. Under those conditions, a wireless firm that offers an inferior set of contract terms will

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[5] Paul A. Pautler, "Evidence on Mergers and Acquisitions," *Antitrust Bulletin* 48, 1 (Spring 2003), pp. 181–82, and references cited therein.
[6] Id. at 189–95.
[7] Id. at 200–01.
[8] See Section 1.5, Concentration and Market Shares. A copy of the guidelines is available at http://www.usdoj.gov/atr/public/guidelines/horiz_book/toc.html.
[9] FCC Wireless Report, at 40.
[10] Id. at 4, 40.

find that it loses current and prospective customers to competitors. Indeed, the well-informed consumers who comparison shop create significant benefits for the consumers who are not very well-informed or who do not want to bother with comparison shopping. A firm whose contract terms are difficult to understand will find itself at a competitive disadvantage versus firms that clearly disclose contract terms. Information disclosure can facilitate competition, but competition also drives companies to disclose information.

For this reason, new disclosure regulations can only be justified if accompanied by a coherent theory explaining why competition systematically fails to produce clear disclosure, along with strong evidence that this is a significant systemic problem. Mandated disclosures should seek to ensure that enough consumers have sufficiently good information to understand the material contract terms that are important to them. Before mandating disclosures, decision makers must understand three key facts that require empirical research on consumer behavior:

1. How many well-informed consumers are "enough" to make competition effective? The answer to this question helps determine what percentage of consumers actually need to understand the mandated disclosures.
2. How much information is enough? The answer to this question helps determine the extent of the required disclosure.
3. What material contract terms are actually important to many or most consumers? This is different from asking what contract terms the legislator, regulator, or small group of vocal consumers thinks is important.

2. How effective are different alternatives?

When there is a systemic problem, there are usually alternative solutions available. Common sense suggests that decision makers should evaluate the pros and cons of each alternative before deciding which one to pursue.

Scholars affiliated with the Mercatus Center frequently offer comments to regulatory agencies when they propose new regulations. We find that agencies often feel that the scope of the alternatives they can consider has been severely limited by legislation—either because Congress ordered them to issue a specific regulation, or because Congress ordered them to issue some kind of proscriptive regulation, even though the agency might have been able to identify other, more effective approaches. For this reason, it is especially important that decision makers in Congress consider alternative solutions.

Contract terms

Competitive markets tend to produce the bundle of contract terms that most consumers are most likely to want. The proposed legislation, S.2033, reflects a belief that wireless markets have failed to do this, and so it mandates specific contract terms. But if competition is insufficient to produce the blend of contract terms consumers are most willing to accept and pay for, policy makers could address the root cause of the problem through competition policy, rather than regulation.

More competition in wireless requires more spectrum for wireless. As part of the Mercatus Center's ongoing program to assess the costs and outcomes associated with regulation, I recently examined the costs of major federal telecommunications regulations.[11] Out of all federal telecommunications regulations, spectrum policy has by far the biggest effect on consumer welfare. The costs of the current spectrum policy are large in an absolute sense—in the neighborhood of $77 billion or more annually. Spectrum allocation is by far the costliest aspect of U.S. federal telecommunications regulation, and it represents a very large share of the total. Even if the actual costs of U.S. spectrum allocation policy were only one-tenth the size that scholars estimate, they would still account for more than 20 percent of the total consumer cost of telecommunications regulation.[12]

During the past two decades, U.S. spectrum policy has gradually become more market oriented. In 1993, Congress directed the FCC to auction an additional 120 MHz of spectrum for wireless communications. Consumers have reaped significant benefits as a result.[13] The upcoming 700 MhZ auction will eventually make more spectrum available for commercial use. But doling out a few more slices of spectrum is not the same thing as a comprehensive, market-based policy. Current policy still generates large inefficiencies by preventing reallocation of additional spectrum to its most highly-valued uses—most likely wireless voice and data communications. At a minimum, Congress could facilitate wireless competition by directing the administration to identify additional spectrum for auction that is currently unused or under-utilized by federal agencies.

Disclosures

If the goal is truthful and accurate disclosure of material information that consumers want to know, there are several possible alternative approaches. One option is specific, mandated billing formats that require certain types of disclosures and prohibit others, but this is hardly the only possible approach. Self-regulation via industry codes of conduct is another possibility. Another regulatory approach would be to require accurate disclosure of all material contract terms and charges without mandating the disclosure or billing format.

One particular regulation affecting disclosure required by S.2033 involves a specific issue I have researched: wireless add-on charges. The language of the bill might prevent carriers from adding charges that recover regulatory costs or universal service assessments, though they could still treat taxes as an add-on charge.

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[11] See Ellig, *supra* note 2.

[12] Jerry Ellig, "The Economic Costs of Spectrum Misallocation: Evidence from the United States," presented to the conference on Spectrum Policy in Guatemala and Latin America, Universidad Francisco Marroquin, Guatemala City, Guatemala, June 9-10, 2005, available at http://cadep.ufm.edu.gt/telecom/lecturas/JerryEllig.pdf.

[13] The results are documented succinctly in Robert W. Crandall and Jerry A. Hausman, "Competition in U.S. Telecommunications: Effects of the 1996 Legislation," in Sam Peltzman and Clifford Winston (eds.), *Deregulation of Network Industries: What's Next?* (AEI-Brookings Joint Center for Regulatory Studies, 2000), at 102-07.

Wireless add-on charges can be substantial, but most of them are in fact taxes. Using 2004 data, James N. Taylor and I estimated that total wireless add-on charges amounted to $110 per subscriber per year, or $9.20 per month, for a total of $18.8 billion. Add-on charges accounted for about 15.5 percent of the average wireless bill. Three-quarters of these charges, however, were federal, state, and local taxes—which even S. 2033 would permit as a separate line item on the bill. About 16 percent of wireless add-on charges consisted of regulatory fees (averaging $1.43 per subscriber per month), and about 9 percent was federal universal service contributions (averaging 83 cents per subscriber per month).[14]

Essentially, then, the legislation affects $2.00–3.00 per month of add-on charges on the subscriber's bill. A naïve observer might think that the legislation's prohibition would therefore save every wireless consumer several dollars a month, since these add-on charges would be prohibited. But since the price of wireless service is not regulated, the carriers could simply roll these charges into the advertised contract price—either by raising the price, or by refraining from price reductions they would otherwise have offered.

The problem with this approach is that regulatory costs and universal service assessments behave pretty much like taxes. Companies have little control over these costs; the costs are imposed as a result of government decisions. Federal universal service assessments are adjusted quarterly, and state universal service assessments are also adjusted at various intervals. New regulatory mandates could appear at any time. Yet most wireless contracts guarantee the consumer a fixed price for at least two years. If the carrier must recover the regulatory and universal service costs in the contract price, then the carrier bears the risk that these costs might change over the life of the contract. If the carrier bears this risk, it will insist on a higher price or a change in some other contract term to compensate it for bearing this risk. There is no reason to believe that this new blend of contract terms will make consumers better off.

The FCC seems to have struck a reasonable balance in its current treatment of regulatory and universal service charges on wireless bills. Companies can add these charges to the bill if they choose, but they must disclose an estimate of these charges before the customer signs the contract. For regulatory charges, different carriers have actually taken different approaches. In 2004, some imposed minimal regulatory charges, while others imposed charges in the $1.55–$1.75 range.[15] The FCC's current approach addresses the core consumer protection concern—ensuring that consumers are informed of possible add-on charges before they commit to a contract—without getting the FCC into the business of regulating the size of the charges.

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[14] See Ellig and Taylor, *supra* note 2, at 52–59.
[15] See Ellig and Taylor, *supra* note 2, at 58.

3. What are the unintended consequences?

Even when decision makers select the most effective means of accomplishing the desired outcome, regulation can have unintended (and undesirable) consequences for consumers. The challenge is to regulate only in those situations where the intended, desirable consequences outweigh the unintended, undesirable consequences.

Contract terms

Wireless service has a variety of dimensions, such as coverage areas, roaming, call clarity, dropped calls, whether the phone can be used as a computer modem without additional charges, quality of 911 service, and availability and responsiveness of customer service. Wireless contracts have many dimensions, such as the monthly fee, treatment of add-on charges, charge per minute over the monthly allowance, pricing of international calls, definition of free "evening" times, roaming charges, early termination fees, free or discounted telephones, and renewal clauses.

Terms of wireless contracts are not comprehensively regulated. As a result, carriers are free to alter any unregulated contract term—or even invent new ones—in response to new mandated contract terms. One specific example is the tradeoff between free telephones and early termination fees. S.2033 requires companies to pro-rate early termination fees, apparently in the belief that such a "reasonable" requirement could induce carriers to continue offering free telephones. But there is a more general point here that should not be lost in the debate over one particular contract term. With dozens of unregulated contract terms and hundreds of contract terms that have not yet been invented, the carrier can always alter something else in the contract to make up for any revenue lost due to a mandate. Even a carefully crafted mandate cannot give consumers the proverbial "free lunch."

Mandated contract terms are unlikely to improve consumer welfare unless decision makers have evidence that the new bundle of contract terms, including both the mandates *and* other changes the carriers would likely make in response to the mandates, is better for consumers than the current bundle of terms.

Disclosures

Even disclosure requirements can have unintended negative consequences for consumers. One problem occurs when so much disclosure is required that consumers experience "information overload"; they simply ignore or only partially process all the information the company is required to give them. Another problem occurs when decision makers attempt to design disclosures without knowledge of how consumers interpret them. A recent FTC study, for example, found that significant percentages of both prime and subprime borrowers could not correctly identify various mortgage loan costs using information that lenders are currently required to supply, but redesigned disclosures

substantially increased consumer understanding.[16] The point is not that mandated disclosures are never appropriate, but rather that decision makers need to do a substantial amount of homework in order to design mandated disclosures that actually convey information accurately to consumers. The FTC mortgage study is an excellent example of the type of homework that should be undertaken *before* new disclosures are mandated.

One aspect of S.2033 would actually reduce, rather than increase, transparency and disclosure on wireless bills. A well-functioning democracy, like a well-functioning market, requires transparent transmission of information that allows citizens to evaluate the pros and cons of various policies. But if carriers cannot break out universal service and regulatory charges separately, then the substantial costs arising from these regulatory mandates will be concealed. Unfortunately, these are precisely the types of costs that consumers are least likely to be aware of or inform themselves about. If these costs are concealed, consumers have little or no ability to assess whether the benefits they receive from the mandates are worth the cost. Deprived of such information, consumers will be less effective participants in the public policy debate over regulation of wireless service.

Note that I am not saying that regulatory mandates are unwise because they create costs. I suspect, for example, that many wireless customers would say that an additional dollar or so per month for 911 service is a good deal. But if the cost information is concealed, consumers will never get to make that assessment.

Conclusion

This Committee is considering proposals that would alter the terms of wireless contracts and mandate the content and form of certain disclosures. To determine which proposals will actually benefit consumers, decision makers need to answer three questions:

1. Is there a systemic problem that regulation might solve?
2. How effective are alternative solutions?
3. What are the likely unintended consequences of new regulation?

Given the substantial evidence on the competitiveness of the wireless market, I am skeptical that there is a systemic problem that regulation can solve. If there is a problem, I suspect Congress can more effectively solve it by requiring the administration to free up underutilized government spectrum for auction, to enhance competition in wireless services. Any new regulatory mandates should also be evaluated for unintended consequences, and I would like to emphasize two: (1) Since wireless contracts are not comprehensively regulated, companies could compensate for any mandates by altering other contract terms; consumers would likely be worse off as a result. (2) Preventing wireless companies from itemizing regulatory and universal service costs would reduce

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[16] James M. Lacko and Janis K. Pappalardo, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms*, Federal Trade Commission Bureau of Economics Staff Report (June 2007), available at http://www.ftc.gov/be/econrpt.shtm.

transparency and disclosure, or precisely the kind of information citizens need to make their own assessments of federal policies affecting their wireless bills.

Even if you do not agree with all of my conclusions, I hope you will ask these three questions and demand rigorous answers. Without those answers, new regulatory mandates for wireless are just a faith-based initiative.

Thank you for your time.