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Do the FCC Policies Promote or Deter Entry?
That is the ONLY Question

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Lawrence J. Spiwak*

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I. Introduction

Lately, the Federal Communications Commission has been on a roll. The Supreme Court has just affirmed their jurisdiction to write interconnection rules under the Telecommunications Act of 1996[1], the 8th Circuit has just upheld the

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1 *AT& T Corp. et al., v. Iowa Utilities Board, et al*. 525 U.S. 366 (1999).

FCC's allocation of access charges[2]; the Fifth Circuit just upheld the FCC's universal service support subsidy mechanisms[3]; and the D.C. Circuit has just upheld the FCC's ability to proscribe unilaterally benchmark settlement rates over the entire rest of the world.[4] Moreover, in the FCC's recent report to Congress under Section 706 of the Communications Act, the FCC proudly reported that advanced network deployment is on track and that their implementation of the 1996 Act has been a smashing success.[5]

Or has it really?

Despite these ostensible victories, just because the FCC has the legal authority to take the above actions still does not *a fortiori* mean that the Commission has enacted good policy.[6] Like it or not, the sad reality is that the FCC has done very little to promote aggressively consumer welfare as the FCC has, in many instances, erected surreptitiously more regulatory barriers to entry than it has removed.[7] Indeed, a brief laundry list of the FCC's anti-entry policies

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[2] *Southwestern Bell Telephone Co. v. FCC,* 153 F.3d 523 (8th Cir. 1998).

[3] *Texas Office of Public Utility Counsel v. FCC,* 183 F.3d 393 (5th Cir. 1999).

[4] *See Cable & Wireless v. FCC,* 166 F.3d 1224 (D.C. Cir. 1999).

[5] *In the Matter of Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996,* FCC 99-5, __ FCC Rcd ___ (rel. Feb. 2, 1999); *see also* William E. Kennard, *The Third Anniversary of the Telecommunications Act of 1996,* INFRASTRUCTURE (American Bar Association Summer 1999)("And the good news is that, although our work is far from over, the 1996 Act has been a resounding success.")

[6] Moreover, a close look at all of these cases reveals that these courts almost unanimously never upheld the Commission on the merits. Instead, because these cases involved rulemakings and not adjudications, these courts generally found these (legitimately) complex issues to be far too complicated to be resolved within their limited ken and, as such, essentially punted on undertaking any meaningful review of the law and economics and instead upheld the Commission's actions by deferring to the agency's expertise. A classic example of this lack of meaningful judicial review can be found in the D.C. Circuit's affirmation of the FCC's recent international telecoms policies where the court reached its flawed decision by totally misunderstanding the facts and economics of the case, throwing into question established U.S. competition and ratemaking law and, most embarrassing of all, misquoting repeatedly the ITU treaty. *See Cable and Wireless, supra* n. 4.

[7] More importantly, people are finally starting to notice. *See, e.g.,* Catherine Yang, *Is the FCC Chief All Talk?* BUSINESS WEEK (Oct. 25, 1999) at 52 ("[W]hile it's too late to reverse the giant

(Footnote Continued. . . .)

include, but are certainly not limited to: permitting the broadcast, cable and ILEC industries to reconcentrate[8]; failing to enact meaningful access charge and universal service reform[9]; only issuing meaningful collocation rules until over three years after the passage of the 1996 Act[10]; and, on the international front, starting a "telecoms trade war" that is dangerously close to spiraling out of hand.[11]

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mergers that have taken place, [FCC Chairman] Kennard still has time to burnish his record as a pro-competitive FCC chairman by making sure that he puts his clout where his mouth is. An industry dominated by a few all-powerful giants is not what the U.S. needs to guarantee the benefits of competition.")

8 *See, e.g., Reconcentration of Telecommunications Markets After the 1996 Act: Implications for Long-Term Market Performance (Second Edition)*, PHOENIX CENTER POLICY PAPER SERIES NO. 2 (July 1998) (http://www.phoenix-center.org/pcpp/pcpp2.doc). Indeed, now that the cow is essentially out of the barn regarding ILEC, cable MSO and broadcast industry reconcentration, it is nice to see that Chairman Kennard is attempting to close the door by talking tough on IXC reconcentration (even though that market has been competitive for over 10 years and the FCC is about to permit ILECs to re-integrate via Section 271 of the 1996 Telecommunications Act even though local markets are far from competitive.) *See, e.g*., October 5, 1999 Statement of FCC Chairman William E. Kennard Statement on Proposed Merger of MCI Worldcom, Inc. and Sprint Corp. ("American consumers are enjoying the lowest long distance rates in history and the lowest Internet rates in the world for one reason: competition. Competition has produced a price war in the long distance market. This merger appears to be a surrender. How can this be good for consumers? The parties will bear a heavy burden to show how consumers would be better off.")

9 For example, the FCC's efforts at access reform are, by design, anticompetitive. Ordover and Panzar show that levying a two-part tariff on a competitive industry (the long distance industry) will reduce social welfare by reducing competition in the downstream market (as fixed costs typically do). If the interexchange carriers could pass-through the two-part tariff, then access reform might improve social welfare. Oddly, such a pass-through was strongly discouraged by senior officials at the FCC and non-linear pricing in a highly competitive industry is often difficult. *See* Janusz A. Ordover and John C. Panzar, *On the Nonlinear Pricing of Inputs*, INTERNATIONAL ECONOMIC REVIEW 23(3) (October 1982) at 659-75.

10 Indeed, even after nearly four years, the U.S. unbundling experience has been a total disaster. In fact, the FCC conceded in its August 1999 Local Competition Report (even with tables updated as of 10 September 1999) that the aggregate amount of loops made available on an unbundled basis since the passage of the U.S. Telecoms Act nearly four years ago is "*a still-small 0.2% of total [Incumbent] lines*." LOCAL COMPETITION: AUGUST 1999, Federal Communications Commission, Common Carrier Bureau, Industry Analysis Division at Table 3.3 (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcomp99-1.pdf).

11 *See, e.g., From International Competitive Carrier to the WTO: A Survey of the FCC's International Telecommunications Policy Initiatives 1985-1997,* 51 FED. COMM. L. J. 111 (1998), *Addendum,* 51 FED. COMM. L. J. 519 (1999); *What Ever Happened to Consumer Welfare? How the FCC's*

(Footnote Continued. . . .)

International Spectrum Relocation Policies Deter - Rather than Promote - New Facilities-Based Entry for Advanced Satellite Telecoms Services, 6 TELECOMMUNICATIONS AND SPACE JOURNAL 291 (1999); *see also*. David Molony, *WTO Basic Agreement Put on Hold as Signatories Clash over Timetable*, COMM. WK. INT'L, Jan. 19, 1998, at 1 (reporting that "signatories to the treaty claim the United States wants to take advantage of the current position by gaining early access to its trade partners' markets on more favorable terms, without having to open its own markets to foreign carriers"); *EU Presses U.S. To Change Telecoms Rules*, REUTERS, Aug. 5, 1997, *available in* LEXIS, News Library, Wires File (reporting that the European Commission warned that the United States "risks violating its world trading obligations" if it continues with mercantile-type policies—i.e., the FCC's continued policy of maintaining "broad and unclear 'public interest' factors" regarding foreign participation in the U.S. domestic telecommunications market and, in particular, the fact that the FCC allows factors such as law enforcement, foreign policy, or trade concerns to be taken into consideration, as well as accepting the concept of "very high risk to competition" as a reason for a license refusal); Albert P. Halprin, *Two Steps Backward on Open Markets*, N.Y. TIMES, July 20, 1997, at F13 ("FCC, citing the supposed requirements of Federal communications law, is . . . backpedal[ing] on major American commitments in the deal. If our nation fails to live up to its end of the bargain, so will other signatories, and this historic opportunity will be lost."). In fact, these mercantile tendencies have become so acute that Alan Greenspan, Chairman of the U.S. Federal Reserve Board, recently took the extreme step of criticizing these policies publicly. In Mr. Greenspan's own words, he "regrets" personally that:

> [D]espite the remarkable success over a near half century of GATT, the General Agreement on Trade and Tariffs, and its successor, the World Trade Organization, in reducing trade barriers, *our trade laws and negotiating practices are essentially adversarial.* They presume that a trade concession extracted from us by our trading partners is to their advantage at our expense, and must be countered. Few economists see the world that way. And I am rash enough to suggest we economists are correct, at least in this regard: *trade is not a zero-sum game.* If trade barriers are lowered by both parties, each clearly benefits. But if one lowers barriers and the other does not, the country that lowered barriers unilaterally would still be better off having done so. Raising barriers to achieve protectionist equality with reluctant trading partners would be neither to our benefit, nor to theirs. The best of all possible worlds for competition is for both parties to lower trade barriers. The worst is for both to keep them up. For these reasons, I am concerned about the recent evident weakening of support for free trade in this country. Should we endeavor to freeze competitive progress in place, we will almost certainly slow economic growth overall, and impart substantial harm to those workers who would otherwise seek more effective longer-term job opportunities. Protecting markets from new technologies has never succeeded. Adjustments to newer technologies have been delayed, but only at significant cost. *Even should our trading partners not retaliate in the face of increased American trade barriers, an unlikely event, we do ourselves great harm by lessening the vigor of American competitiveness.* The United States has been in the forefront of the postwar opening up of international markets, much to our, and the rest of the world's, benefit. It would be a great tragedy were that process reversed.

Remarks by Chairman Alan Greenspan before the Dallas Ambassadors Forum, Dallas Texas (April 16, 1999) (emphasis supplied). Sadly, recent press reports indicate that the FCC has no intentions of departing from business as usual. *See, e.g.,* Theresa Foley, *Profile: Trade Warrior's Hands-on Approach to Regulation,* COMMUNICATIONS WK. INT'L (4 Oct. 1999) ("A veteran trade

(Footnote Continued. . . .)

The root of the problem appears to stem from the fact that despite its stated good intentions, the FCC has failed to admit where it has erred[12] and, more importantly, has refused absolutely to set forth a clear analytical framework to solve the problems of the day. Instead, the Commission continues to engage in a politically driven *ad hoc* approach that simply cannot be sustained. Given the FCC's recalcitrance and apparent inability to engage in anything substantive, therefore, this paper suggests that the FCC view all of its problems through a simple litmus test: *will the FCC's actions promote or deter entry?*[13]

II. Why Entry is Important?

If the ostensible public policy goal is to move from a market characterized by monopoly to a market characterized by multiple firms, then entry of *more* firms is the *sine qua non* of this entire exercise. More firms, however, is not the equivalent

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warrior has taken the helm of the International Bureau at the FCC in Washington, D.C. Don Abelson, 49, *doesn't have a telecoms or satellite background*, but having notched up two decades at the U.S. Trade Representatives' office . . . he is well versed in the ways of international trade.") (Emphasis supplied.)

[12] A classic example of the FCC's refusal to take on these challenges directly can be found in the FCC's Section 706 Report, *supra* n. 5. On one hand, Congress specifically mandated that the FCC :

> shall encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans (including, in particular, elementary and secondary schools and classrooms) by utilizing, in a manner consistent with the public interest, convenience and necessity, price cap regulation, regulatory forbearance, measures that promote competition in the local telecommunications market, or other regulating methods that remove barriers to infrastructure investment.

To facilitate this mandate, Congress tasked the Commission to initiate a Notice of Inquiry to answer a very discrete and simple question: "[W]hether advanced telecommunications capability is being deployed to all Americans in a reasonable and timely fashion." More importantly, however, Congress also mandated that "If the Commission's determination is negative, it shall take immediate action to accelerate deployment of such capability by removing barriers to infrastructure investment and by promoting competition in the telecommunications market." Sadly, nowhere in the FCC's report is this regulatory *mea culpa* ever made explicitly.

[13] Nothing in this paper is meant to suggest that entry is not occurring in telecommunications of information services industries. Quite to the contrary, because these markets still exhibit significant margins, entry will continue to occur in spite of the FCC's policies. Indeed, these markets are very different from, say, the travel agency or real estate brokerage business, where there are really no rents to protect.

of more "choices." As leading one leading telecoms economist recently observed:

> One explanation for the failure of the Act is that an important intermediate step between monopoly and competition has been overlooked. If consumers are to have a choice in local phone markets, the entry of new firms selling local telecommunications services to a broad base of residential and small business consumers is required. "Choice" in any context implies alternatives. *In fact, while the term "competition" has become somewhat synonymous with the Act, the Act is really much less about competition than it is about competitive entry*.[14]

Indeed, while there may be multiple firms "competing" against one another, *so long as these firms are scrambling to use the same underlying network facilities* (*e.g.*, the Incumbent local exchange carrier or "ILEC's" local loop), it does not *a fortiori* mean that "more" firms will produce "more" competition – *i.e.*, better market performance as measured by lower prices or more services.[15] As such:

> An act of Congress cannot force firms to compete, but can alter industry structure in such a way as to make entry profitable and, therefore, viable competition more likely. For example, legislation that reduces entry barriers can increase the number of firms in an industry, and the presence of many firms selling similar products and services will inevitably lead to price and quality competition. *Without entry, however, competition in the local exchange market will remain nothing more than a fabrication of incumbent monopolists and their representatives*.[16]

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[14] George S. Ford, *Opportunities for Local Exchange Competition Are Greatly Exaggerated*, ELECTRIC LIGHT & POWER (April 1998) at 20-21 (http://www.phoenix-center.org/library/ford_1.doc)

[15] Indeed, the dictionary simply defines "competition" as the "act of competing."

[16] Ford, *supra* n. 14.

If we have learned anything from history, therefore, is that it is a metaphysical impossibility to have "competition without change."[17] Instead, new, tangible entry is required.[18]

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[17] Lawrence J. Spiwak, *Antitrust, the "Public Interest" and Competition Policy: The Search for Meaningful Definitions in a Sea of Analytical Rhetoric*, ANTITRUST REPORT (Matthew Bender, December 1997) (http://www.phoenix-center.org/library/neo_comp.doc).

[18] For example, one of the primary problems with the concept of unbundling today is the issue of incentives – *i.e.*, the incumbent LEC has no incentive to sell the primary input of production (the loop) to its rivals. Conversely, rivals also have no desire to purchase loops from a competitor (ILEC or otherwise). However, the economics of the telecoms business may make construction of a new network on a stand-alone basis cost prohibitive. What may solve this problem is the entry of one or more alternative distribution companies or "ADCos" (essentially a "carriers'-carrier" on the line side of the switch) which sells loops and other network services to all comers (*i.e.*, it aggregates the demand) on a non-discriminatory basis in direct competition with the ILEC.

What makes the ADCo story so attractive from a policy perspective is that the entry of an ADCO would provide a tremendous incentive for the ILEC to divest *voluntarily* its loop functions from its marketing functions, because the ILEC would simply find it more efficient to do so under such changed market structure. *See, e.g.*, Oliver Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM (The Free Press 1985).

That is to say, there is great talk currently about forcing incumbent telephone operators to "fundamentally unbundle" their network operations from their marketing arms, such that the ILEC's marketing division would have to buy their network elements from the "LoopCo." Political and legal issues make this an unlikely scenario, however.

Yet, as technology continues to progress and advance, it may be possible for a new entrant to contemplate an entry strategy where they would act as a competitive and ubiquitous alternative *wholesale* distribution provider (*i.e.*, "ADCos"), rather than an entry strategy where they would attempt to act simply as just another end-to-end *retail* service provider. If this strategy is successful, then the overall structure of the distribution market will shift as supply becomes elastic. As this structural change occurs and the incumbent faces an increasingly higher own-price elasticity of demand, the incumbent will no longer have the incentive to engage in entry-deterring strategies but rather have the incentive to disaggregate *voluntarily* – rather than by intrusive regulatory fiat – its loop plant from its marketing activities because it will be a more *efficient* (*i.e., profitable*) way to organize its business. That is to say, the incumbent will find under this altered market structure that it will make *more* money because: (1) its network operation will be able to sell more loops to more providers; and (2) its marketing operation will be able to provide cheaper service because it will always be able to by loops from competitive infrastructure providers.

III. The Economics of Entry: The "Entry Condition"

As the FCC has often recognized in the past, *regulation* has both costs and benefits. Accordingly, regardless of the merits of any rule or regulation the Commission promulgates, it does not *a fortiori* mean that American consumers suddenly will be awash in "waves" of competition. Entry is an extremely time and capital intensive endeavor, and will only occur if the new entrant believes that entry will be profitable.[19] A firm's decision to enter any market can be described as the "entry condition" – *i.e.*, entry will only occur when:

(1) Post-Entry Profit **(d)** minus
(2) Inherent (exogenous) Entry Costs **(x)** minus
(3) Incumbent or Regulation-Induced Entry Costs (endogenous) **(e)** plus any
(4) Spillover Effects **(s)**
(5) Are greater than **Zero**[20]

This maxim can be represented by the formula:

$$\mathbf{d - x - e + s > 0}$$

Post entry profits might be (loosely) defined as revenues minus average cost (excluding amortized sunk costs). This margin must be sufficient to cover any sunk costs (x, e) the firm must incur upon entry (and, to possibly, exit). Sunk costs are akin to a non-refundable deposit, and as such substantially increase the risk of entry. Sunk costs can be either a results of the capital expenses for technology and marketing necessary to enter a market (exogenous sunk costs) or the result of incumbent behavior and regulatory decisions (endogenous sunk costs).

One real-world example of an endogenous sunk cost is the cost of physical collocation in an ILEC central office. That space can, because of regulation, only

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[19] Indeed, entreprenuership – defined by the dictionary those people who are willing both to organize a business venture *and to assume the risk for it* – needs to be affirmatively encouraged and promoted by the Commission, not ignored (or worse, effectively, albeit unintentionally, quashed).

[20] Ford, *supra* n. 14.

be used to provide telecommunications services – once procured, a new entrant cannot readily convert collocation space to a condo or a youth education center. ILECs know this, and rationally price collocation in a manner akin to an "entry tax." Sadly, these construction costs are lightly and ineffectually regulated (if at all) and oftentimes are in excess of $100,000 for each central office. With that type of entry tax, it is not surprising that there has been little entry into smaller or rural central offices.

Spillover effects (s) exist when some firms can enter more cheaply than others can. For example, the FCC recognized in the AT&T/TCG Merger Order that the customer base of large interexchange carriers can be used to leverage entry into the local exchange markets.[21] Virtually every decision, past and present, the FCC makes alters one or more variables in the entry equation (with the exclusion, by assumption, of x). For example (but not limited to), retail and wholesale price regulation will affect d; regulatory requirements for entrants, particularly relevant to this proceeding, raise entry costs (e); and cross-ownership restrictions (and pre-mature Section 271 approval) can reduce spillover effects.

With the exception of some exogenous entry costs (x), the FCC has direct control over all elements of the entry condition equation. To wit, the FCC and state regulators can, and often do, control (d) (revenue minus variable cost) through regulation. (Indeed both phone rates and collocation prices, loop prices, USF taxes, *etc.* are direct controls over (d). Spillovers are less direct, but cross-ownership rules limit the use of spillovers). Furthermore, the FCC recognizes that customer base is big spillover for IXCs in their pursuit of local markets. A pre-mature Section 271 approval will dramatically reduce this spillover and weaken the prospects for competition in local markets (at least by IXCs). The effects on (e) of regulation deal specifically with sunk costs, but regulators are not limited to that.

In the nearly four years since the enactment of the 1996 Act, however, the FCC has not adequately considered the effects of its decisions, from basic rules to

[21] Though recognizing this effect in some proceedings, the FCC has failed to note that premature granting of a Section 271 application must, by the FCC's own logic, substantially weaken the prospects for local entry. See Catherine Yang, supra n. 7 ("To Kennard's credit, he has stood his ground against letting the Bells into long distance until they prove they've opened up their own markets to competition. Bell Atlantic's pending application to enter long distance will be a big test for him. He should stick to his guns: If the company can't show that it has let competition flourish, it can wait.")

merger approvals, on the entry decisions of firms.[22] The FCC's decisions have been too focused on details perceived as required to implement the 1996 Act, *rather than focused on implementing the underlying physical construct (i.e., the promotion of infrastructure entry).* Instead, the Commission simply either attempted to "draw a line straight down the middle"[23] or to determine whether a proposed merger was "eminently thinkable."[24] Now, in the face of great political pressure,[25] the Commission holds public hearings to determine a "Draft Plan for the 21st Century."[26] While any opportunity to take a *tabla rasa* approach to

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22 What is particularly sad is that the FCC had at one point set forth a rational litmus test for regulatory intervention: the "Public Policy Barrier to Entry." That is, the FCC acknowledged five years ago in its First Cable Competition Report, not every perceived barrier to entry is one that requires an immediate regulatory response – only those barriers that are "policy-relevant." To determine whether a particular structural condition is a policy-relevant barrier to entry, the Commission stated that it must engage in a cost-benefit analysis that identifies, *inter alia*:

> all possible economic efficiencies, if any, that might result from the presence of the barrier to entry; (2) all offsetting economic efficiencies that might be attributable to the barrier to entry, if any; (3) all relevant positive and negative network externalities; and (4) the estimated economic cost of eliminating the barrier to entry or minimizing its effects.

*See In re Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, Annual Assessment of the Status of Competition in the Market for Delivery of Video Programm*ing, 9 FCC Rcd 7442, App. H at ¶¶ 29-31 (1994); *see also* Jerry Duvall & Michael Pelcovits, *Reforming Regulatory Policy for Private Line Telecommunications Services: Implications for Market Performance*, FEDERAL COMMUNICATIONS COMMISSION OPP WORKING PAPER NO. 4 (1980) (analysis should focus on market performance, rather than on market participants' residual market power). Sadly, the FCC has never mentioned this test again.

23 *See Industry Told To Avoid "Spins" In Arguing Legislative Intent*, COMMUNICATIONS DAILY (February 26, 1996) (quoting then-FCC General Counsel (and now-Chairman), William Kennard told industry executives that his office will take the "bowling ball" or "straight down the middle" approach in interpreting the 1996 Act.)

24 *See* Reed Hundt, *Thinking About Why Some Communications Mergers are Unthinkable*, Delivered to the Brookings Institution, Washington D.C. (June 19, 1997); June 24, 1998 Statement From FCC Chairman William E. Kennard On AT&T And TCI Proposed Merger **("**If AT&T and TCI make a strong commitment to bring residential consumers more choice in local telephone and high speed Internet access services, then this proposed merger is eminently thinkable."); *but c.f., Hawaiian Telephone v. FCC*, 498 F.2d 771, 776-77 (D.C. Cir. 1974) (FCC "cannot merely assert the benefits of competition in an abstract, sterile way").

25 *See, e.g., Phone Bills: More Confusing than Ever*, CNN Interactive (Sept. 9, 1998).

26 *See, e.g.,* Chairman Kennard's *Draft Strategic Plan for the 21st Century* (August 12, 1999) (http://www.fcc.gov/21st_century/).

contemplate the most optimal way to restructure the telecommunications industry would certainly be nice at this point, however, the eggs are unfortunately already too far scrambled.

As we cannot take a *tabla rasa* approach, our only guidelines from the parameters set forth by Congress (in the domestic context), and the WTO (in the IMTS context) as to what kind of long-term market structure the world wants to create. Whether or not these structural parameters are actually capable of producing rivalrous competition, unfortunately, is a completely other matter and, moreover, is a moot question at this point. It is the FCC's job, therefore, to attempt to promote the best market performance possible under these instructions – no matter how difficult this task may turn out to be.[27]

Unfortunately, recent FCC efforts do not provide any indication that the Commission is going to depart from "business-as-usual." Indeed, rather than undertake the type of rigorous economic analysis suggested above, the FCC simply holds public forums to gauge the political winds.[28] If the Commission wants to encourage new entry, however, it cannot use a static "5-Year Plan" for broadband deployment – *i.e.*, a "regulatory deal" between a few big-time industry players and the U.S. government to deploy a modicum of interesting new services conveniently in time for the 2000 election. The public interest requires more.[29]

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27 In the now-famous words of Justice Scalia in *Iowa Utilities, supra*:

> It would be gross understatement to say that the Telecommunications Act of 1996 is not a model of clarity. It is in many important respects a model of ambiguity or indeed even self-contradiction. That is most unfortunate for a piece of legislation that profoundly affects a crucial segment of the economy worth tens of billions of dollars. The 1996 Act can be read to grant (borrowing a phrase from incumbent GTE) "most promiscuous rights" to the FCC *vis- & agrave*; *-vis* the state commissions and to competing carriers *vis- & agrave*; *-vis* the incumbents – and the Commission has chosen in some instances to read it that way. But Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency. We can only enforce the clear limits that the 1996 Act contains. . . .

Citations omitted.

28 *Id.* Indeed, if the FCC continues on its present course of refusing to face these complex issues head-on, it is one step away from asking the "Flat Earth" Society to present (and of course force all other parties in the proceeding to respond to) their views on the shape of the world.

29 *See, e.g., Northeast Utilities Service Co. v. FERC,* 993 F.2d 937, 951 (1st Cir. 1993) (the "public interest" may not be used to benefit a particular individual or group; rather, an agency's actions must be consistent with the interest of "the public" as a whole).

IV. The Challenges Now Before the FCC

Contrary to the seminal rhetoric flowing free from "techno-savy" politicians, therefore, the core issue at hand is not a question of technological "development" *per se* (indeed, technical entrepreneurship has always been the least of America's problems) but specifically about whether the regulators have promoted affirmatively and as effectively as possible new advanced infrastructure entry to improve overall market performance. Like it or not, the problems facing the telecoms industry continue to stem from dominant firms controlling access to monopoly local plant. That situation cannot be solved through "better pricing" of that plant, however – ultimately, *it can only be solved by entry of new, alternative rival suppliers*. Accordingly, for structural problems, final structural solutions are required.

A. *Identify Optional Long-Term Market Structure*

Accordingly, if the Commission is truly serious about promoting "deregulation" and "competition" and abandoning its current efforts to promote improperly "neo-competition (*a.k.a.*, "fair, competition-type outcomes accompanied by the benevolent use of 'market-friendly' regulation"[30]) then it first needs to formulate, articulate and implement policy paradigms designed to establish, to the extent practicable, a structural framework conducive to competitive entry and rivalry, under which firms will be unable to engage in strategic anticompetitive conduct – even if they try.[31] In a market structure conducive to vigorous rivalry, efficient firms (*i.e.*, those firms that can lower their costs, innovate to make new products, and regularly offer consumers more choices) should, in theory, be able to make *more* money as demand and supply continue to increase. Such an outcome is infinitely superior to the probable

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[30] *See The Search for Meaning, supra* n. 30.

[31] *See generally Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, *reh'g denied*, 509 U.S. 940 (1993); *A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc.*, 881 F.2d 1396, 1401 (7th Cir. 1989) ("Market structure offers a way to cut the inquiry [of potential, anticompetitive strategic vertical conduct] off at the pass . . . ."). *See also* F.M. Scherer & David Ross, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE (3d. ed. 1990) (despite antitrust's focus on structural measures such as the HHI, economic concentration is only one aspect of market structure; other relevant features of market structure include product differentiation, barriers to entry, cost structures, vertical integration, and diversification).

performance of a market that – even though it lacks a structural framework conducive to competitive rivalry – the FCC believes with sufficient intervention is nonetheless capable of achieving a level of "workable" market performance which "mimics" competition. [32]

Stated another way, different market structures induce different types of rivalrous conduct. That is, because firms seek to always maximize profits, if the underlying structure is conducive to competitive rivalry, then firms will be forced to innovate and compete, thus maximizing consumer welfare. Conversely, if a structure is *not* conducive to competitive rivalry, then firms will have the incentive to engage in strategic anticompetitive conduct. As such, if a firm lives in a "toxic" market, then it will make "toxic" decisions.[33]

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[32] Arguing for a efficient, pro-competitive long-term market structure is *not* the analytical equivalent of controlling the market. If regulators are keenly aware of the basic conditions of the market, then, via pro-competitive and narrowly-tailored regulation, they can enact policies that can work towards creating a market that is characterized by low switching costs among suppliers, and low barriers to entry and exit and thus produce vigorous price and non-price competition for the benefit of consumers. A classic example of how the FCC refused to undertake such an analysis can be found in the U.S. wireless industry. There, because the Commission was more interested in revenue raising that ensuring the most efficient use of spectrum, the FCC botched any possibility of having a ubiquitous PCS network that consumers would view as a close substitute to the copper public switched transport network (PSTN). Accordingly, rather than have a PCS market characterized by low switching costs and numerous close substitutes (i.e., to switch wireless carriers in the U.S. one generally has to purchase a completely new phone), the U.S. PCS market is characterized not only by multiple standards, but by multiple frequencies as well. (Dual-mode phone, unfortunately, does not mean both GSM and CDMA.) *See* Steven Brull and Catherine Yang, *Cell Phones: Europe Made the Right Call*, BUSINESS WEEK (Sept. 7, 1998). Moreover, this lack of leadership essentially prevents the majority of U.S. wireless users (non-GSM) from seamlessly using their wireless phones in over 133 countries abroad. And, as if this was not bad enough, the U.S. is using issues to open up yet another from in the growing telecoms trade war in the on going battle to determine a 3G mobile standard. *See* Guy Daniels, *Huffing and Puffing*, COMM. WEEK INT'L, Oct. 1998, at 8 ("As a possible trade war looms and Uncle Sam blusters over compatibility issues, . . . the European Community is holding firm in the face of determined U.S. efforts to muscle-in on the third generation mobile standards agenda"); Robert Aamoth, *One Law for the Rich*, COMM. WEEK INT'L, Nov. 1998 ("The U.S. Federal Communications Commission's international settlement rate policies have caused such disquiet in the global telecoms community that . . . several of the world's largest carriers—and their governments—are prepared to go to law to get things changed").

[33] *See also* Oliver E. Williamson, *supra* n. 18 at 45 (explaining the concept of "bounded rationality" – *i.e.*, "economic actors are assumed to be '*intendedly* rational, but only *limitedly* so.'") (Emphasis in original.)

Properly thought-out pro-competitive regulatory policies have the potential to change market structure for the greater good.[34] As such, unless and until the Commission articulates a clear vision of long-term industry organization within these parameters, it will be extremely difficult for the Commission to evaluate the success of its efforts to "promote competition."[35] Only by spelling out specifically such a view, therefore, can the Commission know when market performance is satisfactory enough to justify the eventual elimination of its regulatory intervention – *i.e.*, truly responsible public policies will, first, correctly and precisely identify whatever structural elements actually frustrate competition, and then (after concluding that the economic costs of the intervention do not outweigh the competitive benefits) narrowly tailor the remedy to mitigate that specific harm.

Indeed, not all elements of a telecoms network share homogeneous economic characteristics and, moreover, most telecoms companies are not single output firms. Instead, they are *multi-product* firms.[36] As such, given the various basic conditions inherent to this industry, the Commission must strive to create the most efficient organization of the market.[37] Because the Commission in most of

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[34] *See, e.g.*, the FCC's successful efforts to bring competition to the U.S. long-distance market through its *Competitive Carrier* paradigm and its efforts to promote competition for information services by aggressively "carving out" the terminal equipment and customer premises equipment markets via stringent structural rules such as standard technical interfaces.

[35] As several leading telecoms economists argued over fifteen years ago:

> Where static and dynamic economic efficiency conflict as public policy goals, policy makers should assess the potential for technological change in the industry subject to their jurisdiction. An industry that manifests potential for rapid technological change and innovation should not be guided by policies focused too narrowly on promoting the best use of society's resources from the standpoint of today's technology and resources availability, *i.e.*, static economic efficiency. Rather, an industry with significant potential for rapid technological advance should not be constrained by regulatory or legislative policies that place too little weight on the importance of dynamic economic efficiency. The telecommunications industry in nearly all market segments is presently and prospectively characterized by rapid technological change. Policy makers, therefore, should carefully assess policy choices such that dynamic economic efficiency is given substantial priority in the decision making process.

Walter G. Bolter *et al.*, TELECOMMUNICATIONS POLICY FOR THE 1980'S: THE TRANSITION TO COMPETITION (Prentice Hall 1984) at 360.

[36] *See Reorienting Economic Analysis of Telecommunications Markets After the 1996 Act*, ANTITRUST MAGAZINE (American Bar Association, Spring 1997).

[37] *See* Williamson, *supra* n. 18.

its decisions post-1996 Act has failed to conduct such an analysis, however – because, as the Commission has often recognized, regulation can have both costs and benefits[38] – then many of the Commission's past efforts have done little to materialize the to achieve the goals of the 1996 Act and, instead, have probably done more to create distortions in market performance than the public interest benefits the Commission is attempting to produce.[39]

B. *Seek to Promote Good Market Performance*

The next step the Commission must take is to ask (a) how the markets under its jurisdiction are actually *performing*; and, moreover, (b) what steps can it affirmatively take to promote additional infrastructure entry and thereby improve this performance over the long-term. "Good" market performance is usually characterized by the presence of static economic efficiencies (declining prices), dynamic economic efficiencies (innovation in new services or technologies), or both. If a market is performing well, therefore, then consumers will enjoy other societal benefits such as the long-term growth of real income per person.[40] More important, however, is that under the rationale of regulation

[38] *See, e.g., In re Competition in the Interstate Interexchange Marketplace*, 6 FCC Rcd 5880 (1991) at ¶ 80 (Finding that when there is no economic nexus between regulations imposed and current market conditions, regulation can have a variety of adverse effects on market performance, including, inter alia: (1) denying a firm flexibility to react to market conditions and customer demands; (2) regulatory delays and uncertainty which reduce the value of a firm's service offerings; (3) affording competitors advanced notice of another firm's price and service changes which fosters a "reactive market, rather than a proactive one," and thus reduces the incentives for firms to "stay on their competitive toes"; and (4) by negating, in whole or in part, a heavily-regulated fi rm's incentive and ability to become a "first-mover" in the market.)

[39] *See, e.g., In re Motion of AT&T Corp. to Be Reclassified as a Non-Dominant Carrier*, FCC 95-427, 11 FCC Rcd. 3271 (1995) at ¶ 32 ("When the economic costs of regulation exceed the public interest benefits, the Commission should reconsider the validity of continuing to impose such regulation on the market."); *see also* Joseph Kattan, *Beyond Facilitating Practices: Price Signaling and Price Protection in the New Antitrust Environment*, 63 Antitrust L.J. 133, 136 (1994); Nina Cornell, Peter Greenhalgh & Daniel Kelley, *Social Objectives and Competition in Common Carrier Communications: Incompatible or Inseparable?*, Federal Communications Commission OPP Working Paper No. 1 (1980); John Haring & Kathleen Levitz, *What Makes the Dominant Firm Dominant?*, FEDERAL COMMUNICATIONS COMMISSION OPP WORKING PAPER NO. 25 (1989).

[40] *See* F.M. Scherer & David Ross, *supra* n. 31 at 4-5.

explained above, if a market is performing well, *then the need for stringent government intervention should be unnecessary*.[41]

Notice that the operative word here is "*well*" – not "*perfectly*." It is well established that various economic factors make it impossible to achieve "perfect competition" in most industries, including many regulated network and public utility industries. For example, because the telecommunications and cable industries are characterized by high fixed and sunk costs, true marginal cost pricing (the *raison d'être* of perfect competition) is almost impossible to achieve.[42] Also, the presence of network externalities (*i.e.*, the value of the network increases with the number of users) makes "perfect competition" difficult to obtain. Finally, the FCC's continuing application of residual "public interest" regulation wholly unrelated to improving overall economic performance (*i.e.*, universal service obligations) will continue to distort market performance by affecting both the structure of many markets and the conduct of firms within those markets.[43]

C. *The FCC Has Neither Articulated a Long-Term View of Industry Structure nor Sought Aggressively to Improve Market Performance (and Eventual De-Regulation) of Telecoms Markets*

Sadly, the FCC appears to be doing its best to deter any meaningful improvement for those markets currently characterized by poor economic performance (*e.g.*, local loop competition; the cable industry) and, more egregiously, to impair those markets demonstrating good economic performance

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[41] *C.f.*, Walter Adams, *Public Policy in a Free Enterprise Economy*, *in* THE STRUCTURE OF AMERICAN INDUSTRY (7th ed. 1986, Walter Adams, ed.) (primary purpose of economic public policy paradigms should be to "perpetuate and preserve, in spite of possible cost, a system of governance for a competitive, free enterprise economy" where "power is decentralized; . . . newcomers with new products and new techniques have a genuine opportunity to introduce themselves and their ideas; . . . [and] the 'unseen hand' of competition instead of the heavy hand of the state performs the basic regulatory function on behalf of society").

[42] *See generally* David Evans & Richard Schmalensee, *A Guide to the Antitrust Economics of Networks*, ANTITRUST (Spring 1996) at 36, 38.

[43] *See generally* Haring & Levitz, *supra* n. 39; *see also* Stephen Martin, INDUSTRIAL ECONOMICS: ECONOMIC ANALYSIS AND PUBLIC POLICY 16 (1988) ("[perfect] competition is a Shangri-La up to which no real-world market can measure").

(*e.g.*, the U.S. long-distance industry).[44] Despite its rhetoric that it wants more "competitors," the reality is that the FCC continues to regulate the industries under its jurisdiction from an "incumbent-centric" approach. Stated another way, the FCC appears to hold to the erroneous view that capacity can be viewed from a static perspective, and therefore existing loop capacity – via resale and unbundling – is sufficient to handle all comers. The problem with this approach is that it prevents sufficient competition to develop to warrant true de-regulation – ostensibly the whole purpose of this massive "restructuring" exercise. In doing so, the FCC's policies inadvertently gives firms the bizarre incentive to throw themselves eagerly into the proverbial "briar-patch" of regulation, rather than the appropriate incentive to innovate, create new infrastructure, cut costs, and compete.[45] It is no wonder, therefore, that neither incumbents nor new entrants (who would like to deploy additional infrastructure and new technologies) benefit from a perpetual incumbent-centric, resale model (including both total product resale and UNE-platform entry), because such a paradigm fails to alter the status quo by appropriately promoting an overall shift in the supply curve itself (*i.e.*, new infrastructure development).[46]

Why is this? It appears that with the growing cynicism at the FCC, the Commission has forgotten the core purpose of regulatory intervention. That is, whenever government decides to "restructure" a particular industry, the economic and societal costs of such an intervention are always substantial. While the general concept of "restructuring" a monopoly industry into a competitive market is certainly laudable, however, perhaps it would be more useful before the process gets too far ahead of itself is to raise the fundamental,

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[44] *See, e.g., In re Low-Volume Long-Distance Users*, Notice of Inquiry, FCC 99-168, ___ FCC Rcd ___ (rel. July 20, 1999).

[45] To wit, look at the recent trend of industry reconcentration with seemingly little regulatory oversight. Indeed, because the Commission is using involuntary "voluntary" commitments as a proxy for a thorough inquiry, we never get to ask the fundamental question of whether, after conducting a detailed legal and economic analysis, the increasing trend in industry reconcentration is really in the public interest. *See Reconcentration of Telecommunications Markets after the 1996 Act: Implications for Long-Term Market Performance (Second Edition)*, PHOENIX CENTER POLICY PAPER NO. 2 (1998) (http://www.phoenix-center.org/pcpp/pcpp2.doc).

[46] Antitrust courts also recognize that for network industries characterized by high fixed costs, consumer welfare is unlikely to benefit so long as constrained supply, in the long-run, remains static. *C.f. City of Anaheim v. Southern California Edison Co.*, 955 F.2d 1373, 1380-81 (9th Cir. 1994).

yet unresolved, issue confronting us all – *i.e., what is our real purpose behind this whole restructuring exercise?* Is it just to reallocate wealth and maintain "benevolent" regulation over one or more industries, or do we really want to maximize consumer welfare?

Apparently, the FCC's actions appear to be designed exclusively to maintain the *status quo,* because the Commission still believes erroneously that competition is a "zero-sum" game – *i.e.*, that one firm can be made better off only unless another firm is made worse off. If the FCC would properly focus it attention on entry and *expanding* – rather than improperly attempting to *split* – the overall market, however, then this flawed notion need to be true.

V. So What Should the FCC Do?

As the FCC has recognized, poorly conceived or economically expensive regulations (regardless of any worthy intentions behind them) may actually harm – rather than promote – consumer welfare. As such, the FCC must explicitly account for how its policies – *e.g*., the economic costs of residual "public interest" obligations such as "universal service" or an "obligation to serve"; mandatory geographic rate averaging and buildout requirements; the economic costs of advanced tariffing and reporting requirements, *etc.* – will affect firms' decisions to commit the substantial sunk costs necessary to enter and compete.

Because market structures are not homogeneous, any regulation imposed by the Commission must not be homogeneous as well. As such, a "one-size fits all" approach ultimately will prove in practice to be both naïve and arbitrary. *Instead, the appropriate approach is for the FCC to contour its regulation to account for (and, of possible, pro-competitively change) the structure of the market, not the other way around.* Accordingly, because different remedies are needed for different types of harms, the Commission must understand that appropriate scope and type of regulation will depend exclusively on the specific set of market conditions. Depending on the facts of the specific case, therefore, the appropriate regulatory response by the Commission may be a combination, and different degrees, of price, conduct and structural regulation, a combination of only two types of the aforementioned regulation, *or simply none at all.*

Moreover, despite its own dicta, the FCC often fails to recognize in practice that government intervention, no matter how innocuous, *de minimis*, or well-meaning, may impose significant economic costs on society. These economic costs include administrative and compliance costs, the possible deterrence or delay of innovation, the creation of market structures which can promote collusive behavior and the often denied, yet highly ubiquitous (and insidious), issue of "regulatory capture." Accordingly, because economic regulation has both costs and benefits, any Commission regulation imposed must have a *direct nexus* to a specific anticompetitive harm and, moreover, must be narrowly tailored to mitigate only that specific anticompetitive harm. Stated colloquially,

> Economic regulation is supposed to be a substitute for, and not a complement of, competitive rivalry. It is not, contrary to popular belief, *"because we can."*[47]

In other words, economic regulation is only appropriate where one or more firms are capable of successfully exercising market power (charging monopoly prices or restricting output) for a sustained period of time, and additional entry is unlikely.[48]

As such, in order to help the FCC formulate a cohesive regulatory framework, perhaps it would therefore be useful to go over (again) each type of regulation at the FCC disposal, and the appropriate circumstances for each, briefly below[49]:

A. *Price Regulation*

Price regulation is only appropriate where one or more firms can exercise market power by raising prices above competitive levels. If price regulation is, in fact, warranted, however, then it does not mean that the Commission suddenly has a "green light" to prescribe specific prices for goods or services. Indeed, if economic regulation is truly supposed to be a substitute for competition, then, just as in competitive, non-regulated markets, the Commission should permit a range of prices for a particular product or service, each of which accounts for different consumer preferences and purchasing capabilities (*i.e.*, volume discounts, superior service quality, *etc.*). Thus, for example, so long as the

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47 *See The Search for Meaning, supra* n. 17 at 7-8.

48 *Id.*

49 Indeed, time and space constraints prevent a detailed critique of every single FCC *faux pas* in this paper. Besides, as noted above, the onus to formulate a cohesive pro-competitive public policy falls on the FCC – and not the industry – in the first instance.

Commission requires geographic averaging of interexchange telecommunications or cable rates, then a new entrant has absolutely no incentive to enter – even on a limited "foothold" basis to compete for high-volume (*i.e.*, high revenue) customers. Geographic averaging requirements serve only to buy incumbents time from competitive entry and ultimately disserve the residential, rural and poor consumers these restrictions were ostensibly designed to protect.

Moreover, the Commission must abandon the flawed notion that rates must be "affordable." "Affordability" is completely subjective in nature.[50] What the Commission must understand is that the "just and reasonable" standard only requires that prices fall within a "zone of reasonableness" – *i.e.*, that these rates are neither "excessive" (rates that permit the firm to recover monopoly rents) nor "confiscatory" (rates that do not permit the regulated firm to recover its costs). They need not – just like caviar or Rolls Royce limousines – be "*fair*" or "*affordable*" for everyone.[51]

Similarly, the Commission is going to have to determine whether the firm(s) under its jurisdiction are single-output or, more likely in today's era of "convergence," multi-product firms. As such, whenever the Commission attempts to define a firm's rate (*i.e.*, define the zone of "zone of reasonableness"), a primary focus on a multi-product firm's *aggregate* profits is irrelevant. Rather, the appropriate scope of the Commission's inquiry must be whether the specific profits derived from providing *regulated* products and services (and *not* from ancillary businesses or investments) are the result of the regulated company's ability to charge an excessive (*i.e.*, monopoly) rate for the regulated product or

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[50] Perhaps one of the primary reasons for the proliferation of the concept of "affordability" stems from current policy-makers' erroneous belief that competition is "one dimensional" – *i.e.*, price competition. There are, in fact, other types of competition such as quality and innovation.

[51] *See Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1504 (D.C. Cir.), *cert. denied sub nom.*, 469 U.S. 1034 (1984) (the concept of "just and reasonable" must clearly be more than a "mere vessel into which meaning must be poured."); *but c.f., Southwestern Bell Telephone, supra* n. 2 ("Access charges imposed on IXCs that include the LECs' universal service cost are not 'above cost' *since universal service contributions are a real cost of doing business.*") (Emphasis supplied.) It would be very interesting to find out, however, exactly which hornbook or what theorist the court is referring to that recognizes or perhaps even defines the concept of "real" as a legitimate type of economic cost.

service – *i.e.,* the product or service over which it can raise price or strict output absent regulation. If the rate reflects the regulated company's true costs of providing the regulated product or service, but the Commission nonetheless believes that this J&R rate is "too expensive," "unfair," or not sufficiently "affordable," then it is therefore wholly improper for the FCC to require the regulated firm to "subsidize" the price it charges for its regulated service with ancillary profits just to make the rate more politically "affordable" or "fair." When this occurs, "affordable" simply becomes an excuse for the Commission to set unlawfully confiscatory rates instead.[52]

Another consequence of multi-product offerings is that cost-allocations decisions will be increasingly important if the Commission decides to engage in price regulation. For instance, recent attempts by ILECs to allocate *all* local loop costs to its monopoly voice service customers and away from its competitive xDSL services – despite the fact that the same loop facility support both services—must be examined carefully and resolved if the FCC believes that rate regulation has a place in this environment.[53] Otherwise, the exercise of reviewing these ILEC tariffs will be a worthless and counter-productive exercise, because approval of these bogus tariffs would confer a modicum of regulatory approval of this practice.

Accordingly, because regulation is supposed to be the substitute for, and not the complement of, competitive rivalry, the Commission should attempt to set a rate that approximates the equilibrium price (*i.e.,* where supply equals demand) that a rivalrous market would produce, including a rational allocation of fixed and shared costs. But if the Commission truly wants to make prices for a "public" good or service more "affordable" – regardless of whether the end-price for this product or service is set by regulation or not – then the Commission needs to focus its priorities on promoting entry and rivalry, such that firms will

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52 *See, e.g.,* Christopher Stern, *FCC Chief Eyes Cable Rate Cap*, Reuters (Jan. 14, 1998) (Reporting that Kennard is "pondering" limits on amount of programming costs cable companies may pass on to consumers. Kennard questioned whether it was "right" to permit cable companies to pass on all programming costs to consumers, adding: "Should the consumer shoulder all the increased costs of programming?" As a possible mitigation measure, Kennard suggested that increased programming expenses should be offset for consumers through other revenues including advertising, commissions, and payments by programmers for carriage.)

53 *See, e.g.,* GTE Telephone, GTOC Tariff No. 1, GTOC Transmittal No. 1148,CC Docket No. 98-79.

be forced to innovate and lower costs and, with such innovation and increased efficiency, force supply and demand to move down and to the right. If this shift occurs, then the entire "zone" should therefore also be forced down and to the right over time. So long as the Commission maintains a static, "incumbent-centric" approach, however (*i.e.*, the incumbent is the only source of distribution), it will provide firms with no real incentive to innovate and lower costs and, as such, true de-regulation and competition will never occur.

B. *Conduct Regulation*

Conduct regulation is usually used to mitigate various types of strategic, anticompetitive behavior, such as undue discrimination to bottleneck facilities, input foreclosure, raising rivals' costs, *etc.* Again, because market structures are not homogeneous, conduct regulation also can take many forms. For example, there may be "passive" types of conduct regulation, where the Commission may impose special reporting requirements on one specific class of firms (*e.g.*, "dominant" firms). Similarly, the Commission may permit the rates of "non-dominant" firms to go into effect immediately, but require any new tariffs from "dominant firms" to endure prolonged notice and comment periods before the rates may go into effect. Conduct regulation may take more "active" forms as well. For example, a firm may have to demonstrate that the economic costs resulting from an exclusive distribution contract do not outweigh the efficiency benefits created by this exclusion.[54] Similarly, a firm might be obligated to provide rivals non-discriminatory access to its network based on a particular cost methodology.

Under any scenario, however, the concept of conduct regulation always implies that the Commission will take enforcement action against one or more firms only when it comes to the FCC's attention – either by complaint or *sua sponte* – that the regulated firm has acted contrary to the Commission's rules. In other words, enforcement of alleged acts of anticompetitive conduct will essentially occur on a case-by-case basis and, moreover, the responsibility for effective enforcement lies squarely on the Commission's shoulders. The big problem, however, is that the FCC has a very poor track record for effective and

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[54] For a detailed exegesis of the FCC's program access rules, *see* James W. Olson & Lawrence J. Spiwak, *Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable Industry Market Performance?* 13 CARDOZO ARTS & ENT. L. J. 283 (1995).

judicious enforcement against one or more firms' ability to exercise market power.[55] Thus, as Judge Frank Easterbrook wrote over ten years ago, the "principle that regulation must extend to catch all substitutions at the margin has a corollary: *if you're not prepared to regulate thoroughly, don't start.*"[56]

The FCC has, laudably, recently attempted to restructure its common carrier enforcement procedures.[57] However, there still seems to be a lack of will or confidence at the FCC to take its powers seriously and aggressively. For instance, ILEC recalcitrance to provide collocation and unbundled xDSL loops – clearly required by Federal law and FCC rules – should be urgently investigated when brought to the FCC's attention, and fines and forfeitures should result if misconduct is found.

C. *Structural Regulation*

Structural regulation attempts to affect positively market performance by establishing "bright line" tests that firms may not cross. Typical examples of structural regulation include ownership limits, standard technological interfaces and standards,[58] and various forms and degrees of structural separation. Like all other forms of regulation, however, structural separation is also not a homogenous regulatory tool. Rather, like all forms of economic regulation, structural separation is question of degree: the stricter the regulatory requirement of "separateness," the higher the cost to the regulated firm. As such, depending on the specific regulatory harm the Commission wants to mitigate or the particular long-term market structure the Commission wants (but has yet to articulate) to achieve, the Commission can avail itself of four primary

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55 *See* Thomas W. Hazlett and George S. Ford, *The Fallacy of Regulatory Symmetry: an Economic Analysis of the "Level Playing Field" in Cable TV Franchising Statutes* (1997) (unpublished manuscript) (notion of "fair, competition-like outcomes" is ridiculous because regulators will never "choose 'efficient' prices, outputs, and quality costlessly and with perfect information."); Harold Demsetz, *Information and Efficiency: Another Viewpoint*, J.L. & ECON. (Apr. 1969) at 1-22; Paul McNulty, *Economic Theory and the Meaning of Competition*, 82 Q.J. ECON. 639-656 (1968)).

56 *See* Frank Easterbrook, *The Court and the Economic System,* 98 Harv. L. Rev. 4, 40 (1984) (emphasis supplied).

57 *See In re Implementation of the Telecommunications Act of 1996, Amendment of Rules Governing Procedures to be Followed when Formal Complaints are filed Against the Commission*, Second Report & Order, ___ FCC Rcd ___, FCC No. 98-154 (rel. July 14, 1998).

58 *See, e.g.*, Part 68 of the FCC's rules, 47 C.F.R. §§ 68.1 *et seq.*, which, by requiring standard technical interfaces, permits competition in the terminal equipment market.

forms of "structural separation" (each of which is listed in order of most significant economic costs to least imposed economic costs): (1) "line-of-business" restrictions; (2) mandatory separate subsidiaries with outside equity participation; (3) wholly-owned separate subsidiaries; and (4) mandatory separate corporate divisions. As a regulatory alternative to strict structural separation, however, it is also possible to impose strict accounting requirements accompanied by various conduct restrictions or mandates.

Yet, if the Commission routinely fails to undertake the prerequisite cost/benefit analysis necessary to determine – in light of where the FCC wants to see the future market structure to be – what the costs and benefit are of the structural rules the FCC wants to impose, then any FCC initiative will deter rather than accelerate, new infrastructure entry. Unfortunately, promulgating "rules for the sake of rules" is no substitute for reasoned public policy decision-making.

For example, one of the most significant barriers to entry for new infrastructure development are regulatory and legislative "buildout" requirements" – *i.e.*, requirements that a new entrant must serve *all* of the franchise territory before it can begin providing service, rather than using an entry strategy that initially targets select areas.[59] This barrier is simply exacerbated when the buildout requirements also require new entrants to build

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[59] *See*, *e.g.*, Cable Act Section 621(a)(3), and by implication, Cable Act Section 621(a), which provide in pertinent part that:

> (3) In awarding a franchise or franchises, a franchising authority shall assure that access to cable service is not denied to any group of potential residential cable subscribers because of the income of the residents of the local area in which the group resides.
>
> (4) In awarding a franchise, the franchising authority –
>
> (A) shall allow the applicant's cable system a reasonable period of time to become capable of providing cable service to all households in the franchise area.

Thus, for example, under current rules, if a SMATV strings a line over a public right of way, it becomes a cable operator and therefore subject to cable rules and obligations – including buildout requirements. Yet, one of the quickest services of cable competition in many areas would be from SMATVs serving adjacent buildings and neighborhoods, because there are few alternative firms that already possess the sufficient economies of scale and scope (*e.g.*, perhaps a LEC or maybe a public utility) necessary to pass existing buildout requirements (*i.e.*, the new entrant must serve an entire franchise area before having a single customer) to make immediate entry likely.

capacity in excess of their own needs for the benefit of potential competitors (*see, e.g.,* OVS buildout requirements). Indeed, considering the considerable sums new entrants must sink (and accordingly risk) to enter an already concentrated market, any requirement that a new entrant must also build additional capacity *for its competitors* well in excess of its own needs simply makes entry unattractive. Moreover, these requirements seem to contradict regulations imposed on the telephone side, where the Commission attempts to spur immediate competition through resale and UNEs, thus permitting new firms to enter in limited areas without having to complete a full overbuild of the incumbent's network.[60]

VI. So Why is the FCC Really Against New Entry?

There are many theories why government may not want true competition. For example, government may not like the outcome that a market may produce.[61] Alternatively, government beligerence towards competition can result from outright naked regulatory capture. Over the last seven years, however, there has been new and troubing third approach on the horizon: naked regulatory cynisim designed to reallocate wealth and achieve political pork.[62]

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60 For example, if the FCC really wanted to encourage additional cable MSO overbuilds, it could take such steps as, inter alia: (1) Streamlining and overhauling its OVS Rules to make entry more attractive (indeed, if Internet video is to become a reality, FCC must be *semper vigilans* regarding rivals' attempts to impose access charges on Internet providers); (2) Encouraging new entrants to bundle telephone and video services using Ramsey-pricing methodology (because video is very profitable, such bundling may actually promote additional facilities-based entry for new telephone service); (3) Eliminating DBS exogenous costs (*e.g.,* elimination of restrictions on retransmission of broadcast and network signals by DBS providers); (4) Continuing not to impose "public interest" broadcast requirements on MVPD providers; (5) Waging a battle against local governments using the franchising process and other regulatory forums as a way to extract revenue, obtain "free" coverage of zoning board meetings, and delay entry overall; (6) Ensuring that local fees for digging up the streets should be non-discriminatory; (7) Eliminating must-carry for "qualified low power" stations (*i.e.,* MSOs should be permitted to "chase the eyeballs" – as such, there is no need to continue to subsidize HSN *et al.*); and (8) Eliminating Leased Access and PEG Channel requirements (*i.e.,* the economic rationale for eliminating these programs is the same for the elimination of PTAR in broadcasting and for the elimination of must-carry for low-powered stations).

61 *See* Scherer & Ross, *supra* n. 31 at 9.

62 *See, e.g.,* Gordon Tullock, *The Welfare Cost of Tariffs, Monopolies and Theft,* WESTERN ECONOMIC JOURNAL (1967).

Think about it. Entry eleminates economic rents. Without economic rents, however, government has no levereage to extract "voluntary" concessions to reallocate wealth and perpetuate individual political narcissism. Stated another way, current regulatory policies appear to be designed *not* to dissipate market power via entry and competition but instead to *transfer* existing market power to the regulators themselves. Why? Because if the market can efficiently allocate resources, then regulators will have no patronage to doll out whenever the mood suits them. As such, why have "competition" when you can have "choices"? If consumer welfare is ever to be improved, however, then such cynicism can no longer be condoned.[63]

A. *Case Study: How Current Universal Service Policies Act as a Significant Barrier to Entry (and thus a Self-Defeating Exercise)*

As a general proposition, universal service is certainly a worthy social goal and a very important public policy. Tragically, the greatest impediment to true universal service (*i.e.*, the notion that "all the people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex," should have, "so far as possible" access to a "rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges"[64]) has been the FCC's own policies – not any action by the

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63 *See, e.g.,* Reed Hundt, *Statement on Westinghouse's Children's Educational Television Announcement, WDC,* Sept. 20, 1995 (visited Nov. 4, 1998) <http://www.fcc.gov/Speeches/Hundt/spreh527.txt> ("Westinghouse's assurance that it will deliver three hours of children's educational TV on CBS underscores the tremendous importance of teaching our kids, instead of harming them, with broadcast TV." In the words of President Clinton, American children must not "lose 'countless opportunities to learn' from quality educational TV delivered by commercial networks for free to every home in the country.") (Note: The FCC attempted to act deceptively when Disney sought to acquire ABC/Cap Cities. Considering Disney's well-documented record with creating children's programming, however, Mr. Hundt could only argue that "it remain[ed] to be seen" whether Disney could still do something more to help America's children.); Statement of Reed Hundt in Response to AT&T's Pledge of $150 Million to Help Put the Nation's Schools on the Information Superhighway, 1995 FCC LEXIS 7113, Oct. 31, 1995 ("We at the FCC hope that AT&T's gift," mysteriously made concurrent with the FCC's decision to declare AT&T as a non-dominant carrier for domestic service "of free internet access and voice-mail to all the children of America will catalyze a nationwide public/private partnership to network all classrooms as the President and Vice President have challenged.").

64 *See* Communications Act Section 1, 47 U.S.C. § 151.

market – that act as substantial barriers to entry and dead weight loss to society.[65]

Once again, regulation and competition are supposed to be substitutes, not complements. Similarly, the whole purpose of the 1996 Act was ostensibly to promote competition and lead to deregulation.[66] It seems a bit paradoxical, therefore, that Congress rationally believed that society could have *both* "competitive" markets yet, at the same time, require firms (a) to guarantee that everyone will receive reliable service, and moreover (b) to ensure that particular sectors of society will enjoy not only "reliable" service but also some sort of *subsidized* service as well.[67]

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65 *See* Jerry Hausman, *Taxation by Telecommunications Regulation*, *in* Tax Policy and the Economy (1998) (calculating that the efficiency loss to society of policy to raise $2.25 billion per year to fund an Internet subsidy to schools and libraries to be approximately $1.25 per dollar raised, or a total of approximately $2.36 billion per year (in addition to the $2.25 billion per year of tax revenue)); Robert J. Samuelson, *Telephone Straddle*, WASH. POST, May 14, 1997, at A21.

66 *See Janet Reno et al. v. American Civil Liberties Union*, 117 S. Ct. 2329, 2337-38 (1997) (Telecommunications Act of 1996 was "an unusually important legislative enactment" because its "primary purpose was to reduce regulation and . . . to promote competition in the local telephone service market, the multichannel video market, and the market for over-the-air broadcasting").

67 *See* Thomas G. Krattenmaker, *The Telecommunications Act of 1996*, 49 FED. COMM. L.J. 1, 41-43 (1996) ("[u]niversal service, as defined in the new Act, and competitive markets cannot coexist, where the goods produced have many substitutes or where the technology is dynamic." Accordingly, argues Krattenmaker, "*it is both bad competition policy and bad regulatory policy to think that one can achieve properly functioning telecommunications markets while a regulator sees to it that these same markets generate subsidized pro-societal benefits.*")(Emphasis supplied.); *What Hath Congress Wrought? Reorienting Economic Analysis After the 1996 Act,* ANTITRUST (American Bar Assoc. Spring 1997) 32, 34 and citations therein; *see also* Harold Demsetz, *Barriers to Entry,* 72 AM. ECON. REV. 37-47 (1982); William J. Baumol *et al.*, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE 362 (1988); Easterbrook, *supra* note 56, at 15-16 ("[P]eople demand laws just as they demand automobiles, and some people demand more effectively than others. Laws that benefit the people in common are hard to enact because no one can obtain very much of the benefit of lobbying for or preserving such laws." As such, because "cohesive groups can get more for themselves by restricting competition and appropriating rents than by seeking rules that enhance the welfare of all . . . we should expect regulatory programs and other statutes to benefit the regulated group. . . ." Accordingly, these groups "*need not 'capture' the programs, because they owned them all along. The burgeoning evidence showing that regulatory programs increase prices for consumers and profits for producers supports this understanding.*" (emphasis supplied and citations omitted)); *see also* George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 2-21 (1971). The Commission should also be aware that its current universal service program is great consternation

(Footnote Continued. . . .)

Yet, as if implementing Congress's apparent schizophrenic policy objectives wasn't difficult enough, the FCC inadvertently made matters far worse by deliberately politicizing the universal service program to advance improperly the Administration's schools and libraries program. In fact, the FCC actually hindered and delayed new advanced telecommunications services to schools, libraries, hospitals and rural areas, because not only does a mandatory universal service requirement – and, in particular, the mandatory requirement that *all* "providers of interstate telecommunications" that offer such telecommunications "to others for a fee" must contribute substantial sums of their *gross* revenues to the universal service fund[68] – impose a significant dead weight efficiency loss on consumer welfare,[69] but, in more practical terms, such a policy also acts as a *major* barrier to entry for new firms. This regulatory barrier to entry is simply exacerbated by the fact that, with one exception discussed *infra*, neither the FCC nor the courts have yet to apply these definitions to any individual cases, hence it is unclear who or what will ultimately be called on to contribute to the fund and how much they will owe. Thus, not only would "typical" providers of interstate telecommunications be required to contribute to the fund (*e.g.*, common carriers and private line operators of telephone or wireless companies) but, more importantly, firms that just *incidentally* may be in telecommunications could be required to contribute. These types of firms could range anywhere from a utility that simply seeks to lease dark fiber to a CLEC, to a Seven-Eleven convenience store that sells phone cards. In addition, because the universal payments are characterized, as of the time of this writing, as "contributions," these "contributions" may not be deducted on a contributing firm's tax return.[70] Accordingly, if a new entrant (or even an existing firm) perceives that the costs imposed by the 1996 Act's mandatory universal service obligations and

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abroad as well. *See* David Molony, *EC and U.S. to Clash Over Universal Service Funds*, COMMUNICATIONS WEEK INTERNATIONAL (April 6, 1998).

68 *See Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report & Order, FCC 97-157 (rel. May 8, 1997) at ¶¶ 794-96.

69 *See* Hausman, *supra* note 65.

70 What is particularly disturbing about this scenario is the fact that this exact type of non-price competition is one of the major reasons why it is highly unlikely that long-distance carriers can successfully engage in some sort of tacit collusion under current market conditions. *See Reorienting Economic Analysis*, *supra* n. 36 at 35.

payments may actually exceed[71] the initial profits it hopes to receive, then entry (or a continued presence in the market) will not be economical and will not occur.[72]

Even more appalling is that entrants do not know how much they will owe to the fund until "bills" are sent out. The FCC revises the USF contribution factors every six months, and those factors are calculated to cover expected costs. Providers are then required to pay that percentage of their revenue from the *prior year*. The result is that a provider can only guess how much of the revenues it generates today will be taxed next year, because today no one can accurately estimate what next year's USF expenses will be. Imagine that you are a telecommunications provider and you are attempting to put together your balance sheet (particular, your accrued liabilities account) for an SEC filing – how do you explain to your auditor your justification for reserving 2%, 4% or even 6% of your gross interstate telecommunications revenues for possible taxation next year? This retroactive taxation is unconscionable, and the resulting uncertainty serves only to decrease the changes that a firm will enter the telecommunications industry, as opposed to other industries where changes in tax rates only apply prospectively.

More importantly, however, is that the Commission apparently believes erroneously that all entrepreneurial firms have some sort of "captured" ratebase just like an established firm, such that they can ensure a constant stream of contributions to the USF. The problem, however, is that entrepreneurial firms, by definition, do not have a steady or guaranteed revenue stream. It is therefore wholly inappropriate for the Commission to talk about taxing gross revenues

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71 Perhaps if Congress is really so concerned about wiring the schools, a direct tax *credit* may be a better way to go – *i.e.*, we eliminate the "middle man" and carriers can get direct positive public-relations benefits from the whole endeavor. This approach might even *encourage* entry! As the empirical evidence unfortunately shows, a multi-billion dollar fund creates just too many incentives for nefarious behavior. *See, e.g.*, James K. Glassman, *Gore's Internet Fiasco*, WASHINGTON POST (June 2, 1998) at A13.

72 *See* Scott Cleland, *Subsidy Reform – Big Skunk at the Competition Picnic?* Telecom Watch (Wash. Research Group, Apr. 25, 1997) ("FCC's subsidy reform of universal service and access charges will prove to be a larger *impediment* to the development of local competition than most appreciate."); Samuelson, *supra* note 65 (while Universal Service's "educational benefits may be phantom . . . the higher overall phone rates needed to pay for them aren't"; moreover, while the "subsidies for the poor may be justified[, t]he rural subsidy isn't. *If people prefer to live in rural Montana, they should enjoy the pleasures and bear the costs*." (emphasis supplied)).

when entrepreneurial firms are attempting to assuage their venture capital investors by producing positive net revenues – an exercise which is essential to continued survival in the first instance. The FCC further exacerbates this already difficult entrepreneurial challenge by imposing additional universal service charges that actually force entrepreneurs' prices to rise – and, *a fortiori*, become less attractive and competitive to established firms' products and services – than they would otherwise be.

The one instance where the Commission did provide some clarity was last year in its report to Congress on Universal Service (*a.k.a.* the "Stevens Report").[73] In the Stevens Report, the Commission decided that it would consider imposing access charge and universal service contributions (albeit on a case-by-case basis) on Internet telephony (IP) providers, which, if adopted in practice, would eviscerate nearly fifteen years of past precedent.[74] At the time of the original *Computer II* inquiry, more enlightened forward-looking FCC staff realized that technological developments may reach a point where enhanced services may truly be a close substitute for traditional, switched-voice services. Rather than attempting to regulate these developments, the FCC decided to let this process begin. Yet – low and behold – just when technology finally has caught-up and IP telephony (complete with the concurrent construction of new state-of-the art networks) is now starting to exert desired downward pressure (both domestically and especially internationally) on the need for universal service and access charges, the FCC has set the stage to pull a regulatory "bait and switch." Specifically, the Commission is now improperly attempting to claim that it is *reducing* the amount each industry participant may contribute overall *yet, at the same time, the Commission is actually increasing the number of people who must contribute to the fund!* Accordingly, the Commission has done nothing more than surreptitiously ensure that the overall amount in the universal service fund arguably will stay the same by deterring competition and denying consumers access to the additional choices and lower prices they deserve and expect. Thus, no one should really be surprised when incumbents immediately attempted to

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73 *In re Federal-State Joint Board on Universal Service*, Report to Congress, ___ FCC Rcd ___, FCC 98-67 (rel. April 10, 1998).

74 *Id.* at ¶¶ 83-93.

do what the FCC stated that they now were apparently entitled to do (*i.e.*, impose access charges on IP providers).[75]

What is particularly sad about this whole process is that entry can solve many of the universal service problems the FCC is so concerned about. To wit, why do you see Apple Computer give equipment to schools and libraries? Are they really so altruistic? Of course not. Because the U.S. computer market is conducive to competitive rivalry (*i.e.*, low barriers to entry, low switching costs, *etc.*), Apple has the incentive to subsidize schools and libraries in order to help build brand loyalty in a viciously competitive market. In other words, given this structure and firms' conduct in this structure, the U.S. computer market is demonstrating good economic performance by producing declining costs, technological innovation and, most importantly, the societal benefits politicians want to see.

Notwithstanding the above, however, with the year 2000 election rapidly approaching, it seems unlikely that any politician will have the political courage to express confidence in the economics of entry verses the immediate political gain of the current program. Indeed, now that the proverbial "pork" from the U.S. Universal Service Fund has started to flow, no politician on either side of the aisle is going to tell their constituents that children, libraries and hospitals are not going to receive "free computers" and access to the "Information Society." Instead, it tragically appears that the Clinton Administration has succeeded once again in using children as *ad homonym* "regulatory human shields" to defend and excuse flawed (and indeed self-defeating) economic policies.

VII. Conclusion

The issues raised in this paper present neither a happy story nor a popular story, but at least they reveal an accurate story. Although the FCC states consistently that it wants to promote competition and de-regulation, their actions and conduct – as revealed by the emerging market structure post-1996 Act – demonstrate otherwise. Instead, the only thing the FCC has managed to accomplish successfully is to breed a growing cynicism (and indeed outright contempt) of regulation specifically and the political process generically which is getting more and more difficult to dispel. Indeed, if the FCC refuses to provide

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75 *See Official Says FCC Hasn't Ruled on IP Telephony Access Charges*, TRDAILY (Sept. 8, 1998).

any analytical foundation, then the FCC should not automatically be accorded deference as an "expert" agency. If the FCC is truly serious, then meaningful leadership and serious analytical "heavy-lifting" is required.

As one of the wisest sages of the late-20th century summarized correctly: "What is right is not always popular, and what is popular is not always right." As we approach the new millennium, these are certainly words for the FCC to heed, for the American public should and must not condone this growing regulatory cynicism.