Proceeding: INQUIRY CONCERNING THE DEPLOYMENT OF ADVANCED TELECOMMU CAPABILITY TO ALL AMERICANS IN A REASONABLE AND TIMELY FASHI Record 1 of 1

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In the Matter of	)	
	)	
Inquiry Concerning the Deployment of	)	
Advanced Telecommunications	)	
Capability to All Americans in a Reasonable	)	CC Docket No. 98-146
And Timely Fashion, and Possible Steps	)	
To Accelerate Such Deployment	)	
Pursuant to Section 706 of the	)	
Telecommunications Act of 1996	)	
	)	

INITIAL COMMENTS OF THE TECHNOLOGY ENTREPRENUERS COALITION ("TEC")

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I. Introduction

The dictionary defines entrepreneurs as those people "who organize a business venture *and assume the risk for it.*" In any business venture, however, if entrepreneurs perceive that the risks of a proposed business venture will outweigh the financial benefits, then entry simply will not occur. Similarly, if entrepreneurs have already entered a market and then subsequently decide that the risks outweigh the benefits of entry, then entrepreneurs might seek to exit the market through merger or consolidation, thus reducing – and not adding to – the amount of additional alternatives in the market. Investment in telecommunications and information services is, by its very nature, a highly capital and time intensive venture. Accordingly, if the Commission truly wants to accelerate the "arrival [of] broadband communications services of the twenty-first century. . . ."[1], then the Commission must understand any rational business decision to enter will depend on whether entrepreneurs perceive that there is an attractive climate for new advanced infrastructure and advanced services entry.

TEC's members include entrepreneurs from all segments of the telecommunications and information services industries. What binds TEC's members together is the common the desire to have U.S. telecommunications public policy makers appropriately focus their attention, pursuant to the plain language of Section 706 of the

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[1] *In re 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*, CC Docket No. 98-146, FCC 98-187, ___ FCC Rcd ___ (rel. Aug. 7, 1998) at ¶ 1.

Telecommunications Act of 1996, to creating such a pro-investment environment. To do so, policy makers are going to have to engage in the uncomfortable task of finding those areas where public policies – rather than structural market conditions – may have inadvertently deterred, rather than promoted, new infrastructure entry.

Moreover, as entrepreneurs, TEC has absolutely no desire for the FCC to use this proceeding to find new ways either to "level the playing field" or to promote "fair" competition.[2] TEC members are perfectly capable of standing on their own competitive merits. For this reason, TEC has absolutely no desire to have the FCC turn this proceeding into yet another forum in which the various segments of the telecommunications industry do nothing more than whine and sling mud at each other.[3] TEC believes that lowering the dialectic to such a level does not advance the ball. Instead, pursuant to the plain language of Section 706, TEC's members want the FCC to finally take a hard and honest analytical look at the regulatory framework which exists today and aggressively find new and innovative ways to ensure that the promises of the

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[2] *See* Frank Easterbrook, *The Court and the Economic System,* 98 Harv. L. Rev. 4, 39 (1984) (those "who see economic transactions as zero-sum games are likely to favor 'fair' divisions of the gains and losses"); John Berresford, *Future of the FCC: Promote Competition, Then Turn Out the Lights?* 21-22 (Economic Strategy Institute, May 1997). Berresford states that the "playing field is never 'even' to begin with, and bringing in a lot of regulatory landscape architects and earth-moving equipment will, in most cases, only postpone the emerging competition and the benefits it would bring to consumers." Thus, once regulators start to level the playing field to be "fair" to one competitor, "all the other competitors will find something unfair to them and will want their valleys to be filled and their mountains and hills to be brought low. The process can become an endless one and, if carried to its logical conclusion, makes the regulator into a cartel manager. This guarantees jobs for the regulators, lawyers and lobbyists, and oligopoly for the so-called competitors, but it will do little for consumers."

[3] Indeed, the "Commission is not at liberty . . . to subordinate the public interest to the interest of 'equalizing competition among competitors.'" *SBC Communications v. FCC*, 56 F.3d 1484, 1491 (D.C. Cir. 1995) (citing *Hawaiian Telephone*, 498 F.2d 771 (D.C. Cir. 1974); *W.U. Telephone Co. v. FCC*, 665 F.2d 1112, 1122 (D.C. Cir.1981) ("equalization of competition is not itself a sufficient basis for Commission action")).

Cable Act of 1992, the Telecommunications Act of 1996, and the February 1997 WTO Telecoms Accord can finally be achieved.

TEC agrees completely with the Commission that because this "proceeding is concerned with the longer-term future" the ideas submitted here must not be "shaped narrowly by the interests of any incumbents" but also "from companies that are not traditional telecommunications firms."[4] As the Commission correctly states, it is "critical that the analysis and debate surrounding section 706 focus not just on the more traditional, wired telecommunications network, but also on other emerging technologies for delivering higher bandwidth services."[5] TEC, therefore, seeks to contribute positively to this dialectic and files these comments in the hope of adding constructively to the debate.

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[4] NOI at ¶ 12.

[5] *Id. See also* J. Gregory Sidak & Daniel F. Spulber, DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES (Cambridge University Press, 1997) at 46, where Sidak and Spulber argue that in order to formulate policies to accelerate the "Schumperterian process by which superior production technologies continuously vie to displace inferior ones", market uncertainty

> should counsel humility, not hubris: Government policy should recognize that current predictions of what consumers will or will not want delivered over the network may prove within a few years as dated as Disneyland's 1950 rendition of "Tomorrowland." There will be little hard evidence of the market demand for new interactive services until firms actually build the networks and experiment with new service offerings. In that start-up environment, it is essential that policymakers allow a wide range of new network designs and new service offerings so that consumers may be afforded as wide a range of choices as possible.

(citations omitted); Friedreich von Hayek, THE FATAL CONCEIT: THE ERRORS OF SOCIALISM 85 (1988) ("What cannot be known, cannot be planned.").

II. Analytical Framework

A. *The Challenges Now Before the FCC*

As stated above, the question at hand in this NOI is not a question of "development" *per se* (indeed, technical entrepreneurship has always been the least of America's problems) but specifically about whether the FCC has promoted affirmatively and as effectively as possible new advanced infrastructure entry to improve overall market performance. What it is critical to understand, therefore, is the fact that 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 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.[6] For structural problems, final structural solutions are required.

The problems facing entrepreneurs 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*. For these reasons, one leading telecoms economist recently observed that:

> 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

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

> 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.*[7]

As such, the more appropriate questions for the Commission to ask in this NOI are (a) how a market is actually *performing*; and, in particular, (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.[8] More important, however, is that under the rationale of regulation explained above, if a market is performing well, *then the need for stringent government intervention should be unnecessary.*[9]

Notice that the operative word here is "*well*" – not "*perfectly*." It is well established that various economic factors make it impossible to achieve "perfect

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[7] 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)

[8] *See* F.M. Scherer & David Ross, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE (3d. ed. 1990) at 4-5.

[9] *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").

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.[10] 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.[11]

B. *Where Do we Want to Go from Here?*

Accordingly, if the Commission is truly serious about promoting "deregulation" and "competition," then it 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.[12] In a market structure conducive to vigorous

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

[11] *See generally* John Haring & Kathleen Levitz, *What Makes the Dominant Firm Dominant?* (OPP Working Paper No. 25, 1989); *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").

[12] *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* Scherer & Ross, *supra* (despite antitrust's focus on structural measures such as the HHI, economic concentration is only one aspect of market structure; other relevant

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 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.

Stated another way, different market structures induce different types of rivalrous conduct. As such, unless 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." 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. Should the Commission fail to conduct such an analysis, however – because, as the Commission has often recognized, regulation can have both costs and benefits[13] – then any attempts by the Commission to achieve the

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features of market structure include product differentiation, barriers to entry, cost structures, vertical integration, and diversification).

[13] *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

goals of the 1996 Act will simply continue to create more distortions in market performance than the public interest benefits the Commission is attempting to produce.[14]

Indeed, as the FCC itself acknowledged over four 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 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.[15]

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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 firm's incentive and ability to become a "first-mover" in the market.)

[14] *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).

[15] *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 Programming*, 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* (OPP Working Paper No. 4, 1980) (analysis should focus on market performance, rather than on market participants' residual market power).

C. *How New Facilities-Based Advanced Infrastructure Entry is the Only Way to Maximize Consumer Welfare in the Long-Run*

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 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. [16] 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

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[16] 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).

itself (*i.e.*, new infrastructure development).[17] If we have learned anything from history, is that it is impossible to have "competition without change."

This vision reveals some startling changes in regulatory emphasis. Amazingly, the FCC currently has a rule that effectively restricts the ability of CLECs to collocate advanced switching equipment – this rule, in essence, creates an incentive for CLECs to simply resell existing ILEC switching equipment rather than purchase and deploy their own! By contrast, this vision would have issues such as innovative alternative collocation solutions, access to inside wiring, building access, and local franchise fees and processes, take center stage. Similarly, so long as the *de facto* priority of the Commission's auctions inappropriately remains the maximization of revenues over and above any rational need to ensure the most efficient use of scarce spectrum, then wireless networks will never truly become an economically close substitute to the terrestrial PSTN.

To wit, just this month, BUSINESS WEEK published an article outlining exactly how 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).[18] Accordingly, rather than have a PCS market characterized by low switching costs and numerous close substitutes, the U.S. PCS market is characterized not only by

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[17] 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).

[18] See Steven Brull and Catherine Yang, *Cell Phones: Europe Made the Right Call*, BUSINESS WEEK (Sept. 7, 1998).

multiple standards, but by multiple frequencies as well. (Dual-mode phone, unfortunately, does not mean both GSM and CDMA.)

The Commission's track record with promoting other wireless technologies tragically does not fare any better. For example, the winners of the Commission's C Block auctions are now in bankruptcy, thus preventing the rapid deployment of this spectrum for years to come. More egregious, however, is the Commission's failure to act aggressively in promoting fixed wireless as a close substitute to the existing twisted pair by, among other things, totally avoiding the issue of a facilities-based CLEC's access to the rights-of-way (including licenses and easements) held by ILECs and other utilities with respect to non-central office buildings, as well as the ability to utilize pre-existing house riser cable and conduit on an unbundled network element basis. For example, this issue was initially raised by one of the first generation fixed wireless carriers, WinStar, in the 96-98 proceeding. Despite the absolutely essential importance of building access and riser cable and conduit to ALL facilities-based CLECs that wish to deploy their own last mile local loop (including the last "hundred feet" to the requesting customer in a multi-tenant building), the Commission has failed to render any ruling whatsoever on the WinStar Petition for Clarification and/or Reconsideration in the 96-98 docket pending *since September 1996*. Similarly, Teligent and WinStar, among others, repeatedly have filed comments identifying the critical need for (and ability of) the Commission to address the building access and inside-wire issues in a variety of applicable proceedings, including its most recent inside wire and pole attachments proceedings. If there is one issue which is determinative of the speed at which fixed wireless CLECs deploy their

broadband services directly to the end user -- including, for example, WinStar, Teligent, OpTel, Advanced Radio Telecom, BizTel (owned by Teleport and in turn by AT&T), and each of the successful bidders in the recent LMDS auction -- it is their ability to access buildings as well as utilize the existing house riser cable and conduit. Thus, despite the plethora of words, the Commission to date is demonstrably short on action.

Accordingly, if the FCC would affirmatively and aggressively promote new, additional *alternative* distribution facilities, rather than just continue to reallocate existing loop plant into whatever regulatory regime they think will promote competition *du jour*, then everyone involved in the process – new entrants, incumbents, the Commission, and especially consumers – will all be far better off. For example, it has been argued recently that policy makers should force (directly or indirectly) the incumbent local exchange provider (ILEC) to "spin-off" major functions of its distribution network (*e.g.*, unbundled local loops, local central office building structures, and ancillary local network components) from the existing ILEC corporate organization and place these functions into a separate, unaffiliated "LoopCo" organization. By doing so, *all* LoopCo customers (including ILECs *sans* distribution functions and Competitive Local Exchange Carriers or CLECs) supposedly would purchase network elements from LoopCo on a non-discriminatory basis. While this proposal certainly seems attractive on paper, a significant sticking point about this approach is that it will require substantial legislative and/or regulatory efforts to make the proposal work. The primary problem with such an approach, however, is that it is simply impossible to create competition merely by legislative or regulatory fiat. It does not solve the underlying problem – the local loop

monopoly remains intact (as has in fact proven to be the case, for example, with respect to the "Rochester Plan" where a nascent version of this proposal was approved by the NYPSC).

What well thought-out regulatory paradigms can achieve, however, is a structure that is actually conducive to competitive rivalry. A better solution to the LoopCo idea may very well be fixing retrograde, cage-based collocation policies – this would help give the *consumer* the greater ability to choose the provider of advanced services over the loop his or her household. Consumers will then vote with their pocket books and entry would flourish. As Ford observed:

> 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.[19]

If the market is structured correctly, therefore, then *competitive pressures* – rather than regulatory initiatives – can force this divestiture, whether the incumbent wants to disaggregate or not.

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[19] Ford, *supra* n. 7.

That is to say, as technology continues to progress and advance, new entrants will contemplate an entry strategy where they would act as a competitive and ubiquitous alternative *wholesale* distribution provider (*i.e.,* Alternative Distribution Companies or "ADCos"), rather than an entry strategy where they would attempt to act simply as just another end-to-end *retail* service provider. If this entry strategy is successful, then this additional infrastructure entry would expand greatly the overall market potential for the distribution business beyond limiting competition to providing an alternative to the "traditional" loop. Market structure should be in place to permit these firms to "build down" to consumers. When this competitive pressure becomes sufficiently large enough to affect noticeably market structure, conduct and performance, then the ILEC may have a strong financial incentive to upgrade, maintain and even disaggregate its loop plant to retain profits (much like the recent AT&T disaggregation experience).[20]

Notice that nothing about the above notion suggests any notion of "fairness" or of "equity." It simply talks of true competition (*i.e.,* the ability to succeed and the ability to fail on one's own merits) and how economic forces, rather than legislative and regulatory fiat, will lead to the most efficient allocation of resources.[21] Accordingly, rather than seek to "level the playing field" by arbitrarily determining who can be significant or insignificant competitors, the FCC should instead focus its efforts on creating an

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[20] *See* Jerry Duvall, *Entry by Electric Utilities into Regulated Telecommunications Markets: Implications for Public Policy*, PHOENIX CENTER FOR ADVANCED LEGAL AND ECONOMIC PUBLIC POLICY STUDIES POLICY PAPER SERIES (Forthcoming Winter 1998).

[21] *See generally*, Oliver Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985).

underlying market structure that is conducive to competitive rivalry, under which firms are unable to engage successfully in strategic anticompetitive conduct – even if they tried.

III. The Economics of Entry

A. *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.[22] 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[23]

This maxim can be represented by the formula:

$$d - x - e + s > 0$$

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

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[22] As explained passim, therefore, 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).

[23] Ford, *supra* n.7.

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 a endogenous sunk cost is the cost of physical collocation in an ILEC central office. That space can, because of regulation, only be used to provide telecommunications services – once procured, the CLEC 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.[24] 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

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[24] Though recognizing this effect in some proceedings, the FCC has failed to note that premature granting of a 271 application must, by the FCC's own logic, substantially weaken the prospects for local entry.

requirements for entrants, particularly relevant to this proceeding, raise entry costs (e); and cross-ownership restrictions (and pre-mature 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 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 two years since the enactment of the 1996 Act, however, the FCC has not adequately considered the effects of its decisions, from basic rules to merger approvals, on the entry decisions of firms. 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).*[25] Instead,

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[25] For example, the FCC's recent access reform decision is, 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

the Commission simply either attempted to "draw a line straight down the middle"[26] or to determine whether a proposed merger was "eminently thinkable."[27] Now, in the face of great political pressure,[28] the Commission simply asks the public to tell it whether a "fundamental change in our statutes is needed."[29] While any opportunity to take a *tabla rasa* approach to 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.

Whether we like it or not, this is the world we live in. Congress (in the domestic context), and the WTO (in the IMTS context) each have provided clear guidelines 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

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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.

[26] *See Industry Told To Avoid 'Spins' In Arguing Legislative Intent,* COMMUNICATIONS DAILY (February 26, 1996) (During a Common Carrier Bureau briefing Friday (2/23) on implementing the Telecommunications Act of 1996, 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 new law.)

[27] *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").

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

[29] NOI at ¶ 10.

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.

Unfortunately, the NOI does 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 asks the industry to file their business internal proprietary business plans and (if this isn't bad enough) to require the industry to ask their rivals to do the same![30] 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.[31]

B. *The Purpose of Regulation: a Cost/Benefit Analysis*

Under Section 706, the Commission must utilize, "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." Accordingly, it may prove useful to review quickly some of the basic concepts of regulation to ensure a useful jumping off point for further analysis.

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[30] *Id.* at ¶ 18.

[31] *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).

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, 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?

Indeed, 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.

C. *Types of Regulation*

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 fit 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."[32]

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[32] *Antitrust, the Public Interest and Competition Policy, The Search for Meaning in a Sea of Analytical Rhetoric*, ANTITRUST REPORT (Mathew Bender, December 1997) at 7-8 (http://www.phoenix-center.org/library/neo_comp.doc).

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.[33]

Each type of regulation at the FCC disposal, and the appropriate circumstances for each, is discussed briefly below:

1. *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 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.

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[33] *Id.*