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Common Carriage at the Crossroads

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Recent economic research suggests that incumbent network monopolists may have, under certain conditions, the incentives to engage in vertical foreclosure: the strategy by which a monopolist refuses to deal in some good or input that is necessary or essential for other firms to compete. The application of this research to current debates in communications is straightforward: policymakers should examine situations in which foreclosure is possible, for instance ISP access to cable systems or the phone network, and try to determine if foreclosure is likely to occur.

The FCC's recent efforts in this area has attempted, with varying success, to cut back on competitors' rights of access, but has largely done so *without* examining the possibility of vertical foreclosure. Instead, the FCC has worked to limit the access and interconnection obligations of cable and DSL broadband providers, placing its faith in inter-model competition to limit the anticompetitive effects of market concentration and the Schumpeterian creed that monopolies are more likely to innovate.

What makes the FCC's indifference to vertical foreclosure so puzzling is that by turning its back on requiring interconnection, its regulations, particularly its efforts on broadband access, forsake ancient principles of common carriage regulation, the body of law that for centuries has governed telephony, telegraphy and other transportation and communications industries. Common carriage's interconnection obligations were designed, consciously or not, to limit market power by eliminating vertical foreclosure as a possible anticompetitive strategy and thereby protect consumers. Common carriage did so by mandating access at existing points of interconnection *without* intrusive regulation of internal infrastructure or organization.

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In opposition to common carriage's limited interconnection rights which arguably balanced the risk of vertical foreclosure against intrusive regulation, the FCC's proposed regulation give incumbent monopolists more freedom than their industrial forbearers possessed in the 19th Century—supposedly the pinnacle of the laissez faire policies. Further, the Cingular merger, currently before the Commission, suggests that the FCC is not really interested in maintaining and strengthening intermodal competition—thus making its indifference to the possibility of vertical foreclosure even more disturbing.

The article proceeds as follows. Section I examines vertical foreclosure as an economic theory, the Chicago School criticism of it, and an explication and examination of the current state of economic theory by Patrick Rey and Jean Tirole. Rey and Tirole conclude that, in certain situations, vertical foreclosure can raise consumer prices and decrease overall efficiency and, in certain instances, “common carrier”-type regulation may be therefore warranted. Section II examines, from a historical perspective, common carriage interconnection obligations and argues that the common law of common carriage was designed to limit strategies of vertical foreclosure. At the same time, the common law, aware of the risks of mandating forced access, provides only limited remedies. Common law's regulation discourages vertical foreclosure but does so in manner that only minimally intrudes on the common carrier's existing infrastructure and organization. Section III then examines current FCC decisions involving vertical integration and broadband, showing that the agency ignores the inarguable potential for anticompetitive results and communication law's historical role in countering these anticompetitive effects. Section IV suggests that this potential is exacerbated by the elimination of intermodal ownership barriers.

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I. Vertical Foreclosure, Interconnection, and Network Industries

Foreclosure is a strategy, often with anticompetitive effects, that refers to a dominant firm's refusal to deal in some good or input that is necessary or essential for other firms to compete. In its classic, received version, the dominant firm refuses to sell because it wishes to extend its monopoly into the adjacent, competitive market. This is the way it was perceived by the so-called Harvard School of antitrust and, as discussed below, resulted in some rather draconian limits of vertical integration. It also resulted in the Chicago School reaction, which rarely saw *any* harm in vertical integration.

Foreclosure is largely an economic term and, therefore, foreclosing behavior is part of numerous antitrust legal doctrines. First, the dominant firm can refuse to deal in a good that competitors need and, therefore, vertical foreclosure can appear as a motivating factor in “refusal to deal” antitrust cases. Second, the dominant firm can integrate vertically with a firm in the downstream market and give its subsidiary favorable terms of access—or refuse to deal at all. Thus, vertical foreclosure can be a motivating factor in essential facilities cases. Third, vertical foreclosure can also occur through tie-ins or the use of incompatible standards. For instance, this can occur in after-markets in which a durable good manufacturer in a dominant position excludes competitors from providing repairs, maintenance, or spare parts—as in the *Kodak* case.¹ Most relevant for communications law, foreclosure can take the form of the refusal of the incumbent phone or cable companies to interconnect or unbundle necessary network elements—or of interconnecting under burdensome conditions thereby favoring their own retail services.

¹ 504 U.S. 451 (1992).

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The following section examines vertical foreclosure and its possible applications to telephone company's and cable company's refusals to interconnect with competitors on reasonable terms. First, it examines the Chicago School approach to vertical foreclosure, which dismisses it as having little potential for negative social welfare impacts. Second, the section examines recent economic research on vertical foreclosure. Influenced by game theory as well as Ronald Coase's theory of durable goods monopoly, the leading economists, Patrick Rey and Jean Tirole, examine the circumstance under which a monopolist would engage in vertical foreclosure and the possible social welfare implications of such behavior.

A. The Chicago School, Conventional Wisdom, and Vertical Foreclosure

Robert Bork's *The Antitrust Paradox*,² a *locus classicus* of the "Chicago School" antitrust doctrine attacks limits on vertical integration on two main grounds. First, vertical integration represents the market decision that certain transactions are more efficiently performed using a corporate command organization and others are more efficiently performed using market mechanisms. Ronald Coase first made this insight, in his seminal article, *The Theory of the Firm*,³ which examines why particular transactions are performed within a firm and others outside the firm through market mechanisms. Or put another way, why do firms have certain tasks performed by employees and "outsource" others to private contractors. Coase's answer is that there are different costs of inter-firm marketing compared to the costs of intra-firm command and control. Given

² Robert H. Bork, *Then Antitrust Paradox: A Policy at War with Itself* (ed. 1993).

³ Ronald Coase, "The Nature of the Firm" (1937), (http://people.bu.edu/vaguire/courses/bu332/nature_firm.pdf)

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the peculiarities of different modes of production, firms will integrate (and disintegrate) in a fashion that maximizes the efficiency of their transactions.

Bork uses the Coasian argument to show that anticompetitive aims do not motivate vertical integration. Commenting on the infamous *Brown Shoe* decision,⁴ Bork points out the absurdity of holding illegal a merger between Brown Shoe, primarily a shoe manufacturer with 4 percent of the national market, and G.R. Kinney, a retailer (that also manufactured some of its product) with 0.5 percent. *Brown Shoe* reasoned that vertical integration operates like a tying clause, forcing Kinney to fill some of its retail needs with Brown's shoes and thereby foreclosing competition. Bork demolishes this argument against vertical integration by pointing out that while post-acquisition Kinney filled 7.9 percent of its needs from Brown Shoe, pre-acquisition, Kinney provided 20 percent of its own retail product—thus “foreclosing” competition to a greater degree *before* the merger. Further, forcing Kinney to sell shoes it would have otherwise bought on the market would be Brown Shoe's gain, but also presumably Kinney's loss—and, thus, it is unlikely that the merged entity would “force” shoes onto its retail business that it otherwise would not have bought. Rather, the decision to integrate, Bork suggest, is motivated by integration's added efficiency.

Second, Bork argues that vertical integration *only* improves efficiency and does not result in changed pricing or output decisions. His primary argument is a form of the single monopoly rent theorem—“a monopolist has no incentive to gain a second monopoly that is vertically related to the first, because there is no additional monopoly

⁴ *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962).

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profit to be taken.”⁵ The argument is intuitive and very powerful. Assume that there is a copper monopolist who sells ingots to a copper pot maker. According to then-current view of antitrust, the copper ingot monopolist would wish to “extend” or “leverage” its monopoly from the ingot market to the copper pot market. If it vertically integrated into the retail copper pot market, it could use its ingot monopoly to drive out the other copper pot retailers and reign supreme in both markets.

What Bork et al. point out, however, is that the demand for copper remains the same whether or not the ingot monopolist is integrated with the copper pot retailers. There is a quantity/price that will maximize the monopolist’s profits, and this quantity/price point is identical in both the integrated and non-integrated world. Thus, the integrated monopolist will not further raise prices or capture more rents. There is only one monopoly rent for copper pots, and integration does not effect whether or not it is captured.

It is essential to remember the historical context of Bork and the Chicago school in order to realize the limits to their argument. They wrote against what is known as the “Harvard School” of industrial organization that forwarded the theory that vertical integration does hurt consumers—in ways adumbrated above in the discussion of the *Brown Shoe* case. A monopolist could vertically integrate in an upstream market, limit supplies to the monopolist’s rivals, raise their costs, make them uncompetitive and thereby allow the leveraging monopolist to expand into the adjacent markets. This

⁵ Bork, *supra* note 2, at 229.

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mechanism was held to occur even with remarkable small market shares, as the 1968 DOJ Merger Guidelines indicate.⁶

Given the small market shares in adjacent markets that the Harvard School maintained could allow foreclosure, the Chicago critics were no doubt correct in their claims that vertical foreclosure is rarely realistic. It seems unlikely that a strategy of limiting supply in an attempt to foreclose competitors would be successful or even attempted. Further, as Bork and the single monopoly rent theorem would point out, it would rarely be desirable, as the putative monopolist could not reap a second monopoly in the adjacent market.

Yet, the Chicago School approach does not necessarily provide knock down arguments against regulatory interference in communications today. Today, the entire debate about communication regulation and open access involves firms with market power in adjacent markets. Unlike the Chicago School—which was addressing limits on mergers—current debates in telecommunications are about opening up *existing* vertically integrated monopolies. The Baby Bells have a monopoly in the local exchange and also provide retail service. The cable companies have monopolies on cable service—and significant market power in programming and internet access. As discussed below, foreclosure strategies may not be motivated by, as Bork believes, “the acquisition by a monopolist of a second vertically-related monopoly.” Rather, the motive may be to *protect* an existing monopoly.

Further, Bork’s Coasian/transactional economics argument—that the market will dictate the efficient degree of vertical integration—does not necessarily apply to cable

⁶ See Department of Justice, 1968 Merger Guidelines, Pt. II (<http://www.usdoj.gov/aatr/hmerger/11247.htm>).

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systems and the incumbent telephone monopolists. A free market—that decides which transactions are best performed within a firm and those best performed without—has not created *their* vertical structure. Rather, decades of intrusive government regulation—some of the most intrusive ever imposed in peacetime United States—has determined their structure. The deregulatory solution is not necessarily to let these unnatural corporate creatures free to roam the earth—rather deregulation requires, as discussed in Section III, that the policy maker decide how and on what terms competitors must have access to the incumbent monopolists’ networks.

Yet, before one decides how best to mandate access, the question of whether there is an economic case for mandating access must be answered first. Under what conditions is it likely that a cable operator will foreclose access to a competing, non-affiliated programmer or internet service provider. Or, under what conditions is it likely that an incumbent telephone monopolist will foreclose against a competitor telephone service. Or, under what conditions would a cable broadband service or telephone DSL service foreclose against a competitor ISP service.

B. Rey and Tirole on Vertical Foreclosure

In a recent article, Rey and Tirole provide an excellent summary of the current thinking about vertical foreclosure and make their own important contributions.⁷ Their perspective on foreclosure is different from Bork’s and the Chicago School’s. Rather than see vertical integration as an effort to expand a monopoly, they conceive of it as a strategy to protect an existing monopoly. A monopolist will engage in exclusionary behavior not in an effort to expand its monopoly but in an effort to continue receiving

⁷ Patrick Rey & Jean Tirole, *A Primer on Foreclosure 1* in HANDBOOK OF INDUSTRIAL ORGANIZATION III (Mark Armstrong & Rob Porter, eds.) (forthcoming).

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rents in an existing monopoly or, as Rey and Tirole say, “[t]he reconciliation of the foreclosure doctrine and the Chicago School critique is based on the observation that an upstream monopolist in general cannot fully exert its monopoly power without engaging in exclusionary practices.”

Rey and Tirole analogize the incumbent monopolist with an “essential facility” or “bottleneck” to the owner of a patent. The patentholder can only profitably license its patent if it can credibly promise that it will *not* “flood the market with licences” thereby allowing the competitive market to dissipate all monopoly rents the patent confers. Thus, the purchaser of the patent license desires a commitment from the patent holder to *limit* the number of licenses granted. On the other hand, once the patentholder has sold licenses, it has the incentive to sell more. The issue is timing. While it may not have a motive to license to numerous parties before it sells to any licensee (because the value of the license would be less), once the license is sold, the patentholder does have an incentive to license again, particularly in secret.

This analogy can be extended to Coase’s commitment problem of a monopolist that sells in durable goods. As Coase pointed out, a monopolist in durable goods cannot long retain its monopolist rents because with every sale it makes, it also makes a competitor. With each sale made, there is more of the good on the market and the good is not going away. Thus, each sale depreciates the value of the good and early buyers are reluctant to purchase.

One way to eliminate this bargaining problem is, therefore, to integrate vertically. A phone company’s desire to continue to reap monopoly profits from access to its network could compel it to integrate with retail service—and then foreclose competitors

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by refusing to sell them access. Similarly, a cable company with a monopoly in the provision of video programming and broadband access would foreclose a video programming provider seeking to distribute via the internet.

Rey and Tirole develop numerous results using a sophisticated mathematical model to expand this initial insight. First, the *more* competitive the downstream market, the lower the bottleneck owner's ability to receive monopolist rents. The *more* buyers of the essential facility that exist, the greater the credibility problem, the greater the buyers' reluctance to pay full monopoly price, and the greater the downward pressure on price. This result implies a policy prescription: the bottleneck should be upstream and the competitive segment should provide goods to consumers. The reason is obvious—if the monopoly is upstream, then the bargaining problem can come into effect and prevent the monopolist from reaping full rents, thereby lowering prices.

Second, Rey and Tirole observe that if there is a vertically integrated monopolist and an inefficient substitute, the monopolist would want to limit the supply to its competitors so as not to undermine its monopoly—but it would be at a price and quantity that would make it more attractive than the price of the inefficient substitute. This implication also argues for placing the monopolist upstream as it creates a downstream stage of competition that “eliminates inferior substitutes.”

These considerations lead Rey and Tirole to support common carrier policy—requiring the bottleneck holder to interconnect with and/or accept the traffic of other networks. They have numerous caveats to this prescription—including a rule that non-discrimination in access price will “have the perverse effect of restoring the monopoly

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power that they are supposed to fight.” Yet, at the very least, their analysis suggests that (i) foreclosure is not, as the Chicago School, would have it, an inconsequential problem and, consequently, (ii) vertical integration may be a strategy that bottleneck owners, *e.g.* telephone companies, cable companies, use to maintain monopoly rents and (iii) some type of common carrier policy may be warranted.

Of course, these policy prescriptions are far from unequivocal. Vertical integration can create efficiencies that outweigh any anticompetitive effects. Further, placing the competitive portion of a network downstream, as Rey and Tirole suggest, often poses incredibly difficult technical issues and may not be efficient in all instances. Any regulation based on the threat of vertical foreclosure must carefully examine the specific factual scenario. Section III will examine how the FCC deals with the threats of vertical foreclosure in several proceedings. We will immediately turn, however, to the history of common carriage regulation and suggest that controlling vertical foreclosure has been its dominant concern for the last 100 years or so.

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II. A Theory of Common Carriage Law

Richard Posner in his celebrated article, *A Theory of Negligence*, forwards the thesis that negligence, as an economically rational concept did not spring forth fully-grown, like Pallas Athena, from the head of Learned Hand.⁸ Rather, Posner suggests “the liability for negligence is designed to bring about an efficient level of accidents and safety.”⁹ He argues that the relaxation of 19th century no fault liability, which became the negligence standard, was not, as had often been claimed, a legal concession to the growing power of industry, particularly the railroads. Rather, the negligence standard constituted an effort to “bring about, at least approximately, the efficient—the cost-justified—level of accident safety.” Posner, therefore, concludes the economic efficiency is the good that the negligence standard optimizes.

Common carriage law has a history almost as long tort law, extending back to the Middle Ages. Just like tort law, common carriage law transformed itself in the 19th century in response to the rise of American industrial society. Bruce Wyman, writing in 1911 on common carriage, remarked that students of the subject see that they “are just entering upon a great and important development of the common law. . . . Enormous business combinations, virtual monopolization of the necessities of life, the strife of labor and capital, not the concern of the economist and the statesman, may prove susceptible of legal control through the doctrines of the law of public callings. . . . General rules, to be sure, have been established but details have not been worked out by

⁸ Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972)

⁹ I BRUCE WYMAN, THE SPECIAL LAW GOVERNING PUBLIC SERVICE CORPORATIONS at x (1911).

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the courts.”¹⁰ During the late 19th century and early 20th century, as Wyman documents, common carriage expanded. Courts struggled with how to extend the regulatory principles governing toll roads, ferries, and bailers to railroads, telegraphs, and telephones.

As with tort law, common carriage law would appear to be motivated to a considerable degree by concerns about economic efficiency. In particular, its holdings concerning interconnection and exchange of traffic seem to be designed to limit the ability of monopolists to vertically foreclose—although the 19th century courts, unlike the 1996 Act, never required sharing of facilities or joint control. Instead, the courts required “open access” at places, like docks, railroad terminals, or telegraph offices, at which common carriers already served the public. Common carriers could not “refuse to deal” with competitors at these points. As we will see, the rather limited form of regulation did prevent certain types of vertical foreclosure without entering the morass of forced access and shared facilities into which the implementation of the 1996 Act fell. In addition, as we will see, *successful* FCC deregulatory efforts like deregulation of customer premise equipment (CPE) and, to some degree, long-distance, followed the traditional, 19th Century model of open access.

A. 19th Century Open Access, Its Limitations, and Vertical Foreclosure

Throughout the 19th century, courts were continually adjudicating the rights of stagecoaches, railroads, ferries, telegraphs, and telephones to interconnect with one another. As a general rule, these carriers were obligated to accept traffic from competitors at points at which they received traffic from the general public. For instance,

¹⁰ 10 N.H. 481 (1839).

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Bennett v. Dutton, according to Wyman a “leading case,” involved possible foreclosure behavior by a stagecoach.¹¹ The stagecoach belonging to defendant, Dutton, ran a route from Nashua through Amherst, Massachusetts ending at Francestown, Massachusetts. Dutton wanted an integrated route (for mail packages) and entered into an exclusive contract with Jonathan French, an owner of one of the Lowell—Nashua lines. Under that contract, the only customers Dutton would pick up in Nashua were those arriving on French’s line, excluding those arriving on French’s. Dutton would not pick up passengers entering from the stagecoach owned by French’s rival, Tuttle. Plaintiff, Bennett, arrived at Nashua on Tuttle’s line, and Dutton refused transport to Amherst.

The court ruled that Dutton’s refusal was illegal. If his stagecoach accepted traffic in Nashua, it had to accept traffic from all, including Tuttle’s. The reasons for Dutton’s behavior are not completely clear from the record, but there is at least the possibility that he was engaged in foreclosure behavior. By refusing connecting services, Dutton and his associates became the only conduit from Lowell to Amherst. Dutton, acting as a bottleneck, was refusing to provide an essential input Tuttle needed to provide through service to Amherst.

The social welfare implications of this arrangement are admittedly ambiguous. Indeed, all the arguments used to defend vertical integration in the modern debates on open access in cable or telephony could be applied to defend the Dutton-French arrangement. Perhaps the Dutton-French contract provided a guaranteed level of demand that would encourage investment. Dutton and French would only invest in new, fancy stagecoaches if they could be sure of a certain level of traffic. Perhaps the Dutton-French

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contract could provide more efficient service without double marginalization and allowed certain economies of scale. In other words, by sharing profits and integrating their activities, Dutton and French could provide better, cheaper service to more people, making it welfare enhancing. On the other hand, perhaps Dutton-French were defending their monopoly of service between Lowell and Amherst and, by refusing interconnection, they could protect monopoly rents for the route.

Common carriage law deals with this economic ambiguity—an ambiguity that persists today in open access debates. It required interconnection at *existing* points of interconnection. Thus, Dutton had to accept all traffic at Nashua; railroads had to accept traffic or freight at public junctions and depots from everyone; telegraph offices had to receive messages from members of the public. But, the common law did *not* require the building of special facilities or the sharing of physical plant. For instance, competing telephone companies had to transmit messages to rivals, *i.e.*, a patron of a Bell company could “call” a patron of a rival by calling the Bell operator who would call the rival’s operator who would then call the called party and tell him or her to call the calling party on a Bell phone. There were not required (under common law) to build special interconnecting switchboard facilities.¹²

Similar rules applied to other common carriers. Consider telegraphs. A sender of a telegram could mandate which successive telegraph company could carry its message. Each telegraph company was required to deliver the message to another office, even if the telegraph companies were rivals or had competing services. Thus, neither could

¹² *See, e.g.*, Michigan State Tel. Co. v. Michigan R.R. Comm’n., 161 N.W. 240, 243 (1916).

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foreclose competitors.¹³

The 19th century common carriage common law took at an intermediate position between the fear of vertical foreclosure and the potential for inefficiencies of shared facilities. At existing points of interconnection, common carriers could not engage in strategies that would have the potential for vertical foreclosure. Instead, they had to hand off traffic to competitors. This made more of the market competitive and allowed more end-users to access such markets. Thus, for instance, if there were only one stage coach (or telegraph company) that served a particular town, its monopoly could not be transformed into a monopoly over all transmissions to all points from that town. At existing points, end-users could use different firms. As Rey and Tirole would suggest, this allowed the more competitive segments of the market to be brought downstream to the end-user. At the same time, carriers were not obligated to modify their physical plant to accommodate competition. Under common law, telephone companies and railroads were not required to build special interconnection facilities at the request of competitors. Rather, this only occurred once regulators got involved.

The common law, therefore, represents a balanced view. On one hand, in a manner reminiscent of Bork's take on transactional economics, courts were quite hesitant to require changes in the way common carriers did business. Under common law, common carriage rights did not mandate any change in infrastructure or business organization. Like Bork, the common law seemed to believe that the shape of firms and the degree to which they integrate between markets were determined by principles of efficiency—and it would be unwise for the judiciary to mandate their shape or organization. On the other

¹³ I WYMAN, *supra* note 9, § 515 at 438.

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hand, once (presumably) infrastructure and business structure developed in a manner that was efficient, common carriers were limited somewhat in their ability to engage in strategic behavior. They could not treat competitor traffic differently than that belonging to members of the public.

B. Early Efforts at Deregulating the AT&T monopoly: common carriage approaches

The common law of common carriage dealing with telephone emerged during the brief period between the expiration of the Bell patent in 1896 and the re-emergence of the AT&T monopoly in the mid-1910s through the 1920s. During most of the 20th century, agency-made rules regulated most parts of the AT&T monopoly, and market-based common law regulation, like common carriage law, played little role.

Starting in the 1970s, under pressure from both the judiciary and the political process, the FCC began to deregulate portions of the AT&T network. As shown below, these efforts at deregulation—though carried out by an administrative agency—employed what can only be called a “traditional common carrier” approach. They involved no sharing of facilities. Rather, they required clear demarcation and delineation of ownership, and (relatively) simple rules for physical interface and the exchange of traffic. At points of interconnection, the incumbents had to provide equal access to all. Thus, very much like traditional common carrier regulation, there was limited oversight of infrastructure and organization—but once infrastructure was established, incumbents could not engage in potentially foreclosing behavior.

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CPE Deregulation. The FCC first deregulated customer premise equipment (“CPE”) or in non-telecomspeak, phone sets. Prompted by several court decisions and well as its own impetus,¹⁴ the FCC deregulated CPE. It set forth numerous technical standards that all equipment manufacturers wishing to use the phone system must adopt and allowed consumers to attach any complying device, made by any manufacturer, into the telephone jack.¹⁵ This represented a sea change in regulatory approach as only a decade or so earlier, the FCC had rejected, in the *Hush-A-Phone* proceeding, the marketing of a plastic device to attach to the phone set to allow for more private conversation, prohibiting it as network interconnection with unregulated equipment.

It goes without saying that deregulation of phone sets was a success. New, better, and cheaper phones appeared on the market. Further, the regulation of the specifications that all sets had to meet was never too. Found in Part 68 of the FCC regulations, they provided (with helpful pictures and diagrams) the technical requirements for phone to interconnection with the network. Indeed, the job of regulating the CPE/network interconnection interface proved to be so non-controversial that the FCC privatized the task, allowing a private consortium to assume its duties.¹⁶ Thus, this story ends sweetly with private actors beginning to assume the role of setting interface specifications and thereby eliminating the need for bureaucratic oversight—a sort of regulatory Marxist heaven with the state just withering away.

¹⁴ *Hush-A-Phone Corp. v. FCC*, 238 F.2d 266, 269 (D.C. Cir. 1956); *Telerent Leasing Corp. et al. v. FCC*, 537 F.2d 787 (4th Cir. 1976).

¹⁵ See 47 C.F.R. Pt. 68.

¹⁶ 2000 Biennial Regulatory Review of Part 68 of Commission's Rules and Regulations, 15 FCC Rcd. 24,944 (2000).

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Observe the “traditional common carrier” aspect of CPE deregulation. There was a clear demarcation point, the phone jack. This arrangement, therefore, involved no sharing of facilities. The subscriber was responsible for his portion of the network (*i.e.*, the phone set) and AT&T was responsible for its portion (everything else). The CPE deregulation involved a sort of “reverse engineering” whereby a point in the network was determined to be an efficient place at which to introduce competition—efficient in the sense that once the point was determined, little cooperation, coordination or even communication was required between the parties.

Competitive Long Distance. Competitive long-distance has been more controversial, though similar in its genesis. Again, the impetus came from the courts—with the *Execunet* decision and Judge Greene’s divestiture of AT&T.¹⁷ Prior to divestiture, MCI had been purchasing access pursuant to special tariffs and connecting to the network essentially as would large, corporate customer. After divestiture, the technical arrangement became more complicated. The Baby Bells were required to create a pre-subscription process that would allow consumers to pick a long-distance carrier and have all their calls routed to such carrier. AT&T and MCI were required to locate their networks in various points-of-presence (or POPs) in the Baby Bell’s region, which were often simply higher level switching locations in the old AT&T monopoly, and receive traffic.

The effects of long-distance competition are not clear. From one point of view, competitive long-distance did indeed provide lower rates for long-distance, as it is unquestionable that rates fell throughout the 1980s and 1990s. On the other hand, some

¹⁷ See *M.C.I Telecommunications Corp. v. F.C.C.*, 561 F.2d 365 (D.C. Cir. 1977); *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131 (D.D.C. 1982).

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maintain that rates fell largely because of technological changes. Rates would have fallen more but that competitive long-distance added a layer of productive inefficiency. (For just one example of this inefficiency, consider dual billing; two phone companies per subscriber makes for a lot of extra envelopes and stamps.) Further, some maintain that the access charge system allowed the long-distance company to escape most of the joint and common costs of the network—thus the Baby Bells “subsidized” long-distance.

Yet regardless of the social welfare costs or benefits of competitive long distance, the system of interconnection “worked” in that several firms entered competitive long distance and ran successful businesses (for a considerable period of time). Again, there is a sort of reverse engineering regulatory approach in long-distance competition that apes or imitates 19th century common carriage law. Certain points of interconnection (on the existing network) were chosen, as places at which the local exchange monopolies and the long-distance companies would interconnect. At these points, there could be no discrimination in that the local exchanges had to serve all long-distance companies. There was minimal coordination, communication, or cooperation at the POPs—though no doubt more than between the CPE consumer and the BOC.

III. Recent Regulation and the FCC

The Powell FCC’s most important proceedings in telephony and broadband reflect, at one hand, an effort to cutback the implementation of the 1996 Act.¹⁸ The FCC’s acquiescence to the U.S. Court of Appeals for the District of Columbia Circuit ruling vacating the Triennial Review Order, which passed significant unbundling issues to the state regulatory commissions, represent a retreat from Reed Hundt’s version of

¹⁸ The unbundling and interconnection obligations of the 1996 Act were first set forth in the Local Competition Order. *See* 11 FCC Rcd 15499 (1996).

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deregulation—with its extensive sharing and cooperation obligation and concomitant onerous bureaucratic oversight.¹⁹

Hundt's implementation of the 1996 Act created a system of remarkable complexity that lacked key features of the traditional common carriage in two significant ways. First, there was extensive sharing of facilities, rather than clear demarcations of ownership. Competitors were permitted to rent unbundled network elements (UNEs) from the incumbents. This is a clear departure from railroad interconnection at public terminals—or even CPE deregulation at the jack. Second, there was no one single standard of interconnection; competitors were free to pick and choose which unbundled network elements they desired. This resulted in intrusive regulation as the FCC and state commissions attempted to slice and dice the incumbent's network in order to encourage competition, manage and supervise the relationship between the incumbents and competitors in the provision of UNEs—and conform to the ever-changing political climate.

While the FCC's retreat from Hundt's vision represents a victory of sorts for more modest efforts at deregulation, the FCC's recent efforts in broadband, if the courts permit them to proceed, would go further and represent an incredible departure from common carriage—permitting the incumbent telephone and cable monopolists the ability to foreclose on competitors in internet access. This danger of foreclosure is made more urgent if the FCC fails to maintain intermodal competition between wireline, wireless, and cable companies. The Cingular merger, currently pending before the Commission,

¹⁹ See Triennial Review Order, 18 FCC Rcd 16978 (2003).

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suggests that it may not. The following section reviews the FCC’s action in the two broadband proceedings and points out their obliviousness to major competitive threats.

A. The Cable Broadband Order

The FCC’s Cable Broadband Order²⁰ had to decide which statutory category cable modem service fit—and consequently which regulatory regime applied. When the 1996 Act was written there was no cable service. The Act defined cable service as the one-way transmission of video service—something cable modem broadband service was clearly not. The Act defined telecommunications service as the offering of telecommunications, which in turn was defined as the “transmission, between or among points specified by the user, of information of the user’s choosing.”²¹ The Act also defined “information service” as the offering of a “capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, making available information via telecommunications.”²² Telecommunications is defined, in turn, as “the transmission, between or among points specified by the user, of information of the user’s choosing, without change in the form or content of the information as sent and received.”²³

These definitions are vital because whichever definition covered cable modem broadband service would determine how such service would be regulated: if it were cable service, it would be regulated by the local franchise authority; if it were telecommunications, it would be regulated by the FCC and subject to certain non-

²⁰ See 17 FCC Rcd 4798 (2002).

²¹ 47 U.S.C. § 3(47).

²² 47 U.S.C. § 3(20).

²³ 47 U.S.C. § 3(43).

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discrimination requirements; or, if it were information services, it would not be subject to any regulation at the moment, but the FCC could regulate it in the future.

When one is confronted by the bizarre opacity of these definitions, one is reminded of the reported comment of some (unidentified) senator to Reed Hundt, “We put everything in it and then we put and its opposite in [the Telecommunications Act].” Cynical witticisms aside, the statutory indeterminacy creates an unfortunate dynamic. It gives the FCC the freedom to promulgate orders with virtually any result it desires and still have some sort of statutory support—at the same time, making it likely that a reviewing court will disagree with the FCC’s take on the statute and remand its decision. Thus, virtually every regulation the FCC has produced under the act carries a significant legal (and thus business) uncertainty. And, that is precisely what happened with the Cable Modem Order. The FCC decided that cable modem service was “information service” and thus not subject to local regulation. At the same time, it was subject to federal authority to regulate, but no regulations existed at the moment. The FCC declined to expand the common carriage-type open access requirements that telecommunications services must follow. The United States Court of Appeals for the Ninth Circuit remanded the decision.²⁴

What is remarkable in the order, however, is its indifference to the primary economic question of open access in cable—what is the likelihood that monopolist cable systems would foreclose on ISPs and would that be a bad thing. As discussed above, allowing consumers to choose their ISPs would have the effect of, as Rey and Tirole would say, moving the competitive segment downstream. Keeping the competitive

²⁴ See *Brand X Internet Services v. FCC*, 345 F.3d 1120 (9th Cir. 2003).

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segment upstream presents the very real possibility that cable companies would foreclose on ISP competitors.

Rather, most of the order was legal analysis—in which the FCC juggled the glass balls of the statutory provisions to arrive at its answer. Of course, in the accompanying Notice of Proposed Rulemaking it left open the possibility that, at some yet undetermined date, it would address the question of whether open access is good thing, but it failed to define the problem with any degree of specificity or theoretical sophistication. In other words, there simply was no economic analysis of whether and under what conditions vertical integration between cable companies and ISPs might create anticompetitive results. Indeed, the Order, itself, admits that it did have a record for beginning an economic analysis, yet the Commission was simply unwilling to do so. (Further, it should be remembered that the Commission does have subpoena and discovery authority and could do its own research, rather than simply review written comments.)

B. The Wireline Broadband NPRM

In a companion promulgation, the Wireline Broadband NPRM,²⁵ the FCC set forth its proposed rules for governing wireline broadband services, or in non-telecomspeak, DSL. As with the cable order, the Wireline Broadband NPRM concluded that DSL was an information service. To achieve this result, the FCC repeated its performance in the cable modem order—juggling statutory terms to arrive at the conclusion that DSL fit into the statutory term “telecommunications” and “information service” but not a “telecommunications service.” Given the definitions of these terms, the Commission’s efforts can hardly be said to be a coherent exercise either in

²⁵ 17 FCC Rcd 3019 (2002).

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determining statutory meaning (as the statute is so contradictory it could mean virtually anything) or uncovering the intent of Congress (as the statute's contradictions belie the claim that any coherent intent exists).

Yet the exercise in the Wireline Broadband NPRM was not identical to the Cable Modem Order because it had an extra challenge. In wireline, there already existed a traditional common carrier-type system of access, known as the Computer III regulations. They required the incumbent monopolists to separate their services into basic and “enhanced,” the latter involving more advanced computer applications— such as dial-up internet access. The incumbents were required to break down their networks into a few, limited number of basic building blocks, and to make those building blocks available to entities, like ISPs, that provided different types services over the telephone lines. In other words, if an incumbent wanted to provide ISP service, it had to provide competing ISPs non-discriminatory access to the necessary elements in the network.

Again, Computer III was a traditional, common carriage approach to deregulation. There was a (relatively) simple standard of interconnection, the “CEI” or comparably efficient interface, that the incumbents were required to make public and available to all competitors. And, at least in encouraging the growth of ISPs and the initial widespread deployment of the internet, Computer III was quite successful. Few, if any, technological advancements were adopted as quickly as the internet, and it seems reasonable that the thousands of independent dial-up ISPs, all of which depended upon the Computer III, played a huge role in making the internet happen.

Oddly, the success of the Computer III regulations goes unmentioned in the Wireline Broadband NPRM. Rather, the NPRM asks whether there still exists a policy

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justification for Computer III. It harps vaguely about the “changes in the technological and competitive landscapes” and avoids any serious economic theory of the anticompetitive effects of denying interconnection.

Further, there is no discussion of the *costs* of compliance with Computer III. Some have argued (with justification) that the costs of implementing the deregulation under 1996 Act outweigh its benefits. Similarly, if a case could have been made that Computer III places unreasonably large burdens on incumbents, then perhaps these costs outweigh the benefits of decreasing the possibility of vertical foreclosure—and Computer III should be scrapped. The Commission, however, did not express an interest in examining the costs of Computer III imposes, let alone balancing these regulation’s costs against their benefits. Rather, the Commission seems poised to turn its back on approaches that have been successful and enter a new world of deregulation—relieving common carriers of obligations they have had for centuries.

IV. Intermodal Competition & Vertical Foreclosure & the Cingular Merger

The Powell FCC always has downplayed the significance of rising concentration (or unchanged) concentration in telephony and cable, arguing that intermodal competition limits market power. Telephone companies cannot raise prices too much because consumers will go to wireless. Cable modem prices cannot be raised too high because consumers will go to DSL, etc. Indeed, reacting to the D.C. Circuit’s vacating of the Triennial Review Order and the FCC’s decision not to appeal, Chairman Powell stated, “There is no need to fear that consumers will be left with nothing to choose from as UNE-P begins to wither. . . . Consumers are using wireless telephones today—many

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now use their mobile phone as their primary phone. Cable companies are offering competitive telephone services to residential consumers.”²⁶

To the degree that intermodal competition exists, it does lessen the risk of foreclosure strategies. If, as Chairman Powell suggests, a consumer seeking broadband services thinks cable charges too much, he or she can subscribe to the DSL service. Cournot equilibriums aside, this competition likely would lessen the ability of either cable company to extract full monopoly rents—as well as lessen the incentive to protect monopoly by refusing interconnection. (There would be no incentive to protect monopoly if there were no monopoly rents to protect.)

Intermodal competition, however, is only effective at countering such strategies to the degree these services are, in fact, substitutable. In other words, a cable company can still foreclose if consumers believe that cable modem service offers benefits or services that DSL does not. Cable companies can exercise monopolies over these consumers, and if there are enough of such consumers, this monopoly would be considerable. Missing from the Cable Modem Order and Wireline Broadband NPRM was any analysis and measure (or intention to analyze) the substitutability of these services.

Finally and disturbingly, the Commission, itself, appears to have a wavering commitment to intermodal competition. In the Cingular merger currently before the Commission, Cingular (a wireless company that SBC and BellSouth jointly own) is seeking to purchase AT&T Wireless. This arrangement would allow the largest wireline company to merge with what would become the largest wireless company—and would

²⁶ Statement of Chairman Michael W. Powell (Aug. 20, 2004).

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reduce intermodal competition in telephony significantly for a huge number of Americans. Press reports indicate that Commission seems receptive to the merger.

Conclusion

The 19th century common law of common carriage relied upon a simple legal regime. Rights over physical facilities were clearly defined. Each carrier had control and dominion over its network but had to provide access to competitors on the same terms as it provided to members of the public. Thus, the ability of carriers to engage in vertical foreclosure was minimized, and intrusive (and potentially inefficient) regulation over corporate organization and infrastructure was minimized as well.

Early deregulatory efforts, such as the deregulation of CPE, Computer III, and competitive long distance, though agency-imposed, followed this traditional common carriage model, adopting similar regimes in the different context of deregulating a government-supported monopoly. Under each of these regimes, there was a clear demarcation of property interests: for instance, the phone jack in CPE and the POP in competitive long-distance, and each party had control and dominion over its side of the network. The regulation, which governed the exchange of traffic, was (relatively) simple. For competitive long distance, the most complicated feature was the payment system, known as access charges, which served a complex subsidization purpose unrelated to interconnection.

The 1996 Act and its implementing regulations represented a departure from the simplicity of the common carriage approach. Its extensive UNE regime blurred the distinction between network that belonged to competitors and that which belonged to incumbents. The provisions for exchange of traffic, governing both the manner and

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price of exchanges, are so complicated that courts have yet to fully rule on their legality, and agencies are overwhelmed implementing them.

Perhaps in reaction to the excesses of the 1996 Act and its implementation, the FCC has moved away from interconnection requirements in broadband—in ways that abandon even relatively simple traditional common carriage approaches. It has done so without seriously assessing the risks of vertical foreclosure and the danger of higher consumer prices and restricted output. At the same time, the Cingular merger suggests that the FCC will not or cannot maintain serious intermodal competition, which is its stated antidote for vertical foreclosure. Especially given the limited information under which regulators operate and their limited ability to understand the markets and industries they regulate, the FCC movement in broadband seems poorly supported in economic analysis, inconsistent with other Commission policies, and oblivious to historical precedent.