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THE FIRST AND CURRENT COMPETITIVE ERAS IN TELECOMMUNICATIONS: LESSONS FROM HISTORY AND LIMITS OF ANTITRUST POLICY TODAY

by

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EXECUTIVE SUMMARY

The Telecommunications Act of 1996 codified a national preference for competition rather than regulation in telecommunications. The telecommunications industry has become a case study of whether competition can be fostered in an industry, and whether competition so fostered can work in conjunction with regulation to the public benefit, possibly even reducing the need for regulation. There is no rule guiding coordination of competition policies with regulation. Indeed, there can be inherent conflict between the "public interest" standard for decision-making by regulators and the competition standard used in antitrust.

Where monopoly still rules, the majority of states have modified regulation to improve the public utility incentives to provide service at low cost: tools such as price caps and incentive regulation have been widely adopted in place of conventional ratebase, rate-of-return regulation. Current theory holds that some mix of competition, consumer bills of rights, franchise requirements, and statutory provisions can substitute for regulation in providing low rates, innovative services, and consumer protections.

Some of these "new" policies have historical antecedents. For much of the nineteenth century, the Congress and state legislatures relied heavily on competition, both within and between industries, to constrain the public utility and transportation firms. Non-commission forms of regulation in the first competitive era included public ownership, judicial regulation, local regulation and charter regulation, and government promotion of competition remained an important constraint on the incumbent utility. Thus, the common method of social control from the 1830s to the 1880s, bears a striking resemblance to the social controls that are again becoming fashionable. As competition and other policies are substituted for regulation, it may well be worthwhile to consider why reliance on competition failed after a half-century of vigorous and enthusiastic trials.

Toward the end of the nineteenth century public opinion began to swing against competition as a means of controlling public utilities, and Congress and the state legislatures developed the commission form of regulation. Commission regulation originally stressed investigations; the modern ratebase, rate-of-return form of regulation evolved from those investigations.

Much, especially technology, has changed since the nineteenth century. Nevertheless, market power issues are relevant in any era. In the nineteenth century, control of market power via competition was fostered by mechanisms such as deliberately supporting and even subsidizing competitors in a manner that would be unacceptable today. On the other hand, today we have antitrust laws that, if vigorously enforced, may address some of the problems that bedeviled competition in the nineteenth century.

Antitrust statutes began to appear in parallel with the regulatory commissions but were rarely applied in the first competitive or early regulatory eras. Today they are likely to be an extremely important tool for promoting workable competition. Legislators and regulators attempting to use competition as a supplement or substitute for other forms of regulatory social control must consider antitrust doctrine and competition policy as part of rather than apart from the regulatory arsenal. This requires significant rethinking on the part of regulators.

The early use of corporate charters, franchises, and competition as regulatory tools failed for several reasons. There were practical difficulties of enforcement, which often required relying on the courts that lacked specific technical expertise or training to deal with utility matters. Franchises and charters could be made to expire, but such expiration created uncertainty, making it difficult to raise money and requiring charter provisions to provide for valuation and transfer of assets on expiration. In addition, coordination of charters and franchises granted by multiple municipalities was nearly impossible.

Although a review of the nineteenth century shows that, where it was feasible, competition was often successful in lowering prices, there was widespread perception that competition also failed to produce desirable results. Competition resulted in turnover, bankruptcies, and financial disorganization. It led to unacceptable levels of price discrimination. It resulted in wasteful construction, and actions by competitors including rate agreements, pools, mergers, and consolidation eliminated competition.

Commission regulation was an attempt to address the problems of franchises. If we seek to rely again on competition as our primary means of control, we can combine it with antitrust, using general statutes and commission rulemaking powers. However, a regulatory mindset may still exist even among people professing allegiance to competition. Indeed, the FCC has permitted anticompetitive mergers or other activities by finding that the adverse effects on competition were outweighed by the public interest standard.

There has been some resurgence of interest in charter regulation. When utilities merge, licenses—certificates of public convenience and necessity—must be transferred to the surviving firm. Such transfers are at the discretion of regulators, and enable them to examine, and possibly constrain, aspects of the utility's operations that may have eluded regulatory control previously. State commission reviews of recent mergers have tended to stress problems in quality of service, and most of the conditions that the states impose on the merging parties are intended to secure improved service quality. Moreover, these measures can be applied in circumstances in which the regulatory body lacks direct authority to act. Some municipal regulators attempted to create a competitive market for high-speed Internet access by requiring "open access" to ISPs of the customer's choice (rather than mandating access via an ISP affiliated with the cable system) as a condition to approving the transfer of cable franchises. Although these attempts were rebuffed in the courts, they showed interest and willingness on the part of local regulators to assert what control they had.

For its part, the FCC has a fairly consistent method of evaluating mergers, which it reviews under the Communications Act as part of the process of transferring wireline and radio licenses. The FCC has stated that it is charged with promoting competition in communications and that it has an obligation to determine whether a merger is in the public interest. This commitment to both competition and to a public interest standard creates a dilemma: the FCC cannot simply assume that competition is invariably in the public interest; rather, if a regulatory procedure can achieve results equivalent to competition, the FCC may, and perhaps must, continue regulation.

The public interest standard and the FCC's powers under the Communications Act, allow it to impose regulatory conditions to mitigate anticompetitive effects of a merger – or other effects that might frustrate its policies or be otherwise contrary to the public interest. The FCC's actions illustrate its conflicted regulatory mindset: competition is only one of its concerns, and it considers regulation to be an effective substitute for competition. Indeed, despite the fact that the Telecommunications Act of 1996 calls for, competition to replace regulation, the FCC has chosen a regulatory path In several cases.

In the Bell Atlantic-NYNEX merger, even though it found that the merger would reduce competition in the New York market, the FCC chose not to block the merger – possibly because the Justice Department had already approved it. Instead, the FCC used the public interest standard to "condition" its approval of the merger, imposing behavioral conditions on the merged company. Several state commissions also imposed behavioral conditions on merged companies.

In the MCI-WorldCom merger, the FCC interpreted the public interest standard to justify accepting an anticompetitive merger, but it did not make a positive public interest case for the merger. The FCC approved the license transfers without imposing significant conditions beyond those already imposed by the Justice Department and by European authorities.

AT&T's acquisition of Tele-Communications, Inc. (TCI) was directly within the FCC's authority under titles II and III of the Communications Act. There were both vertical elements (AT&T gained access to TCI's cable systems, giving it facilities-based access to subscribers in markets all over the country) and horizontal elements (both AT&T and TCI were retail ISPs, and, to some extent, providers of the Internet "backbone"). In addition, there was concern about open access to TCI's cable modems used for broadband access to the Internet. Although eventually rebuffed in the courts, several local government entities, including Portland, Oregon, and Broward County, Florida, tried to impose procompetitive open access rules on cable modems.

Similarly, the FCC's early reviews of whether companies met the "competitive checklist" required for inter-LATA toll authority under Section 271 of the Telecommunications Act of 1996 ignored problems with the ways the incumbent firms were meeting the requirements. The situation improved, but it did so slowly, and there continue to be disputes over whether some of the systems are operating effectively.

Where elements of monopoly remain, price discrimination constraints have not been relaxed. Charges for services provided to the incumbent's competitors or potential competitors are closely regulated. Other discrimination issues now being addressed by regulatory commissions include discrimination in quality of service or in access to network functions and facilities, both of which are important in ensuring workable local competition.

Perhaps paradoxically, the practice of deregulation has much to gain when coupled with aggressive application of regulatory authority to promote competition, either under federal or state antitrust laws, or under the authority to regulate public utility licenses or franchises in the "public interest, convenience, and necessity." Regulators have been generally reluctant to apply their authority aggressively, preferring to assume that the promise of future competition resulting from the relaxation of regulatory and other barriers to entry will be sufficient to cause workable competition to develop.

No regulatory body can create competition where there is none: the best a regulator can do is create conditions that foster competition and induce entry. Effective deregulation requires workable competition to maintain the public interest. Proactive application of antitrust principles by regulators may be required for deregulatory policy to work. Attempts by local regulators to impose proactive, procompetitive conditions on the AT&T-TCI merger are instructive. Had they succeeded, they would have set a precedent for greater procompetitive activity by regulators. Regulatory powers and regulatory mindsets are sorely tested by the recent wave of mergers and by the new emphasis on competition. Regulatory bodies may have to continue applying ingenuity in creating policy and calibrating their powers to meet the new challenges.

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FOREWORD

David Chessler examines the successes and failures of regulation in the "first era" of telecommunications competition and contrasts the lessons learned with the current era. He concludes that both the public interest standard that underlies regulation and the antitrust competition standards need to be reexamined in terms of their usefulness in telecommunications mergers.

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CHAPTER 1

EVALUATING THE SUCCESSORS TO CONVENTIONAL REGULATION

Competition is being introduced in place of regulation in all segments of the traditional utility markets except water supply. Thus, we find efforts to introduce competition into the generation of electricity and the supply of gas, retaining regulation on the distribution of these products to consumers. In telecommunications, after an early success in introducing competition to the provision of customer premises equipment, and a slower-developing success in the provision of interstate and international toll calling, markets have been opened for the competitive provision of local telecommunications service. Where monopoly still rules the majority of states have modified regulation to improve the public utility firm's incentives to provide service at low cost: tools such as price caps and incentive regulation have been widely adopted in place of conventional ratebase, rate-of-return regulation.[1]

For most of the nineteenth century, the promotion of competition was the principal method of control of what are now considered public utilities. In this "first competitive era," even when other methods of control were used, such as franchise restrictions and various early forms of regulation, government promotion of competition remained a very important constraint on the incumbent utility. It was only toward the end of the century that public opinion began to swing against competition as a control for public utilities.

[1] Jaison R. Abel and Michael E. Clements, *A Time Series and Cross-Sectional Classification of State Regulatory Policy Adopted for Local Exchange Carriers: Divestiture to Present (1984–1998)* (Columbus, OH: National Regulatory Research Institute, 1998).

Why did the public give up on competition? What were the market failures that were perceived as so severe and so pervasive that they caused legislation, not just at the federal level but in nearly all states, that fundamentally reshaped the paradigm of capitalism? In the early nineteenth century, economic regulation became pretty much a dead letter in the United States, with primary emphasis on governmental aid for development of transportation and agriculture. By the end of the century it was reinvented in a new form, in response to the action of the unfettered market, and would continue to grow and develop for another three-quarters of a century.

Although much has changed from the nineteenth century, especially technology, market power issues are relevant in any era. As competition is substituted for regulation at the beginning of the twenty-first century, it may well be worthwhile to address the issues that caused competition to fail after a half-century of vigorous and enthusiastic trial. Competition was fostered in the nineteenth century by mechanisms such as deliberately supporting and even subsidizing competitors in a manner that would be unacceptable today. On the other hand, today there are antitrust laws that, if vigorously enforced, may address some of the problems that bedeviled competition in the nineteenth century. The antitrust statutes began to appear at about the same time as the modern regulatory commissions, and were rarely applied in the first competitive era or early regulatory era. Today they are likely to be an extremely important tool to promote workable competition.

This report is one piece of an ongoing effort by the NRRI to anticipate and elucidate possibly appropriate successor regulatory regimes to ratebase, rate-of-return regulation. Other recent work in telecommunications includes an assessment of the evidence on performance of price cap regimes, a report on balancing the conflicting demands of

universal service and competition, and a paper delineating several dozen different approaches state regulators might take going forward.[2]

The Shrinking Sphere of Ratebase, Rate-of-Return Regulation

In recent years, conventional regulation, as it developed over the past century or century and a quarter, has come under intellectual attack for a variety of failings, some real, some alleged. It has been argued that traditional regulation caused the regulated firms to become inefficient and slow to innovate. It was claimed that regulated firms have a tendency to overinvest and to provide a "gold-plated" level of service. It was assumed that the purported consumer protections provided by the regulators were weak, since the regulators were "captured" by the regulated and tended to support the interests of the industry.

Regardless of the strength or weakness of the empirical evidence for most of these effects,[3] for over two decades, academicians, regulators, and legislators have considered ways of improving or replacing ratebase, rate-of-return regulation, regulators began to encourage competition in sub-markets where its introduction seemed feasible and tried to

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[2] Jaison Abel, *The Performance of the State Telecommunications Industry Under Price-Cap Regulation: An Assessment of the Empirical Evidence*, Columbus, OH: NRRI, 2000; Phyllis Bernt, *Balancing Competition and Universal Service: The Role of the Regulator Five Years After the Telecommunications Act* (Columbus, OH: NRRI, March 2001), Raymond Lawton, "Successor Regulatory Regimes: A Transition to What?", *NRRI Quarterly Bulletin,* Vol. 20, No. 1 (Spring 1999).

[3] There is little or no empirical evidence validating the economic theories that, for example, ratebase, rate-of-return regulation causes utility firms to overinvest or to substitute capital assets for labor (the so-called "Averch-Johnson hypothesis," after Harvey Averch and Leland L. Johnson, "Behavior of the Firm Under Regulatory Constraint," *American Economic Review,* Vol. 52, no. 5 [December 1962], 1052–69). All the "evidence" in that article and several others that made similar claims for other industries is anecdotal. (See Fred M. Westfield, "Regulation and Conspiracy," *American Economic Review,* Vol. 55, no. 3 [June, 1965], 424–43; and Stanislaus H. Wellisz, "Regulation of Natural Gas Pipeline Companies: an Economic Analysis," *Journal of Political Economy,* Vol. 71, no. 1 [February 1963], 30–43.) Nearly all subsequent studies have found no measurable effect; a few have been inconclusive or have found slight effects.

improve efficiency by substituting price caps, "incentive" plans, and other alternatives to what had become conventional regulation. Eventually, attempts were made to extend competition to markets for which there was little a priori evidence suggesting that it could work. Workable competition[4] normally provides all the consumer protection that should be necessary, but, for a variety of reasons, competition in many important submarkets of the utility industries has not yet become workable; most of these markets remain subject to some form of regulation. Yet many of the alternative regulatory plans now in use eschew the detailed and careful examination of tariff rates and provisions that was once claimed to be a major protection for consumers, and has been more recently claimed to be a major protection for nascent competition.

Much of the recent effort to introduce competition into the public utility industries reflects the emergence of new technologies. In some instances, as in the case of electric generation, the new technologies are new production methods that make it possible for new suppliers to enter the industry. In the case of telecommunications, interindustry competition relies on new technologies that permit what had previously been separate industries (that is, the firms operated in almost completely separate markets, providing different services to different customers and even different types of customers) to compete with each other. In most instances the industries appear to remain distinct (at least, so far) but the products become partial substitutes for the products of other industries. In some instances, the policy shift reflects only an *expectation* that new technologies will permit competition to develop. For example, wireless alternatives to copper or fiber local loops have been promised, but have not yet garnered appreciable market shares.[5] Indeed,

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[4] David Chessler, *Determining When Competition is "Workable": A Handbook for State Commissions Making Assessments Required by the Telecommunications Act of 1996* (Columbus, OH: The National Regulatory Research Institute, 1996). (Hereinafter, *Workable Competition*.)

[5] Peter S. Goodman, "AT&T Plans Local Push with Wireless Twist," *Washington Post,* November 24, 1999, E1.

competition between cable and telephone companies has been predicted for two decades,[6] and is only beginning to arrive—so far, mostly for broadband rather than message services.

The Telecommunications Act of 1996 imposed a new statutory requirement for "affordable rates," and imposed new requirements that most incumbent local telephone companies provide facilities and services in support of local competition. Similarly, orders or decisions permitting mergers, by states and the Federal Communications Commission (FCC), have conditioned permission to merge on the utility's behaving in certain ways, such as extending service, promoting competition, or both.[7] For years, state regulatory commissions and state legislatures have been imposing similar requirements for improvements in service, network modernization, or network extensions, in exchange for granting a request by a utility, usually for an alternative form of regulation. In addition, some

[6] See, for example, David Chessler, "The 1982 Consent Decree and the Future of the Telephone Industry," *Public Utilities Fortnightly*, Vol. 109, No. 5 (March 4, 1982).

[7] Applications of Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer Control of Corporation and Its Subsidiaries, File No. NSD–L–96–10, Memorandum Opinion and Order, August 14, 1997, (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1997/fcc97286.wp, September 7, 1998). (Hereinafter *BA- Merger Order.*) We will discuss this merger at length below, because it contains, at paragraphs 26, 43, 45, 105, *et passim,* a specific finding that Bell Atlantic had been about to compete directly with in the provision of local service, and this competition was foreclosed by the merger. (It also found at, paragraph 45, that the merger made it more likely that the remaining competitors in the New York market might coordinate their actions.) In exchange, in appendices C and D, and at various paragraphs in the Order, the FCC imposed certain behavioral requirements, of limited duration on the merged firm. The requirements were to have been in place for forty-eight months (see paragraph 181 of the *Order*), but the FCC is now reconsidering this period.

states and public utility commissions are considering moral behavioral constraints on public utilities through various codes of conduct, often under the rubric of a consumer bill of rights.[8]

Analogies to the Nineteenth Century

The United States has nearly a century of experience with alternative forms of regulation. Throughout the nineteenth century, the Congress and state legislatures relied heavily on competition to constrain the public utility and transportation firms. Moreover, they imposed a great many positive and negative behavioral constraints or requirements upon these firms, either in the corporate charters or in the franchises under which the firms operated. Thus, the common method of social control for half a century, from the 1830s to the 1880s, bears a striking resemblance to the methods of social control of industry that are again becoming fashionable. Regulation was for the most part adopted only toward the end of the century, and originally stressed investigations. The modern form of ratebase, rate-of-return regulation appeared at that time.[9]

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[8] The very earliest public utility commissions, between 1860 and 1870, used investigation, exposure, and moral suasion as their principal means of affecting the behavior of public utilities. After 1873, commissions began to get authority to set rates directly. There is some current discussion of reviving some elements of this approach. See Vivian Witkind Davis, *A Critical Perspective of a Telecommunications Bill of Rights* (Columbus, OH: National Regulatory Research Institute, 1999).

[9] The first Supreme Court case addressing ratebase, rate-of-return is Smyth v. Ames, 169 U.S. 466 (1898), a quarter-century after the establishment of an Illinois railroad and warehouse commission, one of the very earliest of the modern commissions, that was involved in the Smyth case and that served as a model for other states. This commission was established in 1871, and was given authority to prescribe maximum rates in 1873. Martin G. Glaeser, *Public Utilities in American Capitalism* (New York: Macmillan, 1957), 63. The present Illinois Commerce Commission was established in 1914. U.S. Senate, Subcommittee on Intergovernmental Relations, *State Utility Commissions: Summary and Tabulation of Information Submitted by the Commissions,* 90th Congress, First Session, Senate Document No. 56 (Washington: Government Printing Office, 1967), table I facing 6.

There is now a popular view that much of the early impetus for regulation stemmed from the industry itself, which sought to use regulation to "rationalize" the industry, promoting monopoly and eliminating price wars and other forms of instability. While there is evidence in favor of this relatively recent reinterpretation of the history, the contemporary view was that the impetus for regulation stemmed from the failure of competition to restrain the exercise of market power by the incumbent utilities. Indeed, even the instability that may have been a manifestation of the working of a competitive market was seen by contemporaries as an undesirable impediment to the smooth provision of services as needed, when needed, with regularity in the supply.

In addition to the promotion of competition, including inter-industry competition, a second approach commonly used in the nineteenth century was to impose formal requirements on the utility firms. In the earliest stages these were usually embodied in the charters or franchises of the firms; later they were embodied in statutes. A franchise was originally considered at law as a grant of special privilege, which could be revoked or modified by the granting agency. The Dartmouth College Case reinterpreted franchises as contracts that could not, constitutionally, be unilaterally modified or abrogated.[10] Just as specific enforcement of the franchise contract was usually impractical in the nineteenth century, so, too, was specific enforcement of statutes. Moreover, there was often legal hostility to suits in public utility cases: sometimes the amounts in question were small, at

[10] Since the consideration given by the franchisee (the utility) is often obscure, and is rarely explicit, it has been difficult to enforce franchises as contracts; it has been difficult to show that the franchisee has violated the contract by failing to deliver the appropriate consideration. Moreover, in those instances when it has been possible to show a failure on the part of the franchisee, the available remedy, abrogating the franchise and replacing the franchisee, usually involves a serious disruption of service to the immediate detriment of the public, however the public may be expected to benefit in the long run. [In some instances, discussed below, franchising authorities have been able to make effective use of franchise revocation or other specific enforcement of franchise terms. Although the courts are increasingly restricting this authority particularly when it conflicts with federal and other statutes.] "The objects for which a corporation is created are universally such as the government wishes to promote. They are deemed beneficial to the country, and this benefit constitutes the consideration and, in most cases, the sole consideration of the grant." Dartmouth College v. Woodward, 4 Wheaton 518, 637 (1819).

least for each individual consumer; sometimes the case hinged on a failure to serve, so crafting an effective remedy would require the court to involve itself in the management of the firm; sometimes the case involved differences in quality of service, or the firm's competing directly with its customers, or some other situation in which damages might be hard to determine. Very often adjudicating public utility cases requires specific and detailed technical knowledge of the utility industry; courts typically lack this knowledge, and it is impractical for them to attempt to acquire it for what may be an isolated case. These difficulties led, starting in the middle and especially at the end of the nineteenth century, to the development of public utility commissions to enforce franchise terms, assume statutory responsibilities, and deal with other perceived market failures.

The use of franchises has correlates in the most recent approaches, in which legislatures or commissions impose behavioral constraints or require specific behaviors when granting utility requests to change the form of regulation or to merge. The analogy to the present period is striking: the Telecommunications Act of 1996,[11] for example, attempts to promote competition, but also imposes behavioral requirements on the incumbent firms (that is, to permit resale of their services and facilities), and a system of incentives for procompetitive behavior on the Bell companies. Moreover, the Act adds a new national policy goal and new requirement: in addition to rates being "just and reasonable," and that the commissions promote "universal service," rates must now be "affordable."

In the present situation behavioral requirements have sometimes been imposed for specific periods, even in the absence of evidence that they will not be needed at the end of the period. Other times behavioral requirements are imposed, but the specific enforcement has proved difficult. Examples abound. For example, in the last decade and a half, cable rates were deregulated, reregulated, and deregulated again, always on the

[11] Telecommunications Act of 1996, Public Law 104–104, 110 Stat. 56, codified as various sections of 47 U.S.C. §§ 151–614.

expectation that impending competition would eliminate the need for regulation: each deregulation has been followed by a period of rapidly rising rates. Competition in the generation of electricity has not resulted in promised reductions in rates to the majority of consumers, except where such reductions were required by statute, and some residential and most small business consumers have experienced increases in rates due to recovery of the costs of stranded plant.[12] Enforcement of the provisions for sale of local exchange "network elements" and services has proved difficult and cumbersome, despite statutory provisions for expedited review, arbitration, and other innovative procedures. Incumbent local exchange carriers are just beginning to be found in full compliance with statutory obligations under Section 271 of the Telecommunications Act of 1996.

The proposed codes of conduct and of consumer bill of rights[13] have some obvious parallels with franchise and statutory obligations of utilities in the last century and discussing the problems of enforcement that were then found. It was expected then that competition would effectively constrain the market power of the utility firms, and that franchise or statutory requirements would provide necessary consumer protections where competition failed to do so. Add consumer bills of rights to the mix, and the theory is the same today. And, again, current theory is that some mix of competition, consumer bills of rights, franchise requirements, and statutory provisions can substitute for regulation in

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[12] That is, the rapid write-off of public utility assets that cannot pay for themselves in a competitive environment. A similar situation occurred with respect to telephone rates in the 1980s: more rapid depreciation of telephone assets "in preparation for competition" led to rises in rates for exchange services and even for toll services for small users, after years of steady decline (there were also some costs of network reconfiguration, though these were alleged to be relatively minor). For details, see David Chessler, *The Effect of Toll Competition on Prices, Costs and Productivity of the Telephone Industry in the United States: Report to the Canadian Radio-television and Telecommunications Commission and the Joint Federal-Provincial Examination of Competition in Public Long Distance Telephone Service* (Hull, Que.: Canadian Radio-Television and Telecommunications Commission, December, 1988, and Bethesda, MD.: David Chessler and Associates, January, 1989). (The *"Sherman Commission Report,"* Volume 4.) Hereinafter, *Toll Competition.*

[13] Davis, *Telecommunications Bill of Rights.*

providing low rates, innovative services, and consumer protections. Thus, it will be instructive to examine the effects of such a mix of policies when they were tried in the absence of regulation.

The large reductions in toll rates in telecommunications occurred only after years of relatively minor reductions for all but the largest customers (and even increases for some customers), as market share of the dominant firm fell slowly until it fell below critical levels needed by the dominant firm to sustain its market power.[14] Similar reductions in rates for station equipment occurred relatively quickly, as market share dropped precipitously. Rates for yellow pages advertising have not been reported to have dropped: most of the alternative yellow pages that were begun in the early 1980s, right after divestiture, have vanished, and competition from the Internet or other sources does not, as yet, appear to have exerted a measurable effect reducing advertising rates.[15]

Today's Confluence of Commission Regulation and Antitrust

At the end of the nineteenth century there were two major innovations: the first was the invention of the modern regulatory commission and ratebase, rate-of-return regulation; the second was the development of antitrust laws. Now, at the beginning of the twenty-first century, these two inventions are converging. In particular, the passage of the

[14] Recognizing that simulation models are no better than their assumptions, it has been shown that, under plausible conditions, if relatively small firms enter a market in which a dominant firm charges high prices (that is, it exercises market power), the entrants will, for a possibly protracted length of time, charge low prices while the dominant firm continues to charge high prices. Eventually, however, as the entrants achieve more substantial market shares the prices of then entrants will rise to meet that of the dominant firm (which will, by then, have lowered its price because, with loss of market share, it will have lost market power). Richard E. Schuler and Richard E. Schuler, Jr., "Predicting the Exercise of Market Power in Formerly Regulated Utility Markets," paper presented at the Transportation and Public Utilities Group, American Economic Association, January 7, 2000.

[15] Chessler, *Workable Competition.*

Telecommunications Act of 1996 represented an attempt to reinstate competition as the major means of control in a public utility industry. It was not the first such attempt;[16] it was however, an attempt to introduce competition in segments of the telephone industry[17] that were, at the time of passage, showing relatively little signs of becoming competitive in general, though elements of competition were appearing in some submarkets. Thus, the telecommunications industry is a case study into whether competition can be fostered in an industry, and whether the competition so fostered can work in conjunction with regulation to the public benefit, or even to effectively reduce the need for regulation.

However, there is no doctrine of how to coordinate competition policies with regulation. Indeed, there is an inherent contradiction between the "public interest" standard for decision-making by regulators (that is, public service commissions), and the competition standard used in antitrust. Thus, Congress specifically removed the FCC's primary jurisdiction under the Clayton Antitrust Act, largely because of the inherent conflict and the inappropriateness of giving a regulatory agency authority to insulate a merger from antitrust scrutiny.[18] It is well-established among empirical economists that only actual competitors with non-trivial market shares have any measurable effect on the prices and practices of dominant firms. Indeed, the only arguments to the contrary—that is, that potential competitors or very small competitors are significant—come from theoretical economists who rely on an extreme model to derive some conclusions—conclusions that

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[16] Deregulation of the airline (the Airline Deregulation Act of 1978), railroad (Railroad Revitalization and Regulatory Reform Act of 1976), and trucking (Motor Carrier Act of 1980) industries came first, and there has been a steady introduction of competitive market structures in various submarkets of the electric industry since the Public Utility Regulatory Policies Act (PURPA) in 1978.

[17] That is, "Local Exchange Service" and "Exchange Access" (the provision of access to interexchange [that is, "toll" or intercity services]).

[18] U.S. House of Representatives, 104th Congress, Second Session, "Telecommunications Act of 1996, Conference Report," Report 104–458 (January 31, 1996), 92, 200. Bills pending in Congress would remove even more of the FCC's authority over mergers, including the authority to use its authority over the transfer of licenses to impose conditions on mergers. GAO, *LEC Merger Review,* 8, fn. 9. At this writing, none of those bills has been voted upon.

they have, thus far, been unable to show to be applicable in a policy sense.[19] However, since local service competition was generally legally precluded prior to passage of the Telecommunications Act, the FCC had to develop and apply doctrines of "actual potential competition,"[20] and "precluded competitor analysis."[21] Since the passage of the Telecommunications Act of 1996, which is generally interpreted to have established a national preference for competition rather than regulation in telecommunications, there have been several instances in which regulators have had to choose between more or less competitive market structures in various telecommunications markets. It is interesting to observe that in some major cases the FCC has acted in such a way as to require continued regulation and to make it less likely that workable competition will develop.

Organization of Paper

A careful review of the American experience in the nineteenth century will identify market failures that continued to occur despite competition and restrictions on the firm in

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[19] For details, see Chessler, *Workable Competition,* 29–31, 34–35, and the sources there cited.

[20] Taken from the Justice Department–Federal Trade Commission merger guidelines, the doctrine refers to "whether, in the absence of a merger, one of the merging companies is likely to successfully enter the other's market, and on whether competition in the market will be substantially lessened by the elimination of such entry. To show that a firm is a potential competitor, however, it is important to have evidence that the firm was actually planning or at least considered entering the market in question." General Accounting Office, *Telecommunications: Process by Which Mergers of Local Telephone Companies are Reviewed,* GAO/RECD–99–233, August 20, 1999 (available as http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.21&filename=rc99223.pdf&directory=/diskb/wais/data/gao, on January 5, 2000), 12. (Hereinafter, *LEC Merger Review.*) According to the GAO, the courts have differed on the standard of proof required to show that a firm intended to enter a market. *Ibid.,* 12, fn. 17.

[21] Since it is difficult to prove that entry was likely if a firm did not enter a market, and since, in any case, the standard was "difficult to apply" in "nearly monopolized" markets, in which "laws, regulations, and related requirements" prevented the firms from entering each other's market areas, the FCC developed the "precluded competitor" framework to "protect the interest defined by the Communications Act." In this analysis, the FCC attempts to determine the likelihood that a firm would have entered a market if it had not been legally precluded from doing so. GAO, *LEC Merger Review,* 12–13. There are few studies of potential entry, and there is no way to predict whether or when it will occur, if ever. Shepherd, *Economics of Industrial Organization,* 277.

franchises and corporate charters. In Chapter 2 we review the past to identify problems that may recur in the public utility industries if they are unregulated and from the review of the past and some more recent experiences, discuss the tools that will be appropriate for utility commissions to retain in an era in which strict ratebase, rate-of-return regulation is no longer the norm.

Antitrust protections stand out in their potential to mitigate market power in today's competitive era, but the current confluence of regulatory and competitive issues presents conflicts in the antitrust arena. Much of this report is devoted to an examination of recent merger cases before the Federal Communications Commission (FCC) to elucidate these problems. In particular, in Chapter 3 we look at mergers in three segments of telecommunications – incumbent local exchange carriers, interexchange (toll) and cable television; moreover, we look at joint marketing arrangements in Internet access. In each of these cases, regulators have adopted long-term regulatory procedures to deal with the immediate anticompetitive effects of the merger or other action.

Chapter 4 briefly summarizes the report and draws attention, based on experience in the far and recent past, to tools that will be appropriate for commissions to retain and actively use in an era in which ratebase, rate-of-return regulation is no longer the norm.

CHAPTER 2

THE EXPERIENCE OF THE FIRST COMPETITIVE ERA

Contrary to popular impression, commission regulation did not arise during the New Deal, nor even in the century just past. Rather, regulation, in its modern form, arose shortly after the Civil War and was widely adopted well before the beginning of the First World War. The first half of this fifty-year period is commonly said to be characterized by unfettered capitalism and widespread competition, even in the public utility and transportation industries, yet many of our present institutional controls of regulation and antitrust were invented and put into effect in many states well before the end of the nineteenth century; the early years of the twentieth century were characterized more by the extension of regulation to additional states and industries.

Throughout most of the nineteenth century the principal regulatory tools were competition and the restrictions in corporate charters and, after the middle of the century, in franchise agreements. Some commissions existed throughout the century, but the commissions did not develop their modern forms until after about 1870. Thus, the history of this period presents an interesting and potentially important question for regulators today: Why did the public and the legislatures give up on competition?

In this chapter I present a framework to analyze the history of the utility industries and the viability of their markets. I discuss the regulatory tools that were used in the nineteenth century. I discuss the problems that persisted despite repeated attempts to promote both direct and interindustry competition, and despite a wide variety of efforts

to constrain the utility firms. I extend this analysis by discussing the reasons attempts to ensure competition were abandoned in the last quarter of the nineteenth century, despite their apparent success in lowering prices.

A Framework for Analysis

Martin Glaeser identified four overlapping periods in the history of American public utilities:

1. A promotional period extending from Colonial times to past the middle of the nineteenth century;
2. An essentially competitive period extending from about 1850 to the end of the century;
3. An essentially monopolistic period beginning gradually in the 1880's and extending to the beginning of the great depression in 1929; and
4. A period of national coordination and planning, with public ownership and public regulation jointly effective in achieving certain public ends, among which conservation of natural resources plays a leading role.[22]

We may add that the fourth period began to be phased out in the 1970s, and we are currently in the midst of a transition to a fifth period.

5. Restructuring, intra- and interindustry competition, market entry, deregulation, and technical innovation.

This chapter focuses on Glaeser's competitive era, drawing comparisons with the current period of restructuring and competition (see Table 2-1).

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[22] Martin G. Glaeser, *Public Utilities in American Capitalism* (New York: Macmillan, 1957), 14.

In a widely quoted passage, Carl Kaysen and Donald F. Turner identified three situations (that is, three forms of market failure) in which regulation or other alternatives to competition may be required:

1. Situations in which competition, as a practical matter, cannot exist or survive for long, and in which, therefore, an unregulated market will not produce competitive results.
2. Situations in which active competition exists, but where, because of imperfections in the market, competition does not produce one or more competitive results.
3. Situations in which competition exists, or could exist, and has produced or may be expected to produce competitive results, but where in light of other policy considerations, competitive results are unsatisfactory in one or more respects.[23]

By way of contrast we note a fourth situation, the normal industry in which regulation is *not* required:

4. Industries in which competition works, or in which the market failure is not of such nature or seriousness as to call for public utility treatment.

[23] Carl Kaysen and Donald F. Turner, *Antitrust Policy: An Economic and Legal Analysis* (Cambridge: Harvard University Press, 1959), 189–90, quoted in Charles F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice,* Third edition (Arlington, VA.: Public Utilities Reports, 1993), 50.

Table 2-1

U.S. Regulatory Regimes and
Their Impact from Colonial Times to the Present

Period	Type of Regime	Assumptions about Utility Markets	Policy Frame-works	Regulatory tools	Results
19th century	Competitive	Competition could work	Encourage entry, including intra-industry and inter-industry competitio n	Corporate charters and franchises Judicial control Local regulation Public ownership	Competition was effective but was increasingly unsatisfactory
1880s to 1929	Monopolisti c	Competition would be imperfect	Tight regulation	Commission regulation	Largely satisfactory inhibition of monopoly power
1930s to 1970s	National coordination and planning	Competition would be imperfect	Tight regulation	Commission regulation	Largely satisfactory inhibition of monopoly power
1970s-present	Competitive	Competition can work	Encourage entry	Restructuring Deregulation Antitrust Consumer protection and education	Regulation was increasingly unsatisfactory; competition has had some success

Source: Author's construct

Glaeser's promotional and competitive periods, which maybe called"the first competitive era" or the pre-regulatory period, were characterized by a belief that competition could be made to work. Governments tried to promote competition both as interindustry competition, even in the form of having competing firms providing similar

services. Although this first competitive era predates the invention of the telephone, we may examine its history for some inklings of the specific regulations or type of regulations that may continue to be required if the industry is workably competitive (or even partially competitive), as in Kaysen and Turner's cases 2 or 3. The major regulatory tools used during this time were corporate charters and franchises. Local regulation, judicial regulation and public ownership were also used.

Partly as a result of government efforts to promote competition, there was a substantial amount of imperfect competition in the utility industries in the nineteenth century. These were primarily the transportation industries—railroads and competing industries such as rivers, canals, and road transport—at that time.

In the "monopolistic" period and the period of national coordination and planning, the prevailing assumption about utility markets was that an unregulated market would not produce competitive results (Kaysen and Turner's case 1). Tight regulation through commissions and ratebase, rate-of-return regulation became, and remained, the norm. The results were largely satisfactory for this long time period, which began in the 1880s and extended through the early 1970s.

Regulatory Tools in the First Competitive Era

In addition to competition, there were experiments with a wide variety of what we would now call "non-commission forms of regulation" throughout the nineteenth century. Non-commission forms of regulation in the first competitive period included public ownership, judicial regulation, local regulation and charter regulation. I will briefly examine the first three of these regulatory tools and more closely examine the experience with the most important, charter or franchise regulation.

Public Ownership

Public ownership has not recently been at issue in the United States or Canada, except for large water and hydroelectric projects, and, while it has been the norm in Europe and parts of Africa, Asia, and Latin America in transportation, electric utilities, and telecommunications, even there the recent trend has been to "privatize" some of these utilities, particularly in telecommunications. However, the failure of public ownership in the United States in the first half of the nineteenth century
led to many of the regulatory provisions that are still enforced by public utilities commissions.

Many of the state enterprises, including state investments in private transportation enterprises (that is, railroads and canals), mostly after 1820, proved to be wasteful, corrupt, premature, and unnecessary. Much of the money (most of which was borrowed abroad) was lost; much of the debt was repudiated (but later paid) in 1837. State-owned railways were mostly sold (the modern term would be "privatized"), and state constitutions adopted after 1840 often prohibited use of state funds or loans for "internal improvements." Thus, the public facilities in this country were developed by private initiative, though often aided by public grants.[24] Water supply was the only one of the public utility industries in which state ownership was more successful than private ownership.

> As in 1830 the federal government stepped aside for state governments, so in 1850 state governments assigned to corporations the duty of furnishing the means for inland transportation. The twenty years intervening were marked by a decline in the theory that the development of a country through

[24] Glaeser, *Public Utilities,* 23.

> canals and railways was a public function, and the gradual rise of the theory that this duty was one which could with greater safety be entrusted to private enterprise.[25]

"In other words, the opinion began to gain ground that the business of a common carrier was purely private."[26] Toward the end of the competitive period, public ownership was given some consideration as a constraint on monopoly power. The best plans involved indeterminate-period franchises or renewable short-term franchises, with the option of municipal buy-out, either at any time or any time after an initial period (for indeterminate franchises) or at expiration (for short-term franchises). If a new company were substituted, it was obligated to compensate the former owner of the property. These provisions eliminated problems of amortization charges and protected the investment. The price at settlement could be arbitrated, or specified in the franchise.[27]

Judicial Regulation

In the early years of the nineteenth century, although the dominant form of control was legislative, in the form of a charter or franchise from the state government, a parallel system of judicial control developed.[28] The basis of judicial regulation was an assumed "common law" right of consumers to reasonable service at reasonable rates. This was the main form of regulation during the early nineteenth century "when ideas of laissez faire held undisputed sway." The police power of the state was "dormant."[29] Early charter-based regulation

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[25] H.C. Adams in introduction to F H. Dixon, *State Railroad Control* (New York: Thomas, J. Crowell & Co., 1896), 6, quoted in Glaeser, *Public Utilities,* 57.

[26] Glaeser, *Public Utilities,* 58, commenting on quote above.

[27] Glaeser, *Public Utilities,* 78.

[28] Glaeser, *Public Utilities,* 31.

[29] Glaeser, *Public Utilities,* 32.

assumed the railway was a public highway as an extension of the theory that the provision of highways was considered to be a state function.[30]

"Regulation by lawsuit" failed. "Judicial methods, certainly those of that period, were designed primarily to remedy past wrongs and visit punishment." Only individual grievances were addressed (not group grievances). "Regulation, in order to be effective, must be preventive and promotive as well as remedial and exemplatory." Glaeser said, in 1957, that the legislatures of the early nineteenth century had not yet learned this (that is, that regulation must be set up to prevent problems and provide incentives to behave well). The courts were too slow, and expensive: "After all, these grievances were petty and loomed large only when taken in the aggregate." But the central difficulty was that the courts were limited to reacting to actions that the utility had already taken.[31]

The training of the judges was not sufficiently specialized and technical "to assume the tasks of constructive regulation." (Now courts limit their review to matters of law, and let "quasi-legislative agencies" determine questions of fact and policy.)[32]

Charters and Franchises

Originally charter grants were special regulations. There was a great diversity of restrictions, but, since state legislatures tended to copy from each other, there was a tendency toward uniformity. After the early 1830s, general legislation permitting incorporating appeared, though some special charters continued to be granted until the

[30] Glaeser, *Public Utilities,* 57.

[31] Glaeser, *Public Utilities,* 32.

[32] Glaeser, *Public Utilities,* 32.

1870s.[33] Legislation creating general incorporation statutes was a reaction to "perfunctory, indiscriminate and even corrupt" issuance of charters "that contained all manner of restrictions and special privileges." Even so, legislatures continued to issue charters until, as in the case of railroad mergers, the resulting legal situation was very complex due to "conflicting, if not mutually exclusive privileges."[34]

An important provision of modern charters is a requirement that a federal, state or municipal agency (as appropriate, and often agencies at several levels) approve any transfer of ownership or control of franchises or operating licenses (these are often called "certificates of public convenience and necessity"). As we shall see below, this clause is important in allowing commissions to review mergers under their more flexible "public interest" powers, rather than under antitrust laws that may not be easy to apply to mergers where the firms have been local monopolies with different service areas, or between potential competitors where competition has not yet developed in the relevant market.

The first effect of general incorporation "was a recession in the vigor of regulation," since there would be little control over the operations of a corporation so established. There were abuses in corporate organization and management. "Even the power of eminent domain was often used by rival companies to defeat legitimate and sound enterprises by blocking construction or by forcing one of them to purchase needed properties at exorbitant prices."[35]

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[33] Glaeser, *Public Utilities,* 58. Even more recently, the Communications Satellite Act of 1962 (76 Stat. 419; 47 U.S.C. §§ 701–757) is a special charter with particular restrictions for the provision of communications common carrier services.

[34] Glaeser, *Public Utilities,* 58–59 and note 4.

[35] Glaeser, *Public Utilities,* 59.

Long term or perpetual (or undated) franchises did not constrain utilities to perform properly. They also led to excess profits when substantial demand appeared, which was often earlier than expected. The remedy was that when franchises expired or had to be amended, short-term franchises were substituted.[36] "Short term" in this context generally meant ten to fifty years, with many in the range of about twenty to thirty years.[37]

"On the whole, the short term franchise was a failure." Because the franchises did not terminate on the same date, and because most utilities had many franchises, "at no time could cities exercise complete control over all of them so as to work out a uniform policy of control." Some claimed that the utilities understood and benefitted from franchises that were not coterminous. Cities could not take over the system piecemeal, or secure bids from competitors, so incumbents had an advantage in negotiations. Also, limited term franchises often did not specify the disposition of fixed assets at termination, and some incumbents argued they could continue to provide service with those assets under their general charter.[38] The uncertainty about renewal made financing difficult toward the end of

[36] Glaeser, *Public Utilities,* 72. In the late 1960s there were still unexpired street-traction franchises. When O. Roy Chalk took over Fifth Avenue Coach in New York City, which had perpetual franchises on some routes, New York City considered the ensuing strike to be an "abandonment of service," terminated the franchises, and seized the property (busses and garages) under eminent domain. The city then used the property to provide service. The courts accepted this argument; Fifth Avenue Coach was compensated for the value of its physical property but received little if anything for the value of its routes.

[37] Glaeser, *Public Utilities,* 73.

[38] Glaeser, *Public Utilities,* 73.

the term of the franchises,[39] and companies were reluctant to build extensions. Companies tried to keep the expiration date sufficiently far in the future so that uncertainty about the renewal did not seriously depress the value of the property. One way the municipalities tried to deal with the problems caused by the proliferation of franchises with different expiration dates was by combining multiple franchises when they came up for renewal.[40]

By the turn of the century, a consensus arose that franchises should be reorganized as a system with a specific period of tenure, a grant of monopoly rights, but with regulation of service and rates. The theory was that competitors were bound to be few, consolidation was apt to follow anyway, that the difficulties of coordinating all the utilities (gas, electric, telephone, street railway) meant that unified operation would result in improved service, and large-scale operations would lead to lower operating cost.[41]

With term franchises it was even more important to limit charges for the franchise period so as to curb the exercise of monopoly power. Other terms of service and charges were also regulated. However, fixed maximum rates became obsolete with increased complexity of operations. Moreover, companies began to appreciate that they could

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[39] See the biblical economic concepts of the "sabbatical year" and the "jubilee year," leading to the adoption of the prosbul. The sabbatical year is the biblical concept that every seven years the land is left fallow. The year following seven sabbatical years (that is, the fiftieth year, is the jubilee, when all debts are forgiven, slaves are freed, and land purchased since the last jubilee reverts to its original owner. (Lev. 25:3ff; Lev. 25:8; Deut. 15) This concept has led to a recent movement to reduce the debts that underdeveloped countries (the third world) owe to developed countries (the first and second worlds) and international institutions. The original jubilee year became a significant burden on commerce, since no one would lend money shortly before the jubilee; thus, Rabbi Hillel (1st cent. BCE) devised a legal method of avoiding such repayments. There are obvious similarities to the present system of bankruptcy in the United States, and the relative ease with which former bankrupts can obtain loans (albeit at high rates of interest) soon after their bankruptcies (when it is seven years until they can again declare bankruptcy). See Cecil Roth and Geoffrey Wigoder, *The New Standard Jewish Encyclopedia,* 4th edition (Garden City, NY: Doubleday, 1970), articles: "Hillel," "Prosbul," "Sabbatical Year and Jubilee."

[40] Glaeser, *Public Utilities,* 74. This could also be used to negotiate a specific end to perpetual franchises, by including them in the general renewal. *Idem.*

[41] Glaeser, *Public Utilities,* 74–75.

increase gross and net earnings by lowering rates. If franchises were contracts, the rate, whether maximum or specific, became an inflexible term in a binding agreement. Inflexible rates were impractical and risky when multi-year arrangements were being negotiated. After 1896, increasing costs required rate increases, which could only be made by agreement of the parties.[42]

The special franchise was particularly ineffective in coping with discrimination in service or rates. Often cities and even municipal employees got free service. "Adequate service" (the common law concept) involved so many elements that it could not be specified with concrete detail. Continuity of service required prevention of strikes and lockouts, which involved municipalities in obtaining fair wages and working conditions for employees and protecting the companies against destruction of property during labor unrest. This resulted in boards of conciliation to settle grievances.[43]

In this respect it is significant that the state commission reviews of recent mergers have tended to stress problems in quality of service, and most of the conditions that the states impose on the merging parties are generally intended to secure improved service quality in the future.[44] Service quality has resurfaced as an issue in telecommunications in recent decades—and many think this loss has been exacerbated by price-cap incentives to

[42] Glaeser, *Public Utilities,* 75–76.

[43] Glaeser, *Public Utilities,* 76–78.

[44] For example, see the discussion of the conditions the states imposed upon the Bell Atlantic-NYNEX merger in chapter 3.

save by curtailing costly maintenance.[45] Economic theory provides the reasons that price cap and similar alternative forms of regulation will lead to deteriorations in service, so that service quality has to become a major focus for regulators.[46]

Local Regulation

Regulation of local utilities (water, gas, urban transit) went through an evolution similar to that at the state level. The early charters were issued by legislatures, but legislation enabled cities to issue the later charters on the theory that the grants by the legislature were "less intelligent and consistent than those conferred by the cities themselves under delegated authority." Eventually, complications led to constitutional provisions preventing the issuance of charters *"without the consent* of local authorities."[47]

Local utility regulation has again been thrust into the limelight because of its prevalence in the regulation of cable television systems. Many of these systems are, even now, also partially regulated by states as they begin to provide telecommunications service,

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[45] Interestingly, the severe service problems of 1984, and the even worse problems of 1968 to 1970 occurred in periods of conventional regulation. Indeed, regulation in the 1968 period was considered by some to be relatively "lax," which should have caused overbuilding if the Averch-Johnson effect were valid. For a description of the 1968 problems, which led to FCC monitoring of service quality starting in 1969 and the creation of the NARUC Staff Subcommittee on Service Quality in 1972, see K. Aubrey Stone, *I'm Sorry, The Monopoly You Have Reached Is Not in Service* (New York: Ballantine Books, 1973), or, for another view, Alvin von Auw, *Heritage and Destiny: Reflections on the Bell System in Transition* (New York: Praeger, 1983), 10-13. There was a rumor that the service problem in New York City was caused by a president of New York Telephone who was three years from retirement, and who reduced maintenance and equipment expenditures so his last years in office would look very good financially. Supposedly, the deterioration in service quality he foresaw but dismissed manifested itself in two and one-half years rather than three. This rumor is supported by an acknowledged AT&T policy at that time of trying to reduce service costs rather than increase rates. Compare the version in John Brooks, *Telephone* (New York: Harper and Row, 1975), 288-295, esp. 293-294.

[46] Jean-Jacques Laffont and Jean Tirole, *Competition in Telecommunications*, chapter 2.

[47] Glaeser, *Public Utilities,* 36, (emphasis in the original).

even though the FCC has resisted regulating cable television as common carriage.[48] As cable television systems become one preferred means of accessing the Internet, the application of nondiscrimination clauses has become a major issue. Such clauses have been part of common carrier regulation for well over a century.[49]

In the later years of the nineteenth century, when general charters became available, the situation was the same with respect to municipal utilities, incorporated under general law and obtaining their franchises from local governments. Regulatory clauses were weak or absent in the general laws. "The familiar charges of fraudulent capitalization, over-capitalization, and exorbitant and discriminatory rates date to practices that crept in during this period." There were legal questions as to whether the city, in granting the franchise, could impose additional restrictions or conditions on the corporation beyond those in the general law. Cities tried to "protect themselves" by granting competing franchises, often with no restrictions to protect the interests of the city or the public. "Thus here, as in the railway field, the belief prevailed that competition was the best regulator and that governmental regulation was unnecessary where competition existed." "Consolidations and mergers placed upon the final incumbent an unnecessary duplication of investment, besides keeping alive in some of the cities the terms of the competing grants."[50]

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[48] It prefers to regulate it as ancillary to broadcast.

[49] The "Lord Shaftsbury Clauses" of early English railroad charters were the direct antecedent of the antidiscrimination language of the Interstate Commerce Commission Act and all later statutes regulating discrimination by public utilities. See Isaac Beverly Lake, *Price Discrimination by Railroads and Other Public Utilities* (Raleigh, N.C.: Edwards and Broughton Co., 1947), 14–15, 23, 37.

[50] Glaeser, *Public Utilities,* 59–60.

Failures of Corporate and Franchise Regulation

There were several reasons for failures of the corporate charters and franchises as regulatory tools.

To begin with, as discussed above, the specific terms of franchises and corporate charters were difficult to enforce in the courts. Because the amounts at issue were small in individual cases, the courts tended not to take the lawsuits seriously.[51] Even when lawsuits were feasible, the legal delays were often excessive. In instances where a rate discrimination was a burden upon competition or small business, this was intolerable. Eventually the courts began to treat the franchise or charter as a contract rather than a grant of privilege from the sovereign; when this happened canceling the franchise ceased to be an option, because the "consideration" being provided by the utility was unclear. Hence, it was difficult to cancel the franchise on the grounds that the utility had failed to provide the service. Finally, the courts lacked specific technical expertise or training to deal with utility matters, which caused further delays in the trials, and led to judicial confusion.

A second reason that franchises and charters fell out of use as regulatory tools is that they were inflexible. This was particularly a problem during periods of declining

[51] Indeed, this would still be a problem today. For the individual consumer the amount at issue is often too small to merit a lawsuit. Only a class-action lawsuit would merit the legal expenses from the consumers' point of view. However, consumer advocacy offices are typically poorly funded, and do not usually engage in class action lawsuits. In fact, class action lawsuits have rarely been used in the public utility arena. Moreover, most deregulatory plans assume that tariff filings will no longer be necessary, or, if they are still made, will not be contested or adjudicated. Thus, deregulation may bring back one of the serious problems of the last century.

prices:[52] the price limits in the charter or franchise were not effective constraints. The renegotiation of terms occurred at rare intervals, or when additional franchises were needed. Hence, it did not necessarily occur when it was economically necessary.[53] Indeed, since the terms of the franchises were often developed individually for each situation, utilities often found that they held many franchises with conflicting or even contradictory terms.

On the other hand, general corporate charters (that is, corporate charters under the general incorporation statutes that developed toward the middle of the nineteenth century) did not provide for necessary oversight for public utility corporations. Indeed, general corporate charters did not provide necessary restrictions and responsibilities appropriate to a public utility, such as the requirement to serve and set prices in a nondiscriminatory manner.

One attempt to develop charters appropriate to the utility industry was to have them expire: the charters could then, in principle, be modified at reasonable intervals. This also failed. Expiration created uncertainty: there were financial issues when the franchise had only a short term remaining, making it difficult to raise money. Moreover, charter provisions had to provide for valuation and transfer of assets when the franchises expired. In any

[52] Prices of utility services have generally tended to fall relative to prices elsewhere in the economy, and even absolutely. This is usually because of the high rates of productivity increase in the industry. However, utility prices also fall as competition becomes effective. Thus, the late nineteenth century was a time of declining utility prices, yet it was the time when franchise regulation coupled with competition were supplanted by the commission form of regulation.

[53] In the modern context, commissions or other regulators can modify the terms of existing charters and franchises (now usually called "certificates of public convenience and necessity," but still called franchises in the cable television industry) when mergers or changes of ownership occur. As discussed elsewhere herein, this leads to the commissions reviewing quality of service as a condition for telephone mergers and discriminatory access in the case of cable mergers.

event, most utilities had many charters (for various routes, services, localities, and so forth), and the charters expired at different dates, so there was never an ideal time to renegotiate the charters.

Promotion of Competition in the First Competitive Era

Competition was the most important, most prevalent, and most successful method of social control of vital industries of all those tried in the nineteenth century. Legislatures and the congress used both intra-industry and interindustry competition: they franchised and even subsidized competitors. They set up and encouraged firms to compete with each other. They did not seem to be concerned by the duplication of facilities and overbuilding. Indeed, for many years they tolerated (or recognized but apparently did little to prevent) financial crises, financial failures, and even frauds attendant on the construction and operation of multiple competing utilities. This was most obvious in the transportation industries, which were the principal utilities of the day, but it occurred in other industries, such as telecommunications (that is, telegraph, and, at a the end of the period, telephone), and manufactured gas.

Throughout the nineteenth century, states and sometimes the federal government promoted interindustry competition. This is most obvious in the transportation field, where canals, riverboats, and other waterways, competed with railroads. The evidence shows that this competition was extensive and the effects are clearly measurable in lowering rates and promoting development in regions where such competition existed. Still, by the 1870s, the first glimmerings of the modern system of commission regulation had begun to appear, and by the 1880s public opinion was clearly switching. Thus, interindustry competition in the absence of regulation in the nineteenth century may do much to inform our analysis of interindustry competition as a substitute for regulation in the twenty-first century.

Railways began to compete with canals in the 1840s, and began to dominate transportation in the 1860s. Canals and turnpikes became feeders or supplements to the railways.[54] Thus, Glaeser argues, the only feasible form of competition was rivalry between railway lines.

From 1840 to the end of the century transportation was somewhat competitive, with limited intermodal rivalry between water and railway routes.[55] River (steamboat) traffic declined after the railroads decided to compete directly in 1879.[56]

Success of Competition in Reducing Rates

In retrospect, interindustry competition was effective at controlling the level of rates, at least, on a gross level. Indeed, it was widely supported and affirmed by congressional investigations as late as 1874.

The evidence suggests that even after the passage of the Granger laws and the establishment of the first modern commissions, with authority to regulate prices and prevent

[54] By the mid-1840s, there were 3,400 miles of canal in the United States, but, by 1840, only 2,800 miles of railroad, nearly all of it built in the preceding decade. However, by 1854, over 3,400 miles of railroad *per year* were being constructed. Benjamin M. Friedman, *Day of Reckoning: The Consequences of American Economic Policy Under Reagan and After* (New York: Random House, 1988), 224–225.

[55] Glaeser, *Public Utilities,* 40.

[56] Glaeser, *Public Utilities,* 41.

discrimination,[57] competition continued to be effective. Prices continued to drop until the end of the century, and there is evidence, that the inter-modal competition between rail and water transportation had a large and measurable effect on the price of farmland.

In 1890 most of the area of feasible commercial agriculture in the United States was within 40 miles of the major waterways (ocean, lake, river, or canal, including some canals that had been abandoned by that date). This was reflected in land prices: within the feasible region improved land was worth $25.16 per acre; outside the region, it was worth only $17.34. This is particularly clear in Iowa: all parts of the state were equally well served by railroads in 1890, but the feasible region represented only 30 percent of the state. Land in the feasible region was worth $32.11 per acre, rather than $23.42.[58] There is an implication, though perhaps not a proof, in these data that interindustry competition between rail and water transport did effectively moderate the monopoly power of the railroads. It would appear from these data that, where there was no water competition, the unchecked monopoly railroad was able to appropriate to itself the "economic rent" value (the locational value or "economic profit") of the land. (Economic theory suggests that a firm with a monopoly at any stage of the production process can appropriate to itself all the economic profits from the entire production process.)

We may draw parallels to the present situation in telecommunications. At present, there is a substantial amount of competition in interexchange telecommunications, though

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[57] Munn v. Illinois, 94 U.S. 113 (1877). As Garfield and Lovejoy say: "It was a Granger regulatory law, enacted by the Illinois legislature, which resulted in the memorable opinion by the Supreme Court of the United States in the case of *Munn v. Illinois*. Handed down in 1877, this decision constitutes the bedrock foundation of the modern public utility concept." Paul J. Garfield and Wallace E. Lovejoy, *Public Utility Economics,* (Englewood Cliffs, N.J.: Prentice-Hall, 1964) 6. Between 1871 and 1874, Illinois, Iowa, Minnesota, and Wisconsin established commissions with authority to set maximum rates, prevent discrimination, and, significantly, prevent mergers of competing railroad lines. Phillips, *The Regulation of Public Utilities,* 132.

[58] Fogel, Railroads and American Economic Growth: Essays in Econometric History (Baltimore: Johns Hopkins, 1964, 1970) 79-80.

opinions differ as to whether it is so substantial as to be "workable". There is much less competition in local communications, and there are persistent questions as to whether telephone companies are failing to serve rural areas adequately, and whether local competition will be effective or even feasible in rural areas.[59] Interexchange prices fell for over a decade[60] before the FCC declared AT&T to be non-dominant,[61] and the FCC exercised its new authority[62] to forbear from requiring tariffs for interstate services,[63] although its review of new tariff filings had been perfunctory to nonexistent for non-dominant carriers since it first tried to forbear from requiring tariffs of non-dominant carriers in the

[59] The Telecommunications Act of 1996 had several provisions to deal with such concerns, such as 47 U.S.C. §§ 153(37), 214(e), 251(f), and 254.

[60] Some of the fall in prices for toll service was clearly attributable to changes in cost allocations that transferred much of the cost that had previously been recovered from toll service to local service for recovery. See David Chessler, "Evaluating Alternative Non-traffic-sensitive Recovery Plans, Pooling, and Nationwide Rate Averaging from an Economist's Perspective", in Richard L. Wallace, ed., *Proceedings of the Thirteenth Annual Rate Symposium: Pricing Electric, Gas and Telecommunications Services, Today and For the Future*, February 10, 1987 (Columbia, MO.: Institute for the Study of Regulation and University of Missouri—Columbia, 1987).

[61] Domestically, the FCC made this declaration in 1995. See Motion of AT&T Corp to be Reclassified as a Non-Dominant Carrier, FCC mimeo 95-427 (released October 23, 1995) ("AT&T Reclassification Order"), paras. 78–84; Reconsideration, FCC Mimeo 97–366, October 9, 1997.

[62] In particular, 47 U.S.C. § 160 permits the FCC to "forbear" from applying any provision of the Communications Act, if the FCC finds that: "(1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory; (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and (3) forbearance from applying such provision or regulation is consistent with the public interest." The FCC has made no such filings, even though it had attempted to de-tariff MCI's services in the early 1980s. Similarly, 47 U.S.C. § 226(h)(1)(B) permits the FCC to waive tariffs for operator service providers, starting in February, 2000. At this writing, no such proceedings appear to be underway. See also, 47 U.S.C. § 617(d) that permits the states to require filing of "informational" tariffs for telephone-like services provided by cable companies (which are not, otherwise, subject to tariff regulation).

[63] FCC, Policy and Rules Concerning the Interstate, Interexchange Marketplace, Second Report and Order, 11 FCC Rcd 20730 (1996), FCC Mimeo 96–424 (October 31, 1996).

early 1980s and been rebuffed by the courts.[64] The FCC continues to deal with consumer complaints about tariffs and their applicability, and it is uncertain as to whether the terms of *unreviewed* "informational" tariffs will continue to override those of negotiated contracts.

In 1869 there were the first mergers of railroads to create directly competing long-distance routes (that is, without requiring connections to go from one city to a distant one). This led to construction of competing transcontinental routes between 1881 and 1883, and speculative "paralleling" of routes in the east. Competing fast express agencies developed.[65] Thus, railroad rates declined almost uninterruptedly from the Civil War until 1900.

There is a clear parallel with the telecommunications industry during its regulatory period (roughly, 1934 to some time after 1982), where there was a steady downward trend in long distance rates, and regulators used an accounting "gimmick" (the transfer of costs to the interstate jurisdiction through the separations process) to reduce local service rates as well. Thus, the impetus for regulation of transportation in the nineteenth century stemmed in large part from something other than the overall level of rates; in particular, it stemmed from

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[64] Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, CC Docket No. 79-252, Notice of Inquiry and Proposed Rulemaking, 77 FCC 2d 308 (1979) (Competitive Carrier NPRM); First Report and Order, 85 FCC 2d 1 (1980) (First Report and Order); Further Notice of Proposed Rulemaking, 84 FCC 2d 445 (1981) (Competitive Carrier Further NPRM); Second Further Notice of Proposed Rulemaking, FCC 82-187, 47 Fed. Reg. 17,308 (1982); Second Report and Order, 91 FCC 2d 59 (1982); Order on Reconsideration, 93 FCC 2d 54 (1983); Third Further Notice of Proposed Rulemaking, 48 Fed. Reg. 28,292 (1983); Third Report and Order, 48 Fed. Reg. 46,791 (1983); Fourth Report and Order, 95 FCC 2d 554 (1983) (Fourth Report and Order), vacated AT&T v. FCC, 978 F.2d 727 (D.C. Cir. 1992), cert. denied, MCI Telecommunications Corp. v. AT&T, 113 S. Ct. 3020 (1993); Fourth Further Notice of Proposed Rulemaking, 96 FCC 2d 1191 (1984); Fifth Report and Order, 98 FCC 2d 1191 (1984) (Fifth Report and Order); Sixth Report and Order, 99 FCC 2d 1020 (1985) (Sixth Report and Order), vacated MCI Telecommunications Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985) (collectively referred to as the Competitive Carrier proceeding).

[65] The first express agency was opened in 1836 between New York and Boston; eventually there were five such agencies. The government merged them into the Railway Express Agency during World War I. Glaeser, *Public Utilities,* 43-44.

various discriminations. The impetus for deregulation of telephone in the 1970s and thereafter stemmed from something other than dissatisfaction with the overall level of rates or their trend: Hushaphone, Carterfone, the Above 890 Decision, the MCI Decision, the Specialized Common Carriers Decision—the landmarks of deregulation in the 1950s, 1960s and 1970s—were not in any way rate cases.

Because the telephone was not invented until 1876 and the patent did not expire until 1893, the competitive period in telephone occurred between about 1893 and the early 1920s, decades after most other public utilities had begun to be regulated. While the telephone patents were in force, the return on equity of the Bell System averaged almost 46 percent, and the dividends averaged about 15 percent. Dividends totaled $25 million on subscribers equity of $20 million (of which about $15.5 million appears to have been paid-in equity), and retained earnings were $15 million.[66] Earnings on average net investment fell to 8 percent for the early competitive period, 1900 to 1906.[67] Average Bell annual revenue per station had been $88 in 1895, the first year of competition; by 1907 it had fallen to $43. Interestingly, the drop in rates was about the same in exchanges where there was direct competition as in exchanges where there was not.[68] Thus the rate of growth in the number of telephone customers was much greater after the expiration of the Bell patents, and by

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[66] Richard Gabel, "The Early Competitive Era in Telephone Communication, 1893–1920," *Journal of Law and Contemporary Problems,* Vol. 34 (1969), 340–359, at 343. (Hereinafter, "Early Competitive Era.")

[67] Gabel, "Early Competitive Era," 352.

[68] Gabel, "Early Competitive Era," 346. During this period there were many municipalities where there existed two or more competing telephone companies, each with its own separate plant, a situation that continued in many places through the 1920s and in a few places, such as Philadelphia, through the 1940s. According to Gabel, the president of AT&T, Theodore Vail, attributed the price drop to cost savings rather than competitive pressures, but, as Gabel points out, there had not, apparently, been such cost savings in the monopoly period. *Idem.* Between 1900 and 1906, several AT&T annual reports complain of having to charge low rates to meet the competition, rates too low to cover expenses. *Ibid.,* 351.

1902, non-Bell companies had 1,053,866 stations, compared to 1,317,178 for the Bell companies; by 1907 non-Bell companies had 3.0 million telephones and Bell companies had 3.1 million.[69]

Until recently most of the anticipated competition to local telephone companies was expected to come from outside the industry. For example, for many years it has been thought that cable television systems would provide two-way service. Cable companies do provide some local competition, as do analog and digital cellular systems, and some of the competitors to local telephone companies come from the other fixed utility industries, which have networks and rights-of-way. It is certainly possible that these will be the dominant competitors in the new century. As competition develops, much of it is coming from other segments of the telephone industry, such as the interexchange carriers. However, the various segments of the electronic communications sector have been converging. For example, AT&T has been acquiring cable television companies, possibly for their rights-of-way, partly as a means of acquiring broadband local facilities, but partly as a means of maintaining a presence in the internet industry.

There are obvious parallels to the telecommunications industry today, in which much of the competition is in limited markets, though more likely product markets than geographic markets. For many years regulators have been dealing with rate cases in which telephone companies have attempted to justify rates for particular services (usually business services such as point-to-point private lines or Centrex; more recently to bulk-rate message services or certain types of access, particularly broadband access services) on the basis of "competitive necessity."

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[69] Gabel, "Early Competitive Era," 344. The year 1907 is significant because that is the year in which the Baker-Morgan banking interests took over the Bell System and re-installed Theodore Vail as president; see Gabel, 345. In this period and until the 1970s, the number of telephone sets or stations was the standard metric for the size of the industry, and corresponded to what we now term the number of access lines.

The parallel between rail transportation in the late nineteenth century and the present situation in telecommunications is obvious. Despite interindustry competition from satellite services, cable television rates continue to rise faster than the rate of inflation, though not as fast recently. Thus, it appears that the limited competition may be having a moderating influence on rates, though it is clearly not fully effective.

Industry Responses to Competition

In general, firms facing weak or limited competition will, if they can, try to form a pool or cartel, and, if that fails or is declared illegal, will merge. In response to competitive pressures, and also the need for through-traffic arrangements, the railroads attempted combinations, starting in the 1850s, but particularly after the Civil War. The railways also developed revenue pools to eliminate competition in the 1870s and 1880s.[70]

When pools (1887) and rate agreements (1897–98) were declared illegal, railroads merged, and formed territorial groups; in 1905 thirty-nine persons constituted a majority of the boards of directors of all railroads in the eastern part of the US.[71]

During the early part of the competitive era in telephone, that is, 1895–1906, the Bell System engaged in propaganda against the independent (that is, non-Bell) companies, refused to interconnect with them, and refused to sell them telephone instruments. The propaganda seems to have affected the larger independent companies, but not the smaller companies that stemmed directly from local needs. The refusal to interconnect took two forms: refusing local interconnection where there were Bell and non-Bell companies in the

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[70] Glaeser, *Public Utilities,* 45–46. The Pennsylvania, New York Central, and other systems took shape by 1880. *Ibid.,* 46.

[71] Glaeser, *Public Utilities,* 71.

same or adjacent territories, and refusal to interconnect long distance. (This latter is the opposite of the recent period where the Bell System tried to use its local monopoly to enforce its long-distance monopoly.) The Bell System's refusal to sell equipment led to the establishment of new manufacturers, Automatic Electric, Stromberg-Carlson, and Kellogg. The Bell System then attempted to acquire Kellogg and Stromberg-Carlson, but this was prevented as an attempt to create a monopoly. Ironically, by the time the Bell System was willing to connect with independents, differences in standards and practices, and differences in equipment, created problems.[72]

In the later competitive period in telephone, 1907 to 1920, the Bell System changed its tactics. It slowed its rate of internal expansion and began to acquire independent telephone companies. This policy was modified in 1913, with the Kingsbury Commitment. In this agreement, AT&T vice-president N.C. Kingsbury agreed with Attorney General George Wickersham not to acquire competing telephone companies and to connect to other companies that met its technical standards. However, AT&T was free to acquire non-competing telephone companies and continued to do so. The Kingsbury Commitment also forced AT&T to relinquish the control it had acquired of the Western Union Telegraph Company, which Postal Telegraph (Western Union's competitor) complained was undercutting it. Independent telephone companies were not very viable, and in 1921 Congress passed the Willis-Graham Act, permitting the acquisition of competing telephone companies; this terminated the Kingsbury Commitment, and AT&T again engaged in aggressive acquisition of independents.[73]

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[72] Gabel, "Early Competitive Era," 349–351.

[73] Gabel, "Early Competitive Era," 351–353.

Both Bell and non-Bell companies were aggressive in resisting interconnection, and in opposing state legislation that might compel interconnection, apparently because each hoped to be the surviving monopolist.[74]

Ownership of the Commodity Transported

After the Civil War a problem of railroads transporting their own wares arose. Previously, common carters had not owned their goods. At first, railroads were transporting coal from their own mines, but later they began to deal in grain, and gave themselves an advantage relative to other grain dealers.[75] Such self-dealing by railroads was prohibited by the Hepburn Act of 1906, which forbade railroads from transporting goods they had mined, manufactured, or produced, and still owned at the time of transportation.[76]

For many years such prohibitions were a staple of common carrier regulation; thus, the 1954 AT&T Consent Decree (that settled the 1949 antitrust case) prohibited most sales by AT&T's manufacturing subsidiary, Western Electric, other than of equipment it produced for use by the Bell System.[77] There had been complaints from other producers alleging that AT&T "looked upon AT&T's inventions and patents outside telephony as instruments of

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[74] Gabel, "Early Competitive Era," 353–354, quoting F. B. MacKinnon, president of the United States Independent Telephone Association, testifying before Congress in 1921.

[75] Lake, *Discrimination by Railroads and Other Public Utilities,* 32, citing: In re Grain Rates of Chicago Great Western Ry. 7 I.C.C. Rep. 33 (1897), McGrew v. Mo. Pac. Ry. 8 I.C.C. Rep. 630 (1901); Wyman, "Business Policies Inconsistent with Public Employment," 20 Harvard L. Rev. 511, 528 (1907).

[76] Lake, *Discrimination by Railroads and Other Public Utilities,* 32, citing United States v. Delaware and Hudson Co., 213 U.S. 366, 29 S.Ct. 527 (1908).

[77] U.S. v. Western Electric Co., and AT&T Co., Final Judgement, Civil Action No. 17–49, D. N.J., January 24, 1956. See Charles E. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice,* Third edition (Arlington, VA.: Public Utilities Reports, 1993), 755–758.

industrial warfare for getting control of other industries,"[78] and tried to use its ownership of wireline transmission to promote its manufacturing position for radio equipment in the 1920s and motion picture sound in the 1930s; Thus, in 1971, in the first Computer Inquiry, the FCC prohibited AT&T from owning the information it carried;[79] a policy it renewed in the second Computer Inquiry in 1980.[80] This restriction was carried forward to the Bell Operating companies, but not AT&T, in the 1982 Consent Decree,[81] sometimes also called the "Modification of Final Judgement" because it modified the 1956 Consent Decree.

Such restrictions were never applied to cable television because the FCC has avoided regulating cable television as common carriage. Rather, the FCC regulated it as ancillary to broadcast, and state or local regulators have even, at times, required cable television companies to originate certain types of local programming. In any event, the

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[78] AT&T disputes whether this memorandum, by an executive at Western Electric, was ever company policy. John Brooks, *Telephone* (New York: Harper and Row, 1975), 181. See also 160–165, 171, 180–185.

[79] FCC, *Regulatory and Policy Problems Presented By the Interdependence of Computer and Communications Services and Facilities,* Docket No. 16979, Final Decision and Order, 28 FCC2d 271 (1971), *aff'd in part and rev'd in part sub nom. GTE Serv. Corp. v. Federal Communications Comm'n,* 474 F.2d 724 (2d Cir. 1973), *on remand,* 40 FCC2d 293. Hereinafter, *Computer I.*

[80] FCC, *Amendment of Section 64.702 of the Commission's Rules and Regulations,* Docket. No. 20828 (*Computer II*), 73 FCC 2nd 384, 35 PUR 4th 143 (1980), *modified on reconsideration,* 84 FCC 2nd 50, 39 PUR 4th 310 (1980), *modified on further reconsideration,* 88 FCC 2nd 511 (1981), *aff'd sub nom. Computer & Communications Indus. Ass'n. v. Federal Communications Comm'n,* 693 F.2d 198 (D.C.Cir. 1982), *cert. denied,* 461 U.S. 938 (1983), *modified,* 3 FCCR 22 (1988). See Phillips, *Regulation of Public Utilities,* 769, 772–774.

[81] *United States v. Western Elec. Co., 1982–2 Trade Cases,* ¶ 64,900, 552 F.Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States,* 460 U.S. 1001 (1983). See Phillips, *Regulation of Public Utilities,* 174–781.

major cable television companies own much of the programming they carry, and this may be a source of market power, to the extent that they can charge their rivals to carry popular programming.[82]

Ownership of the information content being transported continues to be a serious issue in the communications industries. This issue has been addressed by the courts and the FCC several times. It has recently manifested itself in the context of two mergers: the MCI-WorldCom merger, in which control of the Internet was held to be an issue; and the AT&T acquisition of Tele-Communications, Inc., in which monopolization of the "Internet Service Provider" industry was said to be at issue. (Content ownership is a traditional issue in broadcast and cable television regulation, governed by "must carry" and "origination" rules promulgated by the FCC from time to time.)

Since cable television is not common carriage by the FCC's definition, though certain services may be common carriage and regulated as such by some state definitions, restrictions against discrimination (such as refusal to serve) do not apply. Thus, as cable television companies start to provide internet access in competition with local telephone companies' broadband offerings, questions of monopolization may arise. We see these questions, for example, in the context of the AT&T acquisition of Tele-Communications Inc. (a major owner of cable television systems), which AT&T had acquired primarily to obtain facilities over which AT&T could provide local telephone services. Somewhat similar issues relating to control of the Internet also arose in the context of WorldCom's acquisition

[82] General Accounting Office, *Telecommunications: The Changing Status of Competition to Cable Television,* GAO/RECD–99–158, July 8, 1999 (accessed as http://www.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=gao&docid=f:rc99158.txt.pdf, January 4, 1999), 16–17, 21–22, 27. (Hereinafter, *Competition to Cable*.)

of MCI. It is interesting to note that in the case of the MCI-WorldCom merger, the issue was addressed, not by United States regulators or antitrust authorities, but by the European Commission, the Antitrust Authority of the European Common Market.

Starting in 1870, one of the results of the Granger movement was to insert into state constitutions clauses permitting the state to forbid discrimination by railroads. Previously, some of the eastern states held that the common law forbade discrimination by utilities, or that state could forbid such discrimination under the general police power (such statutes were upheld).[83] Lake believes that many of these instances of discrimination involved favoritism (that is, the railroad management favored its friends), or reciprocal dealing (the exchange of favors with other firms). The earliest American decisions on rate discrimination involved personal favoritism.[84] The earliest American decisions on discrimination that held that the common law required uniform rates were dicta in Pennsylvania in 1864 and Maine in 1869. The first decision that actually forbade discrimination in rates was in New Jersey in 1869.[85]

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[83] Lake, *Discrimination by Railroads and Other Public Utilities,* 33. Lake makes the point that the insertion of constitutional clauses suggests that as late as 1880 there was some doubt about the police power of the state to forbid price discrimination.

[84] Lake, *Discrimination by Railroads and Other Public Utilities,* 33, 106; the discrimination cases Lake cites in this context date to 1873 and 1874. Lake also points out that the common law on discrimination did not originally extend beyond refusal to serve on equal terms; discrimination in rates was added to the common law by interpretations of American judges in the last half of the nineteenth century. For example, none of the early cases required uniform rates. *Ibid.,* 9, citing cases from 1840 through 1884. That is, the early meaning of "discriminatory" was that rates be related to costs, not to each other. *Ibid.,* 10, citing a case from 1869.

[85] Lake, *Discrimination by Railroads and Other Public Utilities,* 37–38. The New Jersey Case, Messenger v. Pennsylvania R.R., 36 N.J. Law 407 (Sup. Ct. 1873), affirmed 37 N.J. Law 531 (Ct. Errors and App. 1874), relied on the fact that the contract for a favorable rates, if enforced, would enable the shipper to obtain a monopoly, which would be adverse to public policy, and that the franchise to build the railroad is a prerogative of the sovereign who, by "natural principle," could not favor one citizen over another. In the case that held such discrimination to violate the common law, Justice Doe of New Hampshire admitted that his view of the common law differed from that of the English courts. Lake, 39, citing McDuffie v. Portland & R. R.R., 52 N.H. 430, 451, 13 Am. Rep. 72, 76 (1873).

However, the law on discrimination has not generally been extended beyond the public utility field (that is, railroads and other "exceptional" businesses), and some of the early decisions tied the prohibition on discrimination in rates to the power of eminent domain.[86] On the other hand, as Lake points out, among the abuses that led to the passage of the Sherman Act in 1890 were the heavy discounts given the Standard Oil Company, which tended toward monopoly.[87]

However, outside the public utility field, many of the issues of discrimination that inspired the Granger Movement have few forums in which they may be addressed outside "classical" tariff regulation. Modern antitrust theory is more concerned with the effect of discounts on the competitors of the discounter, rather than regulatory concern with the effect on competition among the customers. In some instances the courts of the early era sustained rates that were clearly designed to put competitors out of business as non-discriminatory because they were open to all, even if the effect was to put a competing carrier (such as a water carrier) out of business.

Contemporary Views of Public Utility Problems in the Preregulatory Period

There were some serious failures of the market throughout the nineteenth century, despite the widespread interindustry and intra-industry competition in the public utility

[86] Lake, Discrimination by Railroads and Other Public Utilities, 47. Illustrative are the cases which extended the prohibition on discrimination to the communications industry; these relied to a great extent on the industry's possession of the power of eminent domain: Western Union Telegraph Co. V. Call Publishing Co., 181 U.S. 92, 21 S.Ct. 561 (1901); Cumberland Telephone and Telegraph Co. v. Kelly, 160 Fed 316 (C.C.A. 6th, 1908); and Postal Telegraph-Cable Co. v. Associated Press, 175 App. Div. 538, 163 N.Y. Supp 4 (1916).

[87] Lake, *Discrimination by Railroads and Other Public Utilities,* 106. Lake also points to an 1897 case in which a court refused to enforce a contract calling for preferential discounts to a shipper on the grounds that it was against public policy because it tended toward a monopoly.

industries, much of which was deliberately promoted by government, often at great public expense, and despite the careful systems of controls and restrictions in franchises, corporate charters, and, toward the end of the century, by statute. Many of these failures were so serious that, by the end of the century, commission regulation was invented as a new form of control. That is, in the last quarter of the century the widespread public perception arose that the market was not providing adequate consumer protection, so that there was a perceived need for an alternate form of consumer protection. The agitation for consumer protection antedates what Glaeser calls the period of monopolization, to which we also refer as the period of modern ratebase, rate-of-return regulation.

An alternative view is that regulation was instituted at the behest of the affected industries to "rationalize" them; that the industries accepted regulation to escape the pressures of competition.[88] While there is undoubtedly evidence to support this latter view, it is certain that the major pressure for regulation came from popular movements such as the Grangers, and it is equally certain that the pressures for antitrust did not come from

[88] The interpretation is generally associated with George Stigler and other economists and lawyers at the University of Chicago. See, for example, George J. Stigler "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science,* Vol. 2 (Spring 1971), 3–21. For example, J.P. Morgan was initially hostile to the Interstate Commerce Commission, but tried to work with it, initially trying to use it to enforce cartel agreements. He also considered it less hostile than the state legislatures of the time. Jean Strouse, *Morgan: American Financier* (New York: Random House, 1999), 257, 260–261, 305–306. Many politicians and business leaders thought the I.C.C. would be entirely anti-business, although a few saw in it an opportunity to prevent rate wars and "rationalize" the industry. *Ibid.,* 257. Although as early as 1893 the I.C.C. asked for authority to prescribe minimum rates, a power that is necessary if a commission is to prevent rate wars, and it repeated the request in 1897, 1898, and 1916, it did not actually get that authority until 1920. State commissions, such as those in New York and Wisconsin, had been granted such authority appreciably before then. Glaeser, *Public Utilities,* 126–127.

within the affected industries.[89] On the other hand, the evidence can be interpreted to reflect "industry capture"—that the industry was able to shape and limit regulatory legislation so that the regulated firms could derive some benefit from it.

For example, in 1907 Theodore Vail was reinstated as president of AT&T through the efforts of the bankers, Baker and Morgan, who were also involved with railroads. As a result of observing the experience of the railroads with the Interstate Commerce Commission (ICC), which had stabilized the markets and prevented price wars without interfering with managerial prerogatives, Vail was favorably inclined toward regulation, particularly if there were no competition.[90] In 1910, the Mann-Elkins Act provided, *inter alia*,

[89] As Donald J. Dewey says: "Cartels invariably arise, provided that they are legal, whenever firms are relatively few and short-run obstacles impede the easy entry of new firms. Since such obstacles characterize most industries most of the time, weak cartels are a thoroughly 'natural' form of market organization." *Microeconomics: The Analysis of Prices and Markets* (New York: Oxford University Press, 1975), 126. Since cartel agreements have never been enforceable at law in the United States, businesses turned to the trust to "rationalize" the industry; when the trust was outlawed, they used mergers. "Antitrust is *not* a policy that has endured and expanded for a century because it creates economic rents for important groups that defend it fiercely." Donald J. Dewey, *The Antitrust Experiment in America* (New York: Columbia University Press, 1990), 2. In this respect antitrust differs from regulation, which some claim can create such rents by rationalizing the industry, eliminating competition. For example, while Morgan "believed in the efficacy of industrial consolidation and also in the need for *administered* markets, but had no faith in the government's ability to do the administering. The country, in his view, ought to leave control of its commercial and financial resources to qualified experts. He told a friend in 1912 that the consolidation of industry was 'the only thing to do': the government was 'crazy to fight it.'" Strouse, *Morgan,* 303–304. Supreme Court decisions in the 1890s, which prohibited weak cartels and price-fixing agreements, led to large scale mergers, a much stronger form of consolidation. *Ibid.,* 316. Thus, Morgan was stunned when President Theodore Roosevelt announced that the administration would move against Northern Securities, which had been created by lawyers with a careful eye on the Sherman Antitrust Act. *Ibid.,* 440.

[90] Gabel, "Early Competitive Era," 355–356, quoting AT&T's 1907, 1909, and 1910 Annual Reports.

for regulation of interstate telephone companies by the Interstate Commerce Commission. Between 1910 and 1920, thirty-one states began to regulate intrastate telephone companies.[91]

Regulation prior to the nineteenth century had concerned itself primarily with levels of rates, refusals to serve, and issues of quality of service. Over the course of the nineteenth century price discrimination became an issue,[92] as did favoring one customer's products over another's, and self-dealing to the utility's financial benefit in non-utility activities.

Abuses included using captive construction companies which had "unduly profitable" construction contracts[93] and irregular methods of finance.[94] While captive suppliers were a major source of contention in telecommunications as late as the AT&T divestiture in 1983, they are not a significant problem, and probably will not be unless the prohibitions on manufacturing are waived.[95]

Other abuses included rebates and discriminatory rates favoring certain customers.[96] Standard Oil's rebates were $10,000,000 in eighteen months, but most other rebates were

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[91] Gabel, "Early Competitive Era," 357. Strouse, *Morgan,* 563.

[92] There were common law proscriptions against *overcharging,* but not against discriminating between two customers, so long as neither was charged an unreasonably high price. "The common law could not proceed from the requirement of reasonable rates to a requirement of no discrimination by sound deductive logic." Lake, *Discrimination by Railroads and Other Public Utilities,* 10. A common law basis for prohibiting price discrimination was found by some American judges in the second half of the nineteenth century, but they did so without specific precedents.

[93] The best known example was the Credit Mobilier which constructed the Union Pacific. (Glaeser, 45)

[94] Glaeser, *Public Utilities,* 45. The best known example is Jay Gould and the Erie Railroad. *Idem.*

[95] These were in the 1982 Consent Decree. Their current status is governed by the Telecommunications Act, 47 U.S.C. § 273.

[96] Glaeser, *Public Utilities,* 45. The prime example was the Standard Oil Company, which used these rebates and rates to crush its competitors. *Idem.*

much less. Still, even a small rate advantage enabled a shipper to "freeze out" competitors; a concession of four percent on railroad rates in the winter of 1877 enabled two shippers to control the grain trade of New York City, then the largest secondary market in the nation.[97] Rate reductions favoring large shippers, or on routes where there was rail or water competition drew complaints.[98]

Excess valuations, duplicate capacity, and unnecessary capacity (capacity built where sufficient demand never developed) were eliminated as up to seventy percent of the railroads went through receivership. Communities and the Granger movement favored competition with other railroads and water transport to keep rates low; it was hard to abandon this policy for a policy of government regulation. Thus, at least in the last decades of the century, interstate regulation was always hostile to monopoly, and sought, if possible, to retain competition. The rate wars and discrimination were the direct effect of "excessive competition." Discrimination arose out of railroads' desires to "build up" particular markets they had entered. Discrimination resulted in high rates for local traffic not subject to competition, and low rates for traffic between junction points where there was competition. In addition, large shippers could negotiate concessions.[99]

The ICC Act was aimed principally at discrimination and rebating. For the general level of rates, competition was relied upon to control the level of rates. After the first few

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[97] Fogel, *Railroads and American Economic Growth,* 6–7, citing Richard T. Ely, "Social Studies; II The Economic Evils in American Railway Methods," *Harpers Magazine,* Vol. 73 (1886), 455; William Larrabee, Governor of Iowa, *The Railway Question* (Chicago: 1893), 141; State of New York, Legislature, Assembly, *Proceedings of the Special Committee on Railroads,* 8 Vols. (Albany, 1879), Vol. 6, 41, 57.

[98] Glaeser, *Public Utilities,* 45.

[99] Glaeser, *Public Utilities,* 65–66, 68.

years, there was considerable hostility between the ICC and the carriers.[100] Still, as noted above, Theodore Vail of AT&T and his backers who had experience in railroading, accepted and even embraced ICC-type regulation, both at the federal and state level, in order to stabilize the industry.

The Twentieth Century Interpretation of the First Competitive Era

For at least the last forty or fifty years, textbooks in regulation and economic history have discussed intra-industry and interindustry competition in transportation as the "long-haul–short-haul problem." Competition or potential competition in the other utility industries was largely neglected and even considered undesirable, because it necessarily involved duplication of facilities.[101] The argument in the textbooks was that there were lower rates per ton-mile on the long routes between major cities, where there was competition, created resentment among farmers, in particular, who shipped from intermediate points where there was little or no competition.[102] To a lesser extent, the textbooks mention rebating and secret discounts, though they tend not to emphasize the anti-competitive effects of these discounts, even though such discounts, particularly to the Union Tank Car Company, are well-documented as major instrumentalities used by John D. Rockefeller in establishing the Standard Oil monopoly. The textbooks also mention the rate wars and instability, which

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[100] Glaeser, *Public Utilities,* 68–69.

[101] See, for example, Garfield and Lovejoy, *Public Utility Economics,* 15, quoting John Stuart Mill, writing in 1848 about London, England, gas and water service, in *Principles of Political Economy,* as quoted in George T. Brown, *The Gas Light Company of Baltimore* (Baltimore: Johns Hopkins, 1936), 63–64.

[102] An early British canal charter required uniform rates throughout the length. There was an early British railroad charter that required uniform rates per ton-mile, but this was not usually a major concern on the relatively short routes in the early years of the nineteenth Century. Lake, *Discrimination by Railroads and Other Public Utilities,* 13, n. 19, 15–16.

were problems for firms in the transportation industries, but would not have been serious problems for shippers. However, the result of the rate wars was usually the combination of the firms to create monopolies.[103]

The bankruptcies and other problems caused by excessive construction costs and irregular methods of finance are also mentioned; these are problems for the shareholders and taxpayers because of the public moneys that were often involved in railroad construction.

In short, reading the twentieth-century textbooks on public utilities or transportation would give the impression that competition was a complete failure in the nineteenth century, and that many of its effects—even when it worked as intended—were pernicious.

Summary: Why Competition Failed

The preceding brief history has shown that throughout most of the nineteenth century the principal regulatory tools were competition and the restrictions in the corporate charters (and after the middle of the century, in the franchise agreements). There were some commissions throughout the century, but commissions did not fully develop their modern forms until after about 1870. Statistical analysis suggests that this competition was effective enough to cause price reductions, particularly in major markets. (Indeed, the effect of competition in transportation can be seen even in prices for farmland.) Still, in the last quarter of the nineteenth century there was a change in perception, and regulation rapidly replaced competition as the mechanism for social control of the utility industries. Thus, the

[103] Garfield and Lovejoy, *Public Utility Economics,* 16. This is, of course, the "natural" result whenever pro fits (or economic rents) are to be made thereby, and there are no statutory prohibitions against such combinations, or the statutes are unenforced.

history of this period presents two questions: why were the corporate charters and franchise agreements ineffective, and why did the public and the legislatures give up on competition?

After being promoted as the principal form of regulation for most of the century, in the last few years of the nineteenth century the encouragement of competition was replaced by a system of regulated monopoly. There were several reasons for this shift—a shift that was very reluctantly adopted by the public and the legislatures: as late as 1874, Senatorial commissions were recommending ways in which competition (including intermodal competition) could be increased.

To summarize the reasons that regulation supplanted the promotion of competition:

- **Competition resulted in turnover and financial disorganization**: Over the course of the century seventy percent of the railroads were reorganized at least once. Some of this financial reorganization resulted from exploitation or corruption and from over-construction.

  Large enterprises began to look to government and customers for large construction subsidies, which were offered to promote economic development.

- **Competition resulted in discrimination**: As emphasized in the twentieth century textbooks, discriminatory pricing between long-haul and short-haul routes, occurred. Some discrimination favored friends of owners or for government employees

- **Competitors were not available**: Water transport, a strong competitor to railroads early in the century, was largely driven out of business. There were markets, for the most part non-nodal, where there was no rail competitor. Small customers sometimes had no alternative supplier.

- **Competition resulted in wasteful construction**: This included over-construction and construction of parallel routes.

- **Rate agreements and pools eliminated competition**: Not illegal at the time, rate agreements and pools were an inevitable and pernicious result of excessive market power.

- **Mergers and consolidations further eliminated competition**: An alternative to rate pools for firms seeking to limit competition, mergers and consolidations became inevitable in partially competitive utility markets when pools and agreements were made illegal. Mergers and consolidations addressed the problem of through traffic.[104] They rationalized excessive construction and parallel routes. They also created legal conflicts due to alternative terms in the franchises of merging firms.

- **Competition was incompatible with large-scale enterprise**: The limitations may have been due to problems of nineteenth century economic organization, capital markets, or the sizes of nineteenth century product markets relative to efficient firm sizes, but this perception was nonetheless common in the late nineteenth and early twentieth centuries.

Thus, over the course of a century, more or less, policy makers changed from perceiving utility markets as ones in which competition can work (Kaysen and Turner's case 2 or 3) to falling under Kaysen and Turner's first case—situations in which competition cannot exist or survive for long.

Most of the problems of the franchises were addressed when commissions were established under legislation that set forth obligations and rights of the utilities and that permitted commissions to investigate and prosecute misfeasance or malfeasance and

[104] Now called "interlining" or the "through bill of lading,"this involved long-distance shipments without reloading or changing cars. This led to the mid-twentieth century quip, that a log could cross the country without changing cars, but not a human.

allowed commissions to modify the rules to deal with particular situations. Indeed, the modern utility commission makes all the specific rules, establishing rates of return and even specific rates in what are technically rulemaking proceedings. (That is, the rate or rate of return is a "rule.") Under these circumstances necessary rights of consumers (or obligations of the utility) could be addressed with dispatch and expertise.

The financial difficulties and uncertainties were also addressed when commissions were substituted for franchise regulation. The uncertainties of expiring franchises, and the ineffectiveness of the franchise form of control when franchises did not expire simultaneously, became moot. The regulations, rights and obligations, were contained in the statutes and the rules of the commission, rather than the franchise, and other forms of enforcement were possible, including fines and forfeitures. Increased flexibility was gained, since the penalties were no longer limited to nonrenewal of the franchise at relatively long intervals.

During the period when commission regulation was being established, antitrust laws began to be enacted. Antitrust laws, by addressing market failures due to lack of competition, and restoring competition, were particularly effective in industries that had been monopolized to "stabilize" the market (that is, to raise prices or prevent rate wars) but in which there were few significant economies of scale.

CHAPTER 3

THE CONFLUENCE OF COMMISSION REGULATION AND ANTITRUST IN THE NEW COMPETITIVE ERA

Even in relatively recent years not all instances of market failure were subjected to regulatory treatment (quite aside from the current trend toward deregulation). Some were ignored; others were and still are addressed by other measures, such as antitrust. These are in Kaysen and Turner's fourth category, industries in which competition works, or the failures are not severe. Only a relatively limited subset of industries is or has ever been subjected to economic regulation,[105] and not all of those are called "public utilities." For the most part, public utilities are involved in transportation of some kind.[106] Most are directly connected to their customers. Most use some scarce public resource, so that entry of new competitors into the market must be restricted.[107] Furthermore, public utilities produce "essential" products or services, "stand at the very gateway of commerce," and their products or services are usually essential inputs to many or most other industries. Garfield and Lovejoy state the classic definition of a public utility thus:

> Unlike other stock corporations [*sic*], public utilities operate with government approval as monopolies and supply a service which is indispensable to

[105] There are exceptions. There were extensive price controls during World War II, the Korean War, and again, for a brief period, in the early 1970's. The railroads were nationalized during World War I. There were also some attempts at regulation of non-utility industries during the early years of the Great Depression of the 1930s. These experiments, most of which fall into the third of Kaysen and Turner's cases, are not germane to this paper.

[106] In this categorization communications may be considered to be the transporting of "information."

[107] Most commonly, there is the need for public rights of way, including the right to dig up the streets. Another involves the electromagnetic spectrum used for broadcasting or various radio communications services.

> modern living. These two unique characteristics make inevitable a third distinguishing feature—public regulation of prices and profits—which sets public utilities further apart from the general run of American business.[108]

When regulatory restraints on any of the present public utility industries are relaxed, there is an assumption, not always fully or clearly expressed, that workable competition is present or possible: Kaysen and Turner's cases 2 or 3: situations in which competition exists but either does not produce the expected results, or which produces results which must be modified on policy grounds. Should the industry be so competitive as to be in the fourth case, or somehow lose its public utility nature, then there is no need for continued regulation. When relaxing regulatory constraints in telecommunications there is an

[108] Garfield and Lovejoy, *Public Utility Economics*) 1. In fact, many utilities are not stock corporations as Garfield and Lovejoy assume. Rather, there are large numbers of consumer cooperatives providing electric and telephone service, and many water and sewer, or electric utilities and a few telephone utilities are enterprises of various levels of government, even in the United States. Neither is it necessarily true that the utilities are monopolies with government sanction. We have seen the breakup of the former Bell System through application of the antitrust laws, and we are now in the midst of government attempts to introduce competition in many of the public utility industries, including telecommunications.

assumption that some regulation will be continued for an undefined transitional period. The panoply of regulation is almost never fully removed.[109]

As we saw in chapter two, the rise of the commission form of regulation in the last years of the nineteenth century was the result of the simultaneous failure of the two principal means of control (the franchise and competition) to address the specific problems of the time. If, a century later, we seek to rely again on competition as our primary means of control, we can wed it to antitrust (that is, procompetitive policies applied elsewhere in the economy) and try general statutes and commission rulemaking as an alternative to the franchise, drawing on our century of experience in this area.

What is particularly unfortunate, however, is that many of the present crop of regulators do not understand competition, and often impose regulatory solutions where competitive solutions would be possible and even preferable. It is not accidental that the Telecommunications Act of 1996 repealed the former primary jurisdiction of the FCC under the Clayton Antitrust Act (110 Stat. 143, § 601(b)(3)) Clayton Act—Section 7 of the

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[109] The most obvious example of a completely successful deregulation is that of telephone station equipment. Even this deregulation, however, appears to have required some constraints on the incumbent retail providers (that is, the telephone companies) until competition developed. There remains a theoretical possibility that telephone service providers with market power could, if completely unconstrained, use that market power to remonopolize station equipment. However, they would do so only if by doing so they could effect an increase in their profits, and in economic theory a firm that has a monopoly at one level of production can reap all the profits (economic rents) that could be reaped by having a monopoly at all levels of production. In the real world, however, there might be strategic advantages to collecting some of the profits at different stages of the production process so that the amount of the rent is less obvious and less likely to attract public condemnation and government intervention. For example, in the years immediately prior to the 1982 Consent Decree, the source of telephone companies' monopoly power appears to have been local service but the profits seem to have been earned in toll service and possibly the rental of station equipment. Situations like this, where the firm exercises its monopoly power at various stages of production may occur under the following circumstances: (1) *if* the firm has enough market power to create and enforce the monopoly at the other stage of the production process; and (2) *if* its efforts to create and enforce the monopoly would not, in and of themselves, provoke government intervention. It is certainly arguable that the efforts of the former Bell System in the 1970s to use its monopoly on local service in most major markets to enforce and sustain its market positions in interexchange communications and telephone equipment are what caused the antitrust case that ended in the dissolution of the Bell System in the 1982 Consent Decree.

Clayton Act (15 U.S.C. 18) is amended in the last paragraph by striking "Federal Communications Commission.") The FCC would often propose to permit anticompetitive mergers or other activity by finding that the adverse effect on competition was outweighed by some public-interest benefit. As we shall see, this regulatory mindset may still be found even among people professing allegiance to competition.

Consider, for example, a 1999 speech by FCC Chairman Kennard. After reviewing some of the history of railroad competition in Chicago in the mid-nineteenth century, he avers: "Competition is our mantra."[110] He says that the FCC is promoting competition by allowing Bell Operating Companies (BOCs) to provide "advanced services" on an unregulated basis, so that the FCC hopes that there will be up to five *facilities based* competitors.[111] He describes this as a deregulatory policy, which he contrasts with the requirement imposed by a municipal regulator[112] that broadband cable be subject to an "open access" requirement. He does not consider that the cable company's tying of broadband Internet access to the use of a particular Internet Service Provider (ISP) may constitute a "tying contract," which might be in violation of the antitrust laws if Cable companies were wholly unregulated.[113] Chairman Kennard presents no evidence or other justification for his apparent belief that enforcement of the antitrust laws will prevent the

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[110] FCC Chairman William E. Kennard, "Remarks Before the National Cable Television Association, Chicago, Illinois," June 15, 1999, 3 (accessed as http://www.fcc.gov/Speeches/Kennard/spwek921.html, June 19, 1999).

[111] Kennard, "Remarks," 5,

[112] The City of Portland and Multnomah County, Oregon. This case is discussed at length in later in this chapter.

[113] See below for a full discussion of the contrast between regulatory and antitrust standards of public benefit. Essentially, a competitive market does not necessarily "just happen." The antitrust laws must be enforced, and anticompetitive activities prevented, or the competitive market is likely to break down through cartelization or merger. There is, in American antitrust law, a strong presumption against tying contracts, though not as strong as the presumption against cartels. See Scherer, *Industrial Market Structure,* 567–569.

growth of facilities-based broadband local service. In fact, he expresses surprise that the FCC had received no petitions for "declaratory relief."[114]

The reasons that the case is entirely in the courts, and the FCC has not been asked to intervene are unclear. However, as discussed below, AT&T has substantially modified the tying arrangement, while continuing to litigate the case. It is also unclear what legal basis the FCC would have for intervening in the transfer of a municipal franchise, and whether the antitrust laws apply to the Cable industry—or the Internet. We return to these points below in the discussion of the Portland litigation.

Chairman Kennard's speech is important for another reason: it explicitly recognizes that it is facilities-based competition with many providers that brings down rates. For example, he says:

> At the beginning of 1850, this town had one rail line. It had one vital connection to the railroad—the 19th century network that was transforming the nation and the world. By 1852, it had five. By 1856, it had ten.
>
> The cost of shipping the staples of the economy plummeted. Businesses and hotels were springing up as quickly as the wheat filled the town's warehouses. People and capital flowed in. And by 1860, this town, Chicago, Illinois, had tripled in size, and by 1870, it tripled again. The rest—as we see today—is history....[115]
>
> In the wireless industry, we introduced more competition by making more spectrum available. Now, in many markets, consumers have a choice of as many as five wireless providers, and can purchase service at prices that last year cost 40 percent less than it did three years ago.[116]

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[114] Kennard, "Remarks," 4, 6.

[115] Kennard, "Remarks," 2.

[116] Kennard, "Remarks," 3.

Recall that, since the advent of cellular service, there have been *two* facilities-based competitors in each market, one affiliated with the land-line telephone company and one without such affiliation (though these were often affiliated with a land-line telephone company in another area). Thus, Chairman Kennard is implicitly recognizing that, as economic theory suggests, a duopoly is likely to act like a monopoly, and that workable competition requires that there be many competing suppliers, all with significant market shares, though none with a dominant market share.

There are several reasons for the resurgence of interest in charter regulation, but the most obvious is that, when utilities merge, licenses—certificates of public convenience and necessity—must be transferred to the surviving firm. Such transfers are at the discretion of regulators, and enable the regulators to examine, and possibly constrain, aspects of the utility's operations that may have eluded regulatory control previously. In this context it is significant that the state commission reviews of recent mergers have tended to stress problems in quality of service, and most of the conditions that the states impose on the merging parties are generally intended to secure improved service quality in the future.[117] Service quality has resurfaced as an issue in telecommunications in recent decades—and many think this reduction in quality has been exacerbated by price-cap

[117] See the discussion of the conditions the states imposed upon the Bell Atlantic-NYNEX merger below.

incentives for the utility to save by curtailing costly maintenance.[118] Economic theory provides the reasons that price cap and similar alternative forms of regulation will lead to deteriorations in service, so that service quality has to become a major focus for regulators.[119]

The other major reason for recent interest in charter regulation and imposing conditions on the transfer of licenses is that these measures can be applied in circumstances in which the regulatory body may lack direct authority to act. The most obvious recent example occurred in the cable television industry. Federal preemption prevents state regulators from using most of the tools of conventional regulation, while the Federal Communications Commission, as a matter of long-standing policy, tries to regulate the cable industry as "ancillary to broadcast," under Title III of the Communications Act of 1934, rather than under Title II, which applies to common carriage. Thus, some municipal regulators attempted to enforce a competitive market for high-speed access to the Internet by requiring "open access" to ISPs of the customer's choice (rather than the affiliated ISP of the cable system), as a condition to approving the transfer of the

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[118] Interestingly, the severe service problems of 1984, and the even worse problems of 1968 to 1970 occurred in periods of conventional regulation. Indeed, regulation in the 1968 period was considered by some to be relatively "lax," which should have caused over building if the Averch-Johnson effect were valid. For a description of the 1968 problems, which led to FCC monitoring of service quality starting in 1969 and the creation of the NARUC Staff Subcommittee on Service Quality in 1972, see K. Aubrey Stone, *I'm Sorry, The Monopoly You Have Reached Is Not in Service* (New York: Ballantine Books, 1973), or, for another view, Alvin von Auw, *Heritage and Destiny: Reflections on the Bell System in Transition* (New York: Praeger, 1983), 10-13. There was a rumor that the service problem in New York City was caused by a president of New York Telephone who was three years from retirement, and who reduced maintenance and equipment expenditures so his last years in office would look very good financially. Supposedly, the deterioration in service quality he foresaw but dismissed manifested itself in two and one-half years rather than three. This rumor is supported by an acknowledged AT&T policy of trying to reduce service costs rather than increase rates. Compare the version in John Brooks, *Telephone* (New York: Harper and Row, 1975), 288-295, esp. 293-294.

[119] For a current treatment of the economic theory of incentives stemming from regulation, see Jean-Jacques Laffont and Jean Tirole, *Competition in Telecommunications* (Cambridge, MA: MIT Press, 2000), chapter 2.

franchise.[120] In this instance, however, the courts held that this application of the franchise authority had been preempted by a seemingly unrelated provision of the Telecommunications Acts.

Current Procompetitive Telecommunications Activity

Statements of FCC Policy

While the FCC has developed a fairly consistent method of evaluation in its reviews of several recent mergers, there is some question as to what it is trying to accomplish. The FCC no longer has actual authority under the Communications Act to review a merger as such, though it appears to retain such authority under the Clayton Antitrust Act.[121] However, antitrust reviews are foreign to the FCC's expertise, and, as we shall see below, the FCC actually conducts its review under the Communications Act, as part of the process of transferring the wireline and radio licenses.[122] The FCC structures its reviews as if they are antitrust reviews, although, as we shall see, it does not actually perform its review under the Clayton Act. FCC Commissioner Furchtgott-Roth's statements concurring in the result on

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[120] Two such cases have reached the courts. A district court decision favorable to the regulators in City of Portland and Multnomah County v. AT&T was overruled by the ninth circuit court of appeals. Broward County v. Comcast was overturned in the eleventh circuit on First Amendment grounds..

[121] This authority, formerly in the Communications Act at 47 U.S.C. § 221(a), was removed by the Telecommunications Act of 1996. However, the FCC does retain jurisdiction to enforce *violations* of the Clayton Act, 15 U.S.C. §§ 18, 19, 21, which would appear to include authority to review mergers.

[122] That is, under 47 U.S.C. §§ 214, 310. This point is made at length by FCC Commissioner Furchtgott-Roth. See Separate Statement of Commissioner Harold Furchtgott-Roth, Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., CC Docket No. 97–211, Memorandum Opinion and Order September 14, 1998 (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1998/fcc98225.wp, December 17, 1999), 2–3 (hereinafter, Statement on MCI-WorldCom Merger; Concurring Statement of Commissioner Harold Furchtgott-Roth, Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Tele-Communications, Inc., Transferor, to AT&T Corp, Transferee, CS Docket No. 98–178, February 18, 1999 (accessed as http://www.fcc.gov/Bureaus/Cable/Orders/1999/fcc99024.wp, December 29, 1999), 2 (hereinafter, Statement on AT&T-TCI Merger).

several recent cases provide a thoughtful counterpoint to the formal views of the FCC. Commissioner Furchtgott-Roth's statements, and the FCC's formal policy statement[123] constitute a valuable dialog.

FCC Policy and Practice with Respect to Mergers

The FCC presented its formal testimony and policy statement on mergers[124] after the first round of mergers, but before the FCC voted on MCI-WorldCom, SBC-Ameritech and some other mergers, not to speak of Bell Atlantic's petition to enter the interexchange (inter-LATA toll) market in New York State.[125] In the case of mergers, the FCC formulated the issue as follows:

> Does the consolidation strengthen the prospects for competition or decrease them? As the independent agency charged with promoting competition in communications, the FCC has a statutory obligation under the Communications Act to determine whether a merger between telecommunications firms is in the public interest.[126]

This statement is significant for several reasons. The first is that the FCC states that the question is whether the consolidation strengthens the prospects for competition. There are few consolidations of any size that strengthen the prospects for competition. It is frequently argued by those promoting a merger that, by strengthening the smaller firms in the industry the merger will render them able to compete better against the market leader. There is no evidence for this theory. Competition is not a bilateral process between the

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[123] FCC Commissioner Susan Ness, "Statement of Commissioner Susan Ness, Federal Communications Commission, on Mergers and Consolidation in the Telecommunications Industry, before the Committee on the Judiciary, U.S. House of Representatives," June 24, 1998, (accessed as http://www.fcc.gov/Speeches/Ness/States/stsn820.wp, December 17, 1999). (Hereinafter "Testimony on Mergers.")

[124] Ness, "Testimony on Mergers."

[125] Ness, "Testimony on Mergers," 3.

[126] Ness, "Testimony on Mergers," 3.

market leader and the second firm: it is a multilateral process involving all the firms in the industry, or, at least, all firms of more than trivial size. All mergers increase concentration in the industry, and concentration remains by far the most significant single indicator of market power. In particular, industries with a few large firms often exhibit the same indicia of market power as do industries with a single dominant firm. Thus, the Department of Justice and Federal Trade Commission rely heavily on the Hirschman-Herfindahl Index (HHI), which is calculated using the market shares of *all* the firms actively in the industry, to assess the probable effect of merger on competition.[127].

Second is the FCC's statement that it is "charged with promoting competition in communications," and that in making determinations it "has a statutory obligation...to determine whether a merger...is in the public interest." However, as Commissioner Furchtgott-Roth points out, the public interest standard *does not* apply to the FCC's limited authority to rule directly upon mergers; the FCC's authority under the Clayton Act permits it only to review whether the merger will impede competition, and it has no direct authority to rule on mergers under the Communications Act.[128] In short, the Commission appears to be creating new law, extending its licensing authority to deal with certain competitive issues. If the industry were about to become workably competitive, so that the FCC might forebear from regulation or even declare the industry deregulated, then application of the public interest standard might not be necessary. However, the mergers to which the FCC applies

[127] U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines,* 27 Fed. Reg. 41,552 (1992).

[128] See Furchtgott-Roth, Statement on MCI-WorldCom Merger, 2–3, fn. 3. Thus, as discussed elsewhere herein, the FCC does not actually conduct a review under the Clayton Act; although it adopts much of the Clayton Act framework, including references to the *Merger Guidelines,* the FCC modifies this framework to conduct its competitive review under sections 214 and 310 of the Communications Act (primarily 47 U.S.C. §§ 214[a] and 310[d]), which deal with the transfer of various operating licenses, and which contain a public interest standard. See also *ibid.,* 2, and Furchtgott-Roth, Statement on AT&T-TCI Merger, 1, 2.

the public interest standard involve public utility segments of the industry, most of which remain subject to some aspects of regulation.[129]

The *public interest* standard is one that developed under regulation, and the FCC is absolutely correct when it presented testimony that the Communications Act of 1934, the FCC's governing statute, requires the FCC to make determinations as to the "public interest, convenience, and necessity":[130] The FCC's mission statement, as stated in the preamble to the Communications Act of 1934, makes no reference to competition;[131] indeed any statement to the effect that the FCC's primary role is to promote competition

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[129] Commissioner Furchtgott-Roth points out that the FCC does not conduct a full "public interest" review of all mergers involving transfers of licenses. For example, he says, the Commission did not conduct such a review of mergers involving companies like the Mobil and Exxon oil companies. Statement on AT&T-TCI Merger, 3. The difference, which Commissioner Furchtgott-Roth does not explain, is, of course, that the FCC conducts its detailed review only of companies that are subject to its jurisdiction in other respects: they are communications common carriers, cable television companies, or broadcasters. The FCC has a general responsibility to regulate these industries in the public interest; it has no such responsibility with respect to oil companies.

[130] This form of the public interest standard appears, for example, in 47 U.S.C. § 214(e)(2), § 251(h)(2)(C), § 252(e)(2)(A)(ii), §§ 254(b)(7) and 254(c)(1)(D). §§ 257(b), 257(c)(1), 257(c)(2), § 271(d)(3)(C), and § 272(f)(3) (there are further references in title 3 of the Act, which deals with radio); elsewhere in the Communications Act, including elsewhere in title two, which deals with common carrier matters, the term "public interest" is used frequently.

[131] SEC. 1. [47 U.S.C. 151] PURPOSES OF ACT, CREATION OF FEDERAL COMMUNICATIONS COMMISSION.

> For the purpose of regulating interstate and foreign commerce in communication by wire and radio so as to make available, so far as possible, to all the people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex, a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges, for the purpose of the national defense, for the purpose of promoting safety of life and property through the use of wire and radio communication, and for the purpose of securing a more effective execution of this policy by centralizing authority heretofore granted by law to several agencies and by granting additional authority with respect to interstate and foreign commerce in wire and radio communication, there is hereby created a commission to be known as the "Federal Communications Commission," which shall be constituted as hereinafter provided, and which shall execute and enforce the provisions of this Act.

was only an indirect inference.[132] However, the preamble to the Telecommunications Act of 1996 states that it is "An Act to promote competition and reduce regulation in order to secure lower prices and higher quality services for America's telecommunication consumers and encourage the rapid deployment of new telecommunication technologies." In fact, the FCC's commitment to a public interest standard means that it cannot assume that competition is invariably in the public interest, however much some economists may wish it to; rather, if it can be shown that some regulatory procedure may accomplish much the same ends as competition, the FCC may, and perhaps must, allow the continuation of regulation. The difficulty with this formulation is, of course, that regulation is commonly said to cause hidden inefficiencies in the industry, to lead to diminished innovation, and to raise prices, camouflaging the increased prices by causing excessive investment in plant and equipment. Moreover, some authorities claim that regulation is unnecessary, and even that regulation is the cause of monopoly, rather than an attempt to constrain "natural" monopoly. However, the public interest standard, which derives from regulatory law and

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[132] For example, the FCC *may* forbear from regulation when there is competition, but note that it is not required to do so:

> SEC. 10. [47 U.S.C. 160] COMPETITION IN PROVISION OF TELECOMMUNICATIONS SERVICE.
> (a) Regulatory flexibility.–Notwithstanding section 332(c)(1)(A) of this Act, the Commission shall forbear from applying any regulation or any provision of this Act to a telecommunications carrier or telecommunications service, or class of telecommunications carriers or telecommunications services, in any or some of its or their geographic markets, if the Commission determines that–
> (1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory;
> (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and
> (3) forbearance from applying such provision or regulation is consistent with the public interest.
> (b) Competitive Effect To Be Weighed.–In making the determination under subsection (a)(3), the Commission shall consider whether forbearance from enforcing the provision or regulation will promote competitive market conditions, including the extent to which such forbearance will enhance competition among providers of telecommunications services. If the Commission determines that such forbearance will promote competition among providers of telecommunications services, that determination may be the basis for a Commission finding that forbearance is in the public interest.

practice, will lead to the retention of regulation in many circumstances. Thus, if competition is really a more desirable economic system than regulation, there must be concern whenever the "public interest" standard is used to reduce competition. On the other hand, if competition will not protect the consumers *fully as effectively* as regulation, then the FCC has a public interest responsibility to continue regulation, even as it tries to mitigate the detrimental effects of that regulation. As the FCC said:

> [W]hile the Commission's analysis of competitive effects is informed by antitrust principles and judicial standards of evidence, it is not governed by them. Therefore, it is possible for the Commission to arrive at a different assessment of the size or nature of the likely competitive benefits or harms of a proposed merger when assessing competitive effects under its public interest standard than the antitrust agencies arrive at under antitrust law.[133]

The FCC goes on to say that "one of the FCC's core responsibilities is to write fair rules of competition for all communications markets, and to forbear from regulation or deregulate where markets have become competitive."[134] Again, fair rules for competition are the concern of the Federal Trade Commission and the Department of Justice, enforcing the antitrust laws, and are, in any case, unnecessary if there is actual workable competition. One concern is that a regulatory agency, with a public interest statutory standard, may write rules of competition that tend to stifle competition. The other concern, which the FCC does not mention, is that, so far, not all markets have become so workably competitive that FCC deregulation and forbearance are consistent with the public interest.

As the FCC phrases it, the Commission evaluates mergers under the public interest standards of 47 U.S.C. §§ 214 and 310(d), and it "also has" authority under

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[133] Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., CC Docket No. 97–211, Memorandum Opinion and Order, September 14, 1998 (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1998/fcc98225.wp, December 17, 1999), para. 13. (Hereinafter, *MCI-WorldCom Order.*)

[134] Ness, "Testimony on Mergers," 4.

section 7 of the Clayton Act. The FCC is somewhat misleading in this statement, partly because the FCC does not actually exercise its authority under the Clayton Act (as Commissioner Furchtgott-Roth explains, and as noted elsewhere herein), and also because the FCC's testimony was no longer fully correct when it was delivered; much of the FCC's authority under the Clayton Act had been deliberately removed by the Congress because procompetitive policy is inconsistent with the FCC's public interest mandate of the Communications Act, and would likely lead to inconsistent or undesirable results. As the Conference Report on the Communication Act notes:

> b) Antitrust Laws.–
> (1) Savings clause.–Except as provided in paragraphs (2) and (3), nothing in this Act or the amendments made by this Act shall be construed to modify, impair, or supersede the applicability of any of the antitrust laws.
> (2) Repeal.—Subsection (a) of section 221 (47 U.S.C. 221(a)) is repealed.
> (3) Clayton act.—Section 7 of the Clayton Act (15 U.S.C. 18) is amended in the last paragraph by striking "Federal Communications Commission,..."[135]
>
> The antitrust savings clause provides that except as provided in paragraphs two and three, nothing in this Act or the amendments made by the conference agreement shall be construed to modify, impair, or supersede the applicability of any of the antitrust laws. The clause was modified to include the repeal of section 221(a) of the Communications Act (47 U.S.C. Sec. 221(a)). Congress enacted section 221(a) in the days when local telephone service was viewed as a natural monopoly. Its purpose was to allow competing local telephone companies to merge without facing antitrust scrutiny. Thus, the statute provides that when any two telephone companies merge, the Commission should determine whether the merger will be of advantage to the persons to whom service is to be rendered and in the public interest. If so, the Commission can render the transaction immune from "any Act or Acts of Congress making the proposed transaction unlawful." In a world of regulated monopolies, this idea made sense.
>
> However, section 221(a) could inadvertently undercut several of the provisions of the Telecommunications Act of 1996. The problem arises for

[135] U.S House of Representatives, 104th Congress, Second Session, "Telecommunications Act of 1996, Conference Report," Report 104–458 (January 31, 1996), 92 (referring to § 601(b) of the Telecommunications Act of 1996).

at least two reasons. First, the critical term "telephone company" is not defined. In the old world of regulated monopolies, a definition probably was not necessary. However, in the new world of competition, many companies will be able to argue plausibly that they are telephone companies.

Second, section 221(a) allows the Commission to confer immunity from any Act of Congress (including the Telecommunications Act of 1996) after performing a public interest review. Section 221(a) could be used to avoid the cable-telco buyout provisions of the Telecommunications Act of 1996. Any cable company that owned any telephone assets could become a telephone company and be bought out by a BOC by applying for immunity under this section.

In addition, if immunity were conferred under section 221(a), it would allow mergers between telecommunications giants to go forward without any antitrust or securities review. In the old world, the statute was usually used to confer immunity on mergers between non-competing Bell operating subsidiaries or mergers between Bells and small independents within their territories. Neither of these situations involved competitive considerations.

However, in the future, the conferees anticipate that cable companies will be providing local telephone service and the BOCs will be providing cable service. Mergers between these kinds of companies should not be allowed to go through without a thorough antitrust review under the normal Hart-Scott-Rodino process. The new language contains a conforming change to clarify that these mergers will now be subject to Hart-Scott-Rodino review. By returning review of mergers in a competitive industry to the DOJ, this repeal would be consistent with one of the underlying themes of the bill—to get both agencies back to their proper roles and to end government by consent decree. The Commission should be carrying out the policies of the Communications Act, and the DOJ should be carrying out the policies of the antitrust laws. The repeal would not affect the Commission's ability to conduct any review of a merger for Communications Act purposes, e.g., transfer of licenses. Rather, it would simply end the Commission's ability to confer antitrust immunity.[136]

The FCC does retain enforcement authority to review mergers under section 18 of the Clayton Act (15 U.S.C. §§ 18, 21), but only with respect to whether or not the merger is

[136] U.S. House of Representatives, 104th Congress, Second Session, "Telecommunications Act of 1996, Conference Report," Report 104–458 (January 31, 1996), 200.

anticompetitive; the FCC can no longer apply a public interest standard to insulate an anticompetitive merger from scrutiny. The applicable standard is:

> No person engaging in commerce...shall acquire,...the assets of another person..., where...the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly. (15 U.S.C. § 18)

This statutory standard leaves no room for judgement that there may be "public interest" benefits offsetting the loss of competition. Thus, it is significant that the FCC consistently declines to exercise its jurisdiction under the Clayton Act.[137] The FCC is often faced with a choice between an antitrust standard that would allow it to consider only the competitive effects of a merger, and the more flexible "public interest" standard, that allows the FCC to consider offsetting benefits. The public interest standard, and the FCC's powers under the Communications Act, allow the FCC to use additional regulation to mitigate anticompetitive effects of the merger, or other effects of the merger that might frustrate its policies or be otherwise contrary to the public interest. Under these circumstances the FCC has consistently chosen regulation, despite statements to the effect that, under the Telecommunications Act of 1996, it is supposed to be replacing regulation with competition.[138] Since the FCC lacks authority to order structural changes,

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[137] The enforcement authority with respect to mergers (15 U.S.C. § 18) and interlocking directorates (15 U.S.C. § 19) is contained in 15 U.S.C. § 21. Examples of the FCC's declining to exercise authority under the Clayton Act may be found at In the Applications of NYNEX Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, File No. NSD–L–96–10, Memorandum Opinion and Order, August 14, 1997, (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1997/fcc97286.wp, September 7, 1998), paras. 2, 29 (arguing that the FCC's public interest examination "subsumes and extends beyond" Clayton Act considerations) (hereinafter *BA-NYNEX Order*); *MCI-WorldCom Order,* at para. 12 ("Because our *public interest* authority under the Communications Act is sufficient to address the competitive issues raised by the proposed merger, we decline to exercise our Clayton Act authority in this case." [Emphasis supplied.])

[138] See, for example, *MCI-WorldCom Order,* para. 14.

such as divestiture, to promote competition, it has no choice but to use regulation that may serve the public interest where competition seems likely to fail, and to use regulation to try to force procompetitive behavior on the incumbents.[139]

For example, in its testimony the FCC went on to explain that it balanced the procompetitive effects of a merger with the anticompetitive effects, without explaining the circumstances under which a merger might have procompetitive effects, or what such effects might be.[140] The FCC looks forward to the expected significance of the merged firms as the industry develops in the future.[141] Again, there is no similar provision in the merger guidelines (or the antitrust laws); the Federal Trade Commission and Justice Department look at the industry as it currently exists, and not as it might develop in the future. As we have shown elsewhere, competition may develop quickly in some market segments and slowly in others, and it is difficult to predict which will be which.[142] Thus, as Commissioner Furchtgott-Roth points out, the FCC relies on a different, less rigorous,

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[139] This is often described by pejoratives like "holding an umbrella over the new entrants." However, it has proved effective in the past. To the extent that interexchange competition developed during the 1970s, it did so largely because of the umbrella that the FCC held to permit the competitors to survive and grow. In 1980, after about a decade of such policies, although toll competition was still minuscule in amount, the FCC considered itself justified in revising depreciation rates to correspond more closely to those that might occur in a competitive industry. Even so, costs rose and productivity fell in telecommunications for most of the next decade, until carefully nurtured competition restored telecommunications costs and productivity to their historic trends. For details, see Chessler, *Toll Competition*. Recall that the "equal access" regulations that led to the rapid growth of toll competition after 1983 were the result of settlement of an antitrust suit brought by the Justice Department in 1976. The FCC had been moving step-by-step in the direction of improved access for toll competitors, but each step had to be ordered, litigated, and shown to be both practical (from a technical point of view) and insufficient (from a competitive-policy point of view). Moreover, despite equal access in the mid-1980s, the FCC was not able to find AT&T non-dominant for many more years.

[140] Ness, "Testimony on Mergers," 6. Mergers that promote competition are usually thought to be limited to instances in which one of the merged firms is failing or otherwise demonstrably incapable of surviving in the market; when the merged firms are truly minuscule the anticompetitive effects of the merger may sometimes be neglected. For further information see U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines,* 27 Fed. Reg. 41,552 (1992).

[141] Ness, "Testimony on Mergers," 6.

[142] Chessler, *Workable Competition,* chapter 4.

standard of evidence than does the Justice Department.[143] On the other hand, the FCC deals with far broader issues than the Justice Department in an analysis that "exceeds even DOJ's principles and that examines broader social issues."[144] The competition that was expected to result from the Telecommunications Act of 1996 has been slow to develop; as we shall see, anticipating such competition was apparently a major reason that the FCC approved what it admitted to be an anti-competitive merger between Bell Atlantic and NYNEX[145]—and the Justice Department has recently argued that, almost two and one-half years after that merger, the competitive guidelines (47 U.S.C. § 271(b)) are not being met.[146]

The FCC went on to testify that it goes on to say that it continues to look for "efficiencies" that might result from the merger to justify it, "if such efficiencies enhance the merged parties' incentives to compete."[147] In fact, such efficiencies are often claimed *ex ante* but are rarely found *ex post*. While merging parties commonly explain that such efficiencies will occur, just as commonly they refuse to reduce rates on a forward-looking basis in anticipation of such efficiencies. Similarly, the FCC stated that it examines whether the increased market power that may result from a merger is likely to induce new

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[143] "For example, under the precluded competitor framework used in part here, our analysis of potential competitors is too speculative, as we do not require the same type of evidence that the Department of Justice's merger guidelines require of intent to enter the market." Furchtgott-Roth, Statement on MCI-WorldCom Merger, 2.

[144] Furchtgott-Roth, Statement on MCI-WorldCom Merger, 2. Commissioner Furchtgott-Roth claims that these issues are "beyond this agency's expertise or authority." *Idem*. See also Furchtgott-Roth, Statement on AT&T-TCI Merger, 4.

[145] It had also passed Justice Department review, because it did not reduce competition since neither firm was an actual competitor in the other's market, and the Bell Atlantic plan to compete directly with NYNEX was not sufficiently certain. We discuss this in detail below.

[146] Peter S. Goodman, "Justice Dept. Resists Bell Atlantic Move into Long Distance," *Washington Post,* November 2, 1999, E1.

[147] Ness, "Testimony on Mergers," 7.

entry to reduce that market power.[148] Again, this is hard to understand: if one accepts the theory that potential entry limits market power, then the fact that market power increases must mean that entry has been made more difficult as a result of the merger; moreover, it is difficult to envision circumstances in which a merger would not create or increase barriers to entry. In any case, the FCC does not actually perform the kinds of detailed market analyses that would be needed to determine whether the increased prices resulting from the merger would make it more likely that new firms would enter the industry.[149] As Commissioner Furchtgott-Roth said, "we do not seem to require the same type of evidence as the Justice Department's merger guidelines would require of intent to enter the market by another means."[150]

In any event, as William G. Shepherd says: "Yet virtually no research has been done to develop methods of identifying potential entrants. Most analyses simply assume that there are many powerful potential entrants. But that need not be true, and in many cases it

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[148] Ness, "Testimony on Mergers," 7.

[149] For example, see the FCC's analysis in the Bell Atlantic merger with NYNEX: there is no analysis of the increased market power resulting from the merger, or whether it would promote or impede entry of new firms. The FCC's analysis was limited to determining whether requiring certain actions (involving pricing, implementation of Operations Support Systems, and reporting quality of service), most of which were already required under various sections of the Communications Act or the FCC's rules, might facilitate entry, with no attempt to measure how strong that effect might be, or how many more new firms might actually enter the market if the merger were allowed. See In the Applications of NYNEX Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, File No. NSD–L–96–10, Memorandum Opinion and Order, Memorandum Opinion and Order, August 14, 1997 (accessed as http://www.fcc.gov/Bureaus/Common _Carrier/Orders/1997/ fcc97286.wp, September 7, 1998). (Hereinafter, *BA-NYNEX Order.*)

[150] FCC Commissioner Harold Furchtgott-Roth, Separate Statement of Commissioner Harold Furchtgott-Roth, Teleport Communications Group Inc., Transferor, and AT&T Corp., Transferee, For Consent to Transfer Control of Corporations Holding Point-to-Point Microwave Licenses and Authorizations to Provide International Facilities-Based and Resold Communications Services, July 23, 1998, (accessed as http:// www.fcc.gov/Bureaus/Common_Carrier/Orders/1998/fcc98169.wp, September 7, 1998), 1. (Hereinafter, Statement on AT&T-TCG Merger.)

certainly is not."[151] Yet the FCC is clearly, in this and other instances, relying on an unsupported assumption that market entry will occur, and will do so soon enough and with enough firms and enough capacity that the market will become competitive. Thus, the FCC's position that it could sacrifice potential entrants into each others markets, like Bell Atlantic and NYNEX (see below), if it made entry easier, is unsupported and represents a misunderstanding of what empirical economics has shown.

Commissioner Furchtgott-Roth raises an additional issue: because the FCC has no actual authority to block the merger, it has few ways to enforce its decisions. It can refuse to permit the transfer of licenses, which *might* prevent consummation of the merger, but it cannot actually block the merger under the Communications Act.[152] The FCC habitually waits for the Justice Department to rule upon the merger, and it would create an interesting situation if the FCC were to attempt to prevent, either through its authority over the transfer of licenses, or more directly through its authority under the Clayton Act, a merger that the Justice Department approved. Rather, the FCC applies "conditions" to the approval of the merger, using its broad public interest standard. The FCC's enforcement authority stems not from antitrust laws, but from its regulatory authority. If it considers a merger not to be in the public interest, it can attempt to apply regulatory conditions that will make it more in the public interest. If competition fails in some respect, the FCC could attempt to apply the Clayton Act, but its expertise lies elsewhere: it would apply its powers under the

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[151] See the extensive discussion in William G. Shepherd, *The Economics of Industrial Organization,* Third Edition (Englewood Cliffs: Prentice Hall, 1990) (hereinafter, *Industrial Organization*), 65-67. See also the caveats, suggesting that both the concentration ratio and the Hirschman-Herfindahl Index should be considered when concentration is high, in Scherer and Ross, *Industrial Market Structure,* 72–73.

[152] Furchtgott-Roth, Statement on AT&T-TCI Merger, 1–3.

Communications Act to redress the specific respect in which competition has failed.[153] In applying its powers in this manner, the FCC acts like most state regulatory bodies. While some state bodies have specific authority to prevent a merger, and some have authority under state antitrust laws, state commissions reviewing mergers generally use their approval authority to achieve regulatory goals and seek to impose regulatory conditions on the mergers to bring them into the public interest.

Apart from the question of whether the FCC can fully understand its changed role in the nation's competitive policy as a result of the Telecommunications Act,[154] the question arises as to whether the FCC–or anyone–is fully cognizant of the inherent conflict between the public interest standard and the standard of competition adopted elsewhere in the economy. Indeed, it is questionable whether *any* agency charged with making decisions based on "the public interest, convenience, and necessity" can do so in a consistently procompetitive manner, since there are always likely to be some *claimed* advantages to the public interest of merger or monopoly, and the advantages of competition are often

[153] The recurring issue of "slamming" (the unauthorized transfer of a subscriber from one presubscribed interexchange carrier to another) is an example. To promote competition in the interexchange market, the FCC made it easy (in a regulatory sense) for interexchange carriers to change a customer's presubscription—they could self-certify the change to the CLECs. There have been abuses of this policy since its inception, and the FCC, Congress, and various state commissions have acted to control slamming. No one has considered the obvious solution—requiring the customer to contact the local exchange carrier and request the change in presubscription—because to do so would make it difficult for interexchange carriers to compete for the residential and small business markets. Rather, the regulators have imposed increasingly complex regulations, and increasingly stringent fines and forfeitures, to control the problem, in the interest of promoting legitimate competition.

[154] That is, the removal of former 47 U.S.C. § 221(a), and the words "Federal Communications Commission" in section 7 of the Clayton Act (15 U.S.C. 18) that had given the FCC primary responsibility in telephone mergers.

difficult to anticipate. Only in retrospect do the advantages of competition become clear—and even then they are sometimes less clear than we might wish.[155]

On the other hand, the FCC's apparent concern between the "public interest" standards of the Communications Act and the "substantially lessen competition" standard of the Clayton Act (and the antitrust laws in general) may really reflect the FCC's difficulties in regulating a public utility industry that is not workably competitive, using the regulatory tools that developed in the last century. The FCC cannot readily undo a merger or order a divestiture, and has not, to date, ordered divestiture as a condition of approving a merger.[156] If it finds market failure, it can apply only to regulatory tools. Again, state commissions face similar difficulties. And no regulatory body can create competition where there is none: the best a regulator can do is create conditions that will foster competition and cause businesses to enter the market. Legislative bodies can, of course, create government competition (that is government agencies that compete in the market). As discussed above, this was frequently attempted in the nineteenth century (most notably with canals to compete with railroads, but in other industries as well). It has not been much tried in the twentieth century, though some might argue that the interstate highway system was a government enterprise that fostered intermodal competition with railroads.

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[155] Competition has lowered rates for toll service and the prices of telephone equipment. It has also resulted in many new toll services and the widespread availability of many new types of telephone equipment. However, local service rates do not appear to have fallen as much as toll rates, and, for several years, they were actually rising as costs were shifted. Thus, competition, like any other policy, has created winners and losers. Chessler, *Toll Competition*. Similar arguments are made for the airline industry: small airports have decreased service at higher rates since deregulation, although rates in general have fallen.

[156] The Department of Justice and the European Commission required MCI to divest itself of its Internet businesses as a condition of its merger with WorldCom. *MCI-WorldCom Order,* paras. 6, 142, 151–154.

The Bell Atlantic and NYNEX Merger

The merger of Bell Atlantic and NYNEX was not the first merger between firms that AT&T had divested in 1983,[157] but it was the first among firms with adjacent serving areas. It was also the first in which the FCC developed and applied its competitive standards, "actual potential competition" and "precluded competitor" analysis, to deal with the situation: until the passage of the Telecommunications Act, direct competition between telephone companies was legally prohibited.[158] More importantly, there was clear evidence that Bell Atlantic had performed several feasibility studies and its management was recommending that it provide competitive service in NYNEX's local service area in New York City, and elsewhere in NYNEX's service territory,[159] although the Bell Atlantic officers and board of directors had not acted on the recommendations. Indeed, the FCC stated that Bell Atlantic should be considered *fifth* among the competitors to NYNEX;[160] that is, a major actual competitor and not merely a potential competitor. There was also some

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[157] Southwestern Bell's (SBC) acquisitions of Pacific Telesis and Southern New England Telephone (SNET) had preceded it. There had also been several mergers among firms in what had formerly been called the "independent" segment of the industry.

[158] GAO, *LEC Merger Review,* 11–13.

[159] These management studies had been performed even before the passage of the Telecommunications Act of 1996, which promoted local competition. Markets in Boston, and Providence were also under study, and the studies were halted only when the merger negotiations were in progress. In the merger announcement, Bell Atlantic's Chairman and Chief Executive Officer described the combined territory as "really one big market." *BA-NYNEX Merger Order,* paras. 43–44, 57. Unfortunately, much of this evidence appears to have been proprietary, and the summaries in the body of the Order are not very specific, even as to the dates the studies were done. Justice Department officials told the General Accounting Office that there was some information to the effect that Bell Atlantic did not intend to provide service in NYNEX's service territory. The GAO does not discuss the nature of this evidence, and it is not discussed in the FCC's order (above), or in Commissioner Furchtgott-Roth's separate statement. GAO, *LEC Merger Review,* 14.

[160] FCC, *BA-NYNEX Merger Order,* paras. 10–11. The detailed analysis is at paragraphs 72–94; the list of "most significant market participants in LATA 132 [New York City]" is at paragraph 94: NYNEX, AT&T, MCI, Sprint, and Bell Atlantic.

evidence that NYNEX had considered or was considering providing service in portions of Bell Atlantic's service area. Thus, the FCC concluded:

> First, we conclude that the merger is likely to strengthen NYNEX's market power against erosion from competition, and to increase the likelihood that one or more of the most significant market participants may unilaterally exercise market power. Second, we conclude that the merger increases the likelihood of coordinated interaction among the most significant remaining market participants to increase (or not reduce) prices, reduce quality or restrict output.
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> We further conclude that, although this remains a regulated market environment, the possible increase in market power remains an important concern....
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> Finally, we find that the applicants have not demonstrated that additional entry and expansion that might occur in response to the exercise of market power is likely to be rapid or sufficient enough to mitigate our concern that the proposed merger may have an adverse impact on consumers. We do find, however, that the commitments made by Bell Atlantic, and made a condition of our approval of the merger, *mitigate* the concerns that we have as a result of our analysis of the likely competitive effects of the merger.[161]

Potential competition is not competition, and mid-management or even senior management recommendations are not corporate policy. But the mere existence of Bell Atlantic and NYNEX provided a basis for comparison that made regulation easier, and both were potential competitors were the BOCs to provide interexchange service. Thus, the FCC said several times in its order that the effect of the merger would be to reduce

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[161] Application by Bell Atlantic for Authorization Under Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of New York, CC Docket No. 99–295, DA–99–2014, September 29, 1999, (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Public_Notices/1999/da992014.doc, December 18, 1999), paras. 144–146, emphasis added. (Hereinafter, *BA In-Region Order.*) In other words, the FCC authorized the merger based on a hope that its regulatory conditions would mitigate (it did not claim "eliminate") the detrimental effects on the public interest. See *ibid.,* para. 192, where the FCC says "the conditions ... will, *to some extent,* mitigate the potential adverse competitive effects." (Emphasis supplied.)

competition. Indeed, the FCC said that the effect of the merger on competition was such as to fail to meet the "public interest standard."[162]

However, the merger had already been approved by the Justice Department. As a practical matter, had the FCC conducted a standard review under the Clayton Act, it would probably also have found that the merger did not involve direct competitors; alternatively, it would have created an embarrassing legal conflict. As discussed elsewhere herein, the FCC did not actually conduct a Clayton Act review, but a public interest review of the transfers of licenses, disguised as a modified Clayton Act review. Even so, if the FCC had refused to approve the transfer of the licenses, the conflict would have been embarrassing. Thus, the FCC extracted what conditions it could from the merging parties. It is unclear why the FCC did not attempt to negotiate further, or even to modify the conditions offered by Bell Atlantic as suggested by some of the other parties, but quite likely the FCC was concerned about its weak legal position, as expressed by Commissioner Furchtgott-Roth, discussed above. The FCC could not legally prevent the merger, and may well have felt that its position would be weak if the merging parties contested its conditions in court.[163]

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[162] FCC, *BA-NYNEX Merger Order,* para. 12. The FCC's public interest standard requires that the petitioner affirmatively show that the public interest is better met by the granting of the petition than by its denial. The FCC found that "the transaction as supplemented by the commitments proffered" was in the public interest, and that its "public interest review here has subsumed Clayton Act considerations," so it did not bring a proceeding under Section 11 of the Clayton Act. *Ibid.,* para. 29. Compare this reasoning with that of the conferees on the Telecommunications Act. U.S House of Representatives, 104th Congress, Second Session, "Telecommunications Act of 1996, Conference Report," Report 104–458 (January 31, 1996), 200–201. At para. 33 of the Memorandum Opinion and Order the FCC asserted that it had jurisdiction under Sections 7 and 11 of the Clayton Act, but stated that its "jurisdiction under the Communications Act is sufficient to address the competitive concerns—including the issue of whether the proposed transfer may injure competition—and because the conditions modifying the merger sufficiently offset our concerns ..., we choose not to exercise our Clayton Act Authority...." At paragraphs 34 and 35, the Commission similarly chose to consider challenges to its authority to consider competitive issues as moot.

[163] The states that approved the merger almost all imposed conditions upon it; we discuss the state approval process below.

The FCC found that there were significant barriers to entry in local telecommunications markets, and that the Telecommunications Act of 1996 might not eliminate all the barriers as it is implemented. Thus, it could not ignore the anticompetitive effects of mergers, and that mergers also can raise concern in markets that are not subject to regulation.[164] Again, paragraph 42 of the FCC's Order, after the FCC had already mentioned and begun to follow the Justice-FTC "Merger Guidelines"[165] illustrates the FCC's conflicted regulatory mindset: competition is only one of its concerns, and it considers regulation to be a substitute for competition; that is, the FCC seems to assume that continued regulation can achieve the same results as competition. There are few if any mergers that increase competition in an industry, and the merger at hand, as the FCC said in the next paragraph of its Order, by eliminating a major competitor[166] was not one of them. As the FCC says in its Order permitting the merger:

> In order to reach a procompetitive de-regulatory industry structure, market performance must improve to the point where competition, rather than regulation, effectively constrains market power. Even under regulation, a firm can exercise market power if, for example, (1) a price cap fails to bind sufficiently to lower prices to competitive levels or allows flexibility with respect to a basket of services, (2) a bundled product offering, such as combined local and long distance service, is only partially price regulated, or (3) quality is difficult to specify and monitor.[167]
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> There are several reasons we believe that some competitive effects—those producing an increase in market power, or an enhanced ability to maintain market power—will generally not be in the public interest, even when the

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[164] FCC, *BA-NYNEX Merger Order,* paras. 42, 60–61.

[165] FCC, *BA-NYNEX Merger Order,* para. 37. However, the FCC then *departs* from the merger guidelines in its actual analysis of markets. *Ibid.,* para. 66; see also paras. 62, 67–69. Essentially, as explained above, if the FCC were to perform a Clayton Act analysis, as it would if it were to follow the merger guidelines, it would be unable to apply the "public interest standard"—the antitrust laws generally allow consideration only of the merger's effect on competition.

[166] FCC, *BA-NYNEX Merger Order,* para. 43.

[167] FCC, *BA-NYNEX Merger Order,* para. 45.

> exercise of market power arguably is constrained by regulation. The 1996 Act set a clear national policy that competition leading to deregulation rather than continued regulation of dominant firms, shall be the preferred means for protecting consumers. Mergers that increase market power or retard the decline of market power conflict with this policy by maintaining rather than decreasing, the need for continued regulation. A merger that reverses or slows the decline of market power may also hinder or make more costly the transition to competitive, deregulated telecommunications markets. Finally, to the extent that regulation is not completely effective at preventing the exercise of market power, a merger that increases market power adversely affects consumer welfare.[168]

However, the FCC, in its conflicted market analysis, recognizes that local service is a *de facto* monopoly, and that standard market analyses, as used by the antitrust agencies, would prohibit any mergers:

> First, telecommunications markets such as local exchange and exchange access services presently have only one supplier as a practical matter or, as in the case of mass market bundled local exchange and exchange access, and long distance services, no current actual suppliers. In contrast, in the typical potential competition case the relevant markets are oligopolies with four or more competitors.[169]

It should be noted that the FCC did not consider local wireless suppliers (cellular radio, Personal Communications Services [PCS], or other) as actual or even near-term

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[168] FCC, *BA-NYNEX Merger Order,* para. 95. In particular, the FCC observes here that price cap regulation may not be an effective constraint on market power. *Idem.,* fn. 201. The FCC does not discuss the implication of its analysis: that competitive policy that permits the increase of market power may force regulators to abandon price cap regulation in favor of the more intrusive ratebase, rate-of-return regulation (which is also argued to cause greater economic distortions).

[169] FCC, *BA-NYNEX Merger Order,* para. 66.

potential competitors.[170] It was only slightly more optimistic with respect to the potential for cable operators.[171]

Since divestiture in 1983, the presence of multiple BOCs has provided a useful "benchmark" on industry performance. Mergers among the BOCs are reducing the value of this benchmark, which is used by the Justice Department and the FCC, and even the BOCs themselves, to detect anticompetitive behavior or market power. Moreover, in the past the value of the benchmarks was increased because the companies were relatively homogeneous in size and in the activities in which they engaged. Thus, all major mergers would appear to have a deleterious effect on competition and regulation, even if, unlike the Bell Atlantic-NYNEX merger, they did not directly diminish competition.[172]

While the companies made claims that the combined firm would be more efficient, with cost savings of $1 billion per year within three years and improvements in service quality, the FCC discounted these claims as unproven.[173] Moreover, the FCC observed that most of the claimed cost savings were overhead costs, rather than marginal costs. The FCC also noted that, even if the efficiency gains were realized, they "are not likely to fully mitigate the proposed merger's potential anticompetitive harms."[174]

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[170] FCC, *BA-NYNEX Merger Order,* paras. 89–91

[171] FCC, *BA-NYNEX Merger Order,* paras. 85–86.

[172] FCC, *BA-NYNEX Merger Order,* para. 148–151.

[173] Bell Atlantic officials told the GAO that "significant" savings were realized. GAO, *LEC Merger Review,* 14.

[174] FCC, *BA In-Region Order,* paras. 168–176. The FCC appears to have relied heavily on confidential information in reaching these conclusions. However, merging companies are remarkably reluctant to commit to future rate reductions as a result of the "hard, real and certain" cost savings. (The so-called certainty of the cost savings is taken from *ibid.,* para. 160, quoting Applicants June 23, 1997 Comments, at 2, para. 3, and the Declaration of Lawrence T. Babbio, Jr. (June 23, 1997), para. 3.

Federal Regulatory Conditions to Constrain Increased Market Power

The FCC claimed that the conditions it was imposing on the merger would, "to some extent, mitigate"[175] what it admitted was an anticompetitive merger.[176] Thus, it is important to examine these conditions, which were of three sorts, based on an *ex parte* settlement offer by Bell Atlantic:[177] a requirement that Bell Atlantic offer its unbundled network elements (UNEs) at forward-looking (incremental) cost, and with easier payment terms;[178] a requirement that, within fifteen months, Bell Atlantic offer a uniform interface, acceptable to

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[175] FCC, *BA In-Region Order,* para. 192. Cf. para. 146, which also uses the term, "mitigate."

[176] The conditions were originally supposed to "sunset" forty-eight months after the consummation of the merger; the FCC is now conducting hearings as to whether the sunset should be set at forty-eight months after Bell Atlantic demonstrates full compliance, so that the competitors will get a full four years of benefit from the conditions. GAO, *LEC Merger Review,* 15, fn. 18; FCC, *BA-NYNEX Merger Order,* para. 181.

[177] FCC, *BA-NYNEX Merger Order,* para. 180. The conditions constitute appendices C and D to the FCC Order.

[178] This requirement had been part of the FCC's *First Report and Order* implementing the Telecommunications Act. On July 18, 1997, a month before the FCC issued its order permitting the merger, the Eighth Circuit had overturned relevant portions of the *First Report and Order* (sometimes called the *Local Competition Order* or the *Interconnection Order*), which it had stayed almost a year previously. However, at the time of the FCC's order permitting the merger, all states were implementing the FCC's rules on pricing of UNEs as if they were still in force, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96–98, First Report and Order (FCC Mimeo 96–325, August 8, 1996). (Accessed as 96325err.wp in http://www.fcc.gov/interconnection/fcc96325.html, October 7, 1996.) (Hereinafter, *Local Competition Order.*) Iowa Utilities Board v. FCC, Order Granting Stay Pending Judicial Review, 8th Circuit (Case No. 96–3321, October 15, 1996). (Accessed as http://www.wulaw.edu/8th.cir/opinions/FCC/963321.008, October 31, 1996.) (Hereinafter, *Stay.*) Iowa Utilities Board v. FCC, Decision, 8th Circuit (Case No. 96–3321 (July 18, 1997). (Accessed as http://www.wulaw.edu/8th.cir/opinions/FCC/963221.wpd, August 8, 1997). (Hereinafter, *Decision*.) Iowa Utilities Board v. Federal Communications Commission, 120 F.3rd 753 (8th Cir. 1997), *aff'd in part and overruled in part, sub nom* AT&T Corp. *et al.* v. Iowa Utilities Board, No. 97-826, U.S. Supreme Court, Slip Opinion released January 25, 1999, Accessed as http://supct.law.cornell.edu/supct/pdf/97-826P.ZO, January 25, 1999. In the Applications of NYNEX Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, File No. NSD–L–96–10, Memorandum Opinion and Order, August 14, 1997, Accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1997/fcc97286.wp, accessed September 7, 1998, para. 13. (Hereinafter, *Opinion*.)

the industry, into its Operations Support Systems (OSS), and facilitate testing; and one establishing a wide variety of requirements for service quality and for reporting of service quality,[179] though the FCC did not make it mandatory that Bell Atlantic retain records to make the reports auditable. The FCC never explained specifically how its conditions compensated for the anticompetitive effect of the merger itself.[180] Apparently, the conditions were intended to promote entry by new Competitive Local Exchange Carriers (CLECs) into the local exchange market in New York City and elsewhere in Bell Atlantic territory,[181] to replace the planned entry by Bell Atlantic into NYNEX's territory and the anticipated entry by NYNEX into Bell Atlantic's territory. Despite the conditions, and the actively procompetitive interventions of many of the state commissions in the Bell Atlantic service area, it does not appear that local-service competition has developed even in all metropolitan areas, or even that Bell Atlantic has met the requirements of the "competitive checklist" (47 U.S.C. § 271(c)(2)(B)) so that it might offer inter-LATA telecommunications services in its home region.[182] Thus, the FCC and Justice Department's analyses in the Bell Atlantic application to provide inter-LATA toll services in New York State permits us to revisit the merger conditions and see how effective they were.

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[179] FCC, *BA-NYNEX Merger Order,* para. 13.

[180] The explanation in the order is that they reduce barriers to entry. FCC, *BA-NYNEX Merger Order,* paras. 193–200; the discussion of rejected alternative conditions (the proposals of intervenors) is at paras. 202–232.

[181] FCC, *BA-NYNEX Merger Order,* para. 124. In this paragraph, the FCC also expressed the hope that increased entry would reduce the risk of coordinated actions by the leading firms—a risk that had been increased when they were reduced in numbers by the elimination of Bell Atlantic as an actual or potential competitor. See also para. 128 on whether the anticipated entry would decrease the risk of increased prices and decreased service quality as a result of the merger.

[182] The Justice Department opposed the Bell Atlantic petition for such authority in New York, despite Bell Atlantic's making more extensive—but still apparently inadequate—efforts to meet the requirements to open its local market. This opposition reflects on the assertions that the conditions imposed on the merger would foster competition. However, the New York Public Service Commission supported the application. See Peter S. Goodman, "Justice Dept. Resists Bell Atlantic Move into Long Distance," *Washington Post,* November 2, 1999, E1. See FCC, *BA In-Region Order,* paras. 44–62, generally; specific detail on the individual requirements of the checklist is found in the following section of the *Order.* The FCC ruled in favor of the Bell Atlantic petition as discussed below.

The conditions on interconnection in the FCC's Order permitting the merger were, for the most part already in place; that is, they were in sections of the FCC's so-called *Local Competition Order* that were not suspended in *Iowa v. FCC.*[183] Indeed, in its order permitting the merger the FCC relied in large part on its *Second Physical Collocation Order,*[184] which was unaffected by the *Iowa v. FCC* litigation.

The FCC recognized that the exercise of market power in telecommunications markets is unlikely to cause rapid entry to constrain such exercise. Thus, it stated that it was relying primarily on Bell Atlantic's offering of UNEs at incremental cost to permit easy and rapid "uncommitted" entry by new competitors.[185]

The FCC believed, based on representations of parties, that nondiscriminatory access to "OSS" functions was essential to the development of local service competition. These OSS are essential to competitors that use any of the facilities or services (that is, UNEs or services for resale) of the incumbent to provide competitive services. Access to these systems has been required by FCC rules since the August 29, 1996 Local

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[183] Iowa Utilities Board v. FCC, *Stay.* Neither were they suspended in the final order, and the relevant clauses that were suspended (those imposing on the states an incremental cost theory of ratemaking) were eventually reinstated by the Supreme Court (though they had not been reinstated at the date of the Order permitting the merger. See, Iowa Utilities Board v. Federal Communications Commission, *Opinion.*

[184] FCC, *BA-NYNEX Merger Order,* para. 13, citing Local Exchange Carriers' Rates, Terms and Conditions for Expanded Interconnection Through Physical Collocation for Special Access and Switched Transport, CC Docket No. 93–162, Second Report and Order, FCC 97–208 (June 13, 1997).

[185] FCC, *BA In-Region Order,* paras. 129, 130–135. The FCC adopted the term "uncommitted entry" from the 1992 *Horizontal Merger Guidelines* to mean new competition that does not require significant sunk costs of entry or exit. Sunk costs are costs that, once expended, cannot be avoided, and inability to recover them will not, in the short run, affect the firm's pricing or output decisions. Uncommitted entry is said to be able to occur in one year, and to be a likely reaction to the exercise of market power. *Order,* paras. 130–131.

Competition Order.[186] OSS include a variety of customer databases and functions consisting of "pre-ordering, ordering, provisioning, maintenance and repair, and billing functions supported by an incumbent LEC's databases and information." (47 C.F.R. § 51.319[f][1]). The FCC had originally ruled that this access was to be available "no later than" January 1, 1997.

The FCC also believed that the extensive reporting requirements and "negotiated performance standards subject to enforcement mechanisms," would also help competing carriers receive "nondiscriminatory access and interconnection." Compensation for failure to meet the standards is to be "negotiated" in service contracts, so that, in the event of failures by Bell Atlantic (now doing business as "Verizon") to provide proper access and interconnection, the competing carrier might receive what the FCC terms "some compensation." The FCC believed that this would reduce potential for discrimination in the provisioning of OSS functions and for competitors' receiving "inferior access and interconnection." This, the FCC said, would reduce the risk of competing with Bell Atlantic, and allow competing interexchange carriers (IXC) to enter the market more quickly.[187] The Department of Justice's November 1, 1999, evaluation was:

> To date, the least common path of entry in New York is entry through UNEs. The use of UNEs was viewed by Congress as one of the principal options for competitors created by the 1996 Act.

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[186] FCC, *Local Competition Order*. They are contained in the FCC's rules at 47 C.F.R. §51.319(f); as noted, this was not suspended in Iowa Utilities Board v. FCC, *Stay;* Iowa Utilities Board v. Federal Communications Commission, *Opinion.*

[187] FCC, *BA-NYNEX Merger Order,* para. 194.

> ...[W]hen Bell Atlantic does return order confirmations, a substantial portion of these confirmations are [sic] incorrect. Bell Atlantic has acknowledged in NYPSC proceedings that as many as thirty to forty percent of confirmations are inaccurate....[188]

While Bell Atlantic committed itself to publishing the statistics, and the FCC made this a requirement in August, 1997, two years later, on June 18, 1999, Bell Atlantic withdrew all its quality of service statistics for the previous eighteen months in the face of questions from other parties.[189] Thus, the probative or other value of these statistics must be questioned. As noted, the FCC refused a request by other parties to require that Bell Atlantic retain data to make the statistics auditable.[190]

The requirement to provide uniform interfaces on a region-wide basis was also said to make entry easier.[191] Many parties have contended that only uniform *national* interfaces would be effective, even though Bell Atlantic-NYNEX is a large region. In any event, in November, 1999, the Department of Justice concluded that there continued to be problems with both Bell Atlantic's proprietary Graphical User Interface (GUI) and the migration to the Electronic Data Interchange (EDI).[192]

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[188] DOJ, *NY Evaluation,* 12, 16.

[189] DOJ, *NY Evaluation,* fn. 27, 15, citing letter dated June 18, 1999, from Randal Milch, Associate General Counsel, Bell Atlantic North, to Andrew Klein, Assistant Counsel, New York Public Service Commission, attached to Bell Atlantic's Brief at Appendix C.

[190] FCC, *BA In-Region Order,* para. 209.

[191] FCC, *BA-NYNEX Merger Order,* para. 195.

[192] DOJ, *NY Evaluation,* 33–36.

The requirement to allow Carrier-to-Carrier testing of OSS was also said to assist carriers in entering the market.[193] The Department of Justice found that competing carriers were continuing to use the GUI system, despite its "instability," poor documentation, and changing specifications, because they found it "difficult" to migrate to Bell Atlantic's EDI.[194]

The FCC ruled that the payment options (that is, competitors who are resellers of Bell Atlantic's services or who rely on UNEs could pay certain nonrecurring charges over a period of time) would encourage entry, because this would reduce the sunk cost and the risk associated with entry into the market. The payment options would also reduce costs for collocation of switches and other equipment, easing capital requirements. The FCC believed that this would increase the threat of market entry if the "firms in the market engage in coordinated anti-competitive behavior," although the FCC does not explain how it reached this conclusion.[195]

The FCC stated that requiring Bell Atlantic to allow its competitors certain requirement that Bell Atlantic provide "shared transport" services would also encourage entry into local exchange markets.[196] The FCC has long had a variety of requirements in its rules that incumbent carriers provide facilities for resale. Modern technologies are such

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[193] FCC, *BA In-Region Order,* para. 196.

[194] DOJ, *NY Evaluation,* 34.

[195] FCC, *BA In-Region Order,* para. 197. Presumably the FCC reaches this conclusion relying on the theory that any credible threat of market entry reduces market power, including the shared market power of firms that might be in such a tight oligopoly as to permit coordinated action. (Recall that any overt coordination is a *per se* violation of the Sherman Antitrust Act; thus coordination can only occur when there are a few firms with large market share that can observe and react quickly to each others actions.) There are numerous instances in which the presence of a fringe of small firms acts as a constraint on coordination of the major firms (as in the present airlines industry), but there is no *empirical* evidence that *potential* entry can have such an effect. (For further information see the discussion of "contestability" in Chessler, *Workable Competition,* 29–36, and the sources cited and quoted therein).

[196] FCC, *BA In-Region Order,* paras. 198–199.

that the sale essentially becomes one of shared bandwidth. In any event, the shared transport requirements would appear to have been anticipated in the FCC's *Local Competition Order*, and incorporated into its rules at 47 C.F.R. § 51.319(d)(1)(ii), and more generally at §§ 51.305–51.309. These sections of the FCC's rules were *not* suspended in *Iowa v. FCC.*[197] Thus, it is difficult to see how the FCC could say that the "shared transport" requirement in the merger approval further reduced any barrier to entry that remained after the application of the FCC's rules.

Finally, we come to the application of forward-looking costs to the pricing of UNEs.[198] These provisions had been in the *Local Competition Order,* and were incorporated in the FCC's rules at 47 C.F.R §§ 51.505, 51.511. These sections of the rules *had* been suspended in *Iowa v. FCC,*[199] so it is arguable that they are new requirements, even though most states, including all states in the Bell Atlantic and NYNEX service territories, were ruling on rates for UNEs (and also on the discounted rates for services to be resold, for that manner) in a manner entirely consistent with the suspended FCC rules—and there was no evidence that they were doing so unwillingly, or would have ceased to do so had relevant sections of *Iowa v. FCC* been sustained.[200] In any case, the Department of Justice observed that, as of November 1, 1999, of the three vehicles for the provision of competitive services, UNEs are the least common, comprising only thirteen percent of the access lines provided by competitors to Bell Atlantic; fifty-nine percent were

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[197] Iowa Utilities Board v. FCC, *Stay.*

[198] FCC, *BA In-Region Order,* para. 200.

[199] Iowa Utilities Board v. FCC, *Stay.*

[200] Iowa Utilities Board v. Federal Communications Commission, *Opinion.*

facilities-based (that is, the competitor had constructed its own network), and twenty-eight percent were resold Bell Atlantic services.[201]

Thus, when the FCC approved the merger it did so in the face of strong evidence that the merger would be anticompetitive and against the public interest. It did so on the basis of representations that Bell Atlantic would take certain actions to facilitate entry of new CLECs, primarily using UNEs provided by Bell Atlantic. In its order the FCC made no distinction between actions that Bell Atlantic was already obliged to provide, and new or additional actions. There is simply no discussion of what, in the Bell Atlantic *ex parte* representation, was a new commitment: the FCC appears to have treated all the provisions as if they were significant concessions on the part of Bell Atlantic, representing new commitments beyond what the company was already required to perform, and the FCC never discussed which commitments it could not include in its rules if it thought they were procompetitive.[202] The FCC did not impose any of the additional commitments suggested by intervenors.

Furthermore, the FCC's order was flawed in its basic concept: it had identified competitors that were seemingly about to enter the market. These were large firms with the necessary experience in providing local service. This could encourage entry from unspecified and unidentified firms that would compensate for the loss of "actual potential competitors." As Shepherd said "there is no way of knowing whether or not when entry will

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[201] DOJ, *NY Evaluation,* 9–10. Competitors to Bell Atlantic were providing 8.9 percent of the 12.7 million switched access lines in the entire state of New York. *Idem.*

[202] As noted above, all the commitments except the reporting requirements were in the FCC's rules, and only the requirement that Bell Atlantic base its rates on "forward-looking" costs had been suspended in *Iowa v. FCC.* Moreover, Bell Atlantic, like the other incumbent local exchange carriers, was already months behind in the provision of access to its OSS, as required by the FCC's rules, and a year and a half later the Justice Department found that the access Bell Atlantic was providing to its OSS was still seriously deficient.

occur, there have been no systematic studies of entry, and, in any event, the FCC made no effort to ascertain whether, when, and to what extent, entry might occur."[203]

Only the requirements that quality and other statistics be published represented a new commitment on the part of Bell Atlantic, and the FCC had ruled that any quality standards and monetary penalties would be entirely the subject of negotiation between Bell Atlantic and its competitors.[204] Since there was no requirement that the statistics be auditable, they were apparently unchallenged until Bell Atlantic submitted them in a regulatory proceeding—at which time it had to withdraw them under scrutiny.

The Department of Justice and the FCC had an opportunity to revisit some of these issues when Bell Atlantic applied for permission to provide inter-LATA toll services in New York State. The Department of Justice opposed this grant, taking a strict view of Bell Atlantic's attempts to implement the competitive checklist, 47 U.S.C. § 271(c); the FCC granted the authority, taking the view that Bell Atlantic had made an effort. The FCC did not say that it believed that it could further improve Bell Atlantic's compliance with the checklist through regulatory means (and possibly conditions on further approvals in other states). Neither did it say that, after three years of experience, it was giving up on the idea that local service would become competitive through the resale of services and UNEs, though it does seem clear that the majority of customers of CLECs are being served by the CLEC's own facilities.

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[203] Shepherd, *Economics of Industrial Organization,* 277

[204] FCC, *BA In-Region Order,* paras. 209, 213, 215.

Conditions Imposed on the Merger by the States[205]

Five state commissions in the NYNEX region held hearings on whether the merger should be consummated. Not all the commissions granting approval had explicit authority to approve the merger, and in one instance, a commission reviewed the merger even though no licenses were being transferred in its jurisdiction.[206] In addition, the state Attorneys General reviewed and passed upon the merger.[207] Of these, only the New York attorney general filed a brief in opposition (at the New York Public Service Commission), and none took legal action to block the merger, though the attorneys general, as a group, had concerns about the effects of the merger on competition.[208]

The New York Public Service Commission conditioned its approval of the merger on the headquarters of the combined company being located in New York City.[209] New Hampshire required that the role of the company's senior representative in New Hampshire not change significantly, and that responsibility for construction, engineering,

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[205] This section does not list all conditions imposed by each state. Rather, it highlights significant benchmarks used by states.

[206] New Jersey issued an order although no licenses were being transferred, and Massachusetts issued an order although it has no explicit statutory authority to review or approve mergers of telephone companies. GAO, *LEC Merger Review,* 10, fn. 15

[207] They have authority to do so under federal and, in some instances, state antitrust laws. GAO, *LEC Merger Review,* 9, fns. 13, 14.

[208] GAO, *LEC Merger Review,* 14.

[209] GAO, *LEC Merger Review,* 16. This requirement has a long history. Connecticut required that the headquarters of SNET remain in Connecticut when it was acquired by SBC. *Ibid.,* 24. When Bell Atlantic was founded at the time of divestiture, Philadelphia was chosen as the headquarters, even though Washington, DC, had been the headquarters of the Chesapeake and Potomac companies, the largest group in the merger. The Illinois Commerce Commission, while not requiring that the headquarters of SBC be moved to Chicago, did require that the headquarters of the Ameritech group remain there.

installation and repair remain with the company's representative in the state, rather than Bell Atlantic executives elsewhere.[210]

Two states, Maine and Vermont, required that Bell Atlantic conform to the "competitive checklist" (47 U.S.C. § 271(c)(2)(B)) before the merger was consummated.

Three states, New York, Maine, and Vermont, required the company to maintain its level of investment in the state. New York required a specific $1 billion investment in the next five years.[211]

Two states, New York and New Hampshire, expressed concern about quality of service. In addition to the $1 billion in investment, New York required that Bell Atlantic provide additional service quality measurements and hire an additional 750 to 1,000 employees by December 31, 1997. New Hampshire required Bell Atlantic to adopt the service standards of the National Association of Regulatory Utility Commissioners (NARUC).[212]

Vermont required Bell Atlantic to provide "intrastate long-distance dialing parity," in which users would dial the same number of digits regardless of whether they used Bell Atlantic or a competitive provider for long distance calls within Vermont.[213]

Thus, we can say that the states imposed substantive procompetitive requirements on Bell Atlantic. However, it is unclear how the states intended to enforce these

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[210] GAO, *LEC Merger Review,* 16–17.

[211] GAO, *LEC Merger Review,* 16.

[212] GAO, *LEC Merger Review,* 16.

[213] GAO, *LEC Merger Review,* 16.

requirements. As noted above, when Bell Atlantic filed for approval as an inter-LATA carrier in New York, it withdrew its reports on quality of service when their accuracy was challenged; thus it is uncertain that Bell Atlantic is properly providing the quality of service reports that both the New York Public Service Commission and the FCC required as a condition of the merger. Moreover, we do not know whether service quality is actually improving. Since being granted inter-LATA permission in New York, Verizon has been granted inter-LATA permission by the FCC in Massachusetts, Connecticut, Pennsylvania, and Rhode Island. It has applications pending before the FCC for New Jersey and Vermont.

The MCI–WorldCom Merger

MCI was the second-largest IXC, with a rising market share. It was also reported to be the largest carrier in certain submarkets, such as the Internet backbone, said to be one of the fastest-growing of the telecommunications submarkets. WorldCom was the fourth largest carrier and had recently acquired UUnet, which was one of the largest carriers of the Internet backbone.[214] Again, the FCC declined to exercise jurisdiction under the Clayton Act, and performed a public interest analysis under the Communications Act.[215] The merger was not as clearly anticompetitive as the Bell Atlantic-NYNEX merger, but the FCC found that most major markets were so concentrated that the merger failed the market structure tests (that is, the HHI standard contained in the Department of Justice-

[214] FCC, Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., CC Docket No. 97–211, Memorandum Opinion and Order, September 14, 1998 (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1998/fcc98225.wp, December 17, 1999), paras. 2, 3, *et passim.* (Hereinafter, *MCI-WorldCom Merger Order.*)

[215] FCC, *MCI-WorldCom Merger Order,* paras. 12, 13.

Federal Trade Commission *Merger Guidelines*).[216] Still, the merger had been approved by the Justice Department and European Commission (with the proviso that MCI divest itself of its Internet businesses).[217] The FCC approved the transfer of licenses without imposing significant further conditions.[218]

The standard for what levels of the HHI should be considered competitive or noncompetitive have varied somewhat with different editions of the *Merger Guidelines*. In general, markets are considered to be fully competitive if the 4-firm concentration ratio[219] is under 40 percent, because when the concentration ratio is higher than 40 percent some studies show the firms to have market power—the ability to increase their prices and earn above-normal profits. The 1982, 1984 and 1992 Justice Department merger guidelines used a HHI of 1000 as indicating full competition (10 firms, each with 10 percent of the market), and 1800 as a measure of a tight oligopoly in an industry, corresponding to

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[216] U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines,* 27 Fed. Reg. 41,552 (1992). See also, Chessler, *Workable Competition,* 22, 25–27, where there are worked examples. The HHI is calculated by taking the squares of the market shares of all the participants in an appropriately-defined market (expressed in percentages), and adding them. For example, if there is only one firm with a market share of 100 percent (a perfect monopoly) the index is 10,000. If there are two firms, each with a 50 percent market share, the index is 5,000.

[217] FCC, *MCI-WorldCom Merger Order,* paras. 6, 142.

[218] The applicants agreed to continue to provide residential service, which had been a large part of MCI's business (but not WorldCom's) before the merger; the FCC would "monitor" this commitment. FCC, *MCI-WorldCom Merger Order,* paras. 191–192. The FCC approved of MCI's sale of its Internet assets to Cable and Wireless (C&W) for $1.75 billion, and did not impose any additional conditions—it rejected all claims by intervenors. *Ibid.,* paras 151–156.

[219] The concentration ratio is an older measure of market share. It is the percentage of the total market accounted for by the four largest firms.

approximately 6 firms of equal size (each with about 16 percent of the market).[220] The standards are not equivalent. An industry with 4 firms, each with 16 percent of the market, will have a 4-firm concentration ratio of 65 percent. On the other hand, the 1982 merger guidelines considered a HHI over 2500 (corresponding to 4 firms with 25 percent each, or, approximately, an industry with 4 firms, with 40 percent, 25 percent, 15 percent and 10 percent[221]) to indicate that the market power in the industry was probably significant.[222]

One of the intervenors, GTE, provided evidence that the HHI was 2,823 before the merger, and would be 3,038 after the merger, based on revenues. The Commission updated the calculation using 1997 revenues, and calculated the index at 2,508 pre-merger and 2,766 after the merger. GTE also presented similar evidence based on presubscribed lines and on points of presence, which the FCC did not report or discuss. The FCC argued against the use of revenues to calculate the HHI, but did not present an alternative calculation based on physical capacity, although its analysis of potential market entry was based entirely on physical capacity (specifically, route-miles of fiber-optic cable). Although the FCC admitted that the 1992 *Merger Guidelines* hold that, if the HHI is between 2,500 and 3,500, and the merger will increase the index by 100 points or more,

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[220] These were the standards of the 1982 and, somewhat modified, the 1984 Merger Guidelines. In 1987, they were adopted, with a different set of collateral considerations, by a group of state Attorneys General. Frederic M. Scherer and David Ross, *Industrial Market Structure and Economic Performance,* Third edition (Boston: Houghton Mifflin, 1990) (hereinafter, *Industrial Market Structure*), 192, citing *Horizontal Merger Guidelines of the National Association of State Attorneys General,* 1987. They were unchanged in 1992: see Department of Justice, "Horizontal Merger Guidelines," mimeo, 28.

[221] There is an observation that firms in many industries are exponentially distributed, so that each firm will have half the market share of its next larger rival. For example, GM had 40 percent, Ford 20 percent, and Chrysler 10 percent. Many industries do have this size distributions, but there are also many industries where the dominant firm is 5 or 6 times the size of its rival (IBM, Campbell's Soup).

[222] Shepherd, *Economics of Industrial Organization,* 277

the merger should be denied,[223] and the Commission admitted that the merger would increase concentration in the short run, it approved the merger on other public-interest grounds: it discounted the significance of this increase in concentration (in an already highly concentrated market), by arguing that there was a long-term trend to decreased concentration through the entry of new facilities-based carriers.[224] (The FCC performed similar analyses for the major international markets, with generally similar results—except for the Pacific market, the merger failed to meet the standards of the 1992 *Merger Guidelines,* and would increase concentration, but the FCC considered new construction without actually recalculating the HHI to reflect that construction, except for the highly concentrated trans-Atlantic and Caribbean markets.)[225]

The FCC discussed four facilities-based carriers that were installing substantial amounts of fiber-optic cable, most of which would be in operation in 1999.[226] Of these, the largest was Qwest. However, Qwest has since merged with U S West, and divested itself of its interexchange facilities and services throughout the 14-state U S West service area.[227] Thus, while the FCC tried to limit its analysis to plant already under construction,

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[223] FCC, *MCI-WorldCom Merger Order,* para. 38 and fn. 103. Generally, the Justice Department will also challenge mergers if there will remain fewer than three actual or potential competitors. GAO, *LEC Merger Review,* 12–13.

[224] FCC, *MCI-WorldCom Merger Order,* para. 36.

[225] FCC, *MCI-WorldCom Merger Order,* paras. 78, 100, 104, 107, 109, 111, 112, 113, and fn. 296.

[226] FCC, *MCI-WorldCom Merger Order,* paras. 43–50.

[227] See, Qwest Communications International Inc. And U S West, Inc. Seek FCC consent for a Proposed Transfer of Control (CC Docket No. 99–272), FCC Mimeo DA 99-1775, September 1, 1999, (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Public_Notices/1999/da991775.doc, December 17, 1999); Qwest and U S West, Response to Comments on Applications for Transfer of Control, In the Matter of Merger of Qwest Communications International Inc. and U S WEST, Inc., et al., File No. 18-EX-TC-1999, CC Docket No. 99-272, October 18, 1999 (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Public_Notices/1999/d992228a.doc, December 17, 1999).

representing substantial sunk costs, Qwest's role as an effective competitor in the near future must be questioned.

Similarly, the FCC discounted claims that WorldCom was a "maverick," preventing price leadership or price coordination among the largest IXC firms by following an independent pricing policy. It pointed, in particular, to Qwest, which was alleged to have lower prices than WorldCom.[228] Again, with Qwest's withdrawal from the interexchange market in a large portion of the country, we must question Qwest's role as an effective competitor in the near future.

The weakness of the FCC's public interest argument is that, rather than relying on market structure and incentives, it relies on policies and practices of individual firms. Unregulated firms will change policies and practices at short notice for a variety of strategic reasons. In the case at hand, Qwest's decision to enter the local exchange market in the west by acquiring U S West forced it to make a partial withdrawal from the interexchange market; it will not be able to reenter that market until U S West wins authority to provide in-region inter-LATA services under 47 U.S.C. § 271. For Qwest to reenter a state, U S West must meet the competitive checklist in that state. U S West has claimed to meet the competitive checklist in some states, but has not yet been permitted by the FCC to provide interexchanging service throughout the region, so Qwest is still not a competitor in a large portion of the country.

Interestingly, despite the FCC's claims to use a public interest standard, nowhere in the MCI-WorldCom merger order is there a discussion of the positive benefits of the merger for the public. There is some discussion of potential cost savings. The FCC

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[228] Claims by several parties that WorldCom is a "maverick" may be found at FCC, *MCI-WorldCom Merger Order,* paras. 23, 42, 67–76. The claim that Qwest has lower prices than WorldCom may be found at, *ibid.,* para. 70, quoting a "recent survey of switched and switchless resellers" submitted by WorldCom in an *ex parte* presentation.

rebuts the claims that the merger would be anticompetitive, and that it would increase concentration. However, even if one accepts the FCC's arguments in all respects, there is no claim that competition or the public interest has *gained* as a result of the merger; the market entry that is decreasing concentration and making the industry more competitive is coming from firms other than merging firms, and, indeed, the FCC had to rebut claims that the merger would in some way create barriers to further entry. In short, the FCC was able to use its interpretation of the public interest standard to justify accepting an anticompetitive merger, but did not make positive public-interest case for the merger. In one significant respect, however, this merger differs from the Bell Atlantic-NYNEX merger discussed herein: there was no serious evidence of decreasing concentration or increasing competition in the local exchange market, and the FCC had to try to argue that the conditions it was imposing on the merger (or, more accurately, that the merging parties had offered), would cause entry at some future date. In the MCI-WorldCom merger the entry was already occurring, independently of the actions of the parties. Thus, the MCI-WorldCom merger may have represented a set-back or delay for competition, but it did not advance regulation as an alternative to competition. The Bell Atlantic-NYNEX merger created additional regulatory reports and scrutiny, and, two and one-half years later, has not been shown to have promoted competition or market entry.[229]

As discussed above, the merger was conditioned on MCI's divesting itself of its Internet line of business. The FCC's Order makes it appear that this was a joint requirement of the Department of Justice and the European Commission.[230] However,

[229] Recall that the form of market entry promoted by the conditions on the merger, resale of UNEs, is the least commonly used form in New York (and probably nationally). Moreover, the OSS that had been required by FCC regulation (47 C.F.R. § 51.319) even before the merger, and are said to be essential to market entry, are still not working well according to the Justice Department. See, DOJ, *NY Evaluation*.

[230] FCC, *MCI-WorldCom Merger Order,* paras. 6, 142, 151.

Commissioner Furchtgott-Roth suggests that the divestiture was actually a requirement of the European Commission.[231]

The FCC itself admitted it did not have authority under the Communications Act to review MCI and WorldCom's Internet lines of business, because no licenses were involved in the transfer.[232] While the provision of Internet backbone services is concentrated, the provision of retail Internet services is not; there was disagreement among the parties as to whether barriers to entry are significant in the market for Internet backbone services.[233]

There were some concerns that MCI-WorldCom might have advantages in reentering the retail Internet market, and might use some of its advantages as a vertically integrated provider to do so (that is, MCI-WorldCom owns its own transmission facilities; most ISPs, including some providers of the backbone, own routers but not the cables and related equipment).[234] At this juncture, the FCC made the point that, if certain pricing practices in the industry were anticompetitive, the merger application was not an appropriate proceeding in which to address them: rather, the aggrieved parties should file a formal complaint before the FCC, which continues to maintain regulatory authority.[235]

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[231] Furchtgott-Roth, Statement on MCI-WorldCom Merger Order, 5.

[232] FCC, *MCI-WorldCom Merger Order,* fn. 381; Furchtgott-Roth, Statement on MCI-WorldCom Order, 4–5.

[233] The FCC concluded there were such barriers: FCC, *MCI-WorldCom Merger Order,* paras. 148–150. For the opposite conclusion, see: Furchtgott-Roth, Statement on MCI-WorldCom Merger Order, 3. The backbone consists of high capacity interregional and international data networks that connect the various networks and subnetworks that comprise the Internet. ISPs who deal with retail customers connect to the backbone. Some backbone providers also deal directly with the public; others do not. *Order,* paras. 143–146.

[234] FCC, *MCI-WorldCom Merger Order,* para. 153–154, 157–159.

[235] FCC, *MCI-WorldCom Merger Order,* paras. 159–161.

Thus, the issue of the Internet business was an opportunity to address the merger as a vertical merger; that is, a merger involving firms at two different stages of production. In the case at hand, it appears to have been primarily the European Community that addressed the possibility that the firms might be able to use their market position as a major IXP (though certainly nowhere near a dominant firm, and with no credible allegations that they would have market power in that market) to achieve market power in another market. Vertical combinations have not been addressed recently in American antitrust law. The merger guidelines with respect to vertical consolidations are those of the 1984.[236] The Department of Justice's analysis is similar to that which it uses in horizontal consolidations, looking at concentration, entry advantages and barriers to entry, market shares of the acquired and acquiring firms, and efficiencies that may result from the merger.[237] The primary problem it looks for is the creation of barriers to entry.[238] Other potential issues include facilitating collusion or (when the acquiring firm is a regulated public utility), evasion of rate regulation.[239] However, in recent years very few vertical mergers have been challenged, due partly to increased hostility to such challenges in the courts, and partly to changing government policy reflecting questions raised in segments of the economics profession.[240]

To the extent that the problems of vertical mergers are expressed in pricing policies, terms and conditions of sale, quality of service, or refusals to sell, regulators have well-established tools to deal with them (although maintenance and enforcement of quality

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[236] See Department of Justice, "Non-Horizontal Merger Guidelines," accessed as http://www.usdoj.gov/atr/public/guidelines/2614.pdf, December 28, 1999). The 1984 "Merger Guidelines" were published as 49 Fed. Reg. 26823 (1984).

[237] DOJ, "Non-Horizontal Merger Guidelines," 24–26.

[238] DOJ, "Non-Horizontal Merger Guidelines," 26–28.

[239] DOJ, "Non-Horizontal Merger Guidelines," 28–30.

[240] See Scherer and Ross, *Industrial Market Structure,* 177–178, 190, 191.

of service has been a problem in recent years, at least in telecommunications). Thus, this may be an important meeting point between regulatory policy and antitrust policy in the public utility industries. However, if regulation is used to deal with the problems inherent in vertical consolidation, then regulation will have to be continued indefinitely—which is contrary to some of the goals being espoused. Moreover, it remains to be seen whether the FCC is serious in its invitation to file formal regulatory complaints that it extends, seemingly routinely, to the parties whose complaints it denies in the merger case.

Although the MCI-WorldCom merger had a significant element of vertical consolidation, it was not a good case in which to examine the potential role of regulators in such mergers for two reasons: first, the FCC did not have direct authority to prevent the vertical elements of the consolidation, since no licenses were involved; the second, the Justice Department and the European Commission had already addressed the issue, ordering a divestiture of a line of business, so there was little that the FCC could do. The AT&T acquisition of Tele-Communications, Inc. (TCI) does have significant elements of a vertical merger and was directly within the FCC's authority under titles II and III of the Communications Act.

The AT&T-TCI Merger

Recall that the Conference Report on the Telecommunications Act clearly did not anticipate the wave of mergers that has occurred since its passage in 1996. As the report said at page 200,[241] it was anticipated that cable television companies would compete with telephone companies, and the congressional conferees specifically wished to avoid allowing the FCC to insulate from antitrust scrutiny any mergers between cable companies and telephone companies. What the conferees appear not to have recognized was that

[241] U.S House of Representatives, 104th Congress, Second Session, "Telecommunications Act of 1996, Conference Report," Report 104–458 (January 31, 1996), 200, as quoted above.

cable companies and telephone companies were not directly competing at the time of passage of the Telecommunications Act—and, indeed, are for the most part not directly competing today.[242] Thus, by the conventional standards of antitrust enforcement, which deal primarily with mergers between firms that compete directly, or which are in the same industry and are clearly potential competitors, this was a conglomerate merger, and not likely to have a direct effect on competition. The technology to permit cable companies to compete with telephone companies has been anticipated for two decades,[243] but is only now becoming reality—and primarily for high-speed data communications, rather than message communications. Thus, TCI and AT&T were potential competitors, and that is how the FCC judged the merger.

In short, the most significant competitive issues in the AT&T acquisition of TCI were primarily those of a vertical acquisition: AT&T gained access to TCI's cable systems, which would give it facilities-based access to subscribers in many markets all over the country. However, there was a horizontal element in that both AT&T and TCI were retail ISPs, and, to some extent, providers of the Internet "backbone." "The primary goal of this

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[242] At the time of the passage of the Act there was a lot of loose talk about alternative technologies that were on the verge of making the local loop competitive. AT&T was demonstrating a new radio service suitable for urban or suburban area, and much competition was predicted to come from cable TV, satellite transmissions, cellular and personal communications service (PCS) telephones, and other technologies. In fact, almost six years later few if any of these technologies have fulfilled early expectations, except in specialized or niche applications. In short, those who expected that new technologies were about to make the local loop competitive were "betting on the come," which is as risky in regulation as it is in poker. AT&T announced a fixed wireless means of access in 1996 ("Project Angel") which it later dropped, reportedly because "officials decided the technology was too costly." In the interim Teligent, WinStar, and other wireless carriers have entered the market. Peter S. Goodman, "AT&T Plans Local Push with Wireless Twist," *Washington Post,* November 24, 1999, E1.

[243] David Chessler, "The 1982 Consent Decree and the Future of the Telephone Industry," *Public Utilities Fortnightly*, Vol. 109, No. 5 (March 4, 1982).

merger, according to the companies, is to combine voice, television, and data services."[244] Even here, one of the most contentious issues, and one still being litigated, was that the combined system could give a competitive advantage to a particular retail ISP and provider of Internet content, "Excite@Home."[245]

Neither AT&T nor TCI was (or is) at present a major competitor in the market for local exchange services,[246] which continues to be dominated by the incumbent local exchange companies. However, both were major providers of Internet service. In addition to its role as one of the providers of the Internet "backbone," AT&T was the

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[244] General Accounting Office, *Telecommunications: The Changing Status of Competition to Cable Television,* GAO/RECD–99–158, July 8, 1999 (accessed as http://www.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=gao&docid=f:rc99158.txt.pdf, January 4, 1999), 27. (Hereinafter, *Competition to Cable*.) "[O]n March 9, 1999, AT&T announced that its merger with TCI was complete and that TCI would become the AT&T business unit, AT&T Broadband & Internet Service. In addition, on May 6, 1999, AT&T and MediaOne Group announced that it had entered into a definitive merger agreement." *Ibid.,* 18. We will not discuss the MediaOne merger herein.

[245] Called "@Home" in court documents. FCC, *AT&T-TCI Merger Order,* para. 18. (AT&T's acquisition of the "web portal" *Excite,* occurred after its merger with TCI and the start of the litigation.) The litigation involves the city of Portland, Oregon's refusal to transfer the franchises from TCI to AT&T unless the franchise provided open access to all ISP—that is, all ISP would be permitted to use the Cable franchisee's facilities to connect to their customers. AT&T Corp., *et al.* v. City of Portland and Multnomah County, D.Or., CV–99–65–PA, Slip Opinion, June 4, 1999 (accessed as http://ord.uscourts.gov/rulings/att_op.pdf, January 3, 2000). (Hereinafter AT&T v. Portland, *Decision.*) At this writing, the 9th Circuit granted expedited appeal of the District Court decision upholding the city of Portland and Multnomah County, and it was argued in October, 1999. "AT&T Reaction to Ninth Circuit Court Grant of Expedited Appeal," AT&T press release, July 6, 1999 (accessed as http://www.att.com/press/item/0,1354,701,00.html, January 2, 2000). The circuit court overrules the district court on the ground that federal preemption over-rode the county's franchising authority. A similar case in Broward County, Florida, was decided on First Amendment grounds. AT&T v. City of Portland, 9th Circ. Slip Opinion No. 99-35609 (June 22, 2000), Accessed July 20, 2000, as http://laws. findlaw.com/9th/9935609.html. AT&T has since agreed to provide equal access when its present contract with Excite@Home expires in mid-2002. "AT&T Commits to Give Customers Choice of ISPs for High-Speed Internet Access via Cable, Fixed Wireless," AT&T press release, December 6, 1999 (accessed as http://www.att.com/press/item/0,134,2320,00.html, January 2, 2000); David N. Baker, vice-president, Mindspring Enterprises, James W. Cicconi, general counsel and executive vice-president, AT&T Corp., Kenneth S. Fellman, Esq., chairman, FCC Local and State Government Advisory Committee, "Letter to FCC Chairman William Kennard," December 6, 1999 (accessed as http://www.att.com/press/item/0,134,2331,00.html, January 2, 2000).

[246] FCC, *AT&T-TCI Merger Order,* paras. 3, 46–50, 57.

largest provider of dial-up Internet access that is not bundled with content, and was one of the largest dial up providers of Internet access.

TCI was the largest provider of Internet access service over cable lines; all of its customers received Internet service from TCI's partially-owned @Home affiliate.[247] Thus, Internet access became a major issue in the proceeding.

Mobile services were also at issue because TCI owned, through a partially-owned subsidiary, some "tracking stock" in Sprint stock "tracking" the performance of Sprint's activities in the "personal communications service" (PCS) market, in which it competed with AT&T which has a significant share of the market. The Justice Department did not order divestiture, but required that the stock be placed in a trust, and that the benefit of the stock inure only to the shareholders of a partially-owned subsidiary. The FCC did not add any conditions of its own.[248]

Because TCI was the largest cable provider in the country, parties raised a number of competitive concerns about rebroadcast rights and multichannel video programming distribution (MVPD).[249] There was little issue with respect to broad-casting production,

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[247] FCC, *AT&T-TCI Merger Order,* paras. 61, 69, 72. While approval of the merger was pending at the FCC and the Justice Department, AT&T acquired the retail customers and other Internet access facilities of IBM, which had been also been one of the largest providers of dial-up Internet access without content. In exchange, IBM would acquire communications services from AT&T. "AT&T to Acquire IBM's Global Network Business for $5 Billion," AT&T press release, December 8, 1998 (accessed as http://www.att.com/press/item/0,134,507,00.html, January 2, 2000).

[248] FCC, *AT&T-TCI Merger Order,* paras. 1, 8, 11, 103–112. United Telecom had become the owner of Sprint, which has gone through several changes of ownership in recent years. United then changed its name to Sprint. Thus, in addition to being an IXC, Sprint is an incumbent local exchange carrier in some areas and a competitive local exchange carrier in others. It also has substantial mobile telephone activities, particularly in the PCS ("Personal Communications Systems") segment of the market, which were the issue in this case.

[249] FCC, *AT&T-TCI Merger Order,* paras. 5–8, 18–23. AT&T did not participate in this market, which involves delivering "packages" of video programming to cable TV systems.

since AT&T did not provide similar services, and international long distance service, which TCI did not provide.[250] It was claimed by intervenors that the merged company would have a size advantage in providing MVPD programming to cable systems, which would give its cable systems an advantage in providing a comprehensive package to customers.[251] Thus the intervenors tried to get access to TCI's programming.[252] The intervenors also attempted to get the FCC to grant them access to TCI's broadband facilities, and to the "structures" (poles, conduits, and so forth) on which the facilities are located. Since the FCC has always tried to regulate the cable industry under Title III of the Communications Act (that is, as ancillary to broadcast television), rather than Title II (common carriage), it was a foregone conclusion that the FCC would rule against this, except to the extent that such access was already in its Cable Rules.[253]

It was the provision of wideband access to the Internet that became one of the most contentious aspects of the merger—and one of the most interesting to state and local regulators. As discussed above, in the context of the MCI-WorldCom merger, the European Commission and the Justice Department required MCI to divest itself of all its

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[250] The FCC did consider video production, but only in the context of MVPD service. FCC, *AT&T-TCI Merger Order,* para. 18, fn. 63.

[251] The U.S. General Accounting Office has recently examined the state of competition in the cable industry. The report addresses, *inter alia,* the control of "content" by major cable systems as an barrier to entry, and the role of federal legislation and the FCC's rules in addressing the control of content. GAO, *Competition to Cable.*

[252] For a full discussion of the statutes, regulations, and industry practices related to the access by cable and other distributors of programming (such as satellite companies) to proprietary programming owned by other providers (principally cable companies), see GAO, *Competition to Cable,* especially 16–28.

[253] FCC, *AT&T-TCI Merger,* paras. 24–43. For FCC attitudes toward ruling Cable to be "broadband," see Jenner and Block "Unanswered Prayers: The Unexplored Role of States in Achieving Open Access," *Legal Notes* paper presented at the NARUC Summer Conference, July 20, 1999, 4–5, citing 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, Report (January 28, 1999), para. 24.

Internet activities, retail and "backbone"; the FCC acquiesced. Commissioner Furchtgott-Roth argued that there was no tendency toward monopoly in any aspect of the Cable industry.

When provided by telephone companies using Integrated Services Digital Network (ISDN) or Digital Subscriber Line (DSL) technologies or dedicated access,[254] broadband access to the Internet is normally available to reach any of the retail ISPs, including those affiliated with the local telephone company; thus, there is no significant competitive issue, especially where there are multiple providers of DSL service. However, cable companies that supply Internet access normally do so as a "package" with an affiliated ISP. There are two sorts of competitive issues in this situation: local and national ISPs that do not provide "content" cannot compete with a company that offers superior access at what may be a

[254] The first two services are widely available to residential consumers. ISDN provides bidirectional access at 64,000 bits per second or 128,000 bits per second; at the slower speed it allows simultaneous voice use of the line. However, modern modems can provide nearly equivalent speeds (to reach approximately 106,000 bits per second "download" speed [in the direction from the Internet to the subscriber] over dialup lines requires the simultaneous use of two access lines; ISDN accomplishes this using only one access line. DSL is available at a variety of speeds, depending on the distance from the central office and the capabilities of the providers. Speeds of up to 768,000/384,000 bits per second or 1,600,000/90,000 bits per second (from and to the Internet, respectively) are available on a single access line (not all carriers provide speeds up to these maxima). There are a variety of plans, and many offer lower speeds. Cable modems provide speeds of up to 10,000,000/3,000,000 bits per second without the use of a telephone line (most provide lower maximum speeds, and some provide only 33,300 bits per second to the Internet, and require the use of a telephone line). See "FFWD ISP Survey," table, *Washington Post,* October 29, 1999, E14–E16; Rob Pegoraro, "Our ISP Survey: A User's Manual," *Washington Post,* October 29, 1999, E14.

comparable price;[255] and companies that provide proprietary content[256] could "sell" subscriptions only to the proprietary content.[257]

Several local government entities, including Portland, Oregon, San Francisco, Los Angeles, Denver, Dallas, and Miami and Broward County, Florida, considered TCI's arrangement with @Home to be potentially anticompetitive, and contemplated opposing it.[258] However, San Francisco did not actually do so.[259] Los Angeles appears not to have

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[255] "...ISPs couldn't compete with @Home's higher speed, wide availability, and relatively low cost. Cable subscribers could access unaffiliated ISPs only through the @Home service at the full retail rate. Few subscribers would pay twice for similar services. The ISPs claimed that they would be driven out of business...." AT&T v. Portland, *Decision,* 4–5. The typical price for cable access is about the same as for unlimited dial-up access, plus the cost of a dedicated telephone line. "FFWD ISP Survey," table, *Washington Post,* October 29, 1999, E14–E16.

[256] All ISPs have a mix of services that, generally, provide connectivity to the Internet, and permit the subscriber to access any information he or she may find there. Others provide, in addition, some proprietary information (that is, information that may be accessed only by subscribers. See Rob Pegoraro, "Logging On: 'Best ISP?' It's all About You," *Washington Post,* October 29, 1999, E1. In addition, there are a number of independent providers of content on the Internet that allow people to view their information only for a fee; they do not provide access to the Internet, and their content may be obtained by subscribers to any ISP. At present, newspapers are a major example of this class of information provider.

[257] The value of the proprietary content of the ISP is difficult to determine. AOL has a plan whereby users supply their own access (that is, through another ISP, or a direct connection at work or school). However, if one compares the price for unlimited monthly access from AOL or Compuserve (the two largest national providers of content bundled with access), they charge only a dollar or two more per month than do other national dial-up providers for unlimited access. See "FFWD ISP Survey," table, *Washington Post,* October 29, 1999, E14–E16. CompuServe is now a subsidiary of AOL.

[258] Hans Greimel, "Court Rules Against AT&T over Access to Cable Lines," *Corvallis (Oregon) Gazette-Times,* Internet Edition, June 5, 1999 (accessed as http://www.mvonline.com/gtonline/gto0605-14.html# TopOfPage, January 5, 2000); Charles Piller and Maria La Ganga, "S.F. Won't Open Cable to Internet Firms," *Los Angeles Times,* July 27, 1999, A-3 (accessed as http://www.latimes.com/cgi-bin/slwebcli? DBLIST=lt99&DOCNUM=62494&QDesc=S.F. Won't Open Cable to Internet Firms. January 5, 2000).

[259] Charles Piller and Maria La Ganga, "S.F. Won't Open Cable to Internet Firms," *Los Angeles Times,* July 27, 1999, A-3.

acted one way or the other.[260] Broward County and Portland, Oregon did, in fact, rule against the arrangement, and AT&T took both to court.[261]

The City of Portland and Multnomah County, Oregon, found that TCI's exclusive arrangement with @Home would give @Home an effective monopoly in the ISP business in its local service area, would drive other ISPs out of business, and would cost the local economy jobs.[262] AT&T had offered to allow subscribers to TCI's service to use any other ISP, but at no reduction in price.[263] Note first that, if TCI's arrangement was anticompetitive after the merger, it was equally anticompetitive before the merger; however, there is nothing in the record to suggest that Portland, Multnomah County, or any other authority had expressed concern previously. Note, too, that if there is no effective competition to cable Internet access in Oregon, it must be because the local telephone companies do not

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[260] The most recent article found in a search on the Los Angeles Times web site was "The Internet Access Tangle," *Los Angeles Times,* July 25, 1999, M–4 (accessed as http://www.latimes.com/cgi-bin/slwebcli?DBLIST=lt99&DOCNUM=62034&QDesc=The%20Internet%20Access%20Tangle, January 5, 2000); see also Sally Hofmeister and Jim Newton, "Battle Over High-Speed Net Access Centers in L.A.," *Los Angeles Times,* July 19, 1999, A–1 (accessed as http://www.latimes.com/cgi-bin/slwebcli?DBLIST=lt99&DOCNUM=60244&QDesc=Battle%20Over%20High-Speed%20Net%20Access%20Centers%20in%20L.A., January 5, 2000).

[261] Miami was expected to follow the lead of Broward County, which made its ruling on July 14, 1999, after the Ninth Circuit had taken jurisdiction over Portland, Oregon's action, and set it for expedited appeal. Sally Hofmeister and Jim Newton, "Battle Over High-Speed Net Access Centers in L.A.," *Los Angeles Times,* July 19, 1999, A–1.

[262] AT&T v. Portland, *Decision,* 4.

[263] FCC, *AT&T-TCI Merger Order,* paras. 95–96; AT&T v. Portland *Decision, passim.*

provide DSL or ISDN connections at affordable rates, or at all.[264] High speed Internet access is also available using direct broadcast satellite (DBS) technology.[265]

On December 17, 1998, the City and County adopted mandatory access provisions:

> Non-discriminatory access to cable modem platform. Transferee [i.e., AT&T] shall provide, and cause Franchisees to provide, nondiscriminatory access to Franchisees' cable modem platform for providers of Internet and on-line services, whether or not such providers are affiliated with Transferee or Franchisees, unless otherwise required by applicable law. So long as cable modem services are deemed by law to be "cable services," as provided under Title VI of the Communications Act of 1934, as amended, Transferee and Franchisees shall comply with all requirements regarding such services, including, but not limited to, the inclusion of revenues from cable modem services and access within the gross revenues of Franchisees' cable franchises, and commercial leased access requirements.[266]

In one respect the substance of the dispute seems to have been decided: AT&T has agreed that when its current contracts expire in mid-2002, it will permit any ISP to use

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[264] Recognizing the importance of DSL as competition to cable modems, the FCC ordered that, when CLECs obtain DSL UNEs from ILECs, they may do so on existing subscriber access lines, so that the subscriber does not have to get an additional telephone line. (The ILECs had been allowing their own DSL customers to get the service on the same access line used for regular telephone service.) See FCC, Deployment of Wireline Services Offering Advanced Telecommunications Capability and Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Dockets No. 98-147 and 96-98, Third Report and Order in CC Docket No. 98-147, Fourth Report and Order in CC Docket No. 96-98, December 9, 1999 (accessed as http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1999/fcc99355.doc, December 22, 1999), para. 3–5 and "Part II. Executive Summary."

[265] FCC, 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, Report (January 28, 1999), 14–15. This requires the use of a telephone line to communicate *to* the Internet.

[266] Quoted in AT&T v. Portland, *Decision,* 5.

its cables to provide cable access to the Internet.[267] There has been no announcement of the reasons that AT&T changed its policy in this way. There might have been business reasons, or AT&T's legal department may be concerned that the company would be vulnerable to private antitrust suits from other ISPs, or that the Portland-Multnomah County suit was likely to succeed.

One of the peculiarities of the case is that the FCC has not asserted jurisdiction over the matter, that is, it has not attempted to preempt the state. While AT&T argued that the FCC had jurisdiction under the Communications Act, the District Court found that Portland and Multnomah County had acted within their authority under state law and the Communications Act, and had not been preempted.[268] The FCC did not enter the case as a party, but did file an *amicus* brief.[269] The FCC has explained its position as wanting an open market, but it is practicing forbearance because it does not know how the market will develop.[270]

In the appeal, AT&T tried to characterize the service as "telecommunications" but

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[267] "AT&T Commits to Give Customers Choice of ISPs for High-Speed Internet Access via Cable, Fixed Wireless," AT&T press release, December 6, 1999; David N. Baker, vice-president, Mindspring Enterprises, James W. Cicconi, general counsel and executive vice-president, AT&T Corp., Kenneth S. Fellman, Esq., chairman, FCC Local and State Government Advisory Committee, "Letter to FCC Chairman William Kennard," December 6, 1999.

[268] AT&T v. Portland, *Decision,* 6–9. The court also rejected claims that the action of Portland and Multnomah County illegally limited AT&T's use of transmission technology, or its right of free speech, or affected the content of cable services. *Ibid.,* 9–12. The Court based its ruling, in part, on AT&T's having said that the customer was free to use any other ISP, having paid for the bundled @Home service. FCC, *AT&T-TCI Merger Order,* paras. 95–96. This, the court said, meant that AT&T's right of free speech was not being infringed upon, nor were the municipalities forcing AT&T to carry cable content other than that which it had already agreed to do.

[269] "FCC to back Cable Firms on Web Access," *Los Angeles Times,* August 14, 1999, C–3 (accessed as http://www.latimes.com/cgi-bin/slwebcli?DBLIST=lt99&DOCNUM=68062&QDesc=FCC%20to%20Back%20Cable%20Firms%20on%20Web%20Access, January 5, 2000).

[270] Jube Shriver, Jr., "FCC Waits to See on Broadband," *Los Angeles Times,* November 9, 1999, C–1 (accessed as http://www.latimes.com/cgi-bin/slwebcli?DBLIST=lt99&DOCNUM=95908&QDesc=FCC%20Waits%20to%20See%20on%20Broadband, January 5, 2000).

"did not challenge" the municipalities' characterizing it as "cable;" the FCC "suggested" that the service is "telecommunications."[271] However, as noted above, the FCC has resisted regulating any service provided by a Cable company as telecommunications (that is, under Title II of the Communications Act), although many states do so regulate the services, and the Telecommunications Act defines cable service as a one-way service.[272] The Court seemed to believe that, if the service were cable, then local regulation would prevail; if it were telecommunications, then the local government could not regulate it, but such a ruling might force the FCC to take regulatory jurisdiction. The FCC did hint that it might, at some future time, regulate high-speed Internet service.[273] Indeed, if the service is "telecommunications," then it would appear that tying the use of the high-speed *telecommunications* service to a particular ISP (such as @Home) would violate the antidiscrimination clause of the Communications Act (47 U.S.C. § 202).

One difference between the position of the FCC and that of the municipalities may be that the FCC is primarily concerned with issues of competition in communications markets it regulates, while the municipalities were concerned with competition and possible job loss that directly affected their constituents. The Justice Department and state Attorneys General may have declined to act because the market is not at present competitive, and no actual competitor was being eliminated.[274] One reason for failing to act is the ambiguous nature of high-speed access service; if it is telecommunications, then

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[271] Peter S. Goodman, "AT&T Cable-Internet Case Looms Large," *Washington Post,* November 2, 1999, E1.

[272] Jenner and Block "Unanswered Prayers: The Unexplored Role of States in Achieving Open Access," *Legal Notes* paper presented at NARUC Summer Conference, July 20, 1999, 1–4.

[273] Peter S. Goodman, "AT&T Cable-Internet Case Looms Large," *Washington Post,* November 2, 1999, E1.

[274] Indeed, it is hard to argue that a potential competitor is being eliminated. AT&T might provide DSL access by reselling the service of the ILECs, or by reselling a service created from UNEs. Such a service would compete with cable service provided by TCI. However, it is more commonly thought that AT&T has been buying into the cable industry to provide itself with a facilities-based means of local access, since it has had great difficulty with its wireless technologies.

it would have to be regulated by the public utilities commissions in many states and probably by the FCC, and the arrangement with @Home would be presumably illegal. If it is cable service, then it is subject to municipal or state regulation. Many states do have specific authority to set terms and conditions on mergers of cable companies, and, in any event, such authority may be contained in the terms of the particular franchises.[275] As noted above, the circuit court found that federal laws regulating cable service effectively preempted the county and city from exercising their franchise authority in this way.

[275] Jenner and Block "Unanswered Prayers: The Unexplored Role of States in Achieving Open Access," *Legal Notes* paper presented at NARUC Summer Conference, July 20, 1999, 4–5. The article does not discuss the authority of municipalities and other franchising authorities to impose conditions on franchise transfers, but the District Court ruled that, under the franchise agreements, Portland and Multnomah County had such authority (it dodged—or assumed to be irrelevant—the issue that the case involved a change of ownership and not, strictly, a transfer). AT&T v. Portland, *Decision,* 13–14.

CHAPTER 4

SUMMARY AND CONCLUSIONS

Throughout the nineteenth century, public policy operated under the assumption that competition in utility industries could be made to work. Clearly, in the eyes of contemporaries, the approach failed. Although competition was associated with lower prices, in capital-intensive industries it led to price and service instabilities that were intolerable for essential services. Legal doctrine was unable to deal with price discrimination. Some of the industries (notably farming) that relied on public utilities (notably transportation) were so competitive that even small amounts of market power (increased or discriminatory prices) were unacceptable. In many places there was insufficient competition. And legal practice finds it difficult to deal effectively with multiple very small claims. The mechanisms for control of competition proved inadequate. And towards the end of the century a wave of mergers reduced competition.

It is interesting that public opinion continued to favor competition as long as it did. Despite the many problems, competition as an alternative to regulation was abandoned only towards the end of the century. By that time the problems in the utility industries, particularly railroads, often involved discrimination which was the result of competition (particularly in markets where competition was not fully workable). Moreover, the trend to large scale enterprise, and problems in other industries may have created a public sense of despair about the possibility of effective competition in modern industry.

Starting in the 1970s, the modern deregulatory and competitive era was ushered in when "other common carriers," like MCI, and then the Justice Department began to sue AT&T and the former Bell System, charging monopolization of various communications markets. We have since opened telecommunications markets to entry, sometimes with some notion that this is sufficient to make markets competitive. In fact, as shown from the experience of the first competitive era, active procompetitive policy is likely to be required if network industries like the formerly regulated public utilities are to become workably competitive. (Recall that antitrust and commission regulation developed more-or-less simultaneously.) We are still in the throes of creation of a regulatory regime that combines competition with forceful procompetitive policy and provides consumers the protection that experience taught long ago will be needed. Vigorous antitrust enforcement can address the breakdown of competition through cartelization by the industry, and the development of tight-oligopoly or dominant-firm market structures. Vigorous regulatory policy carefully targeted to remedy market failures that unacceptably affect consumers is also needed.

The Role of Antitrust Policy

The present situation in telecommunications illustrates the difficulties in applying concepts of regulation and antitrust. The established concepts of antitrust assume that the industry is in a condition of workable competition and is becoming less competitive through merger or other action. Thus, antitrust agencies, such as Attorneys General (or the Justice Department) find mergers among public utilities not to violate the antitrust laws: they do not reduce competition because there is none; while the firms are potential competitors, there is a great distance between potential competition and actual competition, and it is difficult to prove by standards that would prevail in a court of law that a potential competitor would actually compete. Regulators, particularly the FCC, have developed doctrines of potential competition, recognizing that competition has usually been prevented by force of law or regulatory practice, and have applied different standards

of proof to the question of what constitutes acceptable proof of potential entry into a market. Thus, they are in a position to recognize when their procompetitive, deregulatory policies appear to be having the desired effect of attracting entry that might make the market more competitive.

Moreover, regulatory agencies are governed by their statutes, so they have to apply a "public interest" test to any merger or competitive situation. In the past, this has led them to approve (and sometimes insulate from antitrust) mergers that were anticompetitive, but which had some other advantages to the public. At present, the public interest standard still leads the regulators to weigh benefits and harms to competition against benefits and harms to other aspects of public policy. Thus far, it has not led regulators to block a merger, though it has affected the conditions placed on the merger.[276]

Because regulatory bodies often lack the direct authority to address a merger[277] they do so under their general authority to regulate the transfer of licenses in the public interest. However, if the licenses are not transferred, this may not (at least in theory) prevent the merger. Moreover, some of the controversial aspects of recent mergers (such as internet services) may be unlicensed.

However, when it comes to enforcing their procompetitive policies, the regulatory agencies have not been very active. While they may conduct extensive investigations and issue long opinions, the major agencies have not, as yet, chosen to block any combination, and the conditions that they may impose on the mergers have usually been those that were

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[276] Note that the City of Portland and Multnomah County cited potential lost jobs among local internet service providers as a reason for imposing conditions on the transfer of the franchises. More usually, the conditions imposed on mergers have related to quality of service and continuation of investment. The New York PSC and the Connecticut DPUC specified the locations of headquarters, which may partly have been due to regulatory concerns, but may also have been a result of concern about lost jobs.

[277] Some state regulators have direct authority to approve mergers of public utilities. The FCC has such authority under the Clayton Act, but does not exercise it, preferring to rely on the greater flexibility it has applying the public interest standard to the transfer of licenses.

already in the statutes or the regulatory rules. Thus, there was surprise when a few franchising authorities (mostly municipalities) attempted to use their authority over the conditions of transfers of operating licenses to promote competition in internet services, which had been, and is expected to remain, unregulated.

The Limits of Antitrust and the Need for Commission Regulation

One issue that antitrust cannot address is price discrimination. Current antitrust doctrine is mostly concerned with discriminatory rates that may lead to the breakdown of competition—that is, rates that are so low as to drive a competitor from the market. As discussed above, during the late competitive era, relatively minor differences in rates through discounts or rebating could drive some *customers* from the market. We have not seen much private litigation to enforce regulatory requirements for "just and reasonable rates" and "no undue discrimination," because, in the past, these issues were addressed by the regulatory body that accepted or approved the rates. If the industry is deregulated, or even if tariffs are no longer required (as in interstate telecommunications), then concerns about the justness of rates that may arise may have no convenient forum in which they can be addressed.[278]

Since the beginning of modern utilities, even before the inception of regulation, legislatures and the courts attempted to prohibit price discrimination by utilities. In a competitive market, price discrimination that is not "undue" is generally permitted—it is thought that the market itself will protect against discrimination through arbitrage (that is,

[278] One of the reasons courts generally defer to regulators in factual issues concerning the reasonableness of rates is the high degree of expertise required to make such a determination. If the issues are moved to the courts because customers of the unregulated utilities must sue, then the effect would be to convert the courts to regulatory commissions. The courts have traditionally been reluctant to play that role, and cannot be said to have been successful when they have tried.

favored customers would resell the product to disfavored customers),[279] or because alternate suppliers would undercut the price of the supplier who is attempting to discriminate. However, even in utility industries that have been declared competitive the firms remain constrained in some aspects of their ability to charge different prices to customers in the same class.[280] In particular, where elements of monopoly remain, the price discrimination constraints have not been relaxed, and, most particularly, in telecommunications, the charges for services to competitors or potential competitors of the incumbent utilities are very closely regulated.

The same may be said of several other issues now addressed by regulatory commissions. Quality of service has become an important issue that has figured in several recent mergers. Discrimination in access to the network is an important issue in ensuring local competition, and that issue has been handled only by state commissions and the FCC using traditional methods of direct regulation (promulgating rules, holding hearings), as well as a new method, conducting arbitrations.

There are also consumer protection issues. In the past, regulated firms have sometimes been able to alter unilaterally the terms of contracts under the "filed rate" doctrine. More recently, some firms have been accused of requiring arbitration of rate disputes, hiding the provision in tariffs (the provisions of which were not reviewed by the regulators due to policies of regulatory forbearance) rather than the contract with the customer, and using biased arbitrators. Again, these are issues that have been addressed relatively expeditiously by regulators in the past; it is not clear how they would be resolved in the absence of regulatory commissions.

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[279] One of the commonly cited characteristics of public utility industries is direct connection to the customer so that arbitrage is difficult or impossible.

[280] The major exception has been contract rates for certain large industrial customers. Since these contracts are presumably based on unique combinations of circumstances, the rates on the various contracts are not necessarily comparable.

The limited effectiveness of charter and legal restrictions on the exercise of market power as enforced by nineteenth-century courts led to the development of direct economic regulation by commissions. It also led to the codification and extension of the common law through the antitrust laws. Public utility commissions developed ratebase, rate-of-return regulation as an attempt to control price discrimination and the charging of excessive prices. Primarily in other countries, but to some extent in the United States, public ownership was tried. In the United States, customer ownership (that is, cooperatives) is fairly common, as well. Often, government- or consumer-owned utilities are wholly or partially exempted from commission regulation.

Vertical integration is a thorny problem that may not be easily addressed under antitrust statutes and recent antitrust doctrine given the convergence of technologies and businesses in telecommunications today. Since the turn of the century, utilities have been prohibited from competing with their customers. Railroads were not allowed to own the goods they carried. In the 1930s, conglomerate public utilities were largely prohibited. The 1956 Consent Decree and the 1968 First Computer Decision prohibited he Bell System from owning the content of communications.[281] This now manifests itself as issues of vertical integration, particularly in telecommunications. The controversies over the internet subsidiaries in the MCI-WorldCom and AT&T-TCI mergers are particularly clear examples. The internet service providers use the public telephone network as a major input to produce their service. Indeed, one suspects that telecommunications is their largest expense—they rely on local telephone companies to provide access services and on the long distance companies to provide their "backbone" the interconnections between

[281] The 1956 Consent Decree also prevented the Bell System from competing in most manufacturing markets: it could sell only to itself, or goods that it also produced for its own use. U.S. v. Western Electric Co., and AT&T Co., Final Judgement, Civil Action No. 17–49, D. N.J., January 24, 1956. The First Computer Inquiry is FCC, *Regulatory and Policy Problems Presented By the Interdependence of Computer and Communications Services and Facilities,* Docket No. 16979, Final Decision and Order, 28 FCC 2nd 271 (1971), *aff'd in part and rev'd in part sub nom. GTE Serv. Corp. v. Federal Communications Comm'n,* 474 F.2d 724 (2d Cir. 1973), *on remand,* 40 FCC 2nd 293.

computers that make the internet a world-wide network for the diffusion of information. When cable companies began to provide internet access, they were not subject to public utility forms of regulation; most importantly, they were not subject to the restrictions on discriminatory access and pricing that have been applied to public utilities since the early nineteenth century. Indeed, the reports of the oral argument in AT&T's appeal of the Portland, Oregon, case in the Ninth Circuit suggest that the attorneys and the courts have not yet decided how to treat this new entity—telecommunications service provided by a non-telecommunications, non-utility company.

The pre-utility regulatory paradigm treated the obligation to serve as one of the most important characteristics of a common calling, perhaps the most important. The problem now manifests itself in quality of service; companies do not usually fail to provide any service;[282] rather, they provide higher quality service to their favored customers—the large, profitable ones.[283] Moreover, in telecommunications the incumbent carrier is required to provide services and "unbundled network elements" to its competitors—obviously, there are concerns that the quality is less than the incumbent provides to its own

[282] There remain difficulties with the provision of service in rural areas, but it is now conceded that the best mechanism to deal with them is direct subsidy. Thus, the Telecommunications Act of 1996 provided for direct subsidies for high-speed services and internet access to rural healthcare facilities, libraries, and schools. Similarly, the Act provided for mechanisms for direct subsidy to companies that provide basic telecommunications service in rural areas, and their potential exemption from the procompetitive clauses of the Act.

[283] This has been a problem for many years. See the calls for the provision of a "feature rich" basic service in the mid-1980s, and the provisions in the Telecommunications Act to expand the definition of basic service in David Chessler and Michael Dworkin, Reporters, *Proceedings of: The Future of the Public Switched Network,* for The Communications Committee of the National Association of Regulatory Utility Commissioners and the Amos Tuck School of Business Administration, April 7–11, 1986 (Montpelier, VT: Vermont Public Service Board, 1986).

customers. Finally, as utilities have again begun to engage in non-germane activities,[284] regulators have been concerned that they have diverted funds from their regulated enterprises to their unregulated ones, buying non-germane subsidiaries while letting regulated service deteriorate.

Most regulation in the twentieth century has used the ratebase, rate-of-return paradigm. The level of rates is determined by applying an appropriate cost of capital (the "rate of return") to a rate base determined from the accounting measure of net plant.[285] Alternative regulatory plans have almost universally abandoned this approach in favor of caps on the overall level of rates, where the prices on "market baskets" of basic services are constrained without specific reference to their cost of production,[286] and prices of the presumptively more competitive or less essential (often called "discretionary") services are allowed to vary more freely.

In theory, price cap plans, by allowing the utility more flexibility, are more compatible with competition than traditional ratebase, rate-of-return regulation would be. Moreover,

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[284] Most of these had been prohibited by the Public Utilities Holding Company Act of 1935 or by the 1956 Consent Decree in most of the telephone industry, but the issue resurfaced in the early 1980s. David Chessler, "Appropriate Strategies for Regulating the Bell Regional Holding Companies and Bell Communications Research, Inc.," in *New Directions: State Regulation of Telecommunications: Symposium Proceedings* (Olympia: Washington State Legislature, Joint Select Committee on Telecommunications and University of Washington, Graduate School of Public Affairs, 1984).

[285] There are various niceties in how inflation is treated. At various times and places, inflation has been handled by adjusting the rate of return or the rate base, or even the test year (the year for which the accounting financial statements are examined) but all these methods can be made equivalent, and, since Federal Power Commission v. Hope Natural Gas Pipeline Co. of America, 315 U.S. 591 (1944), it has not mattered which was chosen, so long as the results were reasonable.

[286] That is, the level of rates may be modified as a measure of price inflation in the general economy varies, with some offset for an assumed rate of attainable productivity increase. There may also be modifications in rates to recover changes in specific elements of cost that are said to be beyond the control of the utility. Interestingly, the utility can raise rates as these costs rise, but it is often more difficult to get it to reduce rates as they fall. In the present period of general price stability and tax cuts, this may become a serious problem.

their use may make it easier to conduct the transition to deregulation, since the degree of rate regulation for each "market basket" of services can be relaxed individually as competition develops more rapidly in some submarkets than in others. However, we lack sufficient experience with rate caps and with services that actually become workably competitive to say whether these theories are true. In the meantime, there are persistent concerns about declining quality of service under price caps, though these declines may be related to other aspects of deregulation, such as the need to cut costs to meet competition, and investment in non-germane activities.

Conclusion

Perhaps paradoxically, the practice of deregulation has much to gain if it is coupled with aggressive application of regulatory authority, either under the federal or state antitrust laws, or under the authority to regulate public utility licenses or franchises in the "public interest, convenience, and necessity," to promote competition. However, for the most part, regulators have been reluctant to apply their authority aggressively, preferring to assume that the promise of future competition from the relaxation of regulatory and some other barriers to entry will be sufficient to cause workable competition to develop. In fact, there may be barriers to entry that were not considered[287] or were underestimated. Thus, competition may be slower to develop than had been hoped.

Moreover, regulators may be inhibited by the current unsettled and confusing condition of antitrust law in this country. There is a body of thought that claims antitrust to be irrelevant, and changing standards of enforcement, both in the regulatory agencies and the courts, make it difficult for the specialist and the non-specialist alike to decide on the

[287] Regulators and scholars alike were surprised when control of gates (including long-term leases at airports) turned out to be a major barrier to entry in the airline industry.

appropriateness of various policies.[288] Furthermore, antitrust policy as articulated is based upon a response to an action by a participant in a market that reduces existing competition in that market, or that prevents entry into that market.[289] Regulation, on the other hand, maybe proactive.

Effective deregulation requires workable competition to maintain the public interest. Commissions might well consider taking a more active role in shaping the conditions of mergers than they have heretofore. (Some state commissions have very limited authority in this are, and have not been able to exercise much control through their licensing authorities.) This is the importance of the AT&T-TCI merger—because it involved cable companies, there were a greater number of regulators involved, some of whom did innovative things to promote competition. If they had succeeded, they would have set a precedent for greater procompetitive activity on the part of regulators—and if deregulatory policy can be made to work, it will require proactive application of antitrust principles on the part of regulators.

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[288] See Shepherd, *Economics of Industrial Organization,* 8, 21–22 (citing the view of the "Chicago-U.C.L.A. School" to the effect that monopoly reflects superior performance and so is benign); 455–456, 458, 467–468, 472 (discussing the periods of action and inaction in antitrust enforcement); 467, 473–474, 481–486 (on the changes in policy toward mergers).

[289] Note that the "Chicago-U.C.L.A. School" also believes that barriers to entry may be disregarded, even though some theories of potential competition (like "contestability") require that there be no such barriers. Shepherd, *Economics of Industrial Organization,* 5–6, 9, 23, 94, 109–111, 123, 273–277, *et passim*. Note, too, that all versions of the Department of Justice-Federal Trade Commission *Merger Guidelines* have considered barriers to entry.