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The premise of this panel is that the FCC is transitioning from a rate regulation regime to an access regime. A rate regulation regime gives all customers full access to network facilities (common carrier) at regulated rates—generally, rate base rate of return regulation. An access regime is one in which all competitors are given full access to incumbents' networks, with little or no retail rate regulation, thereby allowing competition (over incumbents' networks) to discipline the market. Is this a good idea? Is it likely to work? What is the evidence for this?

At the core of this transition is the idea that incumbent monopolies control bottleneck facilities, such as local loops or cable IP channels,[1] which make facilities-based competitive entry difficult, at least in the short run. Such control will almost surely lead to well-known inefficiencies of monopoly. Can public policy help? Traditionally, regulatory agencies were established (e.g., telephone, airlines, trucking, electric power) that tightly regulated retail prices and entry, often establishing social objectives that were incompatible with competitive markets. For the first two-thirds of the twentieth century, rate base rate of return regulation was perceived as a necessary government intervention to solve the natural monopoly/essential facilities problem and improve social welfare.

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1. We are assuming that the monopoly controls a physical facility, such as an access line, which is difficult, costly, or impossible to duplicate. In contrast to this supply-side bottleneck facility, there may also be demand-side market restrictions, such as those that occur with (irremedial) network effects, in which customers must use a common standard or protocol to communicate with one another, and a single firm controls that standard or protocol. Microsoft's control of Windows is an oft-cited example as is AOL's control of its Instant Messaging platform. We do not consider demand-side barriers in this Article, focusing only on supply-side essential facilities.

During the last third of the twentieth century, political scientists and economists undertook a major revision of this perceived wisdom, showing that in industry after industry, regulation maintained monopolies, inefficient price structures, and reduced incentives to innovate.[2] In some industries, such as airlines, analysts saw a competitive industry struggling to emerge from the "dead hand of regulation";[3] in others, scholars recommended deregulating parts of the industry and isolating the natural monopoly, where it could be regulated safely with access to all in the competitive sector. More generally, scholars argued that the cure of regulation may be worse than the disease of monopoly.[4]

In the face of this withering critique of traditional rate base rate of return regulation, regulators sought alternative ways to achieve the public policy objective of the control of monopoly power without the stultifying reach of bureaucratic regulation. Obviously, the best outcome could be achieved with competition, but if the presence of bottleneck facilities made competition impractical, then some form of regulation, it is argued, is needed—just not the oppressive rate base rate of return regulation.

One candidate for regulatory reform is to focus on the actual bottleneck facility itself, and to mandate that the owner of the bottleneck facility make it available to all firms, including, and especially, its competitors, at "reasonable" rates and terms of trade. Regulators took a page from classic antitrust, which for many years recognized the "essential facilities" doctrine. First affirmed in *Terminal Railroad*,[5] Richard Posner describes it:

> A consortium of 14 of the 24 railroads that shipped freight across the Mississippi River at St. Louis got control of the terminal facilities at each side of the river. The Supreme Court, while assuming that the operation of these facilities as a single entity was the most efficient way to operate them (that is, they comprised a natural monopoly), held that the Sherman Act required the consortium to provide access to the

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2. The focus here, and throughout this paper, is economic regulation, in which a regulator controls the price, entry, and investment decisions of all market participants. This is in contrast to so-called social regulation, such as environmental regulation, occupational safety and health, banking, and air safety regulations, which are not the focus of this paper.

3. James Q. Wilson, *The Dead Hand of Regulation*, THE PUBLIC INTEREST, Fall 1971, at 39.

4. A good starting point in the vast scholarship on regulation is JAMES Q. WILSON, THE POLITICS OF REGULATION (1980). A very simple model of how even "perfect" political regulation of a natural monopoly can be significantly more inefficient than unconstrained monopoly is in Gerald R. Faulhaber, *Voting on Prices: The Political Economy of Regulation*, *in* INTERCONNECTION AND THE INTERNET: SELECTED PAPERS FROM THE 1996 TELECOMMUNICATIONS POLICY RESEARCH CONFERENCE, 275 (Greg Rosston & David Waterman eds., 1997).

5. United States v. Terminal R.R. Ass'n, 224 U.S. 383 (1912).

terminal facilities to the 10 other railroads on nondiscriminatory terms.[6]

The essential facilities doctrine promised a magic bullet for the cure of natural monopoly: remove the power of the owner of the bottleneck to throttle competition via its control of that facility so that competition can flourish unfettered by the monopolist. Simply prizing open the bottleneck facility would allow the competitive market to work, thus removing the need for rate base rate of return regulation to achieve efficient prices.[7] In the case of telecommunications, the bottleneck facility (*circa* 1980) was the local network, and the Bell System breakup was about ensuring equal access to that network by all long-distance carriers. By separating the Bell System's long-distance carrier, AT&T, from the local network owners, incentives were aligned to ensure that the owner of the bottleneck facility would treat all long-distance carriers the same.

So, if full competition, à la airline or trucking deregulation, is not possible, what is? Opening these bottleneck facilities so that entrants can use them to challenge incumbents would appear to be an economist's dream solution—the ultimate good idea. But what is the reality of access regulation?

The first result is surprising, but on reflection, obvious: access regulation does not get rid of rate base rate of return regulation; it simply changes its locus from retail rates to wholesale rates. Even if retail rates can be deregulated at the sweep of a hand, wholesale rates to potential competitors cannot be deregulated. Regulation is now focused on the cause of market failure, namely, the bottleneck facility. But, the monopolist still has incentives to raise its rates to the fullest extent permitted by regulation and to offer the minimum terms of trade with which it can get away. The regulator must maintain her vigilance undeterred, but now the focus is on wholesale rates.

There are three factors which may make access regulation even worse. First, since competition will not arise instantaneously in the presence of open access, it is very likely that regulation of both retail and wholesale rates will continue through an undoubtedly lengthy transition period. Second, if the interface between the owner of the facility and potential competitors wishing to use it is sufficiently complex, then regulation and monitoring of a complex business relationship, which one party has entered under compulsion, becomes very complicated and

6. Blue Cross & Blue Shield United of Wis. v. Marshfield, 65 F.3d 1406, 1412 (7th Cir. 1995).

7. As a practical matter, virtually all regulators created price distortions away from efficient pricing, allegedly for "social" reasons, or more likely, political reasons. Thus, achieving efficient prices may not have actually been an objective of regulators, although it is their oft-proclaimed goal.

problematic. Third, if the owner of the bottleneck facility also competes downstream with the firms who use its facility, then it has a positive motivation to discourage its mandated wholesale customers from using the bottleneck facility. If it cannot do this by raising its price, it will surely reduce quality of interconnection, speed of installation, and high field failure rates. At the time of divestiture, care was taken to ensure that the retail long-distance unit was separated from the bottleneck-facility owner so the local telephone companies would have incentive to carry all long-distance traffic and not discriminate. Later policy changes were not quite so discerning, unfortunately.

Telecommunications provides us with four great experiments aimed at opening access to competitors of the incumbents' bottleneck access lines, so it is natural to look at how these experiments worked in practice.[8] The examples were terminal equipment deregulations, the FCC's attempts to open long-distance competition, the Department of Justice's opening of long-distance competition, and the Telecommunications Act of 1996's attempts to open the local loop. Of these four, I found two were successful and two were failures. I conjectured then, and put it forward again today, that success requires either one of two conditions be met: (i) the interface between the entrant's business and the incumbent's business must be simply and easily monitored for compliance; or (ii) the incumbent is not a player in the competitive market against entrants. Unless at least one is satisfied, I argue, attempts at equal access using incumbents' facilities are doomed. We may really want it to work, and regulators will make mighty efforts to assure it will work, but they will fail.

Case in point: making local-loop unbundling work in the aftermath of the Telecommunications Act of 1996. It was both the intent of Congress and the target of intense and sustained FCC efforts to open up the incumbent local exchange carriers' (ILECs) local access lines to competitive local exchange carriers (CLECs) who could then compete against the ILECs for "last mile" services without having to build their own access lines. Seldom have the forces of public policy in telecommunications been as powerfully aligned as they were on the issue of local-loop unbundling. And yet, the effort was a failure—the evidence for which is the demise of the CLECs.[9] The reasons for this failure are clear: (i) the interface between the regulated monopoly owning the local-access line and the CLECs who wished to use it was highly complex; and (ii) the ILECs not only owned the local loops, they also competed in the retail market for access services with the very CLECs who had to use their

8. *See* Gerald R. Faulhaber, *Policy-Induced Competition: the Telecommunications Experiments*, 15 INFO. ECON. & POL'Y 73 (2003).

9. *See supra* note 7.

facilities. The result was that ILECs had every incentive to make life miserable for the CLECs in any way they could, and the complexity of the interface gave them plenty of opportunity.[10]

The lesson we draw from the history of access regulation in telecommunications is that it simply will not work unless these incentives and complexity issues are addressed. Otherwise, the evidence suggests such efforts will end in costly tears and negative results.

Now, having made some very strong statements about the ability to implement equal access, let me change tack by emphasizing that my conclusions apply only to the domestic United States. Through some unknown magic, forcing open access in France, Germany, Japan, and other countries, especially for Internet services, apparently has been a great success. Surprisingly, it was the United States and the FCC that sold the concept of local loop unbundling to the world, and yet we are apparently the only country that cannot make it work.

Why is this so? Frankly, I have no idea. My current hypothesis is that in other countries, when the government tells you to do something, you do it and you do it quick. In the United States, when the government tells you to do something you don't want to do, you whine about how unfair it is, complain to your congressman about how you are being picked on, you bring suit against the FCC, and you almost never have to do what they told you.

10. This is not to say that CLECs were otherwise efficient firms who were laid low by ILEC regulatory machinations. The rather sorry story of the incompetence of at least some CLECs is thoroughly explored in MARTIN F. MCDERMOTT III, CLEC TELECOM ACT 1996: AN INSIDER'S LOOK AT THE RISE AND FALL OF LOCAL EXCHANGE COMPETITION (2002).