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Remedies and the Institutional Design  
of Regulation in Network Industries

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# REMEDIES AND THE INSTITUTIONAL DESIGN OF REGULATION IN NETWORK INDUSTRIES

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## INTRODUCTION

In the United States, the topic of remedies in network industries cuts across antitrust law and sector-specific regulation, including telecommunications. The legal and economic understandings of a "remedy" are not synonymous in American usage. In law, a remedy is the corrective measure that a court orders following a finding of liability. With the exception of interlocutory relief, such as preliminary injunctions or temporary restraining orders (which might apply to a proposed merger, for example), legal remedies are retrospective in their orientation. They seek to right some past wrong. They may do so through the payment of money (whether that is characterized as the payment of damages, fines, disgorgement, or something else). Or they may seek to do so through a mandated change in market structure, as in the case of divestiture, or in the imposition of affirmative or negative duties, as in the case of "behavioral" injunctions. *United States v.*

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*Microsoft Corp.* [hereinafter *Microsoft*]<sup>1</sup> presented the tradeoff between these various remedial alternatives.<sup>2</sup>

Industry-specific regulation, such as regulation of the telecommunications industry by the Federal Communications Commission (FCC), is an alternative to reliance on liability rules. Therefore, it is not obvious what a “remedy” is in a traditional regulated network industry—at least if we are employing the standard American meaning of a legal remedy.

In contrast to these legal connotations of a remedy, the economic meaning of a remedy emphasizes market failure. The market failure may result from the unchecked exercise of market power, or from the uncompensated generation of an external cost or benefit, or from an insufficiency of information with which to make efficient choices concerning consumption, production, or investment. Whereas lawyers think of a remedy as what to do after a finding of liability, economists think of a remedy as what to do after a finding of market failure. The two approaches overlap perfectly if legislators and courts make liability rules that are triggered only after a finding of market failure. Of course, if legislators and courts actually did so, the *Journal of Law & Economics* would be a very slim volume that would have ceased publication years ago.

### I. EX ANTE AND EX POST PERSPECTIVES

The difference between the legal and economic conceptions of remedy highlights another important distinction, namely, the difference between *ex ante* and *ex post* interventions in the market. Under the *ex post* approach, a remedy is imposed if and only if liability is first proven. And it is the government or a private plaintiff that bears the burden of proving liability. This arrangement describes the operation of monopolization law under the Sherman Act,<sup>3</sup> as in *Microsoft*.

In contrast, the *ex ante* approach imposes a remedy before any specific finding of liability. The rationale for this prophylactic approach may be one or more of the following considerations:

- The probability of anticompetitive behavior in the absence of the prior restraint is high.
- The magnitude of the harm from such behavior would be great.

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1. 253 F.3d 34 (D.C. Cir. 2001).

2. See Howard A. Shelanski & J. Gregory Sidak, *Antitrust Divestiture in Network Industries*, 68 U. CHI. L. REV. 1 (2001).

3. See 15 U.S.C. §§ 1-7 (2000).

- The likelihood and magnitude of offsetting efficiency justifications for the behavior are low.
- The danger of false positives is small.

This kind of reasoning can be found in dominant carrier regulation practiced in the United States and other nations. For example, a Bell operating company in a given state is forbidden to offer long-distance service from one local access and transport area (LATA) to another until it makes an arduous showing under section 271 of the Telecommunications Act that its market entry will not harm competition in the local access market.<sup>4</sup> Sometimes this *ex ante* imposition of remedial duties cannot even be justified on the basis of dominance, though it surely is asymmetric. The classic example is the imposition of a resale obligation on an incumbent local exchange carrier's provision of digital subscriber line (DSL) service, despite the fact that cable modem service offered by cable operators holds twice the market share as DSL.<sup>5</sup>

How should we choose between the *ex post* and *ex ante* approaches? The first consideration is surely which regime is better able to gather and process the information necessary to determine whether the remedy being sought is indeed beneficial to consumer welfare rather than antithetical to it. This is the central difficulty with the FCC's framework for mandating the unbundling of network elements and the pricing of them at prescribed rates based on regulator's estimates of the total element long-run incremental cost (TELRIC).<sup>6</sup> This experience could fill an entire conference. The short lesson to take from the TELRIC experience is that, whether the FCC admits it or not, it has interpreted the Telecommunications Act to create a competitor-welfare standard rather than a consumer-welfare standard for deciding what must be unbundled and how it must be priced.<sup>7</sup>

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4. See 47 U.S.C. § 271. For an empirical assessment of the detrimental effect of section 271 on prices in interLATA markets, see Jerry A. Hausman, Gregory K. Leonard & J. Gregory Sidak, *Does Bell Company Entry into Long-Distance Telecommunications Benefit Consumers?*, 70 ANTITRUST L.J. 463 (2002).

5. See generally Robert W. Crandall, J. Gregory Sidak & Hal J. Singer, *The Empirical Case Against Asymmetric Regulation of Broadband Internet Access*, 17 BERKELEY TECH. L.J. 953 (2002).

6. Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, 11 F.C.C.R. 15499 (Aug. 8, 1996), *vacated in part sub nom.* Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), *rev'd in part and aff'd in part sub nom.* AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999).

7. See Jerry A. Hausman & J. Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 YALE L.J. 417 (1999).

So the TELRIC experience suggests a second consideration for choosing between *ex ante* and *ex post* regimes for imposing remedies in network industries: Who will make decisions about industry-specific regulation? Is the decision maker independent and impartial? Does the regulator act strategically in terms of his use of administrative procedures, as Chairman Reed Hundt admitted he did in his adoption of the FCC's unbundling rules in 1996?<sup>8</sup> Would a regulator or court that had a broader portfolio of industries be less inclined to pursue a controversial remedy against a particular set of firms in a particular industry?

One example comes to mind. The federal courts in the United States have almost never imposed an open-access regime in the scores of antitrust cases brought under the essential facilities doctrine.<sup>9</sup> Yet, open-access regimes are the norm among industry-specific regulators at the state and federal level (and in other countries). Perhaps the difference can be explained by selection bias: maybe the antitrust cases are almost always frivolous, but perhaps, as an alternative explanation, the rejection of this particular remedy reflects the differing degrees to which industry-specific regulators are subject to pressures from specific competitors; or it may reflect raw political pressures, which, in my view, are incorrectly dismissed as not being significant in so arcane a field as telecommunications regulation; or the proclivity to choose a particular remedial framework could reflect the personal ambitions of regulators.

There is an intermediate institutional design for imposing remedies in network industries in the United States that has grown with the speed and tenacity of a weed. It is the consent decree. The Antitrust Division (and to a lesser extent, the Federal Trade Commission) sues a company or group of companies for violating the antitrust laws. The case is then settled pursuant to a consent decree. In other words, issue-specific litigation leads to a negotiated, prospective regime of company-specific regulation. If a single firm is the object of the antitrust case, and if it is prominent enough in its industry (I will avoid using the loaded term "dominant"), then the consent decree becomes the *de facto* asymmetric regulation of the entire industry. The most obvious example is the Modification of Final Judgment,<sup>10</sup> by which the federal judiciary governed the telecommunications industry after the antitrust

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8. See REED E. HUNDT, *YOU SAY YOU WANT A REVOLUTION: A STUDY OF INFORMATION AGE POLITICS* 154 (2000).

9. See Abbott B. Lipsky, Jr. & J. Gregory Sidak, *Essential Facilities*, 51 *STAN. L. REV.* 1187 (1999).

10. Modification of Final Judgment, *reprinted in* *United States v. AT&T Co.*, 552 F. Supp. 131, 226-34 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983).

breakup of the Bell System in January 1982 until Congress enacted the Telecommunications Act in February 1996.<sup>11</sup> A more recent example, of course, is the *Microsoft* case, whose remedial structure following a settlement between the Antitrust Division and Microsoft remains the subject of continuing litigation in federal court.

The consent decree is an amalgam of the ex post and ex ante approaches. This characteristic explains why more than a decade ago Professor (now Circuit Judge) Michael McConnell questioned the constitutionality of consent decrees.<sup>12</sup> He regarded them as a commingling of essentially ex post law enforcement powers belonging to the Executive Branch and ex ante legislative powers belonging to Congress, which then were handed over to the Judiciary to oversee.

American telecommunications deregulation provides other current examples of the combination of ex ante and ex post regulatory models. I mentioned earlier the process under section 271 of the Telecommunications Act by which a Bell operating company may apply to enter the interLATA market. Such applications are reviewed by the FCC and the relevant state public utilities commission, obviously under an ex ante approach. For these regulatory commissions, the status quo is the continuation of an entry barrier. That is a kind of the prospective remedy, though a foolish one in my opinion. Setting aside the wisdom or folly of the remedy, it seems odd that the Antitrust Division of the Justice Department participates in this process. Although the Division has expertise in telecommunications, it is an enforcement body. It executes the law on an ex post basis—by applying an existing legal standard to a set of facts that have already occurred. The Antitrust Division is not a legislative body that exercises the power to establish rules regulating prices, entry, and other terms and conditions of competition in specific industries.

The conflict between ex post antitrust remedies and ex ante telecommunications regulation also has arisen in a set of cases known as the *Goldwasser* cases,<sup>13</sup> named for the first case in a series of conflicting lower court rulings. The Supreme Court has granted certiorari in one such case, *Trinko*, for the October 2003 Term.<sup>14</sup> The issue in these cases is whether a

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11. Pub. L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 15, 18, and 47 U.S.C.).

12. Michael W. McConnell, *Why Hold Elections? Using Consent Decrees to Insulate Policies from Political Change*, 1987 U. CHI. LEGAL F. 295.

13. *Goldwasser v. Ameritech Corp.*, 222 F.3d 390 (7th Cir. 2000). For representative decisions that show the divergence of opinion on this legal question, see *Covad Communications Co. v. BellSouth Corp.*, 299 F.3d 1272 (11th Cir. 2002); *Law Offices of Curtis V. Trinko v. Bell Atl. Corp.*, 294 F.3d 307 (2d Cir. 2002), *cert. granted*, \_\_\_ U.S. \_\_\_, 123 S. Ct. 1480 (2003); *Cavalier Tel., LLC v. Verizon Va., Inc.*, 208 F. Supp. 2d 608 (E.D. Va. 2002).

14. *Law Offices of Curtis V. Trinko*, 294 F.3d 307.

Sherman Act claim for monopolization is available to a competitive local exchange carrier (CLEC) that alleges that the incumbent local exchange carrier (ILEC) has failed to comply with the FCC's unbundling and pricing regulations. It is a fair question to ask why it is necessary to have both ex ante and ex post remedies to address the perceived market failures that motivated passage of the Telecommunications Act of 1996.

Let me shift the subject slightly. So far I have discussed only private firms in network industries but many network industries, such as postal services, still have state-owned enterprises dominating them. With public enterprises in network industries, the causes of competitive concern and the range of remedial policy instruments are different. State-owned enterprises have a greater incentive than private, profit-maximizing firms to engage in predatory pricing and anticompetitive network discrimination.<sup>15</sup> In principle, state ownership of enterprise is supposed to internalize regulatory decisions within managerial decisions. At a stylized level, the state-owned enterprise is assumed to maximize some specification of social welfare, which presumably would include consumer welfare.

With respect to state-owned enterprises, the feasible set of remedies in cases of market failure gets truncated because of at least three factors. First, the state's conflicting interest in maximizing the firm's value in anticipation of its privatization may impose practical political constraints on the intensity and invasiveness of potential remedies designed to increase competition. Second, where independent regulators do exist, as in the case of the Postal Rate Commission in the United States, the regulator may be weak, both legally and politically, especially given the political influence of the large work force that a state-owned enterprise often employs. Third, at least in the United States, the doctrine of sovereign immunity may bar private parties from pressing antitrust claims against the state-owned enterprise.<sup>16</sup> For these reasons, it is important to keep state ownership in mind when examining the feasible set of remedies in network industries.

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15. See David E. M. Sappington & J. Gregory Sidak, *Are Public Enterprises the Only Credible Predators?*, 67 U. CHI. L. REV. 271 (2000); David E. M. Sappington & J. Gregory Sidak, *Incentives for Anticompetitive Behavior by Public Enterprises*, 22 REV. INDUS. ORG. 183 (2003); David E. M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. (forthcoming Dec. 2003).

16. The Supreme Court granted certiorari for the October 2003 Term in a case in which the Ninth Circuit had denied the U.S. Postal Service sovereign immunity. See *Flamingo Indus. (USA) Ltd v. United States Postal Serv.*, 302 F.3d 985 (9th Cir. 2002), cert. granted, \_\_\_ U.S. \_\_\_, 123 S. Ct. 2215 (2003).

## II. THE REVERSAL IN THE FLOW OF POLICY INNOVATION AND EXPERIMENTATION

Let us return to the distinction between *ex ante* and *ex post* remedies in network industries. Given the choice between *ex ante* dominant firm regulation and *ex post* antitrust litigation, which approach has been more intellectually forceful in shaping what I will broadly call the “remedial orientation of competition policy”? Twenty years ago, it was clearly the case that its embrace of economic analysis made antitrust law intellectually dominant over industry-specific regulation in the United States. More than any of the FCC proceedings that preceded it, the antitrust case against the Bell System is considered (sometimes for the wrong reasons) the defining moment in reorienting the telecommunications industry toward deregulation. The diffusion of ideas flowed from antitrust to the regulatory agencies.

Then something happened, and the direction of policy innovation reversed. Today, American antitrust law and its notions of feasible remedies in network industries are influenced by the theories of market failure predicated on network effects.<sup>17</sup> Those theories were developed at Berkeley and Stanford in the 1980s. They began influencing thinking on telecommunications regulation, and by the early 1990s they dominated policy formation at both the FCC and the Antitrust Division, when the Berkeley and Stanford theorists came to Washington.

Even the practice of antitrust law evolved over that period into more of an administrative practice, characterized by numerous policy statements and guidelines issued by the Antitrust Division and Federal Trade Commission that resembled the prospective rulemakings at the FCC. In relative terms, antitrust became less a body of actual law written by courts deciding specific cases on an incremental basis, and more a body of regulation taking the form of generalized statements of abstract principles, promulgated by a bureaucracy. The culmination of that process was the *Microsoft* antitrust case,

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17. See Michael L. Katz & Carl Shapiro, *Technology Adoption in the Presence of Network Externalities*, 94 J. POL. ECON. 822 (1986); Joseph Farrell & Garth Saloner, *Installed Base and Compatibility: Innovation, Product Preannouncements, and Predation*, 76 AM. ECON. REV. 940 (1986); Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 RAND J. ECON. 70 (1985); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424 (1985). This phenomenon has received little attention from scholars. For two timely and thoughtful exceptions, see DAMIEN GERADIN & MICHEL KERF, *CONTROLLING MARKET POWER IN TELECOMMUNICATIONS: ANTITRUST VS. SECTOR-SPECIFIC REGULATION* (Oxford University Press 2003); Joseph Farrell & Phillip J. Weiser, *Modularity, Vertical Integration, and Open Access Policies: Towards a Convergence of Antitrust and Regulation in the Internet Age* (Feb. 2003) (unpublished manuscript).

by which the Antitrust Division installed itself, whether it intended to or not, as overseer of a regime of dominant firm regulation of the software industry. Given the rapid technological change in software, that de facto regulation was necessarily prospective and hypothetical.

### III. TELECOMMUNICATIONS LAW'S POTENTIAL TO SHAPE ANTITRUST REMEDIES IN NETWORK INDUSTRIES

So it is now natural to speculate about how the FCC's crowning achievement since 1996—namely, the Supreme Court's vindication of the agency's TELRIC pricing rules in 2002 in the *Verizon* case<sup>18</sup>—will influence the development of antitrust law concerning remedies in network industries. How, for example, will TELRIC pricing affect the development of antitrust law concerning Microsoft? The influence may prove to be substantial.

There is an obvious relationship between an ex ante regulation requiring unbundling of network elements and an ex post antitrust rule penalizing the failure to offer a product or functionality on an unbundled basis. The latter is the antitrust doctrine concerning tying arrangements, which was so contentious in the *Microsoft* case. When read together, *Verizon* and *Microsoft* have potentially broad implications for antitrust remedies relating to bundling and unbundling of products having substantial sunk costs and network complementarities, including intellectual property. The traditional antitrust case law on tying is not much help in the context of intellectual property and other sunk-cost investments that exhibit network effects. In this respect, such sunk-cost assets cannot really be treated the same as widgets in bundling cases. I have three observations in this regard.

First, to repeat the obvious, after the D.C. Circuit's 2001 decision in *Microsoft*, the economic subtleties of product bundling in network industries lend themselves better to analysis under the monopolization principles embodied in section 2 of the Sherman Act<sup>19</sup> than to the more linguistic formulations of liability in section 1 of the Sherman Act<sup>20</sup> and section 3 of the Clayton Act.<sup>21</sup> Along these lines, the separate-product analysis in tying cases is less likely to be fruitful in cases involving intellectual property, such as computer software, than in cases involving widgets. The strategic motivation for bundling may have nothing to do with conventional theories of tying predicated on leveraging or price discrimination. Furthermore, the attempted preservation of a monopoly over the tying product—whether it is an operating

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18. *Verizon Communications Inc. v. FCC*, \_\_\_ U.S. \_\_\_, 122 S. Ct. 1646 (2002).

19. *See* 15 U.S.C. § 2.

20. *See* 15 U.S.C. § 1.

21. *See* 15 U.S.C. § 14.

system, a primary patent, a broadband Internet conduit, or the like—is hard to evaluate in economic terms when forced into traditional tying law.

Second, although certainly critical of the *Microsoft* case, I encourage scholars, enforcement agencies, and courts to refine David Sibley's theory of "partial substitutes," which was essential to the government's theories of liability and remedies in that case.<sup>22</sup> Sibley provided perhaps the most innovative theory of antitrust liability since the raising rivals' cost literature emerged more than a decade earlier. But the theory's eventual exposition in Franklin Fisher's testimony, and in the government's subsequent briefs, left the impression that a formal economic model has yet to be presented.<sup>23</sup> We do not have a formal explanation in consumer demand theory for how a complement turns into a substitute. Yet this metamorphosis is a recurring theme in the discussion of remedies in network industries. In telecommunications, for example, the leasing of selected unbundled elements at regulated prices is vigorously defended by CLECs and regulators as a complement to subsequent facilities-based entry, not a substitute for it.

Third, if we take tying law seriously in the context of network industries, we arrive at a serious pricing problem at the stage of fashioning a remedy. This pricing problem is likely to be much more challenging when the bundled products consist almost entirely of intellectual property, because of its zero marginal cost. Presumably, a prohibition against tying does not mean that a firm may not offer *A* and *B* in a bundle. Presumably, the prohibition means only that the firm must also offer *A* and *B* separately. Call *A* the tying product, which is a bottleneck of some sort. Call *B* the tied product, which is competitively supplied. How much of a discount off the bundled price must the firm therefore offer when it is compelled by antitrust law to sell *A* on an unbundled basis? When a high price is demanded for an unbundled version of *A*, does that price itself become an antitrust violation?

This question is closely related to the one that the FCC and the Supreme Court addressed in the *Verizon* case concerning TELRIC-based pricing of

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22. Declaration of David S. Sibley, *United States v. Microsoft Corp.*, Civil Action No. 98-1233, at ¶¶ 44, 49 (filed D.D.C. May 15, 1998) available at <http://www.usdoj.gov/atr/cases/f1700/1767.htm>; see also J. Gregory Sidak, *An Antitrust Rule for Software Integration*, 18 YALE J. ON REG. 1 (2001) (critiquing Professor Lawrence Lessig's application of Sibley's theory of partial substitutes).

23. See Declaration of Franklin M. Fisher, *United States v. Microsoft Corp.*, Civil Action No. 98-1233, at 8 n.3 (filed D.D.C. May 12, 1998) ("Microsoft's bundling of IE with the Windows software it distributes through retail channels is a similar effort to weaken Microsoft's browser competition in order to protect Microsoft's dominance in operating systems."); Direct Testimony of Franklin Fisher at ¶¶ 22, 81, *United States v. Microsoft Corp.*, (D.D.C. 1999) (No. 98-1233); see also Franklin M. Fisher, *The IBM Case and Microsoft: What's the Difference?*, 90 AM. ECON. REV. PAP. & PROC. 180 (May 2000).

unbundled network elements. If TELRIC-based pricing is reasonable to impose on a former statutory monopolist subject to rate regulation that has not committed any antitrust violation, then it is doubtful that a court in an antitrust case would have qualms about applying TELRIC to an unregulated monopolist found to have violated section 2 of the Sherman Act by its unlawful bundling of software. There are, of course, many alternative pricing rules that might be employed to fashion the remedy in such a tying case, but surely TELRIC rules the day and will be pursued by plaintiffs and prosecutors because it is most favorable to their cause.

How then would antitrust law implement a TELRIC approach to fashioning the unbundling remedy in a case of software integration? One approach is the top-down, avoided-cost calculation: What is the long-run average-incremental cost (LRAIC) of *B* that is avoided when *A* is unbundled? Subtract that LRAIC from the previous bundled price to determine the permissible unbundled price of *A*. But, if the telecommunications experience is any guide, the objection will be raised that the bundled price incorporates monopoly rent and inefficiency, and that these components must be subtracted also. It will also be argued that product *B* should contribute substantially to the recovery of the defendant's common costs.

The defendant in such a case will argue in rebuttal that the cost that it avoids when selling *A* without *B* bundled to it is trivial if the provision of *B* exhibits economies of scale—since, by assumption, it will still be lawful for the firm to offer a bundled version of *A* and *B*. The defendant can further be expected to argue that there may be new incremental costs of unbundling (perhaps making the net avoided cost negative), and naturally there will be a dispute over who shall pay those incremental costs of unbundling.

The other remedial approach is a bottom-up calculation of the LRAIC of product *A*, in addition to which the defendant should be allowed to recover a reasonable share of common costs, including a competitive return on capital. In principle, the top-down and bottom-up approaches should yield equivalent results. However, if they do not in practice, obvious strategies will emerge between plaintiffs and defendants over which approach is the proper test. The experience in telecommunications is that regulators implement the two pricing calculations in ways that permit divergent results, and that there is no acknowledgment by regulators or courts of the strategic behavior that such a divergence induces. The controversy over whether ILECs have a duty to offer all network elements as a platform, priced at the sum of the TELRIC prices,

would not exist if not for this methodological inconsistency tolerated by regulators.<sup>24</sup>

In short, the *Verizon* case concerning TELRIC pricing will likely influence the shape of antitrust remedies in product integration cases. In the intellectual property area, we can expect to see more monopoly-preservation tying cases, relying on Sibley's theory of partial substitutes. These cases will immerse the litigants and the courts in TELRIC-like questions of the pricing of the tying product on an unbundled basis. The sunk-cost character of intellectual property will make these remedial proceedings highly contentious and highly consequential, for the desired remedy may succeed in appropriating quasi-rent rather than preventing the defendant from earning true economic rent. Nonetheless, the remedial experience in American telecommunications regulation since 1996 suggests that plaintiffs and prosecutors will prevail at the end of the day.

#### IV. THE U.S. TRADE REPRESENTATIVE AS REGULATOR

A final regulatory design takes the form of bilateral or multilateral trade agreements.<sup>25</sup> On February 15, 1997, seventy countries working within the framework of the World Trade Organization (WTO) agreed on a multilateral reduction of regulatory barriers to competition in international telecommunications services.<sup>26</sup> At the time, the signatory nations to the WTO agreement on telecommunications services represented markets generating ninety-five percent of the \$600 billion in global telecommunications revenues.<sup>27</sup> Beginning January 1, 1998, those nations started a phased process to open their telecommunications markets to competition. Since 1997, the U.S. government has attempted to use the WTO agreement on

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24. For an analysis of this controversy, see Allan T. Ingraham & Gregory Sidak, *Mandatory Unbundling, UNE-P, and the Cost of Equity: Does TELRIC Pricing Increase Risk for Incumbent Local Exchange Carriers?*, 20 YALE J. ON REG. 389 (2003).

25. See Jeffrey H. Rohlfs & J. Gregory Sidak, *Exporting Telecommunications Regulation: The United States-Japan Negotiations on Interconnection Pricing*, 43 HARV. INT'L L.J. 317 (2002).

26. World Trade Organization, *The WTO Negotiations on Basic Telecommunications* (Feb. 17, 1997) (unofficial briefing document). For an analysis of the WTO agreement on telecommunications services, see J. GREGORY SIDAK, *FOREIGN INVESTMENT IN AMERICAN TELECOMMUNICATIONS* 367-94 (1997). See also EDWARD M. GRAHAM & J. DAVID RICHARDSON, *GLOBAL COMPETITION POLICY* (1999); John H. Harwood II, et al., *Competition in International Telecommunications Services*, 97 COLUM. L. REV. 874, 881-84 (1997).

27. Edmund L. Andrews, *U.S. Remains Odd Man in Global Push for Phone Deal*, N.Y. TIMES, Feb. 14, 1997, at D1; Anne Swardson & Paul Blustein, *Trade Group Reaches Phone Pact*, WASH. POST, Feb. 16, 1997, at A33.

telecommunications services as a vehicle for "exporting" American principles of telecommunications regulation to other nations.

In 1997 the United States took the position that the WTO agreement on telecommunications services requires signatory nations to follow the FCC's practices on interconnection pricing under the Telecommunications Act of 1996.<sup>28</sup> That effort has culminated in the initiative by the Office of the United States Trade Representative (USTR) to use the implicit threat of trade sanctions to influence Japan's domestic regulatory policy on the pricing of mandatory competitor access to the unbundled elements of the local network belonging to the operating companies of Nippon Telegraph and Telephone Corporation (NTT).<sup>29</sup> The USTR's efforts against Japan have not been an isolated case. The USTR has sought to place detailed interconnection requirements in a bilateral treaty with Singapore, and it has initiated a WTO arbitration proceeding against Mexico over telecommunications pricing issues in what is the very first WTO case of any sort under the General Agreement on Trade in Services.

The USTR's expertise lies in negotiating trade agreements. "The Trade Representative shall have primary responsibility . . . for developing, and for coordinating the implementation of, United States international trade policy" and "shall serve as the principle [*sic*] advisor to the President on the impact of other policies of the United States Government on international trade."<sup>30</sup> The USTR's expertise is not access pricing, telecommunications economics, antitrust law, or industrial organization. It appears that the USTR was, and may still be, unaware that almost continuously since 1996, many American experts on telecommunications policy have doubted that American consumers have benefited from the very FCC policies that USTR would have Japan, Singapore, Mexico, and other nations emulate. Commenting on the applicability of the U.S. model of telecommunications liberalization to other nations, Robert Crandall wrote in 1997 that "[t]he most contentious single issue in implementing the 1996 Telecommunications Act in the United States is the measure of cost to be used in setting rates for wholesale unbundled elements."<sup>31</sup> Not surprisingly, the FCC's policy in this area has generated continuous litigation since 1996, including two Supreme Court cases, and is

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28. Pub. L. No. 104-104, 110 Stat. 56. (Feb. 8, 1996).

29. For further discussion of the USTR's interconnection negotiations with Japan, see Rohlfs & Sidak, *supra* note 24.

30. Reorganization Plan No. 3 of 1979, reprinted in 19 U.S.C. § 2171(b)(1) (1982).

31. Robert W. Crandall, *Telecommunications Liberalization: The U.S. Model*, in DEREGULATION AND INTERDEPENDENCE IN THE ASIA-PACIFIC REGION 415, 428 (Takatoshi Ito & Anne O. Krueger, eds., 2000). See also MARTIN CAVE & ROBERT W. CRANDALL, TELECOMMUNICATIONS LIBERALIZATION ON TWO SIDES OF THE ATLANTIC (2001).

too unresolved for the United States to force on its trading partners. Yet, despite that irresolution, interconnection pricing is today the very aspect of the Telecommunications Act of 1996 that the USTR aggressively seeks to impose on other nations in the name of enforcing the WTO agreement on telecommunications services.

It is unlikely that the USTR has the detailed knowledge, the expertise, and the proper incentives to negotiate trade agreements on interconnection pricing. The public policy issues associated with telecommunications regulation are far more complex than those associated with steel or bananas. One should question the propriety of using the USTR to influence the domestic regulatory policy of another country on a topic as complex as the efficient pricing of mandatory access to unbundled network elements. The USTR's power to formulate trade policy on this subject resides in officials who are unlikely to possess the economic expertise and resources necessary to evaluate the consumer-welfare implications of the policies that they would have Japan and other nations adopt. For these reasons, the USTR cannot credibly make the interconnection pricing policies of another nation a legitimate concern of U.S. trade policy.

It is hard to comment definitively on the process by which the Office of the U.S. Trade Representative sets trade policy concerning telecommunications services. The process is opaque. Through comments from various carriers, I have a vague notion of how the USTR process works, but because my understanding is incomplete, it is sometimes more appropriate for me to pose questions for others to consider.

Why is USTR's process so secret? USTR does not have something akin to the notice and comment process at the FCC when soliciting input from companies that have economic interests that are antagonistic to one another. It does not have *ex parte* rules like those at the FCC. Given this lack of transparency, it is worth asking why USTR has gained a reputation for being solicitous to the advice of interexchange carriers but not that of incumbent local exchange carriers.

There is also concern that the Trade Representative and his deputies are not engaged in the process by which their subordinates have turned international trade negotiations into detailed demands about the pricing of unbundled network elements and the like. It is inappropriate for the Trade Representative and his deputies to give subordinates who were never nominated by the President and confirmed by the Senate the leeway to dictate important trade policies with Japan and Mexico, and the formation of a template bilateral trade agreement with Singapore.

I doubt that the telecommunications regulatory policy of the Bush Administration and Chairman Powell in 2003 is the same as that of the Clinton Administration and Chairman Hundt in 1996. And so, I do not

understand why the White House, the Department of Commerce, and the FCC fail to give USTR clear instructions or advice on what constitute appropriate telecommunications regulatory principles for the United States to demand of its trading partners. Silence is the abdication of responsibility. Senior Administration officials and Chairman Powell should be concerned that USTR is advancing an interpretation of American telecommunications regulations that ignores the current policy direction of the FCC as well as the reversal of certain local competition rules by the federal courts of appeal.

I wonder whether USTR is aware that, from 1996 through 2002, the *FCC Record* averaged 23,838 pages per year. I wonder how many persons at USTR have read the FCC's August 1996 order on interconnection pricing and unbundling. If, as I suspect, USTR is out of its depth on local telecommunications regulation, then one must wonder, How and from whom does USTR supplement its own expertise? For example, to what extent has USTR relied on the representations made by telecommunications carriers whose senior executives have pled guilty to securities fraud?

Moving from process to substance, the USTR's negotiating positions implicitly espouse a competitor-welfare approach to telecommunications regulation rather than a consumer-welfare approach. It is understandable that USTR would want to promote the interests of American companies. But in this case, it is promoting the interests of a subset of American carriers while ignoring the interests of other American telecommunications carriers as well as American producers of telecommunications equipment.

No American carrier will want to invest in building a network in a less-developed country if it knows that it will immediately have to lease unbundled network elements to a competitor at a price calculated, after considerable debate, on the basis of long-run average incremental cost. The disincentive to investment will not produce any sales of telecommunications equipment by American producers. How is that outcome a good trade policy for *any* constituency in the United States? It certainly does not help consumers in the less-developed country.

Congress, the Administration, and the FCC should beware of the USTR boomerang. Section 252(i) of the Communications Act provides: "A local exchange carrier shall make available any interconnection, service, or network element provided under an agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement."<sup>32</sup> It will surely be argued, on the basis of section 252(i), that treaty obligations that the United States undertakes pursuant to a bilateral agreement apply to domestic carriers

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32. 47 U.S.C. § 252(i).

as well. In other words, uncompensatory pricing policies for unbundled network elements that USTR succeeds in imposing on Singapore, for example, will become the new standard that U.S. competitive local exchange carriers seek to have imposed by domestic regulators on U.S. incumbent local exchange carriers. Suddenly, a career bureaucrat in USTR will have overridden Congress and the FCC and the federal courts. To make matters worse, judicial review of USTR actions seems difficult if not impossible under D.C. Circuit precedent.<sup>33</sup>

I doubt that Congress intends to relinquish its ability to legislate domestic telecommunications policy. Even if it did, there would be constitutional questions concerning separation of powers and bicameralism if domestic telecommunications policy were made this way by the Executive. Congress must not permit this usurpation of its authority to continue.

European regulators in Brussels and London with whom I have met do not regard the Telecommunications Act of 1996 as a success, and they do not want to emulate it. To the contrary, the Europeans have embarked on a new model of telecommunications regulation that is motivated by competition law principles. In theory at least, that approach will maximize the welfare of consumers rather than competitors. Has USTR considered how its current approach to telecommunications policy will affect our relations with our European trading partners?

Congress should ask the U.S. Trade Representative to explain the process by which his office has come to impose detailed telecommunications regulation on America's trading partners. Congress should insist that presidential appointees in the Executive Branch regain control of that process rather than delegating important policy decisions to subordinates. Finally, Congress is entitled to expect the Chairman of the FCC and the Assistant Secretary at NTIA not to be bystanders in this matter, saying, implausibly, that they must defer to USTR's expertise on telecommunications policy. The President should request their advice on the substance of appropriate U.S. trade policy concerning telecommunications services, and then he should direct the U.S. Trade Representative to make an informed decision.

#### CONCLUSION

Remedies in network industries emerge from multiple institutions that complement or compete with one another. We observe, in addition to ex ante industry-specific regulation, remedies being fashioned through ex post antitrust litigation, ex ante regulation through antitrust consent decrees,

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33. See Rohlfs & Sidak, *supra* note 24.

regulation through public ownership and the terms of privatization, and regulation through international trade negotiations and the threat of trade sanctions. The substantive outcomes under any one of these institutional designs will likely influence the substantive outcomes that eventually emerge under the alternative institutional designs. Access pricing and unbundling are early candidates for this spillover effect.

In many circumstances, however, the most powerful regulator is the rough and tumble of competition. It would be tragic if the fascination with the varied institutional design of regulation in network industries were lead to an erroneous presupposition that competitive markets require remedial intervention simply because an institution exists to regulate them.