A Sensible Approach to Avoiding a Tragedy of the Telecommons:
Sound Policy for the 21st Century

Manhattan Institute Conference
May 17, 2004

Jay P. Lefkowitz and John O'Quinn[1]

Today's conference, and particularly this panel on how regulatory incentives are affecting competition and investment in telecommunications couldn't be more timely. Just last month, the Administration unveiled its agenda for "A New Generation of American Innovation." And the focus of that agenda, in large part, is on promoting innovation and the economy through broadband technology – including wireless broadband. The President understands that access to information is transforming our economy in unprecedented ways. As he said on April 6, "the flow of information and the flow of knowledge will help transform America and keep us on the leading edge of change." Unfortunately, as the President also recognizes, we are lagging far behind. South Korea, Hong Kong, and Canada remain far ahead in wiring their economies for the digital age, and they are not alone. A recent study from the United Nations communications agency, the International Telecommunications Union, found that the United States ranks a distant ***11th*** in numbers of high-speed Internet connections per capita.

Why are we behind, and what can we do to catch up?

These are the questions that the Administration is grappling with, and that this panel has helped shed light on today.

Dr. Hazlett has identified perhaps the single most important issue facing the exploding wireless telecom market – spectrum allocation. Just look around this room. Handheld wireless

---

[1] Jay Lefkowitz, a partner at Kirkland & Ellis LLP, is the former head of the White House Domestic Policy Council. John O'Quinn is an associate at Kirkland & Ellis LLP and previously served as a law clerk to Justice Antonin Scalia.

devices are ubiquitous, and their uses are proliferating. Think the camera-phone is innovative? That the Blackberry is hip? You ain't seen nothing yet. We are witnessing the intersection of wireless applications in new handheld devices, and this is just the beginning as wireless goes broadband. This February's *Technology Review* reports that chips have been developed will enable new mobile phones and other wireless devices operating at the 2-gigahertz range and above to provide "fast, high-resolution Web surfing, and even passable real-time video, meaning that they could incorporate video cameras for recording, videoconferencing, and sophisticated game playing – possibly even movie watching." (*See* Freedman, "Gadgets in the Superchip Age," *Technology Review*, at 56 (Feb. 2004)). With smarter hardware, a single wireless device can take on the functions of PDAs and even PC's including online shopping, email, calendar features, and navigation aids—all with a voice interface. And universal translation software could transform mobile phones into universal communicators. (*See* "10 Emerging Technologies That Will Change Your World," *Technology Review*, at 34 (Feb. 2004)).

There are only two limits to the future of wireless: imagination and spectrum. Wireless devices depend on the availability of spectrum – the same spectrum shared with radio and television. And spectrum is not limitless. (*See Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367 (1969)). It truly is a commons, which, depending on regulatory incentives could either be overused, or could lie fallow. Thus, as Dr. Hazlett observes, spectrum allocation runs the risk of either giving rise to either a tragedy of the commons – if rights and obligations are not clearly defined, or a tragedy of the anticommons – if restrictions on use and transfer are too burdensome, all depending on the regulatory regime created by the Federal Communications Commission (FCC or Commission).

Unfortunately, the last major spectrum allocation was an unmitigated disaster. In 1995, the FCC sold nearly $5 billion of radio spectrum to a company called NextWave in an action reserved for "small businesses and other designated entities." In short, the small business bought off more than it could chew and went bankrupt before paying the FCC. During the years of litigation in which the FCC sought (and failed) to reclaim its licenses, that portion of the spectrum lay dormant. Worse yet, prolonged litigation prevented NextWave from selling its licenses to a hungry market. Thus, when a mainstream panel of the U.S. Court of Appeals for the D.C. Circuit, consisting of both Republican and Democratic appointees unanimously held that bankruptcy law prevented the FCC from simply revoking the licenses, the Commission should have abided by that decision. Instead, they appealed to the Supreme Court, and over a year-and-half later, the Supreme Court gave them the exact same answer. The moral of the story – when a unanimous balanced panel of the D.C. Circuit rules against you, don't appeal – but more on that later.

The next round of spectrum allocation is all the more critical. The Commission is supposed to complete reallocation of certain UHF television frequencies to more effective use by 2006. As that deadline approaches, the FCC needs to (1) follow through on spectrum reallocation; and, (2) design its auction or allocation procedure in a manner where those companies that are in a position to provide competitive services will be able to do so. And as Dr. Hazlett suggests, creating quasi-property rights in spectrum allows the market, rather than regulators holed up in Washington, to meet consumers needs, and thus ensures that spectrum is put to its highest and best use.

Ultimately spectrum allocation is about providing expanding wireless service literally in the hands of the millions who crave it. But the wireless services of tomorrow could look

radically different from the services of today. Service providers need the flexibility to adjust to market demands. Reallocating spectrum from underutilized, outdated 20th century applications to what is clearly the future of telecommunications simply makes sense. Truly broadband wireless would provide unprecedented personal freedom in the 21st century economy. But most importantly, assigning licenses so that licensees receive exclusive, flexible use, allows the Invisible Hand of the free market to ensure that spectrum will not be wasted.

Our second presenter, Professor Smith has identified the key issue facing wireline business and regulation today. The FCC's regime of unbundled access has created a kind of "semi-commons" where so-called Competitive Local Exchange Carriers (CLECs) can demand access to most of an Incumbent Local Exchange Carrier's (ILEC – typically a former Bell Operating Company) network elements at what are, in effect, official determined prices – TELRIC. Thus, as Professor Smith notes, prices should be designed to induce proper use. Put differently – prices should be fully compensatory so that CLECs share both the benefits, and the burdens that went into the incumbent's development of its network. If prices are not fully compensatory, then the result is indeed, a tragedy of the anticommons. Why? Because in that scenario, ***neither*** an ILEC ***nor*** a CLEC has any incentive to build or improve facilities. CLECs have no incentives to build out, because they can piggyback on the work of the ILECs at a lower cost than if they built their own facilities. And ILECs have no incentive to further build or improve their facilities, because they know that their profits will be sapped by forced sharing with the CLECs. The result is stagnation.

Bill Barr, former Attorney General, and now General Counsel of Verizon, has been a voice in the wilderness crying out against this emerging anticommons. His point is simple and straightforward – the Takings Clause of the Constitution requires that ILECs receive just

compensation for the government-mandated use of their facilities. And just compensation means compensation for full historical costs. If CLECs are to share in the rewards from ILEC investment, they must also share in the risks – and for every successful technology that has been unbundled, there are dozens of designs, inventions, and aborted attempts, that resulted in losses. TELRIC fundamentally fails to take that into account, and leaves ILECs under-compensated. Worse still, however, is the whip-saw that companies like Verizon face between TELRIC-priced unbundling requirements, and the limitations on retail rates imposed by state public utility commissions. States require phone companies to provide service to rural areas at a subsidized rate. Traditionally, ILECs could recover their costs from supercompetive prices in more lucrative markets; however, today, they face competition from CLECs who are able to lease network elements below cost. As a result, incumbents cannot obtain the profits necessary to offset these subsidies.

Put this all together and the result we have seen over the last five years is ***exactly*** what Professor Smith anticipated: strong disincentives to improving wireline services.

Thus, what we have is a tragedy of the anticommons in the wireline market. If the incumbent carriers – those with the capital and the know-how to improve service, can't make money, then they won't invest. Its simple Economics 101.

So what is the immediate harm? Clearly, there will be fewer improvements to existing service. Worse yet; however, is a reluctance to invest in new services and technologies. In other words, there is a real hesitancy by incumbent carriers to roll-out broadband.

As the President said on April 6, "the proper role for the government is to clear regulatory hurdles so those who are going to make investments do so. Broadband is going to spread . . . ***so long as the regulatory burden is reduced***." The President said that telecom

"policy at the government level [needs to] encourage people to invest, not discourage investment." So how do we get there?

First, and foremost, the FCC should ***not*** appeal the D.C. Circuit's decision in *USTA II* to the Supreme Court, but rather should abide by the court's decision.

The D.C. Circuit's opinions in *USTA I* & *USTA II* – unanimous decisions of mainstream judges, namely a Carter, Reagan, and Bush I appointee – provide a framework for proper unbundling requirements that will create certainty and thus promote investment – both by incumbents, who will no longer fear being the victims of Robin Hood, and by the CLECs who will know the limits on piggybacking. What the market needs right now is certainty, not another *NextWave*.

In accordance with the Court of Appeals decision, the FCC should adopt a sensible approach to determining "impairment" to competition – impairment being the standard that gives rise to unbundling.

First, The FCC must give its "entry into the market" standard some teeth, such that competition is impaired only if *no* new entrant could economically enter the market. Alternatively (and preferably), the Commission should adopt a natural monopoly standard for impairment.

Second, The FCC must strongly consider the competition created by new technologies – particularly cable and wireless. It is not enough to pay new technologies lip-service in assessing competition, but then to ignore their actual effects on the market. Wireless service is, in particular, transforming the telecom landscape. Indeed, if the Commission fails to recognize the impact of wireless in imposing unbundling (and with it TELRIC pricing), it may gut the ability of land-line service to offer meaningful competition to wireless.

Third, Rather than consider state-imposed below-cost service requirements as an impairment to competition and thus grounds for unbundling, the Commission should instead recognize these requirements are harmful to incumbents when the incumbents are precluded from recovering super-competitive prices due to competition from CLECs. The interplay between the FCC's TELRIC prices and state commission's below-cost retail for rural areas is likely to give rise to an anticommons where no sensible telephone company will want to operate, much less invest in new and improved service.

Moreover, the Commission needs to finish what it started in the Triennial Review, and clear the path for investment in broadband, thus keeping the President's promise to "clear out the underbrush of regulation," and free new broadband investments from legacy regulations. Our third presenter, Commissioner Martin emphatically agrees. He has said that the FCC should "refrain from applying voice rules to broadband data," and thus "level the playing field between phone companies and cable companies competing to provide broadband services." (*See* Martin, "A New Framework for Broadband Deployment," TIA Regulatory Session (June 3, 2003)). Thus, Commissioner Martin believes that "phone companies, like cable operators, should have the proper incentives to invest the capital necessary to make 21st century broadband capabilities available to all American consumers."

Unfortunately, the Triennial Review Order doesn't quite get us there.

The FCC needs to make clear that section 271 cannot be used to require unbundling of broadband. Imposing unbundling obligations under Section 271 would have the same negative effects on broadband deployment that the Commission correctly concluded would result from an unbundling requirement under Section 251. Requiring unbundled access to broadband loops would require a significant redesign of integrated fiber network architectures to create new and

artificial points of access to individual components of the network. Thus, the FCC has actually created a new layer of uncertainty and financial risk, which would apply ***solely*** to the former Bell companies – and not to their cable competitors who currently dominate the broadband market, or to CLECs.

The FCC should also eliminate unbundling requirements for "dark fiber" broadband in the so-called "enterprise" markets. Unsurprisingly, non-incumbents are already actively building out in the enterprise market. Today, the largest providers of broadband services to enterprise customers by far are AT&T and MCI – not the incumbents – controlling nearly two-thirds of the nationwide market. To spur real, facilities-based competition, the FCC should make clear that broadband will not be unbundled in any market. The D.C. Circuit vacated this portion of the Commission's order, and on remand the FCC should simply scrap it.

Finally, even if the FCC does not eliminate the potential for unbundling in enterprise markets, it should at least eliminate it in apartments, condos, and the like. These are the very facilities where cable is entrenched, and where new entrants have the proper incentives to invest. It would be anomalous to require unbundling where the incentives for natural competition are self-evident.

If the broadband roll-out is going to happen, then wireline businesses have to have confidence that they can invest in these new and, to some extent, risky technologies, without the specter of having successful technologies commandeered by competitors through unbundling. Without that certainty, investment will simply not come – or at least not at the rate that we would otherwise expect it. Similarly, CLECs need to know that they will not be able to free ride on broadband investments. As the D.C. Circuit recently observed, the "absence of unbundling" in broadband "will give all parties an incentive to take a shot at this potentially lucrative market."

In short, if the Administration and the FCC want to avoid a tragedy of the anticommons in wireline technology, and instead spur what would literally be billions of dollars in investment (and with it, jobs), then it simply needs to send the right signals. After all, the purpose of the '96 Act "is not to provide the widest possible unbundling, or to guarantee competitors access to [Bell-company] network elements at the lowest price that government may lawfully mandate. Rather, its purpose is to stimulate competition — preferably genuine . . . competition." (*USTA II* (D.C. Cir. 2004)). If incumbents know that their investments will be respected, then they will make investments in new technologies; and likewise new entrants will be forced to invest in hardware and real, genuine facilities-based competition.

In closing, we are at a crossroads.

Down one path lies stagnation. The phone service of tomorrow is already here – because it won't be getting any better:

-Video phones? Forget it.

-Higher quality connections? Maybe for some, but certainly not for all.

-New means of faster transmission? Not likely to be widespread.

Down the other path is innovation, development, and job creation. If spectrum is allocated in a sensible manner that permits the free market to put it to its highest and best use and if regulatory disincentives to wireline improvement and development are cleared out of he way, then the sky's the limit.

With the right incentives, the telecom companies with the capital and know-how will launch a new wave of competition that will bring better, faster products into the workplace, and in particular the home, sooner. That is the Administration's goal, and the President is depending on the FCC, and particularly Commissioner Martin to get the job done.