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# Eli Noam: Regulating in order to deregulate

The US Supreme Court has sanctioned a damaging extension of the telecoms regulator's powers

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This is first article in a fortnightly series, the New economy policy forum, in which four leading US academics will debate the regulatory and legal issues generated by - and also shaping - the high-tech industries. Click here to learn more about the contributors, or here for a more detailed explanation of how the forum will wo rk.

It is rare enough for the US Supreme Court to decide a case dealing with telecommunications. But it is entirely unprecedented for it to do so twice in a single week, as has just happened. Both cases concern the price that new telecom entrants must pay the traditional big phone companies to access their networks. And both rulings, though issued by an economically conservative court, considerably strengthen the regulatory powers of the Federal Communications Commission in Washington.

Interconnection prices may seem an eye-glazing topic of little public appeal. But the internet rides on telecom networks and depends on their well-being, which in turn is affected by interconnection prices.

The price of interconnection is becoming to the telecoms sector what interest rates are to economic policy: the key variable that determines the health of network companies. Central bankers nudge interest rates up or down in pursuit of macro-economic goals such as growth or low inflation. Telecom regulators are discovering that they can use interconnection and access prices to control their industry. These prices add up to many billions of dollars, and spell life or death for new companies. Set the price too high and no competitors will challenge the monopolist. Set it lower, and they might survive. Set it too low, and entrants will be subsidised by the incumbent and lose incentives to build their own network, while the incumbent lets its own network deteriorate.

Capping a bitter six-year struggle, the Supreme Court, in *Verizon vs. Federal Communications Commission*, has ruled that regulators can set these interconnection prices as long as they link them somehow to cost.

"Cost", of course, is a concept that has induced much human creativity. The FCC's so-called Telric rules require the incumbents to make the various elements of their networks available to competitors at a favourable rate. That price is based not on the actual "historic" cost to the provider but on a hypothetical "best practice" in the industry - the price if a perfectly competitive market prevailed. Such cost is often calculated on the basis of impenetrable engineering cost models that Lenin would have liked if he only had had computers. European countries and Japan are considering or adopting similar rules.

This is really quite an intrusive regulation, and yet it is being defended by such champions of deregulation as Michael Powell, the FCC chairman. And indeed it has economic champions. But so has the other side. There is no shortage of rival theories and approaches to interconnection pricing, all advocated by distinguished economists with well-compensated passion.

New Zealand Telecom, for example, managed to persuade another court of last appeal to accept almost the opposite theory. It argued that economic efficiency dictated that the incumbent should be allowed to charge a high interconnection price equal to its opportunity cost - which in this case would mean its forgone monopoly profits, even higher than historic cost. The Privy Council upheld this so called Efficient Component Pricing Rule.

Which of those theories is right? In a way, all and none are. It all depends on the policy goals. Interconnection prices are the tool and economic theorists provide the rationale.

At present, most regulators set very low prices, to coax competition into a system of traditional monopoly. This is a laudable goal. In the world of information technology, where Moore's Law seems to decree inexorable cost reductions, a forward-looking cost is generally lower than historic cost, by one half and more.

But the Supreme Court ruling gives the FCC pretty much *carte blanche* to set these prices. Government has thus gained a major tool to direct investments and inter-company payments within a key sector of the economy - a big thumb on the competitive scale.

It gets worse. The second Supreme Court ruling, *Verizon vs PSC of Maryland*, strengthens the FCC relative to the 51 state public utility commissions. The decision permits a telecom company that does not like a state commission's interconnection rules to sue it in federal courts.

This might seem a technical jurisdictional matter, but the practical implication is that it opens yet another venue for delaying tactics by deep-walleted litigants. To avoid this spectre, a state commission is likely to toe a line close to the FCC's rules - rather than experiment with a different policy approaches.

The best argument for low interconnection rates is that they make it possible for competition to emerge. We must regulate today in order to deregulate tomorrow. But this notion of a temporary intervention will prove to be wishful thinking. In some segments of the market, monopoly is persistent; in others that become competitive, a commodification of prices makes everyone unprofitable. In consequence, the entrants are dying: last year, 14 per cent of all bankruptcies of publicly traded US companies were telecom companies.

As the telecoms incumbents reassert their power, based on economies of scale and their ability to resist change, there is no reason to believe that an interventionist interconnection regime can be temporary only. Nor will there be a shortage of other policy goals - support of schools, rural areas, high-tech applications, etc - which regulators and legislators will try to address by fiddling with the interconnection prices that affect those favoured groups.

When in 1996 the Telecom Act was passed, many people hailed it as a Magna Carta of deregulation. It is turning out to be the enabler of long-term regulatory intervention and of a centralisation of regulation in Washington. Ironically, it is the economic conservatives on the Supreme Court who have now sanctioned this expansion of central regulatory powers.

The 1996 Telecom Act was built on the fundamental assumption that competitive markets will emerge. Today, it seems the best we can hope for is an oligopoly. Given this and similar lessons, it is perhaps time to take a realistic look at the Act (and similar laws elsewhere) and seek its replacement by other approaches. This will take much time, but it is not too early to begin the debate.

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