

***The Role of Property Rights in Understanding  
Telecommunications Regulation***

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Good afternoon, and thank you for inviting me to speak with you today. I commend you for putting together such an interesting program. Policymakers seldom focus explicitly on property rights, and yet such a discussion can shed light on how regulation affects investment incentives and the behavior of firms in the marketplace. It also helps us discuss the justifications offered in defense of various regulations. So I am glad this is our focus today, and I will explore the relevance of property rights in both the wireline and wireless arenas.

One interesting observation is that while incumbent wireline carriers actually *own* their networks, the FCC has established a much more intrusive regulatory regime on the wireline side than it has for wireless carriers, even though wireless carriers make use of *publicly owned* spectrum to provide service. Of course, this dichotomy results in large part from the fact that incumbent LECs have traditionally exercised monopoly power. But I believe it also reflects a certain ambivalence on the part of regulators about whether wireline networks are *truly* private property. Indeed, the very terminology used by regulators — for example, we refer to wireline networks as the *public* switched telephone network, or PSTN — reflects a conception of such networks as a quasi-public resource. I think this mindset helps explain why regulators have continued to impose extensive regulations on local telephone companies despite the termination of their legal monopoly

status and the rapid growth of intramodal and intermodal competition. This traditional heavy-handed regulatory model has persisted at the FCC and in the states, for both retail and wholesale services. Some critics of the FCC's approach to wireline competition often blame excessive regulation for lagging investment and growth. No doubt some of these criticisms have merit, and an understanding of property rights and economic incentives helps explain why we at the FCC should be more circumspect about the efficacy of regulations that treat private property as if it were public.

But let me begin by discussing wireless services, because the wireless regulatory regime provides a good backdrop for understanding the more contentious issues surrounding wireline regulation.

### **Wireless Regulation**

The wireless arena is something of a hybrid between a *property rights* model (for licensed spectrum) and a *commons* model (for unlicensed spectrum).

The Commission has distributed spectrum licenses for years, using a variety of allocation schemes, including first-come first-served, comparative hearings, lotteries, and auctions. Although the public retains *ownership* of the spectrum, licensees acquire significant property rights regarding *usage*, including the right to exclude others and the right to be free from harmful interference. Recently, the FCC has taken steps to enhance licensees' property rights, for example by authorizing more flexible uses of spectrum and by establishing a more effective secondary market for certain licenses.

The economic underpinning of the licensed model is that granting meaningful property rights gives licensees an appropriate incentive to invest, innovate, and provide high-quality services — all to the benefit of consumers. The government imposes

various obligations and limits on licensees, including the obligation to meet core social objectives such as universal service, access for persons with disabilities, and access to E911. But Congress and the FCC made a crucial decision to employ a light touch, ensuring that any regulations imposed are narrowly tailored to important governmental objectives. For example, the Commission made a critical decision to refrain from imposing economic, public-utility-type regulations relating to price and service quality. And Congress preempted the states from imposing rate or entry regulation, thereby freeing wireless carriers from the most intrusive forms of state regulation. The result has been a vibrantly competitive market with six nationwide providers and dozens of regional and local providers. Consumers enjoy declining prices, innovative features and calling plans, and generally very good service quality. So a property-rights regime, paired with a commitment to avoiding excessive regulation, has proven to be an excellent model — and one that I have advocated following in other areas.

The other model employed in the wireless world is a commons approach, which is used for unlicensed spectrum. Here, users do not enjoy the right of exclusivity or the right to be free from harmful interference; rather, the bands are open to all comers as long as they operate approved equipment that meets defined technical parameters. This drastically reduces the entry barriers associated with auctions, which sometimes require payments in the hundreds of millions, or even billions of dollars. At the same time, users must develop the technological means of co-existing with others in the band. For example, at 900 MHz, we have cordless phones, baby monitors, and the like; and at 2.4 GHz, we have similar uses as well as Wi-Fi. Manufacturers of such devices must ensure

that they are designed to tolerate a certain amount of interference, or they will be of little use to consumers.

The commons approach has been a great success, just as the property-rights approach has been. I don't think anyone in the government could have predicted the exciting applications like Wi-Fi when we first allocated spectrum for unlicensed uses, but that is the beauty of the model. By allocating spectrum, defining basic rules, and then getting out of the way, we allowed engineers and entrepreneurs to tap into the spectrum resource and deliver unforeseen benefits to consumers.

### **Wireline Regulation**

If wireless regulation follows the twin models of a generally unregulated commons and a lightly regulated property rights regime, what about wireline regulation? Well, it does not really fit into either category, and perhaps that is why it is such a source of disputes. While incumbent LECs, as I mentioned earlier, own their networks as a formal matter, they lack many of the basic rights traditionally exercised by property owners, such as the right to exclude others. In fact, there is virtually nothing incumbent carriers can do without governmental oversight. Wireline carriers generally cannot enter a new line of business without governmental scrutiny, nor can they exit an existing business. States regulate prices as well as service quality, and they impose carrier-of-last-resort obligations that force local telephone companies to provide service regardless of the economic merits of doing so. Pursuant to the Telecommunications Act of 1996, the FCC requires incumbent LECs to interconnect with competitors on a regulated basis; to resell their services at a discounted rate; and, under a provision that has generated an avalanche of litigation over the past eight years, to provide "unbundled" access to

network elements, such as copper loops, switches, and interoffice transmission facilities.

Why this regime as compared to what evolved in the wireless arena? Fundamentally because wireline voice capability was regarded as a natural monopoly and therefore heavy-handed regulation was quid pro quo for a guaranteed income stream and protection from competition. This predictable, safe and boring environment was shattered when new technologies dispelled the underlying premise of a natural monopoly and when Congress passed the 1996 Telecom Act.

### *1. Voice Networks*

While the 1996 Act continues to compel a certain amount of regulation, the FCC was given wide latitude in determining which piece parts of the network would have to be made available to competitors, and at what price. With respect to unbundling obligations, the Act says only that the FCC must consider, at a minimum, whether competitors would be *impaired* without access to a particular element. The pricing standard says that the price of network elements shall be cost-based and nondiscriminatory and may include a reasonable profit.

So what did the FCC do, and what has been the effect of its decisions? The FCC's approach starting in 1996 was designed to maximize competitive entry, in many respects, jump start competition. While this a worthy goal, it also betrays a viewpoint that minimizes the weight given to property rights and investment incentives. In its 1996 Local Competition Order, the FCC ordered the incumbent LECs to provide access to just about every element that could be conceived of — and in doing so created what has become known as the unbundled network element platform, or UNE-P. Specifically, the FCC stated that incumbents had to unbundle every element, for every service, in every

geographic market. The courts have not looked favorably on that approach, as I'll discuss in a moment. As for pricing, the FCC developed a forward-looking cost methodology called TELRIC, which assumes perfect efficiency and is often alleged to under-compensate incumbents at rates that do not cover their actual, real-world costs. The Supreme Court, however, held that the pricing standard is not *constitutionally* deficient, because it does not necessarily produce rates that are confiscatory. But the fact that TELRIC is not unconstitutional does not really address whether that pricing scheme, paired with an expansive approach to establishing unbundling obligations, will promote or instead retard investment and growth in the telecom sector. That is important policy question we must ask ourselves.

While the Supreme Court upheld the TELRIC methodology, the FCC's unbundling rules have *never* been judicially sustained, even eight years after the passage of the 1996 Act. So one legacy of the policy of maximum unbundling has been tremendous regulatory uncertainty. In *AT&T v. Iowa Utilities Board* in 1999, the Supreme Court vacated the initial attempt to define unbundling obligations, holding that the FCC could not authorize *blanket access* to incumbents' networks. Rather, the Court said that the FCC was required to develop a meaningful limiting principle. The Court also held that the Commission could not blind itself to the availability of facilities outside the incumbent's network — which includes the ability of competitors to self-provision facilities or to obtain them from third parties.

On remand, the FCC reinstated virtually the same list of network elements, generally preserving UNE-P nationwide. The D.C. Circuit vacated that second attempt to establish unbundling rules in 2002, for reasons that reflected and elaborated on the

Supreme Court's earlier decision. The court stated that the FCC had to consider the *costs* of unbundling, as well as the benefits. In particular, echoing Justice Breyer's separate opinion from the *Iowa Utilities Board* case, the court opined that unbundling discourages infrastructure investment by network owners, and that the FCC must take this social cost into account when establishing unbundling obligations. The court ultimately directed the FCC to limit unbundling obligations to situations where competition otherwise could not develop — that is, where a natural monopoly exists. While the court did not frame its opinion in terms of property rights, I think it is fair to say that the judges were troubled by the extent to which the FCC seemed to elevate the interests of competitors over those of the property owners.

Last year, the FCC set out to establish unbundling obligations for the third time. As most of you know, the Commission ended up divided over the appropriate course. A majority of the Commission decided to make UNE-P available nationwide once again, subject to the possibility that state commissions would remove unbundling obligations based on their own localized findings.

Chairman Powell and I dissented from this decision for a number of reasons. While we agreed with our colleagues that most local loop facilities and certain interoffice transmission facilities should be unbundled because these are true bottlenecks, we did not agree that the Commission should continue in most circumstances to unbundle circuit switches. The record demonstrated that more than 200 different competitors had deployed a total of more than 1,300 switches, in areas serving approximately 87% of the population. Chairman Powell and I believed that the majority impermissibly failed to take account of this competitive deployment, and in doing so created artificial incentives

to pursue UNE-P rather than a facilities-based competitive strategy. We also dissented on the ground that the FCC could not transfer the authority to make final unbundling determinations to the state commissions, and we argued that giving 50 individual states such a role would produce a regulatory and litigation morass, rather than the certainty the industry craved. In short, Chairman Powell and I argued that the majority failed to pay heed to the D.C. Circuit's directive to employ the extraordinary remedy of unbundling only where doing so was necessary for competition to develop. The outcome of the majority's approach, we argued, would be continued uncertainty and diminished investment in facilities.

In March, the D.C. Circuit generally agreed with these criticisms and vacated the FCC's third attempt to establish unbundling rules for traditional voice networks. The court held that the delegation of decisionmaking authority to the states was unlawful, and also held that most of the provisional impairment determinations made by the FCC were unjustified. As in the D.C. Circuit's earlier decision, the court found the majority's efforts to preserve UNE-P inconsistent with the statutory scheme. Arguably, as in the prior decision, the court regarded the majority's expansive unbundling approach as inconsistent with appropriate notions of property rights.

## *2. Broadband Networks*

As this brief history demonstrates, the FCC's efforts to establish a policy of maximum unbundling has not fared very well in the courts. In contrast, the Commission's relatively *deregulatory* approach to broadband facilities was *upheld* by the D.C. Circuit. Specifically, a majority of the Commission — this time including Chairman Powell and myself — decided to refrain from unbundling packet switches and



most fiber loop facilities. And we made clear that inconsistent state regulations would be preempted. Notably, we adopted this broadband framework based in large part on the argument that excessive sharing requirements would deter investment by property owners, as well as by prospective entrants. So property rights seem to have played a much greater role in the fashioning of broadband regulations than they have on the narrowband side.

This same observation holds true with respect to the FCC's treatment of cable modem services. For several years, the Commission has resisted calls to mandate open access to broadband cable networks, again because of the concern that such regulation would deter property owners from making the costly and risky investments that are needed to fund network upgrades.

So it seems that network owners have been more successful in getting the FCC to rein in regulation when it comes to broadband networks, based on the particular importance of investment incentives in that context and the competitive nature of the market. By the same token, the failure of incumbent LECs to persuade a majority of the FCC (and most state commissions) to scale back narrowband requirements seems to reflect a desire on the part of regulators — whether conscious or not — to *downplay* the significance of property rights in that context and instead embrace a regulatory climate that is protective of new competitors.

## **Conclusion**

In closing, what lessons do these various regulatory experiences teach us? To me, one of the core lessons is that where possible we should emulate what has worked well, such as the approach to wireless services. The unlicensed commons approach has yielded

a huge amount of innovation and investment, because government has stayed out of the way. The licensed property rights regime also has been a huge success, in large part because the government established strong property rights and imposed appropriately narrow regulatory obligations to further critical social policy goals.

The good news is that we seem to be following these models in our approach to broadband facilities and IP-enabled services. I mentioned how our broadband framework gives property owners an incentive to invest and innovate, and our recent NPRM on IP-enabled services likewise creates a blueprint for a policy that respects property rights by avoiding unnecessary economic regulation and intervening in the marketplace only to the limited extent necessary to promote core social goals. One could further argue that our approach to peer-to-peer Internet voice applications, such as Free World Dialup or Skype, is faithful to the commons model of unlicensed wireless services. In the *Pulver.com* ruling, we made clear that such applications represent interstate information services, and in doing so we signaled that the government will generally stay out of the way and let application providers see what benefits they can deliver to consumers.

Where we have departed from these two models, the results have been far more mixed. The suppression of incumbent LECs' property rights is not only mandated by various statutory provisions but it has certainly been necessary *to a degree*, to stimulate the development of intramodal competition. And Congress made clear that the FCC must promote *both* intermodal and intramodal competition. But the key question is whether the FCC has *gone too far* in promoting the sharing of facilities at TELRIC prices. The D.C. Circuit certainly has concluded that we have, as a legal matter. And I have argued that the UNE-P regime is largely a failure as a policy matter as well, because

of its negative impact on investment by incumbents and competitors alike. As we continue to struggle with these complex and difficult issues, I hope that by focusing on the importance of property rights, and the successful models offered by wireless regulation, we will find a better path, one that recognizes the importance of respecting property rights while at the same time promoting a robustly competitive market.