

PUBLICATION

**Making and Keeping Regulatory
Promises**

Warren G. Lavey

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Executive Summary

Both regulated and unregulated businesses face uncertainties about factors such as market demand, technology changes, supply costs and competitors' strategies. For businesses in regulated industries, uncertainty about future regulations can add to operators' difficulties in attracting capital and making investments in infrastructure, products and services.

The industries and consumers affected by regulations make decisions on investments and other actions which are inherently multiyear, forcing them to make assumptions about future regulatory conditions. Markets reflect regulatory uncertainties even if regulators do not weigh these consequences. Regulatory uncertainties can harm consumers by diminishing competition, raising costs and prices, reducing investment in innovative services, limiting network deployment and in other ways.

Under some conditions, regulators have boldly broken out of the piecemeal, ad hoc approaches to regulations as short-term fixes to be revised when and how the regulators subsequently decide. Multiyear promises have been adopted and enforced in some instances to address complex, interrelated issues and establish a predictable framework for investments, operations and technology development.

This paper considers the effects of multiyear regulatory promises through analysis of several regulatory actions involving telecommunications carriers in Mexico, Venezuela, Hungary and the United States. The examples involve (A) three privatizations of national telephone operators with long-term plans for sweeping changes in rates and service quality, network expansions and upgrades, and introduction of competition; (B) sequenced changes in access charges, universal service support and rates; and (C) phased development and deployment of wireless emergency location capabilities.

The analysis considers the conditions leading to the making of these promises and the decisions to comply with them, often under market and political conditions substantially different from what was expected when the promises were made. While multiyear plans may contain clear adjustment mechanisms for some possible future conditions, major macroeconomic downturns can swamp some of the rate and service commitments by both regulators and carriers. This paper also discusses attempts to change some elements of a multiyear promise midterm; the

balance of various interests through one set of regulations can be replaced by another plan which rebalances these interests through a different set of regulations as long as there is a net gain to distribute.

The efficiency benefits of multiyear regulatory promises are often substantial compared to ad hoc, short-term regulatory decisions whose timing and important details have large uncertainties for the telecommunications industry. Clarity in the standards and timing for future regulatory actions can enhance the efficiency gains and serve the interests of consumers, telecommunications operators and governments. This paper concludes with recommendations for legislators, regulators and judges to promote greater use of multiyear regulatory plans.

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Introduction

Multiyear regulatory commitments, or their absence, are an important part of the functioning of the telecommunications services and products industries. Most regulators were probably taught by their parents to promise only what they intend to do, and to do what they promise. Perhaps these regulatory parents did not get into the economic efficiency of reducing uncertainty for companies and investors by committing to and complying with multiyear plans. Regulators are seldom forced to address the opportunity costs of not making or not complying with multiyear promises, in issuing orders, in discussing their agendas with the industries and legislators, or likely in talking with their parents.

Any significant regulatory change requires regulators to weigh a variety of complex economic and political considerations. While focusing on multiyear plans for regulatory changes, this paper is not intended to belittle the difficulty of deciding on and implementing any significant regulatory change, even on an incremental basis. The point of this paper is that, under some conditions, it is both possible and beneficial for regulators to commit to a well-defined, multiyear sequence of regulatory changes. As the Organisation for Economic Co-operation and Development ("OECD") observed in 1997:¹

Comprehensive reform is based on a complete and transparent package of reforms (aimed at a single policy area, sector or multiple sectors) designed to achieve specific goals on a well-defined timetable. Comprehensive reform does not mean that all changes occur immediately; rather, it is consistent with sequencing strategies and transitional steps as long as they are temporary and steps and timing are clear. There are several advantages to comprehensive reform: benefits appear faster (which means that pro-reform interests are created sooner); affected parties have more warning of the need to adapt; vested interests have less opportunity to block change; and reform enjoys higher political profile and commitment.

This paper examines several examples of how efforts for comprehensive reform fared in real multiyear implementations, or how piecemeal

¹ Organisation for Economic Co-operation and Development, The OECD Report on Regulatory Reform: Synthesis at 25 (1997) ("OECD").

regulatory changes evolved into efforts for comprehensive reform based on a well-defined sequence.

Although regulators sometimes can choose between short-term and long-term approaches, most telecommunications carriers must operate on the basis of assumptions about long-term industry conditions. Generally, telecommunications carriers make large investments in long-lived assets and face long cycles for product/service development and competitive positioning.

Both regulated and unregulated businesses face uncertainties about factors such as market demand, technology changes, supply costs and competitors' strategies. For businesses in regulated industries, uncertainty about future regulations can add to difficulties of companies in attracting capital and making investments in infrastructure, products and services. Business plans are developed with long-term assumptions about a wide range of factors, some of which are heavily influenced by regulators. While regulators require or induce carriers to spend billions of dollars annually on networks and offerings, regulators also often preserve the flexibility of present and future commissioners to shape future regulations, which will determine in substantial part the carriers' returns on these investments. The business uncertainty for carriers resulting from such regulatory flexibility can impose costs on carriers in terms of less productive use of resources and lost opportunities as well as on consumers in terms of higher prices and lower service quality.

This paper considers the effects of multiyear regulatory promises through analysis of several regulatory actions involving telecommunications carriers in Mexico, Venezuela, Hungary and the United States. Regulators have made and kept (more or less) bold multiyear promises under some conditions. The analysis considers the conditions leading to the making of these promises and the decisions to comply with them, often under market and political conditions substantially different from what was expected when the promises were made. While multiyear plans may contain clear adjustment mechanisms for some possible future conditions, major macroeconomic downturns can swamp some of the rate and service commitments by both regulators and carriers. This paper also discusses attempts to change some elements of a multiyear promise midterm; the balance of various interests through one set of regulations can be replaced by another plan which rebalances these

interests through a different set of regulations as long as there is a net gain to distribute.

There appear to be substantial efficiency benefits from multiyear regulatory promises compared to ad hoc, piecemeal, short-term regulatory decisions whose timing and important details have large uncertainties for the telecommunications industry. Although conditions may not be conducive to multiyear promises in some areas, clarity in the standards and timing for some future regulatory actions can enhance the efficiency gains.

The remaining analysis of this paper is divided into four sections. Chapter 1 presents the framework for analyses based on several economic perspectives and an overview of piecemeal regulatory decision making. Chapter 2 discusses examples of multiyear regulatory promises made and enforced (more or less) in four countries. The first part of this section deals with three examples of the fairly unusual conditions surrounding the privatization of national telecommunications carriers, and the second part deals with two areas of sequenced regulatory changes by the United States Federal Communications Commission ("FCC"). Chapter 3 presents two conclusions about making and keeping regulatory promises. First, regulators have made and kept (more or less) bold multiyear promises under some conditions. The atypical procedures leading to these multiyear commitments could be employed more frequently. Second, the efficiency benefits of multiyear regulatory promises are often substantial compared to ad hoc, short-term regulatory decisions whose timing and important details have large uncertainties for the telecommunications industry. Clarity in the standards and timing for future regulatory actions can enhance the efficiency gains. Finally, Chapter 4 summarizes the conclusions and recommendations for promoting greater use of multiyear regulatory plans.

Chapter One

Framework for Analysis

Regulatory decisions develop through a complex evaluation of various statutory, political, technological, economic and other considerations falling within the "public interest." Legislative directions (or their absence) often give regulators substantial discretion to fashion the scope and timing of their decisions. Many factors drive regulators to adopt decisions explicitly intended to address only a short time period. These factors include a desire to obtain information on and analyze the market effects of the short-term rules before implementing rules for later time periods; testing the political waters before committing to multiyear regulations; allowing for judicial review before setting long-term expectations; and developing a more complete record on options and their costs and benefits.

On the other hand, some short-term regulatory decisions can be costly in many ways, including in the productive use of economic resources. Telecommunications carriers and their suppliers run their businesses based on multiyear business plans. Predictable future regulations can help them plan their investments and operations, with benefits to competition, consumers and investors.

The following framework for analysis of multiyear regulatory plans has two parts -- an explanation of several economic perspectives, and a discussion of legal and political considerations in piecemeal regulatory decisions.

A. Economic Perspectives.

Economists have focused on many principles and tools to improve the contributions of telecommunications regulations to enhancing consumer welfare and "efficiency."² Economists argue, as illustrations, that the concepts of cross-subsidies

² See Coase, "The Federal Communications Commission," 2 J. Law & Econ. 1 (1959); Mansfield, E., Principles of Microeconomics 240-60 (1980); Lavey & Carlton, "Economic Goals and Remedies of the AT&T Modified Final Judgment," 71 Geo. L.J. 1497 (1983); Owen, B. & Wildman, S., Video Economics (1992); Lavey, "Inconsistencies in Applications of Economics at the Federal Communications Commission," 45 Fed. Com. L.J. 437 (1993); Baumol, W. & Sidak, J., Toward Competition in Local Telephony (1994); Rosston & Steinberg, "Using Market-Based Spectrum Policy to Promote the Public Interest," 50 Fed. Com. L.J. 1 (1997).

and predatory pricing should be based on marginal costs rather than fully-distributed or embedded costs. Spectrum should be allocated through auctions with flexible uses rather than through comparative hearings based on vague "public interest" criteria and with restricted, government-mandated uses. Moreover, maximum rates should be determined through incentive-based price caps rather than through rate-of-return, cost-based regulation. Economists argue that the application of these and other economic principles have added to the competitiveness, price decreases and service improvements of telecommunications markets.

Many economists have addressed the importance of information on future market conditions in maximizing the efficiency of business operations.³ In the world of standard economic theory, perfectly competitive markets occur when all actors have perfect information about current and future conditions affecting supply and demand, or when efficient markets exist for dealing with uncertainties, such as insurance or contingent contracts. However, the importance of clear information about future conditions is not a principle which economists have emphasized in their

There are a variety of definitions of "efficiency" in the economics and law-and-economics literatures. See Posner, Economic Analysis of Law 10 (2d ed. 1977) ("Posner") ("Efficiency' means exploiting economic resources in such a way that 'value' – human satisfaction as measured by aggregate consumer willingness to pay for goods and services – is maximized."); 2 The New Palgrave Dictionary of Economics and The Law 19-27 (1998) ("efficient norms" and "efficient statute law"). Robert Bork distinguishes between "productive efficiency" and "allocative efficiency." Bork, R., The Antitrust Paradox 91 (1978). "Productive efficiency refers to the effective use of resources by particular firms. The idea of effective use . . . encompasses much more than mere technical or plant-level efficiency." Id. at n.*. "Productive efficiency is any activity by a business firm that creates wealth . . . Economies of scale, specialization of function, ability to obtain capital, management skill -- all of these and many more are elements that contribute to the firm's ability to please consumers, but they are causes rather than manifestations of efficiency. Efficiency is at bottom a value concept, not a description of mechanical or engineering operation." Id. at 104-05.

³ See Stiglitz, "The Contributions of the Economics of Information to Twentieth Century Economics," 115 Quarterly J. Econ. 1441 (2000); Stigler, "The Economics of Information," 69 J. Polit. Econ. 213 (1961); Spence, M., Market Signaling: Information Transfer in Hiring and Related Processes (1974); Arrow, K. and Hahn, F., General Competitive Analysis 125-26 (1971); Gould, J. and Ferguson, C., Microeconomic Theory 22, 479-82 (1980).

writings on regulation.⁴ Moreover, while risk arbitrageurs are active on some regulatory issues, such as whether a specific proposed merger will be approved by regulators, there are no organized markets to hedge, insure against or trade contingent contracts for most regulatory uncertainties.

The principal concern of this paper is that telecommunications carriers make less productive decisions on uses of resources because of uncertainties about future regulation. Professor Michael Porter's analysis of competitive strategies for businesses under uncertainty describes the framework for this concern, without specifically addressing a long-term approach to regulatory decision making:⁵

Uncertainty is not often addressed very well in competitive strategy formation When facing considerable uncertainty, firms tend to select strategies that preserve flexibility despite the costs in terms of required resources or diminished competitive position Industry scenarios allow a firm to translate uncertainty into its strategic implications for a particular industry The important uncertainties are those that will influence industry structure, such as technological breakthroughs, entry of new competitors, and interest rate fluctuations. External factors such as macroeconomic conditions and government policy affect competition through, and not independently of, industry structure. Structural change almost always requires adjustments in strategy and creates the greatest opportunities for competitors to shift their relative positions Early information about the future state of scenario variables has a high strategic value.

Porter's analysis points to the various types of costs of industry uncertainty. According to Porter, when facing plausible scenarios with different strategic implications, companies can bet on the most probable scenario; bet on the most advantageous scenario; hedge through a strategy that produces satisfactory results under all scenarios (usually implying higher costs or lower revenues than a betting strategy); preserve flexibility by delaying commitments (often sacrificing first-mover advantages); or use resources to influence the causal factors behind the scenario variables.⁶ Uncertainty about industry conditions has negative implications

⁴ See Kahn, A., The Economics of Regulation (1988); Brown, S. and Sibley, D., The Theory of Public Utility Pricing (1986). See also Breyer, S., Regulation and Its Reform (1982).

⁵ Porter, M., Competitive Advantage at 446, 448, 478 (1985) (emphasis added).

⁶ Id. at 473-75.

for capacity utilization, planning and implementing investments, changing operations, developing product/service offerings, making procurement decisions, and other issues in productive use of company resources and competitive positioning.⁷

The business strategy of preserving flexibility by delaying commitments in the face of regulatory uncertainties is illustrated by the following recent statement about a large carrier's delays in deploying broadband services in the United States:⁸

The biggest thing we're seeing is that every vendor is asking us every day what the regulatory environment is going to be so they can start designing hardware. We can't go to our board of directors and make long-term investment decisions when we can't guarantee that we even have a chance to recover our cost of capital in the current regulatory environment. And, at the same time, we're overwhelmed with demands from our consumers to go broadband. . . .

Along the same lines, the economists Janusz Ordovery and Robert Willig observed in 1998:⁹

⁷ Id. at 476-77.

⁸ "With Fiber on the Horizon, SBC Seeks New Approach to Policy," Telecommunications Reports (Feb. 11, 2002) W-1, at W-3 (interview with Wayne Masters, SBC Communications, Inc.'s senior vice president-network services). See also Prepared Statement of James H. Henry, Managing General Partner, Greenfield Hill Capital LLP, in The Internet Freedom and Broadband Deployment Act of 2001: Hearing before the Committee on Energy and Commerce, House of Representatives (107th Cong., 1st Sess.) on H.R. 1542, Serial No. 107-24 (Apr. 12, 2001) ("Internet Hearing") at 51 ("I have had a number of conversations with institutional investors, including private equity investors, public equity investors, and high yield investors, that have cited regulatory uncertainty as one of the principal reasons for avoiding the telecommunications sector in general and [competitive local exchange carriers] in particular."); OECD, supra, at 25 ("[P]rivate investors are usually reluctant to enter the market when reform is unpredictable and there are risks of reversals and delays.").

⁹ Declaration of J. Ordovery and R. Willig at 20-21, attached to AT&T's and TCI's Joint Reply to Comments and Joint Opposition to Petitions to Deny or to Impose Conditions, Joint Application of AT&T Corp. and Tele-communications, Inc. for Transfer of Control to AT&T Licenses and Authorizations Held by TCI and Its Affiliates or Subsidiaries, CS Docket No. 98-178, Nov. 13, 1998. See also Lavey, "Innovative Telecommunications Services and the Benefit of the Doubt," 27 Cal. W.L. Rev. 51 (1990).

Forced unbundling with its attendant regulatory uncertainty would likely slow down the investment in the development of broadband last mile transport. Investing under the shadow of uncertain regulatory rules in innovative service exacerbates the already substantial risks associated with that investment.

Although many U.S. regulators claim to support faster broadband deployment by carriers,¹⁰ uncertainty about the details of future regulations can cause carriers and their suppliers to delay investment and service commitments.

Applying "real option theory" analysis from the corporate finance literature, Martin Taschdjian comes to the same conclusion as Porter on the business strategy of preserving flexibility by delaying long-term investment commitments in the face of regulatory uncertainties.¹¹ Taschdjian assumes that, even if policy-makers fail to recognize the effects of uncertainty about regulatory changes, the market does recognize regulatory uncertainty in determining financial value and making investment decisions.¹² He analyzes a hypothetical decision on investing in a local telephone network under real option theory and concludes:¹³

If the public policy goal is to maximize the flow of investment into new networks and technology, the policy framework suggested by real option theory is very clear. In order to minimize the policy barriers to new investment, policymakers need to create a stable regulatory environment, removing policy as much as possible as a source of uncertainty. In this context, stability does not mean that policy never changes. Rather, it implies that the conditions that will cause intervention are announced in advance, so that investors understand and can consider the policy impacts on their decisions.

¹⁰ See Separate Statements of Chairman M. Powell and Commissioners K. Abernathy, M. Copps and K. Martin, Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, 2002 FCC LEXIS 824 (2002).

¹¹ Taschdjian, M., From Open Networks to Open Markets: How Public Policy Affects Infrastructure Investment Decisions 26-33 (Harvard Program on Information Resources Policy, 2000) ("Taschdjian"). See also Brealey, R. and Myers, S., Principles of Corporate Finance 619-44 (2000).

¹² Taschdjian, supra, at 30.

¹³ Id. at 33.

Another analytic perspective on multiyear regulatory promises comes from the law-and-economics literature on contracts.¹⁴ Under general contract law, legally enforceable promises allow one party to induce actions by the other party that would not be undertaken in response to an unenforceable statement of intent. Regulators may be able to induce industry actions which are attractive to the regulators by creating a binding obligation for future regulators to conform to an announced sequence of regulatory changes. Such industry actions would not be undertaken at all or as promptly in the context of piecemeal regulatory decisions or a mere statement of regulatory goals and agenda. According to this analysis, the effectiveness of regulatory decision making suffers in some instances from the inability of regulators to create commitments which bind their agencies in the future.¹⁵

For industries with large investments in long-lived assets and long cycles for product and service development, regulatory uncertainty or churn has substantial costs.

One type of cost is in terms of business planning and operations.¹⁶ Consumers are harmed because businesses are handicapped in raising capital and are

¹⁴ See Posner, supra, at 63-98; Posner, "Gratuitous Promises in Economics and Law," 6 J. Legal Stud. 411 (1977); Craswell, "Two Economic Theories of Enforcing Promises," in Benson, P. (ed.), Readings in the Theory of Contract Law (2001); Kaplow, "An Economic Analysis of Legal Transitions," 99 Harv. L. Rev. 509 (1986) ("Kaplow"); Epstein, R., Takings: Private Property and the Power of Eminent Domain (1986); Fischel & Sykes, "Government Liability for Breach of Contract," 1 Am. L. & Econ. Rev. 313 (1999); Wickelgren, "Damages for Breach of Contract: Should the Government Get Special Treatment?," 17 J.L., Econ. & Organization 121 (2001).

¹⁵ See Landes & Posner, "The Independent Judiciary in an Interest-Group Perspective," 18 J. Law & Econ. 875 (1976).

¹⁶ Federal Communications Commission Chairman Michael Powell recently recognized the benefits of reducing uncertainties in the forms of delays in reaching decisions and judicial reversals (but without addressing the benefits of providing a multiyear regulatory framework):

[W]e have committed ourselves to *driving out uncertainty, by getting out decisions*. There is no greater threat to an entrepreneur, or any business, than uncertainty. A key government decision that hangs in suspended animation will kill the best-laid business plan. Competitors are risk

reluctant to develop services, add capacity or enter new markets under conditions when regulators substantially change rules several times within a few months or years.

Another type of cost is the limited ability of regulators to cause market changes through regulatory changes. When regulators make a determination, compliance requires businesses to make planning and operations decisions in light of uncertainties about how that ruling will evolve over many years. As regulators pursue new policies to promote the public interest, they attempt to steer providers of telecommunications services and products in different directions. The power of regulators to effectuate market changes is restricted by their limited influence over buyers from and suppliers to regulated carriers. Moreover, the regulators' ability to cause these market changes usually is handicapped by their failure to lay out a predictable multiyear regulatory environment as well as their precedent of revising or not enforcing many orders. For example, regulators are more likely to be frustrated by slow growth of investments by local telephone competitors when there is an overhang of uncertainty about interconnection terms and rates. The OECD concluded that "some reforms are nearly impossible to introduce in gradually without careful and transparent advance planning."¹⁷

takers and are incredibly agile in their ability to adapt to change, but they must know what to adapt to.

I cannot promise that you will always like our decisions. I cannot make that promise to any industry, for we are charged with reaching decisions that are faithful to the statute, and that promote the public interest, not any one private interest. I can promise, however, that we will strive aggressively to get decisions out rapidly— decisions that are clear and sufficiently well-reasoned to withstand judicial scrutiny, for a decision made quickly that is overturned is of no use at all. We must avoid do-overs.

Remarks of Michael K. Powell at the Association of Local Telecommunications Services, www.fcc.gov (Nov. 30, 2001) ("ALTS") at 2.

¹⁷ OECD, supra, at 25.

B. Piecemeal Regulatory Decisions.

Regulators tend to make decisions on rates, services and other aspects of a telecommunications market one step at a time, based on the record that is developed for a single time in a narrowly focused proceeding. According to the OECD, piecemeal regulatory decisions tend to be unplanned and tend to address easy reforms first, even if more difficult reforms would have the most benefits.¹⁸

There is a reluctance to make decisions with steps to be implemented in one or more years after adoption of the decision. While agencies can reconsider and reverse their prior orders, decisions with multiyear implementations limit at least somewhat the regulators' discretion to adjust their rules over time to changing political and market conditions.¹⁹

Additionally, any steps which are to be implemented in the future are more likely to be overturned by the courts for lack of a reasoned decision based on record evidence. Even single-step decisions do not give the telecommunications service and equipment industries short-term regulatory certainty because of frequent changes in decisions through reconsideration of orders by the regulators and/or judicial review as well as regulatory discretion in interpreting and enforcing their decisions.

Legislators may encourage regulators to take an incremental approach. Legislators rely on regulators' expertise to fill in details in statutory schemes, address fact-specific issues, and respond promptly to specific needs. On the other hand, legislators may be opposed to a commission's commitment to a well-defined sequence of regulatory changes or long-term regulatory plan as invading the legislators' domain.

¹⁸ Id.

¹⁹ "We have recognized that the Commission is 'entitled to reconsider and revise its views as to the public interest and the means to protect that interest,' so long as it gives a reasoned explanation for the revision." MCI Worldcom Network Services v. FCC, 274 F.3d 542, at 548 (D.C. Cir. 2001) (quoting DirecTV, Inc. v. FCC, 110 F.3d 816, 826 (D.C. Cir. 1997)). See also Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co., 463 U.S. 29, 56 (1983) ("While the agency is entitled to change its views on the acceptability of [a prior policy], it is obligated to explain its reasons for doing so.").

Most decisions by United States telecommunications regulators address a fairly narrow range of issues and time period.²⁰ While there are often good reasons underlying the choice of a narrow scope and short-term duration for a regulatory decision, there may also be substantial costs in terms of the productive use of economic resources by carriers (such as the ability of companies to plan and implement their investments, run effective levels of capacity utilization, and develop and offer new services).

As examples, the FCC has been trying to increase the efficiency of spectrum uses;²¹ however, efficiency is sacrificed by its separate auctions of limited blocks of frequencies without a firm, publicly-announced schedule for additional spectrum auctions,²² as well as its decisions to allow more flexible uses of limited blocks of frequencies without addressing future actions for other frequencies.²³

²⁰ United States telecommunications regulatory decisions are used as illustrations here. The approach discussed is not confined to any one country or agency.

²¹ See Press Conference of FCC Chairman Michael K. Powell, "'Digital Broadband Migration' Part II," www.fcc.gov (Oct. 23, 2001) at 5 ("It is important that the Commission move from its traditional spectrum management paradigm of 'command and control' to a paradigm of market-oriented allocation policy to provide more flexible allocations that allow multiple uses so that spectrum can be put to its highest and best use.").

²² See Amendment of Part 95 of the Commission's Rules to Provide Regulatory Flexibility in the 218-219 MHz Service, 15 FCC Rcd 1497, 1509 (1999) ("Part 95") ("All auction applicants participate in the Commission's auctions process subject to a developing telecommunications market [W]e conclude that auction winners have no expectation that they will be shielded from potential competition when the Commission determines that it is in the public interest to allow such potential competition - either through allocations or expansion of existing services"); Amendment of the Commission's Rules to Establish Part 27, the Wireless Communications Service, 12 FCC Rcd 10785 (1997) (auction of the frequencies at 2305-2320 and 2345-2360 megahertz).

²³ See Part 95, 15 FCC Rcd at 1509 ("We have repeatedly allowed for the provision of additional services in existing licensed services after concluding that it was in the public interest to do so."); Amendment of Part 2 of the Commission's Rules to Allocate Spectrum Below 3 GHz for Mobile and Fixed Services to Support the Introduction of New Advanced Wireless Services, including Third Generation Wireless Systems, 16 FCC Rcd 17222, at 17223 (2001) ("We recognize that consideration of this band for advanced wireless services has created uncertainty about the future of the new broadband fixed services being developed under the current allocation and service rules. Because we believe it is important to remove

Similarly, the FCC issues individual orders from time to time requiring telecommunications carriers repeatedly to modify their networks, so as to allow automatic location identification,²⁴ wiretapping,²⁵ collocation,²⁶ line sharing,²⁷ number portability²⁸ and interconnection with unbundled network elements;²⁹ productive efficiency would rise if carriers could plan and implement interrelated network upgrades of software features, hardware configurations and

this uncertainty, we are now separately addressing and resolving the allocation issues involving this band . . ."). Protracted litigation over the interplay between the bankruptcy and communications laws in connection with the FCC's 1996 auction of certain spectrum licenses for personal communications service further illustrates the regulatory-related uncertainties facing some carriers. See NextWave Personal Communications Inc. v. FCC, 254 F.3d 130 (D.C. Cir. 2001), cert. granted, Nos. 01-653, 01-654, 01-657 (S. Ct.).

²⁴ Revision of the Commission's Rules to Ensure Compatibility With Enhanced 911 Emerging Calling Systems, 11 FCC Rcd 1867 (1996) ("E911 Order").

²⁵ The Communications Assistance for Law Enforcement Act (CALEA), Section 107(c) Extension of Capability Requirements, 16 FCC Rcd (2001).

²⁶ Deployment of Wireline Services Offering Advanced Telecommunications Capability, 15 FCC Rcd 17806 (2000).

²⁷ Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, 14 FCC Rcd 20912 (1999).

²⁸ Telephone Number Portability, 11 FCC Rcd 8352 (1996), 12 FCC Rcd 12281 (1997).

²⁹ See Performance Measurements and Standards for Unbundled Network Elements and Interconnection, 16 FCC Rcd 20641, at 20643-44 (2001) ("Performance Measurements") ("Implementation of the [Telecommunications Act of 1996] in these numerous proceedings has yielded benefits to the public in the form of increasing local competition. The sheer variety and number of regulatory requirements, however, has also led to concern about how or whether these rules should operate together at present and in the future. Indeed, at the federal level alone, the Commission's obligations to implement and enforce the Act have relied largely on general, prophylactic regulations, case-by-case adjudication, and, in the context of Section 271 proceedings, analysis of performance standards on a state-by-state basis. This regulatory patchwork fails to provide industry with consistent and 'bright line' guidance as to whether an incumbent [local exchange carrier] has provided just, reasonable and nondiscriminatory service in any given situation. This makes it harder for the industry to comply with the Act and more costly to both the industry and the Commission to enforce it.").

switching/transmission capacity reflecting a predictable plan for such regulatory requirements. Another area of inefficient regulatory signals involves local service competition; the FCC has repeatedly changed the rules for compensation to competitive and incumbent local exchange carriers³⁰ as well as interconnection requirements,³¹ making it difficult for all carriers to plan investments and services.

While far from comprehensive in addressing a relevant business planning period, even these narrow orders often are also far from straightforward. In many cases, a regulator's incremental approach removes as much uncertainty as the regulator can achieve at that time. The FCC often receives a wide range of opposing comments which conflict on factual and legal issues; spends months or years developing proposals, findings, statutory interpretations, policy judgments and rules; must address Congressional inquiries, concerns and legislative proposals; does not control its agenda, with carriers filing sporadic applications to merge, petitions for waivers of rules or other requests for regulatory action; and suffers reversals from court reviews. Months or years later, the FCC may identify flaws in the rules it adopted, from market experience, by assessing changing market conditions, by developing a new evaluation of options or after judicial reversal.

Yet there are some circumstances in which regulators in the United States and other countries seek to implement a predictable multiyear regulatory environment in order to expand beyond the efficiencies that would be gained through step-by-step orders. As discussed below, establishing multiyear regulatory promises

³⁰ See Access Charge Reform; Reform of Access Charges Imposed by Competitive Local Exchange Carriers, 16 FCC Rcd 9923 (2001); Developing a Unified Intercarrier Compensation Regime, 16 FCC Rcd 9610 (2001); Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Intercarrier Compensation for ISP-Bound Traffic, 16 FCC Rcd 9151 (2001); Powell, ALTS, supra at 3 ("The reciprocal compensation issues remained unresolved at the FCC for several years, having bounced back from court and then remaining unresolved for far too long. The uncertainty of the outcome was draining the life out of many [competitive local exchange carriers], as the capital markets assumed the worse from our impending decision.").

³¹ See Performance Measurements; Powell, ALTS, supra at 4 ("Another critical proceeding in the area of unbundled elements is the Triennial Review. This proceeding is designed to roll up a number of [unbundled network elements] issues that have been pressed upon us in piecemeal fashion. A comprehensive proceeding will allow us to examine the host of UNE related issues that have been swirling around.").

often promotes efficiency even when the regulator retains the authority to, and does, change the rules during the applicable term.

Chapter Two

Multiyear Regulatory Promises Made and Enforced (More or Less)

This section considers three sets of examples of multiyear regulatory promises which were made and enforced (more or less): (A) privatizing national telephone companies, including promises as to competition, rates, network expansion and service quality standards; (B) restructuring U.S. interstate access charges and universal service funding; and (C) implementing automatic location identification capabilities for United States wireless services. The analysis deals with the conditions from which the multiyear promises developed, the terms of the obligations on both the regulators and the carriers, and the record of enforcement and compliance.

A. Privatizing National Telephone Companies.

One set of conditions giving rise to multiyear regulatory promises involves the privatization of national telephone companies through sales of equity interests to strategic buyers.³² Under these conditions, the buyers are asked to pay a large up-front purchase price for the equity interest and want to know the multiyear outlook for the company. Regulatory issues are of great importance in valuing the company, including what services it will be allowed to offer, when it will face competition for various services, what rates it can charge, what service deployment schedules it must satisfy, and what network and service quality improvements it must implement. Prospective buyers want certainty as to these regulatory issues for at least several years, such as a five-year period for network expansion, service quality improvement and rate restructuring before the incumbent national carrier faces competition in some services.

Uncertainty lowers the amounts that prospective buyers are willing to bid, thereby working against the interest of the government in maximizing the sale price. Also, uncertainty limits the bidders' willingness to commit to some proposed

³² See generally World Bank, Techniques of Privatization of State Owned Enterprises (1988); Wellenius, B., Telecommunications – World Bank Experience and Strategy (1993); Petrazini, B., The Political Economy of Telecommunications Reform in Developing Countries: Privatization and Liberalization in Comparative Perspective (1995); FCC, Connecting the Globe: A Regulator's Guide to Building a Global Information Community (1999).

restrictions and obligations. Rather than committing to aggressively investing in network expansion and upgrades, a bidder facing regulatory uncertainty about rates and competition would likely take a more hedged approach and attempt to preserve its flexibility to invest only where the payoff is most attractive. Moreover, there is usually no history of regulatory decision making or judicial review of regulatory actions in the country at the time of the privatization, and this increases the bidders' desire to have the future regulatory conditions spelled out in detail in a contract enforceable against the government.

This section reviews promises made in the context of privatizing three national telephone companies, presented in chronological order: (1) Teléfonos de México, S.A. de C.V. ("Telmex"); (2) Compañía Anónima Nacional Teléfonos de Venezuela ("CANTV"); and (3) Magyar Távközlési RT. ("MATAV"). Regulators and carriers agreed to detailed long-term plans for radically transforming all aspects of the national telecommunications sector. Aside from showing that detailed, complex multiyear regulatory promises were made by diverse regulators, these three examples also reflect diverse experiences in complying with and enforcing these promises by both regulators and carriers. Although major macroeconomic downturns swamped some of the rate and service commitments by both regulators and carriers, some of the experiences described show that the multiyear plans functioned as part of the ongoing relations between the carrier and regulator, with room for amendments in light of market experience and changing conditions. There appear to be clear efficiency gains from these long-term plans compared to *ad hoc*, piecemeal, short-term regulatory decisions which leave carriers and other interest groups with large uncertainties about future regulatory rules and actions.

1. Telmex: Good Guidance from the Plan. In August 1990 the Mexican government amended the license agreement or concession of the sole provider of landline public telecommunications services in Mexico in connection with the sale of stock to a strategic investor group.³³ The changes in the concession were in three main areas, each involving multiyear promises.

³³ The shares sold represented 20.4% of the capital stock and 51% of the voting shares of Telmex. The investor group, which was viewed as having capabilities to transform the national carrier, consisted of a group of Mexican investors and subsidiaries of Southwestern Bell Corporation and France Telecom. Prospectus of Teléfonos de México, S.A. de C.V.; 40,000,000 American Depositary Shares (filed

First, the agreement established a new method of rate regulation applicable with some differences to the periods 1991-96, 1997-98, and 1999 and thereafter.³⁴ Through 1990 Telmex had to apply to the Mexican Ministry of Communications and Transportation ("Ministry") for any rate change, with rates established separately for each category of service. The Ministry applied various analyses and responded to various political interest groups in deciding whether to allow a particular rate change, including a policy of keeping local service rates low. The new method in the concession agreement replaced the ad hoc rate filings and broad Ministry discretion over rates with formulae involving aggregate price caps and individual service rate flexibility for Telmex. In aggregate, the carrier's rates could increase to reflect Mexican national consumer price inflation. Different productivity adjustments to the national inflation index applied to the aggregate prices in the three different periods.³⁵ Within the applicable ceiling on aggregate charges, the method gave Telmex substantial flexibility to restructure its rates for particular services with the goal of gradually reducing cross-subsidies (increasing local service rates to cover costs and decreasing long-distance rates). As long as Telmex complied with the price cap formulae in the concession agreement, the carrier did not require the approval of the Ministry to change rates, although the Ministry retained the ability to modify rates when required by the public interest.³⁶

Second, the concession agreement established annual standards for line growth, expansion of rural service and quality of service.³⁷ Telmex agreed to (i) expand the number of lines in service by an average minimum annual rate of 12% from August 1990 to December 1994; (ii) expand its services to rural areas, including by providing by December 31, 1994, at least one public telephone or other service in each town with more than 500 inhabitants; (iii) expand the number of

with the U.S. Securities and Exchange Commission ("SEC"), May 13, 1991) ("Telmex Prospectus") at 3.

³⁴ Id. at 36.

³⁵ The annual productivity adjustment was 0% for 1991-96, 3% for 1997-98, and to be determined by the Ministry for 1999 and every four years thereafter to permit Telmex to earn a rate of return equal to its weighted average cost of capital. Id.

³⁶ Id.

³⁷ Id. at 36-37.

public telephones from 0.8 per 1,000 inhabitants in 1990 to 2 per 1,000 inhabitants by the end of 1994 and 5 per 1,000 inhabitants by the end of 1998; and (iv) reduce the maximum waiting time for installation of telephone service in certain cities to six months by 1995 and to one month by 2000. The concession also set forth annual standards for increased service quality.

Third, as long as Telmex complied with the concession, the Ministry could not license a competing provider of domestic or international long-distance services or local services to operate before August 1996.³⁸ Thereafter, Telmex would be required to allow resale of its services by other long-distance carriers. The concession further provides that after December 31, 1996, Telmex would have to interconnect its network with other licensed carriers and allow customers to choose their long-distance carrier.

In summary, the Telmex concession contained commitments by the regulators and carrier extending for six or more years as to performance in rates, network expansion and service quality, and competition, with many standards applicable annually or for other periods. The concession represented a huge change from the uncharted, *ad hoc* approach to these regulatory issues which maximized regulatory discretion. The new framework built on multiyear promises not only increased the value of the equity sale but also created incentives for investments which were lacking in the prior approach. For example, Telmex could plan network expansions with the knowledge that for six or more years it could implement rates designed to stimulate demand for particular services in particular areas; would not be required by regulators to meet new, unexpected network and service standards; and would not be forced to face competition, with consequent possible losses of revenues and costs for interconnection.

How did the multiyear promises fare in Mexico? In general, the regulator and carrier complied with the promises over many years and varied market conditions. A report at the end of 1996 concluded that "[b]y all accounts, [Telmex] fulfilled [its] part of the bargain"; this report cited network expenditures of \$12 billion, laying more than 18,000 miles of fiber-optic cable, increasing the number of telephone lines by 66 percent, extending telephone service to 25,000 small towns,

³⁸ *Id.* at 37.

and increasing the network's digitalization from 30 to 90 percent.³⁹ In early 1991 (about nine months after grant of the concessions), Telmex reported that it budgeted capital expenditures (expressed in constant pesos) for each of the years 1991-95 that were at least 50 percent higher than the capital expenditures in 1990.⁴⁰ Of the carrier's total lines in service at December 31, 1996, 35 percent were restored or replaced since 1991.⁴¹ In terms of competition, Telmex implemented changes in its network and systems to allow interconnections with competitors starting on January 1, 1997, and nine competing long-distance carriers were in operation in 1997.⁴² In 1998 Telmex reported that it had met all of the requirements established in the concession agreement to be met through the end of 1997, surpassed many of these standards, and implemented many other operating efficiency and service improvements.⁴³

A deeper look at 1995-97 reveals more about the challenges facing multiyear regulatory promises typically and the Telmex concession specifically. A Mexican economic crisis from about December 1994 through early 1996 affected the rate adjustment mechanism in two ways. First, Telmex postponed its inflation-based rate adjustments in "voluntary compliance" with the price stabilization measures implemented by the Mexican government in December 1994; the measures generally froze prices of public utilities.⁴⁴ Beginning on March 1, 1995 and through monthly rate increases in 1996, Telmex raised its aggregate rates, but by less than the amount allowed in the concession agreement in light of the 52 percent inflation for 1995.⁴⁵

³⁹ Anderson, J., "Mexico Hangs Up On Long-Running Phone Monopoly; Laggard Service Primes Market for Major Bidders From Abroad," Wash. Post (Dec. 30, 1996) at A13.

⁴⁰ Telmex Prospectus at 33.

⁴¹ Form 20-F of Teléfonos de México, S.A. de C.V. (filed with the SEC, June 30, 1997) ("1996 Telmex 20-F") at 6.

⁴² Id. at 11.

⁴³ Form 20-F of Teléfonos de México, S.A. de C.V. (filed with the SEC, June 30, 1998) ("1997 Telmex 20-F") at 2.

⁴⁴ Id. at 4.

⁴⁵ Id.

Second, Telmex slowed the elimination of cross-subsidies in its rate structure during 1995. To catch up, throughout 1996-97 Telmex introduced extensive rate increases for local services and restructured its rate structures for local and long-distance services.⁴⁶

Partly as a result of the effects of this economic crisis on Telmex's rates, the transition to competition in 1996-98 may have been rougher than what the parties anticipated when they entered into the concession agreement in 1990. Among other issues,⁴⁷ a major dispute arose over the fees paid by interconnecting carriers for use of Telmex's lines to originate and terminate calls. The concession agreement provided that the terms of interconnection, including fees, were to be negotiated between the carriers, with the Ministry to impose terms if the carriers are unable to agree.⁴⁸ The carriers were unable to agree, and the Ministry stepped in amidst reported threats by Telmex to increase its local rates by as much as 70 percent if it did not get the interconnection fees from long-distance services it wanted.⁴⁹ In April 1996 the Ministry established the structure for these fees, including a 58

⁴⁶ Id. at 4-5. See also Preston, J., "Mexico's Telephone Revolution," NY Times (Nov. 14, 1996) sec. D, p. 1, col. 3 ("In the midst of a national economic crisis in 1995, Government regulators refused to allow big increases in local phone rates. This year [1996], with Telmex forced to prepare for diminishing long-distance revenue, it felt compelled to jack up local rates rapidly."); Geldzahler, B., "Get a good partner; Mexican telecommunications market," Telephony (June 24, 1996) 92. Telmex reported that it eliminated cross-subsidization by the end of 1997. 1997 Telmex 20-F at 4.

⁴⁷ Another dispute arose over the Telmex's resale obligations in the concession agreement. Through November 1998, the Ministry did not license non-facilities-based carriers to provide "pure" switched resale services. Telmex did allow licensed facilities-based carriers to resell its services. The FCC alleged that the limited scope of resale authority violated Mexico's commitment made in the World Trade Organization's Basic Telecommunication Services Agreement. Telmex/Sprint, L.L.C.; Application for Authority Under Section 214, 12 FCC Rcd 17551, 17559-61 (1997) ("Authorization Order"), 13 FCC Rcd 24990, 24993 (1998) ("Order to Show Cause"). Also, the Ministry released technical rules in 1994 and 1996 addressing various issues in long-distance competition, such as points of interconnection and customer selection of carriers. 1996 Telmex 20-F at 13-14.

⁴⁸ Id. at 15-16.

⁴⁹ "Mexico Sets Telmex Fees Before Allowing Competition," Bloomberg News (April 26, 1996).

percent surcharge on inbound international calls paid to Telmex in 1997-98.⁵⁰ This surcharge had the effect of partially protecting from competitive erosion the remaining cross-subsidies in Telmex's rates (below-cost local rates and above-cost long-distance rates).

This surcharge attracted claims by several U.S. interexchange carriers that the Mexican government was failing to comply with its commitment to open its market to competition made in the World Trade Organization's Basic Telecommunication Services Agreement, leading to discussions between the U.S. Commerce Department and the Mexican Ministry in April 1998.⁵¹ The FCC expressed concern over this surcharge as discriminatory in an October 1997 order and issued a show cause order in November 1998 stating its belief that "this surcharge unfairly benefits Telmex over new competing facilities-based international carriers."⁵² Responding to these pressures, the Ministry eliminated this charge in December 1998.⁵³

In review, it appears that the multiyear promises in the concession agreement established a predictable regulatory framework which fostered Telmex's large increase in network investments and improved operations. Telmex satisfied the targets without having to seek modification of them or waiver of penalties, in part because of the need to prepare for competition in long-distance services and the profits associated with expanded and improved services. The Mexican economic crisis of 1994-96 led to pressures for Telmex to forgo some rate increases and rate

⁵⁰ 1996 Telmex 20-F at 14.

⁵¹ Keaveny, J., "US Backs MCI and AT&T in Mexican Dispute," Bloomberg News (Apr. 21, 1998).

⁵² Authorization Order, 12 FCC Rcd at 17584-85; Order to Show Cause, 13 FCC Rcd at 24995-96.

⁵³ Baldwin, K., "Mexican Competitors Receive Interconnect Reprieve," Bloomberg News (Dec. 2, 1998). See also "Mexico - Measures Affecting Telecommunications Services; Request for the Establishment of a Panel by the United States," www.wto.org (communication dated Feb. 13, 2002) (request for dispute settlement panel under the World Trade Organization's General Agreement on Trade in Services alleging, inter alia, Telmex's failure to provide interconnection to U.S. telecommunications carriers at reasonable rates and on reasonable terms and conditions).

restructuring allowed under the concession agreement. Despite these changes from what the parties may have expected in 1990 and how Telmex had been preparing to compete, the Ministry adhered to the dates for competitive entry and interconnection in the concession agreement. While the concession agreement left open the level of interconnection charges for competitors, the pressures by Telmex resulting from its "voluntary" restraints on its rates probably led the Ministry to adopt higher interconnection fees through the 58% surcharge than what it may have expected for a competitive market. Thus, deviation from one part of the multiyear plan (rates during and following the economic crisis) had an impact on another part of the multiyear plan (competitive entry under reasonable interconnection rates).

The multiyear commitments in the concession agreement likely fostered substantial productive efficiencies for the carrier compared to the regulatory approach which preceded it. Before the concession agreement, governmental decisions on the national telephone network were piecemeal, with large uncertainty about the timing and details of other actions. The concession agreement stated a unified, long-term framework for the interrelated aspects of rates, network expansion and upgrades, service quality and competition. This framework facilitated a large increase in network expansions and upgrades. There was less business justification for hedging or preserving flexibility, such as regarding investments in facilities to support services for which the regulator promised rate increases phased in over several years. With explicit service improvement standards, the carrier could take an orderly approach to improving its network and operations. On the other hand, the incomplete aspects of the plan regarding interconnection charges for competitors (which were not specified by the regulators until the eve of competitive entry and then sharply revised two years later) produced uncertainty and some inefficiencies for competitors as well as Telmex.

2. CANTV: Baseline Plan with Many Deviations and Renegotiations. Like the Telmex concession, the CANTV concession established a complex, detailed, multifaceted plan for the Venezuelan telecommunications sector from 1991 through 2000 in connection with the government's sale of a strategic interest in the national telephone carrier.⁵⁴ The plan included (i) quarterly

⁵⁴ The interest sold represented operating control and 40% of the equity share capital of CANTV. The strategic investor group included subsidiaries of GTE Corporation, Telefónica Internacional de España, La Electricidad de Caracas and AT&T Corporation. Prospectus of Compañía Anónima Nacional Teléfonos de Venezuela

adjustments in aggregate rates according to a price cap related to the rate of inflation in Venezuela, (ii) measures to achieve rate rebalancing gradually, with some flexibility for the carrier in setting individual service rates, (iii) detailed standards for the expansion, modernization and improvement of the quality of CANTV's network and services, and (iv) assurance that CANTV would be the exclusive provider of local, national and international switched, landline telephone services until October 2000, except in areas where it failed to meet service requirements.⁵⁵

The years after adoption of this multiyear promise were filled with the carrier's expansion and improvements, but also deviations from and substantial amendments to the requirements. The causes of the deviations fall into three major categories.

The first category of deviations primarily resulted from factors beyond the control of CANTV or the Venezuelan Ministry of Transportation and Communications ("Ministry"). Macro-economic conditions in Venezuela experienced serious declines from late 1992 through 1996.⁵⁶ With the decreased demand for telephone services, CANTV failed to satisfy certain service expansion requirements in the concession agreement. The Ministry agreed to reduced requirements for 1996 through 2000 together with a commitment to review the expansion standards from 1999 to 2000 to reflect economic conditions as they developed.⁵⁷ The carrier also cited the government's imposition of exchange controls as causing delays in obtaining equipment and leading to its failure to install required numbers of public telephone lines in 1995.⁵⁸ CANTV reported that it remedied the shortfall in early 1996 and that the Ministry decided to waive any penalties applicable under the concession agreement.⁵⁹ As another example, much

(CANTV); 20,520,000 American Depositary Shares (filed with the SEC, Nov. 21, 1996) ("CANTV Prospectus") at 6-7.

⁵⁵ Id. at 8.

⁵⁶ Id. at 61.

⁵⁷ Id. at 61-62.

⁵⁸ Id. at 17, 63.

⁵⁹ Id. at 63.

as was described for Telmex, high inflation led the Ministry to confine some aggregate rate increases to levels below those provided for by the price cap formulae in the concession agreement, and to limit rate increases for basic residential local service.⁶⁰ In light of concerns about CANTV facing competition in 2000, the Ministry and carrier entered into a Rebalancing Agreement in 1996 providing for "catch-up" rate adjustments in the following years.⁶¹

The second category of deviations from the multiyear plan involved shortfalls in the carrier's performance in many categories. Some of these shortfalls led to remedies provided under the concession agreement while others triggered further negotiations between the carrier and the Ministry. As an exception to the general prohibition on competition until 2000, the concession agreement allows the Ministry to grant other concessions to provide basic local service if CANTV fails to serve a rural area or fails to meet its network expansion, modernization and service quality requirements in an urban area for two consecutive years. Starting in 1996, the Ministry exercised this authority to award other concessions in several areas.⁶² Also, CANTV reported numerous and repeated other shortfalls in its network expansion and service quality performance, such as in time to install new lines, repair times and billing statement improvements.⁶³ Following CANTV's request and several years of negotiation, the Ministry and CANTV in February 2000 entered into an agreement which superseded the service levels and rate structures in the concession agreement.⁶⁴ This agreement added some requirements based on technologies developed after the 1990 concession agreement; one such requirement was the

⁶⁰ Id. at 17, 20, 64.

⁶¹ Id. at 66.

⁶² Form 20-F of Compañía Anónima Nacional de Teléfonos (CANTV) (filed with the SEC, Apr. 24, 1998) ("1997 CANTV 20-F") at 31.

⁶³ Id. at 26. On the other hand, CANTV reported that it exceeded several modernization and quality improvement requirements for several years. Id. From 1991 to 1999, customer satisfaction jumped from an average of 47 percent to 90 percent, and CANTV nearly doubled its number of users. Colitt, R., "CANTV Gets Ready to Line Up Rivals: The Venezuelan Telecoms Group Is Preparing to Lose Its Monopoly," Financial Times (London) (May 18, 1999) 30.

⁶⁴ Form 20-F of Compañía Anónima Nacional de Teléfonos (CANTV) (filed with the SEC, May 25, 2001) ("2000 CANTV 20-F") at 9, 42-43, 47.

installation of a new signaling system for interconnections.

Third, some deviations can be viewed as reluctance from time to time by the regulator to limit its discretion or abide by some provisions of the concession agreement when CANTV was in breach of other provisions. For example, in 1997 the regulator announced that it would not permit CANTV to receive the full amount of the tariff increases and rate rebalancing provided by the concession agreement and the Rebalancing Agreement until the regulators completed a review of the carrier's costs.⁶⁵ According to CANTV, the concession provided for such a review but did not make the review a condition for implementing the rate changes. Subsequently the carrier and regulator entered into an agreement allowing the rate changes to go into effect and having the carrier file cost information.⁶⁶ Following further delays in tariff approvals in 1999 and the commencement of a preliminary proceeding in contemplation of a legal action by CANTV against the government for breach of the concession, the carrier and regulator entered into an agreement in February 2000 which superseded the concession as to rate rebalancing and service level mandates.⁶⁷

Aside from these deviations and amending agreements, the most important development in the multiyear plan, competitive entry in late 2000, went forward largely on schedule.⁶⁸ A new telecommunications law was enacted in June 2000 which, inter alia, sought to establish conditions for fair competition between

⁶⁵ Colitt, R., "CANTV Hit by Row Over Rate Rise," Financial Times (London) (Mar. 12, 1997) 28; 1997 CANTV 20-F at 29.

⁶⁶ Id.

⁶⁷ 2000 CANTV 20-F at 43. The regulator sought improvements in service quality as a prerequisite for rate increases. Schneyer, J., "Venezuela to Meet CANTV, Discuss New Phone Rates for 1999," Bloomberg News (Aug. 23, 1999). In July 1999 CANTV sued the Venezuelan government; CANTV demanded \$8.7 million in damages for the government's noncompliance with the terms of the concession. "Venezuela's CANTV Sues Government," Wall St. J. (July 23, 1999) A10. In October 1999 CANTV and the government agreed to appoint a panel of independent telecommunications experts to help resolve the tariff dispute. Colitt, R., "Experts to Judge CANTV Dispute," Financial Times (London) (Oct. 8, 1999) 26.

⁶⁸ See "Venezuela Lifts Telephone Monopoly Before Auction," Reuters (Nov. 28, 2000); Webb-Vidal, A., "Sell-off of Venezuela Phone Licenses Starts," Financial Times (London) (Nov. 29, 2000) 41; Flynn, D., "Venezuela Approves Law to Open Telecoms Sector," Reuters (June 1, 2000).

operators and service providers.⁶⁹ In November 2000 the regulator adopted regulations for new concessions and interconnection requirements applicable to CANTV and other carriers.⁷⁰ Also, in November 2000 the regulator began the auction of frequencies for wireless local loop services. Six such concessions were granted by early 2001, with CANTV not allowed to participate in the auction.⁷¹ Other technologies were also open to competitors in local and long-distance services, and several competitors were licensed.⁷²

Even this development was not as straightforward as contemplated in the concession agreement. In 1997 and 1998 the government took several actions aimed at authorizing new carriers to build telecommunications infrastructure prior to November 2000, with competitive services starting at that time.⁷³ In 1999 CANTV and the regulator negotiated, without finalizing an agreement, a package of amendments to the concession involving an early end to CANTV's monopoly as well as revisions of CANTV's remaining investment requirements and performance targets.⁷⁴ In 2001 CANTV stated that there could be no assurance that rate rebalancing to prepare CANTV for competition would ever be completed as contemplated by the concession and the 1996 Rebalancing Agreement.⁷⁵

⁶⁹ 2000 CANTV 20-F at 43; Webb-Vidal, A., "Venezuela on Course for Revolution in Telecoms," Financial Times (London) (June 14, 2000) 5.

⁷⁰ Id. at 44.

⁷¹ Id. at 17. See also "Italian-owned Digitel to Invest US\$250 million in Venezuela," Reuters (Apr. 4, 2001). "Bell South Wins Fifth WLL License in Venezuela," Reuters (Jan. 9, 2001); "Genesis Wins Two Venezuelan Telecoms Licenses," Reuters (Dec. 19, 2000).

⁷² 2000 CANTV 20-F at 17.

⁷³ Colitt, R., "Caracas Takes Phone Dispute to Court," Financial Times (London) (May 1, 1998) 5. The regulator in 1997 announced an international tender for additional operators to compete in basic telephony and in 1998 sought a Supreme Court ruling on the scope of CANTV's monopoly under its concession agreement.

⁷⁴ Colitt, R., "CANTV Wants to End Monopoly," Financial Times (London) (May 5, 1999) 32; Colitt, R., "Experts to Judge CANTV Dispute," Financial Times (London) (October 8, 1999) 26.

⁷⁵ 2000 CANTV 20-F at 14.

What is to be learned from this regulatory promise covering ten years? As in Mexico, the experience in Venezuela teaches that major macroeconomic downturns can swamp the rate and service commitments by both regulators and carriers. An additional lesson from Venezuela goes to the difficulty in specifying network modernization and service standards by area over a multiyear period. Such standards are designed to promote the public interest, including by requiring investments to serve areas which would not be profitably served in an unregulated market, and to guide the carrier's investment decisions. With uncertainties about demand for services, upgrading large networks, changing telecommunications technologies and changing international standards, it is difficult to select reasonable network modernization and service standards over a long period. Another lesson is that a multiyear agreement is made in the context of ongoing relations between the carrier and regulator. The carrier can seek waivers of penalties and amendments to the agreement, and the regulator can also seek additional restrictions on rates, new service standards and amendments to the agreement. The promises of one party do not result in completely predictable actions for the other party.

Because the national telephone company had been operated as a branch of the government with no history of regulation of a private company by an independent regulator, a concession agreement with multiyear commitments was necessary both to attract a private strategic investor to CANTV and to satisfy political concerns in Venezuela. Aside from the threshold conditions which produced the multiyear agreement in Venezuela, the following inquiry is helpful in order to develop general lessons: With so many deviations and amendments, does hindsight make the multiyear agreement for CANTV look like it enhanced economic efficiency in developing the telecommunications sector in Venezuela?

This multiyear promise probably did enhance economic efficiency compared to piecemeal, ad hoc, short-term regulatory actions addressing limited changes in the telecommunications sector. At minimum, it established a time frame for competitive entry with which the regulator complied; it specified formulae for quarterly rate adjustments with inflation – this replaced a completely ad hoc process built on government discretion; and it set forth a process for gradual rate rebalancing toward cost-based rates. Compared to sporadic, ad hoc decisions to transform the national telecommunications sector, having a specified ten-year framework for these

major regulatory changes was of likely benefit to CANTV's ability to attract capital and planning of its investments, operations and service offerings. Even though disputes with the regulator arose as to implementing the rate changes in some years, the multiyear promise of inflation-based increases in aggregate rates and rate rebalancing prior to competitive entry probably facilitated the "catch-up" agreements in 1996 and 2000.

Next consider the network modernization and service improvement standards, which were exceeded in some regards and unsatisfied in others. The multiyear promise probably enhanced efficiency by providing a baseline for the carrier to plan investments and operational changes as well as a framework for discussions between the regulator and the carrier. The carrier probably recognized at many times and for many areas that it would not satisfy some of the standards. But, as in the case of the shortfall in public telephone lines in 1995, the multiyear plan allowed the carrier and regulator to discuss this performance in the context of catching up to the standard shortly thereafter. In other cases, the multifaceted plan allowed the carrier to point to standards that it exceeded in arguing that it should not be penalized for some shortfalls or that other standards should be amended. For some standards that were unsatisfied repeatedly, the plan forced the carrier and the regulator to address the reasonableness of the standard from the baseline of the mutual prior commitment to that standard. Perhaps they could agree that, in light of the carrier's satisfaction of other standards, changed circumstances or new evidence on the cost of compliance, the standard should be modified.

Of course, even if an agreement developed to waive or amend a standard, for the carrier any such process had costs, including in negotiating with the regulator and perhaps trading off other obligations. Initially agreeing to a "better" requirement in the plan would have promoted efficiency. Yet there may still be efficiencies from somewhat imperfect stated standards over a multiyear period as opposed to no agreement. Silence produces greater uncertainty about what a regulator may require and when.

3. MATAV: More Renegotiations and Narrowing of Exclusivity. The MATAV concession in Hungary granted in December 1993 gave the national telephone company exclusive rights to provide local, domestic long-distance and international public telephone services for most of the country through

December 2001.⁷⁶ As in Mexico and Venezuela, this concession also established for this period detailed annual standards for line growth, service quality improvement, network expansion and network modernization; a mechanism for adjusting aggregate rates according to inflation-based price caps; and a process for rate rebalancing.

The regulator agreed in the concession contract that until December 22, 2001, it would use its best efforts to prevent changes in the decrees relating to interconnection, tariffs or other telecommunications matters which would have a material adverse effect on MATAV.⁷⁷ On the other hand, in the concession agreement the Hungarian government retained the ability periodically to review the provisions of the concession "in the interest of national defense, public security, consumer interest, economic development and the fulfillment of Hungary's international agreements."⁷⁸ Subject to a reconciliation procedure in which the government's conclusions must be supported by evidence, the government could unilaterally modify such provisions, in which event MATAV would be entitled to compensation.⁷⁹

Following the fairly lengthy discussions of the multiyear promises in Mexico and Venezuela, I will limit the analysis of the Hungarian regulatory commitments to two topics, penalties and accelerating competition.

Regarding penalties from service-quality and network-improvement commitments, MATAV increased the number of telephone lines from 1.3 million in

⁷⁶ The strategic investors in MATAV at the time of the 1993 concession agreement were Ameritech and Deutsche Telekom. That agreement covered service in 31 local concession areas as well as domestic long-distance and international services. MATAV entered into subsequent agreements giving it exclusive rights to provide local public fixed-line telephony services through May 2002 in an additional five local concession areas. Together, MATAV's local concession areas covered approximately 75 percent of Hungary's population. The remainder was served by other local operators, which interconnected their networks with MATAV's networks. Prospectus of Magyar Távközlési RT.; 247,749,368 American Depositary Shares (filed with the SEC, Nov. 14, 1997) ("MATAV Prospectus") at 1.

⁷⁷ Id. at 78.

⁷⁸ Id. at 12.

⁷⁹ Id.

1993 to 2.1 million in 1997.⁸⁰ However, MATAV reported that it paid monetary penalties as provided in the concession agreement for failing to meet certain targets in 1995, 1996 and 1997.⁸¹ MATAV stated that it had in each year agreed with the regulator on the penalties charged for failure to meet quality of service targets.⁸² The targets originally established in the concession agreement were adjusted twice, on a mutually agreed basis, to achieve what MATAV described as more closely reflecting international and European standards.⁸³ For failing to connect some subscribers within the period required by the concession agreement, MATAV had to pay additional liquidated damages in 1998 and 1999.⁸⁴ MATAV stated that it did not have to pay any such penalties or liquidated damages in 2000.⁸⁵

It is hard to say whether the penalties specified in the multiyear plan served their purpose of providing incentives for compliance without unreasonable cost for failure. Clarity in the standards and penalties in a plan can reduce disputes and decrease the costs of implementing and enforcing a plan.

A longer discussion is required to address the developments regarding the exclusivity granted to MATAV under the concession agreement. Apparently, the government decided at about mid-1997, three and one-half years into the eight-year exclusivity period, to take steps to increase competition in public telephony services.⁸⁶ Among the possible reasons for this policy were MATAV's failure to

⁸⁰ Lieven, A. and Robinson, A., "Making Impressive Progress," Financial Times (London) (Dec. 9, 1997) at 4.

⁸¹ The service targets included percentage of call completion, dial tone delays, customer service call response times and number of billing complaints. MATAV Prospectus at 79; Form 20-F of Magyar Távközlési RT. (filed with the SEC, Apr. 28, 1998) ("1997 MATAV 20-F") at 32.

⁸² Id. at 32.

⁸³ Id.

⁸⁴ Form 20-F of Magyar Távközlési RT. (filed with the SEC, May 9, 2001) ("2000 MATAV 20-F") at 35.

⁸⁵ Id.

⁸⁶ MATAV Prospectus at 70; Nye, S., "Alliances Set to Clash Over Hungary," www.totaltele.com (June 9, 1997).

satisfy certain service quality and network improvement targets; a determination by the Hungarian Competition Council in February 1997 that MATAV set unreasonably high access fees for access to its rights-of-way by a cable television company; claims by telephony operators in areas not served by MATAV that MATAV abused its dominant position in setting high interconnection charges; Hungary's efforts to gain membership in the European Union, which established policies requiring telecommunications competition; and, starting in July 1998, the replacement of the dominant government coalition.⁸⁷

The government took several types of action to promote competition against MATAV before the end of the exclusivity period. In May 1997 it announced that it wanted the state-owned broadcaster to establish a second national operator along with the state rail operator, the national oil company and a foreign telecommunications operator or consortium.⁸⁸ For this joint venture, called PanTel, the Hungarian government actively sought bids from foreign telecommunications operators. The new operator was granted two licenses by the regulator in 1999 for voice over Internet telephony services.⁸⁹ These licenses, for telephony provided via a new technology which was not available when the MATAV concession was granted, were treated by the government as outside the scope of MATAV's exclusivity but clearly competitive with MATAV's exclusive services. PanTel targeted business users, which paid the highest prices while MATAV was gradually rebalancing its rates over the exclusivity period.

⁸⁷ MATAV Prospectus at 71-72, 79, 86-87; Lieven, A. and Robinson, A., "Making Impressive Progress," Financial Times (London) (Dec. 9, 1997) at 4; Jefferson, R., "Hungary's New Government May End MATAV's Monopoly Early," Bloomberg News (July 10, 1998).

⁸⁸ Nye, S., "Alliances Set to Clash Over Hungary," www.totaltele.com (June 9, 1997); MATAV Prospectus at 70.

⁸⁹ International Telecommunication Union, ITU Internet Reports: IP Telephony 29 (2000) (Hungarian regulatory agency "was willing also to look for ways of introducing 'soft competition' to Matav ahead of full competition in 2002"; more than 15 companies licensed to provide Internet protocol voice telephony services by December 2000); "Setting a Fast Pace for Hungary and Europe," Financial Times (London) (Oct. 8, 1999) 31; McClune, E., "Profile – Keep an Open Mind in an Open Market," Communications Week International (Feb. 5, 2001); Chapman, C., "Hungary: Eastern Promise," ci-online (July 1, 2000).

Three other operators were licensed in 1999 and began offering advanced data services for business users (again treated by the government as outside the scope of MATAV's exclusivity on public telephony services) and voice over Internet telephony services.⁹⁰ Early entry into these services gave these companies an opportunity to expand their telecommunications networks and customer bases for stronger entry when subsequently authorized for full-service competition against MATAV.

Additionally, there were reports starting in July 1998, when a new Hungarian government took office, that the government sought to end MATAV's monopoly on long-distance and international calls one year early.⁹¹ These reports described talks between the government and MATAV in 1999 through which the government attempted to obtain agreement to this change in the concession agreement. No such agreement to amend was reached, and the government did not use its authority unilaterally to modify the concession. With the agreed date for ending MATAV's exclusivity unchanged, a new telecommunications law establishing the framework for competition was approved by the Hungarian Parliament in June 2001 to become effective in December 2001, and the government passed all necessary decrees to implement the law.⁹²

The government's conduct indicates that, but for the 1993 concession agreement, the government probably would have authorized full competition for long-distance and international services earlier than December 2001. Moreover, the government's actions probably narrowed the scope of MATAV's exclusivity to less than what MATAV expected in 1993. For example, MATAV's initial public offering in November 1997, more than four years before the end of the exclusivity

⁹⁰ "Setting a Fast Pace for Hungary and Europe," Financial Times (London), (Oct. 8, 1999) 31; Jefferson, R., "MATAV Faces Competition from Second New Hungarian Phone Company," Bloomberg News (Nov. 10, 1998); 2000 MATAV 20-F at 31; Chapman, C., "Hungary: Eastern Promise," ci-online (July 1, 2000).

⁹¹ Jefferson, R., "Hungary's New Government May End MATAV's Monopoly Early," Bloomberg News (July 10, 1998) (citing the new Minister of Transport, Water and Telecommunications); Jefferson, R., "MATAV Monopoly May End Earlier Than Planned," Bloomberg News (Jan. 15, 1999).

⁹² "Hungary Gives Green Light to Deregulation," Reuters (Dec. 4, 2001); 2000 MATAV 20-F at 6.

period, stated in the first risk factor that the "Hungarian Government is actively seeking to promote competition in the provision of public telephony services."⁹³

Did the multiyear promise in Hungary promote efficiency when, midway through the term, the most fundamental provision regarding competitive entry was subject to uncertainties about duration and government actions to narrow? The analysis considers two perspectives, that of the carrier and that of the regulator.

For MATAV, there appear to be efficiency benefits from the multiyear promise compared to piecemeal, ad hoc regulatory decisions and the absence of any government commitment on competition. The exclusivity period was an essential part of a comprehensive regulatory commitment by the carrier and government. Other related aspects involved gradual rate rebalancing to eliminate cross-subsidies that would not be sustainable under competition and would sharply increase politically sensitive residential local service charges; expanding services to cover areas that may be unprofitable without cross-subsidies; and meeting targets for service-quality improvements and network modernization which may be inconsistent with the investment priorities of a carrier facing competition.

The concession provisions likely restrained the scope of competition that MATAV faced during the exclusivity period, giving it a more stable regulatory environment in which to plan and implement the other commitments in the concession agreement. While some of the government's actions to promote competition may have surprised MATAV, the carrier nevertheless did not face full competition until the date specified in the concession agreement eight years earlier. MATAV's investments and business operations were subject to less uncertainty under the concession agreement, even with the government's actions, than under a step-by-step regulatory framework. Without the commitments, the government might have collected information and weighed various factors from time to time (when and according to the regulator's discretion) in determining whether to license competitors.

Now consider the regulator's perspective on this experience. At a point midway through the exclusivity period, the government determined that the public interest would be served by accelerating competition. Suppose that this conclusion was correct and that accelerating competition would have increased the

⁹³ MATAV Prospectus at 11.

efficiency of the telecommunications sector. If the concession agreement restrained implementation of this new policy, was not the agreement inefficient?

The concession agreement did not prohibit the realization of efficiencies from advancing the date for competitive entry. In initially agreeing to the multiyear, comprehensive regulatory promise, the regulator had to weigh any benefits of any date for competitive entry against the consequences of competition for other regulatory targets and requirements. The existence of the multiyear promise forced the regulator again to weigh any benefits from advancing the date for competitive entry against the comprehensive set of other regulatory targets and requirements set forth in the plan. In changing policies, the agreement required the regulator to allocate some benefits to some groups which would otherwise be harmed by advancing the date for competitive entry compared to the plan.⁹⁴ The amount of such benefits which must be allocated to offset harms compared to the plan could be less than, equal to or greater than the benefits from the policy change. As long as the political and private transaction costs are not so large as to make any change unreasonable, requiring a reallocation of benefits is not contrary to the public interest and allows for new efficiencies to emerge.

Beginning in 1993, the regulator required the privatized MATAV to satisfy certain service and network targets and abide by certain rate regulations through 2001. Each year of the market conditions associated with exclusivity provided part of the compensation to MATAV's strategic investors and other shareholders for accepting these requirements. In addition to the interests of MATAV's shareholders, these market conditions also formed the basis for the regulator to get to certain segments of the public the benefits from cross-subsidized rates and some service-quality and network targets that would not have been achieved under unregulated competition.

The regulator could have proposed several forms of compensation to MATAV's shareholders in connection with advancing the date for competition. As in the reported negotiations between CANTV and the Venezuelan regulator,⁹⁵ the Hungarian regulator could have proposed to relieve MATAV of various investment

⁹⁴ See Kaplow, *supra*, 99 *Harv. L. Rev.* at 576-81.

⁹⁵ See Chapter One, A.2, *supra*.

and performance requirements over the remaining term of the concession agreement. These changes would have reduced MATAV's obligations to invest in rural areas (that would not be profitable and would remain a cost disadvantage for the national carrier as it faced selective competition for urban business customers) or to invest in service upgrades for residential customers (who would not have competitive alternatives for several years). A second form of compensation would be to accelerate the rate rebalancing and rate increases that had been scheduled to be gradually implemented over the exclusivity period. These steps could allow MATAV to prepare for competition sooner and could be combined with allowing higher short-term earnings for MATAV (until competition constrained earnings). A third form of compensation would follow the surcharge applied to competitors' services in Mexico.⁹⁶ While such a surcharge would have attracted opposition from other carriers and possibly also from foreign regulators, it would have temporarily decreased the harm to MATAV of competitive entry prior to the completion of its rate rebalancing and the burden on it of unprofitable service and network obligations.

Compared to continuation with the obligations in the concession agreement, some segments of the public would be worse off under the combination of early competition and changes in the concession. The concession agreement established not only a multiyear set of rights and obligations for the carrier but also a multiyear set of rights for various segments of the public (which were important for political approval of the privatization). While the beneficiaries of early competition were likely to be largely urban business users, the beneficiaries of the concession included residential and rural subscribers. The regulator could have compensated the residential and rural subscribers that would be harmed by the changes in the concession through a universal service fund or other mechanism. For example, all carriers could contribute a portion of their revenues to a fund to help support the rates that residential and rural subscribers would be charged under competition, or to help support the costs of expanding and upgrading rural networks.

Suppose that the regulator determined that the amount of benefits flowing from early competition would exceed the amount of benefits that would have to be allocated to MATAV and some segments of the public in changing from the concession agreement. Under this assumption, in a world of economically

⁹⁶ See Chapter One A.1, supra.

rational actors and low transaction costs, the regulator should have been able to achieve amendment of the concession agreement by mutual consent. If MATAV held out for a windfall gain, then the regulator could have invoked the provision allowing it to modify the concession agreement unilaterally for "consumer interest" and "economic development" reasons and pay MATAV compensation.⁹⁷

In conclusion, this discussion of the Hungarian experience dealt with two points. First, penalties stated in a long-term plan were applied in some instances. Clear specification of the standards and penalties is helpful in avoiding disputes over enforcing a multiyear agreement. Second, even with the government's attempts to promote competition midway through the exclusivity period, the plan likely created a better framework for investments, operations and even discussing changes compared to piecemeal, ad hoc decisions on transforming the telecommunications sector.

B. Restructuring United States Interstate Access Charges and Universal Service Funding.

The next example of a multiyear promise comes from an order adopted by the FCC in May 2000.⁹⁸ Through a five-year plan, the order reforms the charges paid by long-distance carriers to local exchange carriers for originating and terminating calls, called "access charges," as well as the universal service support mechanism. While the scope of this FCC plan and its duration are less than those in the concession agreements for Mexico, Venezuela and Hungary, this order was viewed by the FCC as a major achievement in taking an integrated, predictable approach to important pricing issues. The FCC found that the five-year plan would provide "relative stability in the marketplace" and that the plan would give all parties

⁹⁷ MATAV Prospectus at 12. Without going into the details of the specific formula for compensation in the concession agreement and the Hungarian laws, common formulations for damages from breach of contract would have required the regulator to compensate MATAV for the harm to it from the lost exclusivity. See Corbin, A., Corbin on Contracts (1964) (Vol. 5, 31-35).

⁹⁸ Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-volume Long Distance Users; Federal-State Joint Board on Universal Service, 15 FCC Rcd 12962 (2000) ("CALLS Plan"), aff'd in part and rev'd in part sub nom. Texas Office of Public Utility Counsel v. FCC, 265 F.3d 313 (5th Cir. 2001) ("Texas PUC").

"a much clearer blueprint for developing their business plans and attracting capital..."⁹⁹

The plan made four major changes in access charges and universal service funding.¹⁰⁰ It eliminated one element of access charges through which long-distance carriers paid part of the non-traffic-sensitive costs of local loops; increased the flat monthly charges imposed on residential lines in four annual steps, with the last two steps implemented only after the FCC conducted a study and made findings on the appropriateness of the charges; recharacterized and set a factor in the formula for price caps applicable to access charges; and established a transitional universal service fund to provide support for poor and rural customers.

There are several reasons that the FCC adopted a multiyear plan addressing both access charge and universal service issues. There was a confluence of issues pending at the FCC at that time. The Telecommunications Act of 1996 directed the FCC to take a wide variety of actions. One of the main goals was to increase competition in local exchange services, including for access services. Another legislative priority was to continue the provision of affordable telephone service to all Americans, but to replace implicit subsidies with an explicit mechanism that was consistent with competition.¹⁰¹

The FCC conducted rulemaking proceedings on these and many other issues in the months and years following passage of the legislation. In May 1997 the FCC issued an order reforming access charges; this order was upheld on appeal in 1998.¹⁰² However, the FCC viewed the rate mechanisms in that order as only

⁹⁹ CALLS Plan, 15 FCC Rcd at 12977. The FCC quoted with approval the comments of the Massachusetts regulator: "Resolving so many contentious issues . . . as [this] plan does, reduces this uncertainty to the point that it should not be a significant factor in capital investment." Id.

¹⁰⁰ Id. at 12974-75, 12988; Texas PUC, 265 F.3d at 320.

¹⁰¹ CALLS Plan, 15 FCC Rcd at 12965. See Lavey, "Some Legal Puzzles in the 1996 Statutory Provisions for Universal Telecommunications Services," in Cherry, B., Wildman, S. and Hammond, A., Making Universal Service Policy: Enhancing the Process Through Multidisciplinary Evaluation 179 (1999).

¹⁰² Access Charge Reform, 12 FCC Rcd 15982 (1997), aff'd sub nom. Southwestern Bell v. FCC, 153 F.3d 523 (8th Cir. 1998).

transitional and subject to further proceedings; carriers had raised various issues to the FCC about implementing some charges, and in 2000 the FCC observed that a rate element introduced in that order created market inefficiencies.¹⁰³ Also in 1997, the FCC issued an order revising the productivity factor in the price cap formula for access charges; this order was overturned on court review as arbitrary and capricious, and remanded back to the FCC.¹⁰⁴ A third order adopted in 1997 sought gradually to remove implicit subsidies from access charges and replace them with an explicit universal service fund; parts of this order were reversed and remanded in 1999.¹⁰⁵

Aside from these related pending proceedings, the multiyear nature of the plan grew out of the FCC's desire to avoid sharp increases in some rates, referred to as "rate shock," especially in rates that would threaten the affordability of services to some residential users.¹⁰⁶ Another reason for committing to several reforms spread over several years was the FCC's recognition that the access charges at the time of the order, or even after implementing the first step of the reforms, created incentives for inefficient investments and other multiyear decisions.¹⁰⁷ Only by clearly committing to further reforms could the FCC hope to lessen the inefficiencies occurring during the gradual transition. Accordingly, the FCC sought to develop a clear but gradual transition to a more economically rational approach to access charges and universal service.¹⁰⁸

A final reason for the multiyear plan is that it developed through an agreement involving four of the five largest local exchange carriers and two of the

¹⁰³ CALLS Plan, 15 FCC Rcd at 12970.

¹⁰⁴ Price Cap Performance Review for Local Exchange Carriers, 12 FCC Rcd 16642 (1997), rev'd sub nom. United States Tel. Ass'n v. FCC, 188 F.3d 521 (D.C. Cir. 1999).

¹⁰⁵ Federal State Joint Board on Universal Service, 12 FCC Rcd 8776 (1997), aff'd in part and rev'd in part sub nom. Texas Office of Public Utility Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999).

¹⁰⁶ CALLS Plan, 15 FCC Rcd at 12973.

¹⁰⁷ Id. at 12991-92.

¹⁰⁸ Id. at 12973.

three largest long-distance carriers.¹⁰⁹ Typically, FCC orders evolve from a proposal developed by the FCC staff or a request filed by a single carrier. Since the breakup of the local exchange and long-distance operations of AT&T in 1984,¹¹⁰ the parties to the agreement had fought over many aspects of access charges and universal service funding in proceedings at the FCC, judicial review of FCC orders and lobbying for legislation. The plan reflected the desire by these carriers to have a comprehensive solution and certainty instead of piecemeal rulemakings and uncertainty. The FCC put out the plan for public comments, and the group modified its agreement several times after initially filing it with the FCC.¹¹¹ Ultimately the FCC adopted the proposal; the FCC said that it was exercising its independent judgment and found that the proposal "falls easily within the range of reasonable solutions to the problems it addresses."¹¹²

Three further points about this multiyear plan are interesting.

First, the FCC's commitment to a five-year plan was never rock solid. The planned increases in the flat monthly charges for residential lines scheduled to be implemented in 2002 and 2003 were subject to the findings in a proceeding to be commenced in late 2001.¹¹³ This contingency allowed the FCC to demonstrate its commitment to keeping residential local service affordable.¹¹⁴ In addition, the FCC stated the following reservation about all aspects of the plan: "[T]he Commission has the authority to modify the rules adopted today before the end of the five-year term.... This Order addresses a marketplace that is dynamic and evolving, and the

¹⁰⁹ Id. at 12964 n.1, 12974. The group filing the proposal was called the Coalition for Affordable Local and Long Distance Service ("CALLS").

¹¹⁰ United States v. Western Elec. Co., 569 F. Supp. 1057 (D.D.C. 1983), aff'd sub nom. California v. United States, 464 U.S. 1013 (1983).

¹¹¹ Id. at 12964; Texas PUC, 265 F.3d at 325-27.

¹¹² CALLS Plan, 15 FCC Rcd at 12981.

¹¹³ Id. at 12994. On September 17, 2001, the FCC commenced this proceeding and requested that carriers submit cost information. Initiation of Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps, 16 FCC Rcd 16705 (2001).

¹¹⁴ Texas PUC, 265 F.3d at 323, 325.

Commission may exercise its authority should the need arise."¹¹⁵ Perhaps the FCC thought that this reservation was important to shield the plan from judicial reversal because there is little precedent for a comprehensive five-year plan in court reviews of FCC orders.¹¹⁶ Alternatively the FCC may have been reluctant to give up its discretion to adjust access charges and universal service funding which had been subject to so many adjustments over the preceding years, especially in light of the opposition of some carriers, state commissions and consumer groups to some aspects of the plan. In any case, the FCC did not discuss how these contingencies would likely affect the degree of regulatory certainty produced by the plan for business investment and operations decisions.

Next, the uncertainties embedded in the FCC order were compounded by judicial review. About fifteen months after the FCC adopted its order, the Fifth Circuit Court of Appeals affirmed the parts of the order involving the structure of access charges and the increased flat monthly charges for residential lines but reversed the parts changing the price cap formula and establishing a transitional universal service fund.¹¹⁷ The court held that the FCC lacked a rational basis for determining the amounts of the latter factors, and remanded these matters to the FCC. As FCC Chairman Powell observed in November 2001, a decision that fails to withstand judicial scrutiny is "of no use at all."¹¹⁸ When the order was adopted, carriers had to develop business plans in light of the uncertainties about the timing of judicial review, its outcome, when the FCC would issue an order on remand if parts of the original order were reversed, how any such subsequent order would differ from the first, and then again the overhang of judicial review for the subsequent order. While the standard for judicial review gives general presumptions in favor of

¹¹⁵ CALLS Plan, 15 FCC Rcd at 12977 n.45.

¹¹⁶ See Texas PUC, 265 F.3d at 325, quoting Southwestern Bell v. FCC, 153 F.3d 523, 547 (8th Cir. 1998) ("The FCC has reasonably exercised its predictive judgment If, in light of the actual market developments, the Commission determines that competition is not having the anticipated effect on access charges, the agency presumably will revisit the issue.").

¹¹⁷ Texas PUC, 265 F.3d at 329.

¹¹⁸ ALTS at 2.

orders adopted by regulatory commissions,¹¹⁹ the legal standard for vacating and remanding an agency's order does not explicitly weigh the costs of uncertainties that would result from overturning a plan intended to provide long-term predictability in a marketplace.

Finally, the FCC followed the example of this plan, which was applicable to large local exchange carriers, with another five-year plan applicable to small local exchange carriers. The second plan, adopted in October 2001, again addressed both access charge and universal service issues and evolved from a proposal developed by a group of carriers.¹²⁰ The FCC noted that it would continue to refine its policies and was committed to investigating alternative regulatory methods that would benefit both these carriers and their customers.¹²¹ In adopting the order, the FCC also began a proceeding on other proposed changes to increase the efficiency and competitiveness of these carriers' access services.¹²² Thus, this plan was intended to provide only a limited degree of regulatory certainty for these services over the five-year period.

C. Implementing Automatic Location Identification Capabilities for United States Wireless Services.

The last example of a multiyear promise deals with the FCC's efforts to cause cellular and personal communications services ("PCS") carriers to implement automatic location identification capabilities for calls to emergency services ("E911"). The proceeding illustrates the difficulties regulators encounter in

¹¹⁹ Chevron U.S.A. v. Natural Res. Def. Council, 467 U.S. 837, 842-44 (1984) (allowing for reversal of an agency's decision only if it is arbitrary, capricious or manifestly contrary to the statute); MCI Telecomm. Corp. v. FCC, 675 F.2d 408, 413 (D.C. Cir. 1982); Nat'l Ass'n of Regulatory Util. Comm'rs v. FCC, 737 F.2d 1095, 1134 (D.C. Cir. 1984) (noting the "breadth of the Commission's statutory discretion to balance the multiple goals in the Communications Act").

¹²⁰ Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers, 16 FCC Rcd 19613 (2001).

¹²¹ Id. at 19620.

¹²² Id. at 19622, 19702.

trying to decrease the uncertainty of deploying new communications technologies.¹²³ While regulators control access charges and universal funding mechanisms, they do not control, and often have poor visibility into, technology developments for some new services. Repeated rule changes and recent waivers in this proceeding point to the fine line between enforceable commitments and nonenforceable statements of intentions.

In 1996 the FCC adopted rules to stimulate the improvement in handling calls to emergency services by wireless carriers.¹²⁴ The order recognized the benefits of providing automatic identification of the caller's location to the emergency services. The order established two sets of requirements. Phase I requires the carrier to deliver to the emergency service the location of the cell site or base station receiving the emergency call. These capabilities were to be initiated within twelve months and completed within eighteen months after issuance of the rules. Phase II requires the carrier to deliver to the emergency service more specific latitude and longitude location information on the caller. These more advanced capabilities were to be achieved within five years after issuance of the rules.

The FCC's five-year implementation schedule for Phase II evolved from a proposal developed by the FCC's staff two years earlier.¹²⁵ Initially the wireless carriers opposed a fixed, mandatory schedule while the public safety organizations supported it.¹²⁶ The carriers stated that the systems to achieve the Phase II accuracy objectives had not been standardized, manufactured or field-tested. Over a year after the FCC issued its proposal, the five-year schedule gained the support of a consensus agreement by the leading association of wireless carriers and representatives of public safety organizations.¹²⁷ Some suppliers of location systems

¹²³ See also Communications Assistance for Law Enforcement Act, 14 FCC Rcd 16794 (1999) (schedule and cost-recovery procedures for deploying technologies to facilitate electronic surveillance), vacated and remanded sub nom. United States Telecom. Ass'n v. FCC, 227 F.3d 450 (D.C. Cir. 2000).

¹²⁴ E-911 Order, 11 FCC Rcd at 18682-84.

¹²⁵ Revision to the Commission's Rules to Ensure Comparability with Enhanced 911 Emergency Calling Systems, 9 FCC Rcd 6170 (1994).

¹²⁶ E911 Order, 11 FCC Rcd at 18688, 18704-05.

¹²⁷ Id. at 18705.

filed comments stating that the systems could be developed to meet the five-year schedule.¹²⁸

Some comments favored allowing the location identification capabilities to develop based on the demands in the marketplace at a market-driven pace, or urged the FCC to limit its role to encouraging voluntary development of the capabilities.¹²⁹ Instead, the FCC found that a mandatory implementation schedule was necessary to ensure expeditious deployment of technologies to enhance public safety communications. The FCC sought to impose a schedule which was "rigorous without being impossible or commercially self-defeating."¹³⁰

The FCC modified its rules several times over the years following adoption of the initial schedule, including to allow for a handset-based technology which was not anticipated in the initial order.¹³¹ If a carrier chose to implement location identification capabilities through handsets, it could phase in the availability on an initial schedule from March 2001 through December 2005. The FCC also required carriers to file implementation reports detailing their progress and plans. In an order adopted in August 2000, the FCC found that "much progress has been made in developing technologies to make wireless E911 a reality, although much still remains to be done."¹³² That order extended the initiation date for handset-based technologies by seven months, modified the phase-in schedule and granted a further waiver to one carrier. Finding that location technologies "are already, or will soon be, available that provide a reasonable prospect for carriers to comply with the E911

¹²⁸ Id. at 18704. As for costs, the FCC noted a huge range of estimates in the record, from \$510 million to \$7.5 billion depending on the technology, and found that it was reasonable to conclude that these costs were likely to decline in the future. Id. at 18708.

¹²⁹ Id. at 18707.

¹³⁰ Id. One party argued for an "evolutionary path for the E911 rules because the timing of implementation is affected by 'economic, operational and technological feasibility.'" Id. (quoting comments filed by a public safety organization).

¹³¹ Revision of the Commission's Rules to Ensure Comparability with Enhanced 911 Emergency Calling Systems, 12 FCC Rcd 22665 (1997), 14 FCC Rcd 10954 (1999), 15 FCC Rcd 17442 (2000) ("2000 E911 Order").

¹³² 2000 E911 Order, 15 FCC Rcd at 17443.

Phase II requirements," the FCC stated that any waiver request must be "specific, focused and limited in scope, with a clear path to full compliance."¹³³

The schedule came under strong fire from many wireless carriers in the final year of the five-year period. While the leading wireless carriers had engaged in field test and/or development work with manufacturers, none of the carriers was implementing the capabilities according to the schedule. The carriers pointed to the failure of their vendors (which they claimed was beyond their control) to supply equipment necessary to satisfy the accuracy requirements in the rules. In October 2001 the FCC conditionally approved, with certain modifications, the compliance plans of five nationwide carriers and initiated enforcement investigations regarding some smaller carriers.¹³⁴ These orders extended the initial deployment milestone, preserved the 2005 milestone for completing deployment, warned of strong enforcement of the revised milestones, required the carriers to file quarterly progress reports, and opened an inquiry into technical issues, including technology standards, development of hardware and software, and supply conditions. Three carriers quickly filed petitions for reconsideration,¹³⁵ claiming that the waivers were too harsh in holding the carriers to the milestones (which they had proposed)¹³⁶ regardless of the availability of compliant technology from suppliers and predetermining that enforcement actions will be invoked against carriers in cases of noncompliance.

Two questions arise from this experience. First, in light of the failure by carriers to meet the initial implementation milestone and the FCC's numerous modifications and waivers of its rules, how did the "mandatory" schedule affect the

¹³³ Id. at 17457-58.

¹³⁴ See "Fact Sheet: E911 Phase II Decisions," www.fcc.gov (Oct. 2001); Revision of the Commission's Rules to Ensure Compatibility with Enhanced 911 Emergency Calling System, 16 FCC Rcd 18253-393 (2001); Testimony of Thomas J. Sugrue, Hearing on Wireless E911 before the Senate Subcommittee on Communications, www.fcc.gov (Oct. 16, 2001) ("Sugrue").

¹³⁵ Cingular, Nextel, and Verizon File Petitions For Reconsideration of Commission Orders on Wireless E911 Phase II Waiver Requests, 16 FCC Rcd 20438 (2001).

¹³⁶ See Separate Statement of Commissioner Michael Copps in Review of the Commission's Rules to Ensure Compatibility with Enhanced 911 Emergency Calling Systems, 16 FCC Rcd 18271, 18275 (2001).

conduct of the industry and the regulator? Second, does the record support the view that the commitment to a deployment schedule promoted efficiency?

On the effects of the schedule on the industry and the regulator, this proceeding illustrates the "holding their feet to the fire" approach to regulation. The FCC does not have jurisdiction over telecom equipment manufacturers and system suppliers and was not in a position to dictate development and production of this technology by them. While the FCC has jurisdiction over the carriers, the regulator lacked the technical capability and willingness to micromanage the carriers' relationships with their suppliers. Nor was the regulator willing to require the carriers to spend billions of dollars on one technology when the carriers claimed that an effective, lower-cost technology would be available "soon." What the FCC could and did do was to establish the schedule as mandatory for the carriers, repeatedly speak out on its commitment to bringing about the public interest benefits of the technology, and show only limited willingness to vary from these rules in light of emerging technology and market conditions. Compared to letting the market evolve without regulatory intervention, the schedule had the effect of creating stronger incentives for equipment manufacturers and system suppliers to develop new technologies, and for carriers to devote resources to product development with suppliers, field tests and deployment planning.

How strong were the effects of the schedule on the industry? The schedule, together with threats of enforcement actions, filings of implementation plans and only limited waivers, gave some push to the industry. On the other hand, the carriers no doubt anticipated some flexibility from the regulator, especially when the carriers could place the blame on their suppliers and the FCC had repeatedly modified the schedule and technical requirements. The FCC's orders describe general progress by the carriers and their suppliers. Perhaps more would have been accomplished by the carriers and their suppliers if the FCC had signalled earlier a tougher enforcement posture. In a statement accompanying the October 2001 waivers, Chairman Powell stated his determination to achieve complete availability of wireless location capability: "Given that this service can save lives, I trust that the carriers, the manufacturers and public safety authorities will work tirelessly to get this service to people as soon before the deadline as possible. It is not good enough

to go for a gentleman's 'C.' This test requires an 'A+' effort."¹³⁷ It is not clear whether the chairman was critical of prior orders for binding the industry only to a "C"-level push for deployment.

The schedule adopted in 1996 influenced subsequent actions by the FCC. The schedule created a promise by the FCC to public safety organizations and Congress. Through legislation and hearings,¹³⁸ Congress embraced the rapid deployment of wireless location capabilities. With the strong growth of wireless usage and wireless calls to emergency services during the five-year period, changing market conditions increased the political pressure on the FCC to turn its promise into reality. In each order allowing for slippage of milestones, the FCC had to demonstrate that it had lost none of its commitment to this goal.

We can now analyze whether the FCC's multiyear commitments in its 1996 order promoted productive efficiency. The FCC's order decreased the uncertainty about when carriers would implement location technologies and the performance standards. Even though the possibility of waivers hung over this process, carriers at least had to create a record of attempted compliance on which to seek waivers. The leading wireless carriers and some of their suppliers took the schedule seriously enough to engage in product development, field testing and implementation planning. The waivers disrupted some business plans for the initial milestone but preserved much of the rollout schedule for the subsequent years. Absent the FCC's orders, carriers and their suppliers would have done even more guessing about when market demands would have resulted in orders for this technology, or the possibility of the FCC, Congress or state and local authorities mandating a deployment schedule and technical standards.

The five-year commitment was not just the FCC's shot in the darkness of distant future wireless technologies. Rather, the carriers had agreed to this schedule and some vendors went on record supporting the availability of systems in

¹³⁷ Separate Statement of Chairman Michael Powell in Revision of the Commission's Rules to Ensure Compatibility with Enhanced 911 Emergency Calling Systems, 16 FCC Rcd 18265 (2001).

¹³⁸ Wireless Communications and Public Safety Act of 1999, Pub. L. No. 106-81; Sugrue; Statement of Thomas J. Sugrue to the House Subcommittee on Telecommunications, Trade and Consumer Protection, www.fcc.gov (June 14, 2001).

that time frame. The carriers may have perceived opportunities for productive efficiencies from not facing a shorter implementation deadline or from less uncertainty about when location requirements would be imposed on them. The vendors may have perceived that the FCC would expand the market opportunity for these new technologies.

Given that the FCC could not control the technology development, there were some types of inefficiencies from locking carriers into an implementation schedule and performance standards. Carriers had to expend resources testing technologies and convincing the FCC to grant waivers. The mandatory schedule caused the regulator to make formal adjustments to the rules several times in light of technology and market developments. Each petition and order required more resources from carriers and the regulator than would have been employed with a less firm commitment, such as an ongoing panel to study and encourage location technology deployment. Also, some potential suppliers might have invested heavily in product development, field testing with carriers and manufacturing capacity in anticipation of substantial orders for the October 2001 implementation date. The waivers changed the competitive landscape for suppliers, perhaps depriving rewards to those suppliers which came closest to meeting the technical and availability requirements established in the prior orders. If these suppliers had operated in a market without a regulatory schedule for deployment, they could have avoided some costs.

In summary, the FCC's commitment to a deployment schedule and technical standards was built on guesses about technology developments that neither the regulator nor the carriers could control. The five-year promise was never written in stone. It was subject to both interim modifications in response to technology changes and last-minute waivers. While the FCC's approach likely fostered some efficiencies as well as some inefficiencies compared to ad hoc, short-term regulatory decisions, the balance probably weighs in favor of the efficiencies. The FCC's attempts to bring clarity to this area for a five-year planning horizon helped guide the carriers, their suppliers and public safety agencies.

Technology developments on this politically hot issue faced inherent uncertainties. The FCC's commitment involved many adjustments over time, but its intent is admirable. It may have been easier for the FCC to limit its role to issuing annual reports on developments in this area or addressing certain deployment-related

issues, such as how carriers could recover their costs from deploying this capability. Instead, the FCC recognized that some uncertainty facing carriers and their suppliers needed to be removed in order to accomplish the policy goal of rapid development and deployment of this capability. The multiyear promise, while unstable and imperfect as to timing and technical standards, did remove some uncertainty and thereby promoted productive efficiency.

Chapter Three

Lessons on Multiyear Regulatory Promises

This section draws two lessons from the analysis of various multiyear regulatory promises in the preceding section. First, under some conditions regulators have departed from a step-by-step approach to adopt multiyear plans. Regulators could make more use of atypical procedures to achieve predictable multiyear plans for other issues. Second, such plans can produce efficiency gains compared to piecemeal, *ad hoc*, short-term regulatory decisions. Through analysis of a U.S. plan intended to promote local telecommunications competition, this point also explains that clear standards and a fixed schedule can promote efficiency gains.

A. Regulators Do, Under Some Conditions, Make and Keep Multiyear Promises.

The five multiyear promises analyzed in Chapter 2 developed from diverse conditions and do not reflect "ordinary" regulatory decisions or decision making processes. Each of these examples involves an agreement with major industry actors, not just a regulatory evaluation of a record and creation of rules. Such atypical approaches could be used by regulators more frequently, by encouraging or mediating industry negotiations aimed at long-term solutions. A review of the conditions and processes underlying these ambitious regulatory plans may be helpful in guiding future orders and processes.

The lesson here is that multiyear regulatory promises develop when regulators and the telecommunications industry focus on the benefits of reducing uncertainties over time, not just resolving a dispute or establishing an immediately applicable rate or obligation of uncertain duration. Under these conditions, regulators can and have made complex, politically-sensitive, multiyear promises.

1. Privatizations. The three examples of regulatory plans made in connection with sales of strategic interests in national telephone carriers were enormously ambitious. The plans were intended to provide predictability for long periods (six to ten years) and address major changes in the full scope of national regulatory issues, including rates, network expansion and modernization, service-quality improvements and competition. The plans are especially impressive when compared to the preceding governmental actions in the telecommunications sectors

of these countries, typically limited to isolated rate and network construction decisions to comply with general governmental economic and social policies.

The plans were intended to sell the privatization transaction to two audiences. Both audiences were very focused on having a clear long-term picture of regulation as well as definite milestones.

On the one hand, potential buyers for the strategic interest included major foreign telecommunications operators. In developing business plans for investing billions of dollars for the initial stock purchase and network improvements, the potential buyers needed to develop annual forecasts of revenues and expenses extending out many years. The buyers wanted rate rebalancing before competitive entry and were willing to commit to gradual rate rebalancing only when the regulator gave assurance that competitive entry would be sufficiently delayed. Similarly the buyers were willing to commit to network expansion and service quality improvements, including in unprofitable rural areas, but wanted a reasonable schedule and clear standards so that they would not be exposed to unexpected penalties or expenditures. With little or no precedent for telecommunications regulation by an independent agency in these countries, the buyers wanted many issues applicable to future years addressed in the concession agreement. Additionally, the buyers recognized the unique conditions surrounding the transaction giving them perhaps greater influence over regulatory decisions than they would have in the future.

On the other hand, the plans had to sell the transaction to the domestic political audience. Politicians wanted to see commitments to expanding the networks to serve the many people waiting for service. They also wanted to see service-quality improvements, network modernization to support economic development, and rate changes which protected subscribers from sharp increases. With the global move to telecommunications competition, domestic politicians wanted to make sure that their country would introduce competition without unreasonable delay.

Along with the multiyear focus of the audiences for the plans, the transactions brought together unusual teams to craft the multiyear regulatory promises. The governments were advised by teams of investment bankers, international telecommunications consultants and international lawyers, all with expertise on telecommunications regulations. Instead of relying solely on the staff of the regulatory agency, the plans were developed with advisors having a more long-term

orientation to the carrier's business and telecommunications regulations.

Now consider the conditions influencing the regulators to keep these multiyear promises, more or less. Part of what tied the regulators to their plans in the following years was related to the transaction. The buyers paid serious money to the government and had contractual remedies for violations of the concession agreements which are not normally available to carriers when regulators change their rules. These transactions also preceded the national carriers' initial public offerings which involved further sales of shares held by the governments. These subsequent sales gave the governments incentives to abide by the multiyear promises and not to impose new onerous requirements or restrictions on the carriers. Similarly, telecommunications privatizations in those countries were often followed by other privatizations, giving the government further reason to establish a reputation as an honest player that keeps its promises.

Aside from the context of the transactions, these multiyear, multi-faceted plans reflect a balancing of many interests. Not adhering to these promises would require addressing the expectations of various interest groups. Most changes would benefit some interest groups while harming others. While the examples show that it is possible to work through some modifications, such as altering some service-quality standards, it is much more difficult to make other changes, such as early competitive entry. Early competitive entry would make it much harder for the regulator to obtain network expansion in rural areas and gradual increases in residential local service rates. The carriers could have a stronger expectation of regulators keeping their promises with regard to a plan's aspects that are tied to the interests of some politically influential groups.

2. FCC Access Charge and Universal Service Plan. The conditions related to the FCC's multiyear plan for reforming access charges and universal service funding were quite different from those pertaining to the three privatizations. The plan emerged out of several sources of uncertainty. During the preceding three years, there had been numerous separate orders which addressed parts of these interrelated issues. Some of those orders were reversed and remanded, in whole or part, by the appellate courts. Portions of the regulations that were adopted in those orders pointed to the temporary nature of the charges, anticipating further revisions by the FCC. Also, carriers were requesting reconsideration of at

least one element which was proving difficult to implement, and argued that the FCC's decisions had not gone far enough in reforming these charges.

While the FCC was continuing to analyze options and develop factual records on these issues through rulemaking proceedings, some major local exchange and long-distance carriers worked on a consensus plan. The plan reflects the participating carriers' desire to remove some of the uncertainty surrounding these charges via a predictable, five-year framework. Greater certainty about moving to lower access charges, even if phased in, would help these carriers compete (including against carriers that did not have to impose or pay these charges), plan services and network facilities, and forecast demand. Without the agreement of these carriers, the FCC would not likely have committed to this five-year regulatory plan.

Perhaps it was too good to be true. The carriers' ability to remove uncertainty through a multiyear regulatory commitment was limited. A midterm review by the FCC had to be built into the plan to address political concerns about increasing charges on residential customers. On top of this, the FCC explicitly reserved its options to change the rules over time, possibly out of concern that a court would reverse its surrender of discretion and possibly out of concern that it would need this discretion to address changing market conditions. The group supporting the plan did not include all interested parties; thus, as with most proposals filed with the FCC, the uncertainty persisted through the FCC's rulemaking process and court review. These other parties preferred the possibility of other regulations, along with the uncertainty of what the FCC would adopt and when, over the certainty of the plan's commitments. Then came court reversal of some elements of the plan as not supported by the record, leading to more FCC proceedings and uncertainty.

3. FCC Schedule for Wireless E911 Capability. Finally, the main driver behind the five-year plan for wireless E911 capability was political support for the public safety benefits. When the FCC commenced its rulemaking proceeding, automatic location identification for landline calls was widely available in the United States and the number of wireless calls to public safety agencies was already large and growing rapidly. Public safety agencies were clamoring for governmental action to save lives, with widely accepted assumptions that the technologies could be readily developed and that the benefits would outweigh any costs imposed on the burgeoning wireless industry. The FCC needed to show

Congress that the regulators were strongly promoting wireless carriers' deployment of this capability. It was not enough to point to the possibility that an unregulated market would produce this capability eventually, nor show that the FCC was studying the issue and would take action at some unspecified future time if deemed warranted based on further information about the technologies.¹³⁹

From the industry perspective, there was substantial uncertainty about what would be required and when. The wireless industry had succeeded in avoiding most of the types of regulatory burdens imposed on landline carriers, such as rate regulation and unbundled interconnections. Although wireless carriers could point to an increasingly competitive marketplace that would drive advances in their service offerings, they also were aware of the active roles of governmental authorities in implementing landline E911 capability and the political support for wireless E911 capability. Following the FCC's notice of proposed rulemaking, the carriers argued that the timing should be determined by the marketplace; the carriers preferred to control the planning without regulatory intervention. When the industry recognized that this position appeared unacceptable to the FCC, representatives of the carriers and public safety agencies agreed to a five-year schedule and filed that consensus agreement with the FCC. The carriers probably viewed this agreement as helping them avoid a more aggressive deployment schedule or set of technical standards that the FCC, Congress, or state and local authorities might have mandated.

The consensus agreement was important for adoption and enforcement, more or less, of the five-year plan. Instead of having the FCC adopt the schedule as its own best guess of what could be reasonably accomplished, the carriers committed to complying with this schedule. This made it harder for all parties to justify slippage. The promises by all parties were made in the context of the FCC's ongoing review of its technology standards and readiness to make adjustment for technology developments. Nevertheless, the mutual promises established a marker in the sands of the uncertain future of wireless technologies.

¹³⁹ The FCC took a different approach in Promotion of Competitive Networks in Local Telecommunications Markets, 15 FCC Rcd 22983 (2000) (combining some rules with monitoring and potential for additional rules if warranted by market conditions); Wireless Telecommunications Bureau Requests Comment on Current Status of the Market for Local and Advanced Telecommunications Services in Multitenant Environments, 16 FCC Rcd 20972 (2001).

B. Multiyear Regulatory Promises Can Produce Efficiency Gains.

The analysis in Chapter 2 identified certain efficiency gains from the five multiyear regulatory plans. Two points emerge from this analysis - - that the promises can produce efficiency gains and that efficiency-enhancing changes can be implemented with benefits redistributed according to the earlier promises. After explaining these points, this section concludes with a discussion of the structure of a United States multiyear promise covering local competition which has yielded some inefficiencies from continued uncertainties.

1. Gains from Decreasing Uncertainty. A predictable regulatory framework can promote productive efficiency by carriers as well as the ability of regulators to obtain their objectives. Put differently, regulatory decisions setting only interim rules of indefinite duration and open-ended uses of regulatory discretion to modify rules can have an opportunity cost for the industry, consumers and public policy goals.

Businesses use multiyear plans to guide investments, operations and product development. Along with assumptions typical of unregulated markets regarding technology, demand, costs, competition and other market factors, the business plans of telecommunications businesses include assumptions about regulated rates, network and service requirements, regulatory rules for competition, and other terms by which regulators heavily influence the industries. Uncertainties regarding these regulatory-influenced factors cause costs in these business decisions - - underutilized facilities when regulators delay authorization for services, fail to enforce interconnection standards or impose costs which decrease demand; costly retroactive upgrades of hardware and software to meet new regulatory requirements when economies were available if these standards were known before some deployments; opportunity costs from not developing capabilities to offer services because regulators would not commit to authorizing an offering or pricing it in line with its costs, and so on.

In some cases, such as the privatization transactions, major investments would not have been made in the absence of commitments by the regulators to a detailed, comprehensive plan extending over six- to ten-year periods. In the case of the FCC plan for access charges and universal service funding, some leading carriers worked hard to reach agreement on a five-year plan for rates from which they could develop plans for facilities, interconnection arrangements and

service offerings. The example of the wireless E911 technology dealt with a multiyear program of technology development by manufacturers and field testing by carriers where knowledge of the regulators' performance standards and implementation milestones saved costs by guiding the technology choices and implementation planning.

From the perspective of regulators trying to implement new regulations, a multiyear plan can decrease implementation costs which ultimately are borne by consumers. Also, the industry may be able to implement a regulatory change earlier if the regulator makes an advanced commitment to the change. For example, the wireless E911 plan adopted in 1996 probably accelerated the development and deployment of this technology.

2. Promises to Redistribute Gains in the Event of Changes. We have analyzed several instances in which regulators sought, or explicitly reserved the right, to change multiyear plans midterm, including regarding fundamental commitments. The overhang of uncertainty about such changes can decrease the efficiency gains from a multiyear plan. Nevertheless, a second point about efficiency benefits is that multiyear plans can function to redistribute the gains of regulatory changes without barring changes which would enhance efficiency.

Part of regulators' reluctance to adopt multiyear plans may be their concerns about subsequently developing different conclusions which would enhance efficiency. Such changes may develop from new market conditions or analyses of options and could involve different rate structures, standards for network and service performance, timing and conditions for competition, or other rule changes. Just as a panel of regulators would not want to be entirely bound by the decisions of its predecessors, so, too, would a panel of regulators be reluctant to bind its successors entirely.

As discussed in connection with the analysis of attempts to accelerate competition under the privatization plans in Venezuela and Hungary, multiyear commitments can influence the process and beneficiaries of regulatory changes but should not bar regulatory changes which would enhance efficiency. A plan makes commitments to various interest groups. A regulatory change which would adversely affect some groups may require that those groups be compensated for the loss compared to proceeding with the plan. However, as long as the change represents a net gain to the country, it should be possible to arrange such compensation

and still proceed with the change. In other words, a plan which balanced various interests through one set of regulations can be replaced by another plan which rebalances these interests through a second set of regulations as long as there is a net gain to distribute.

In effect, a plan establishes a multiyear baseline set of expectations. Greater benefits in terms of reduced uncertainty arise from clear, predictable regulatory commitments. Yet a plan can also produce efficiency gains by structuring the regulatory commitments as follows: The regulator specifies the future regulations over a term as clearly as possible at that time; it does not promise that such regulations will remain unchanged but does promise to give serious consideration to the conditions specified therein and compensation for the related expectations in making any changes. Such compensation can take the form of agreed remedies according to contractual provisions, trading off against other regulatory restrictions or obligations in bilateral negotiations, or otherwise addressing the interests of groups harmed by the change compared to the baseline conditions. The commitment to engage in this process of recognizing expectations and redistributing gains results in less uncertainty than an open-ended characterization of a regulatory decision as merely interim with no setting of baseline conditions.

3. A Multiyear Promise with Too Much Uncertainty About Carriers' Obligations and Regulatory Criteria. The final point is that clarity in commitments and restricting carriers' and regulators' discretion decreases uncertainty and promotes efficiency. This point is illustrated by an area of particularly strong regulatory turbulence and industry uncertainty involving local exchange competition in the U.S.

One of the main goals of the Telecommunications Act of 1996 is to open local markets to competition.¹⁴⁰ The legislation removed legal barriers to competition (such as some state protections of monopolies in local switched services)¹⁴¹ as well as some economic and technical barriers to competition (such as

¹⁴⁰ Congress sought "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition." S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. at 1 (1996).

¹⁴¹ 47 U.S.C. § 253(a) (2001).

requiring that incumbent carriers interconnect with competitors by offering unbundled network elements, co-location of network facilities and number portability).¹⁴² The statutory provisions spawned a long series of FCC rulemaking proceedings, which in time spawned numerous court reviews and remands, reconsideration proceedings and complaints.¹⁴³ Uncertainty persisted especially where rules were adopted as "interim" or "transitional."

An important multiyear promise in the legislation relied on an incentive approach to easing some economic and technical barriers to competition,¹⁴⁴ with much uncertainty surrounding whether carriers would respond to the incentive and when, as well as how regulators would judge compliance with the standard.

Some market-opening measures were specified in the legislation as requirements for most incumbent local exchange carriers, and the FCC adopted detailed performance standards and implementation schedules for such requirements within a few months or years after enactment of the legislation.¹⁴⁵ The statute also

¹⁴² 47 U.S.C. § 251 (2001).

¹⁴³ See, e.g., Draft Implementation Schedule for the Telecommunications Act of 1996, www.fcc.gov (Jan. 13, 1997) ("Implementation Schedule"); Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, 11 FCC Rcd 15499 (1996), aff'd in part and vacated in part sub nom. Competitive Telecommunications Ass'n v. FCC, 117 F.3d 1068 (8th Cir. 1997), aff'd in part and vacated in part sub nom. Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), aff'd in part, rev'd in part and remanded sub nom. AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999); Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, 15 FCC Rcd 3696 (1999) ("UNE Remand Order"); Deployment of Wireline Services Offering Advanced Telecommunications Capability, 14 FCC Rcd 20912 (1999); Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, 16 FCC Rcd 22781 (2001). See Beynon, "The FCC's Implementation of the 1996 Act: Agency Litigation Strategies and Delay," 53 Fed. Com. L.J. 27 (2000); Mandy, "Progress and Regress on InterLATA Competition," 52 Fed. Com. L.J. 321 (1999).

¹⁴⁴ 47 U.S.C. § 271 (2001).

¹⁴⁵ See generally Implementation Schedule. For example, the legislation explicitly required local number portability, and the FCC adopted detailed rules for local number portability, including an implementation schedule. Section 251(b)(2) requires all local exchange carriers "to provide, to the extent technically feasible, number portability in accordance with requirements prescribed by the Commission." 47 U.S.C. § 251(b)(2) (2001). The legislation defined number portability, 47 U.S.C. § 153(30), and addressed how the cost would be recovered in order to prevent such

allowed the FCC to identify other market-opening measures not specified in the law (such as access to operational support systems to speed the processing of interconnection requests).¹⁴⁶ The FCC could order that such measures be implemented generally, and also review such implementation in the context of applications by Bell regional operating companies (the local exchange carriers created by the divestitures of local exchange carriers from AT&T in 1984) to obtain

cost from thwarting competition, 47 U.S.C. § 251(e)(2). The FCC adopted a series of orders requiring local exchange carriers to offer interim number portability "to the extent technically feasible" and gradually to implement permanent number portability. Telephone Number Portability, 11 FCC Rcd 8352 (1996), 12 FCC Rcd 12281 (1997), 13 FCC Rcd 11701 (1998), 14 FCC Rcd 16459 (1999). Compliance with the number portability regulations is also specified in the legislation as an item on the checklist for Bell company entry into long-distance services. 47 U.S.C. § 271(c)(2)(B)(xi).

¹⁴⁶ 47 U.S.C. § 271(c)(2)(B)(ii) (2001). "Under checklist item 2, a Bell Operating Company must demonstrate that it provides non-discriminatory access to the five operational support systems (OSS) functions: (1) pre-ordering; (2) ordering; (3) provisioning; (4) maintenance and repair; and (5) fitting." Joint Application of SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Arkansas and Missouri, 16 FCC Rcd 20719, 20846 (2001) ("SBC AK-MO Order"). See also Application of Bell Atlantic New York for Authorization under Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of New York, 15 FCC Rcd 3953, 3961-63 (1999) ("Bell Atlantic NY Order"), aff'd sub nom. AT&T Corp. v. FCC, 220 F.3d 607 (D.C. Cir. 2000); Sprint Communications Co. v. FCC, 274 F.3d 549 (D.C. Cir. 2001).

The FCC determined in 1999 that requesting carriers are impaired without nondiscriminatory access to incumbent local exchange carriers' OSS functions, and mandated that these functions be made available as unbundled network elements under 47 U.S.C. § 251(c)(3). See UNE Remand Order, 15 FCC Rcd at 3867, 3875, 3887; Bell Atlantic NY Order, 15 FCC Rcd at 3990. However, the FCC decided not to adopt quantitative and qualitative performance measurement rules for this unbundled network element and instead to rely on state commission review and its review of Section 271 applications. UNE Remand Order, 15 FCC Rcd at 3889-90 (rejecting request of one competitive carrier to adopt performance standards so that failure to satisfy these standards would "automatically trigger a process to identify and correct the root cause of the OSS problem"). See also SBC AK-MO Order, 16 FCC Rcd at 20857.

authority to provide long-distance services.¹⁴⁷ For operational support systems, the FCC decided to interpret this standard and judge a company's compliance with it through case-by-case determinations over time in response to applications for long-distance authority.¹⁴⁸

The Bell companies had sought a clear path to long-distance service authority in the legislation. Congress viewed the incentive of this authority as a very tempting carrot to get these companies to implement the measures which the FCC would review in the context of such applications. Although the legislation had not provided a schedule for implementing some of these measures, many legislators, regulators and carriers assumed that this incentive was sufficiently strong that they could count on widespread implementation within at most a few years.

The multiyear promise took the following form: if a Bell company demonstrated that it had implemented all the market-opening measures in a state and the FCC determined that such standard was satisfied, then the Bell company would be authorized to provide long-distance services to users in that state. In the months and years following enactment of the legislation, billions of dollars were spent based on these expectations. Competitive carriers collected billions of dollars from

¹⁴⁷ The legislation specified a fourteen-point checklist which had to be satisfied for a Bell company to be authorized to provide long-distance services in a state, a time limit for FCC consideration of any application, and a procedure involving review by the applicable state commission and the U.S. Department of Justice. 47 U.S.C. §§ 271(c)(2)(B), 271(d)(2)(A), 271(d)(2)(B), 271(d)(3); SBC AK-MO Order, 16 FCC Rcd at 20846-52.

¹⁴⁸ Even after more than five and one-half years, and experience with many applications, the FCC chose to continue by case-by-case determinations:

The determination of whether the statutory standard is met is ultimately a judgment the Commission must make based on its expertise in promoting competition in local markets and in telecommunications regulation generally. The Commission has not established, nor does it believe it appropriate to establish, specific objective criteria for what constitutes "substantially the same time and manner" or a "meaningful opportunity to compete." Whether this legal standard is met can only be decided based on an analysis of specific facts and circumstances.

SBC AK-MO Order, 16 FCC Rcd at 20849.

investors, negotiated interconnection agreements with the Bell companies, developed networks and/or resale strategies, marketed services and submitted interconnection orders on the belief that this incentive would quickly drive the Bell companies to implement measures to satisfy the standard.¹⁴⁹ On the Bell companies' side, some companies deployed facilities and implemented systems which they believed would satisfy the standard for authorization to provide long-distance services and devoted resources to preparing for providing these services.

The lack of a clear commitment by the regulators and carriers to a schedule and standards for some market-opening measures cost both the competitive carriers and the Bell companies dearly. Some Bell companies did not go after the carrot aggressively.¹⁵⁰ For these carriers, the opportunity to provide long-distance service did not offset the costs of implementing these measures and losing market share in local services. This left the competitors in many states befuddled by local markets which were less open than they expected. As the market results of new entrants fell below expectations, investors lost interest in many competitive carriers.

Moreover, the criteria applied by regulators in determining whether a Bell company successfully implemented some of these measures was not clear in the legislation and remained unclear for many years.¹⁵¹ No application was found to satisfy the standard for more than three and one-half years after enactment of the legislation,¹⁵² and as of April 18, 2002 (over six years after enactment), approvals were granted for only eleven states and at least eleven applications had been denied or withdrawn.¹⁵³

¹⁴⁹ See Prepared Statement of James H. Henry, in Internet Hearings at 51 (competitive local exchange carriers deployed approximately \$55 billion in capital to build alternative local networks).

¹⁵⁰ For example, one Bell regional holding company, US WEST (now a subsidiary of Qwest Communications Inc.), has not applied to the FCC for long-distance service authority for any of the fourteen states where it provides local exchange services through April 1, 2002.

¹⁵¹ See SBC AK-MO Order, 2001 FCC LEXIS 6265 at Appendix D.

¹⁵² Bell Atlantic NY Order.

¹⁵³ RBOC Applications to Provide In-region, InterLATA Services Under § 271, www.fcc.gov. "Unfortunately, implementation of this congressional vision of increased telecommunications competition has, in many instances, not proceeded

Even after some Bell companies had implemented these measures in some states and gained FCC approval, the FCC did not establish a schedule or uniform standards for the deployment of these capabilities in other states¹⁵⁴ and found that some applications for long-distance authority failed to demonstrate adequate compliance. Uncertainty continues in these states as to when the Bell companies would choose to implement the market-opening measures and how the FCC will judge particular cases, with consequent costs for the competitive carriers and the Bell companies.

The legislation created a multiyear promise relying on an incentive approach to achieving market-opening changes which were important for the policy goal of local competition. However, the carriers did not promise (nor were required) to implement the measures on a fixed schedule. Nor did the legislation together with the FCC's regulations give clarity to the standards for judging implementation of those measures for at least several years. This approach did not achieve rapid implementation of these changes and caused costs from the uncertainties related to the timing and scope of such measures.

swiftly or smoothly. For example, some of the Section 271 applications that we have reviewed to date have fallen far short of the statutory requirements." Bell Atlantic NY Order, 15 FCC Rcd. at 3956. See also Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Services in Michigan, 12 FCC Rcd. 20543 (1997); Application of BellSouth Corporation, et al. Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Services in South Carolina, 13 FCC Rcd 539 (1997); Application of BellSouth Corporation, BellSouth Telecommunications, Inc. and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana, 13 FCC Rcd. 20599 (1998); SBC AK-MO Order; Statement of FCC Chairman Michael Powell on Withdrawal of BellSouth 271 Application, FCC News Release, www.fcc.gov (Dec. 20, 2001).

¹⁵⁴ See Prepared Statement of Clark McLeod, Chairman and Co-CEO, McLeodUSA Incorporated, in Internet Hearings 64, at 68 ("What I propose here is adding a 'stick' to our policy scheme, in addition to the 'carrot' So the key is for Congress to amend Section 271 to require the Mega-Bells to meet those requirements to the satisfaction of the FCC by a date certain.").

Chapter 4

Conclusion

Under some conditions, regulators have boldly broken out of the piecemeal, ad hoc approaches to regulations as short-term fixes to be revised when and how the regulators subsequently decide. Multiyear promises have been adopted in some instances to address complex, interrelated issues and establish a predictable framework for investments, operations and technology development.

The industries and consumers affected by regulations make decisions on investments and other actions which are inherently multiyear, forcing them to make assumptions about future regulatory conditions and to adopt strategies with some losses in effective uses of productive resources. Markets reflect regulatory uncertainties even if regulators do not weigh these consequences. Regulatory uncertainties can harm consumers and be contrary to the public interest. Regulators should more frequently recognize the large efficiency enhancements of decreasing the uncertainty surrounding future regulations and strive to adopt well-defined sequences of regulatory changes with clear timing.

In some circumstances, addressing an issue with an interim marker is as well as regulators can do; the delays from formulating a multiyear plan would be costly, and the broad contingencies that would have to be addressed may substantially diminish the benefits from a longer-term framework. On the other hand, legislators, regulators and courts should weigh the opportunity costs to businesses and consumers of the uncertainties surrounding future regulatory actions and seek to provide more predictable future regulatory rules.

Specifically, there should be an increase in:

(1) legislators (a) adopting statutes in which a well-defined sequence of regulatory changes is timed based on clear, readily observed market conditions as opposed to commission findings regarding the occurrence of broad, ambiguous criteria, (b) refraining from adding to regulatory uncertainty by the frequent introduction of bills to amend statutes, including legislation to reverse regulatory decisions, and (c) encouraging regulators to adopt multiyear commitments for regulatory stability or well-defined regulatory changes;

(2) regulators (a) adopting multiyear commitments for regulatory stability or well-defined regulatory changes, with narrow criteria for waivers or mid-term adjustments, (b) making comprehensive decisions on interrelated regulatory changes, (c) refraining from substantially modifying rules on reconsideration soon after adoption or granting broad waivers, (d) adopting rules with well-defined criteria based on clear, readily observed market conditions as opposed to case-by-case analysis of broad, complex factors, and (e) encouraging industry and consumer groups to work out multiyear agreements on regulatory stability or changes; and

(3) judges giving weight to the benefits of regulatory certainty when reviewing the record evidence or cost/benefit analysis supporting a multiyear or comprehensive agency decision, or a denial of a request for reconsideration or waiver.



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