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## Synthetic Competition

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## SYNTHETIC COMPETITION

by

The Honorable Douglas H. Ginsburg\*

In the 1960s, academic lawyers and economists began focusing upon economic regulation, that is, regulation by an administrative agency typically limiting market entry, fixing prices, and setting other terms of competition. These scholars asked what turned out to be an embarrassing question for regulators and regulated firms alike: Where did economic regulation come from in the first place? In time, the answer to this question and the insight gleaned from it would lead to the deregulation of some industries and the advent of a regulation-driven form of competition, which I call “synthetic competition,” in others. The latter development – a hybrid of New Deal-style economic regulation and orthodox antitrust or competition policy – has challenged many, particularly judges, to reconsider the standards by which agency regulations should be reviewed.

### I

#### NEW DEAL REGULATION

The crucial intellectual event in the creation of the modern regulatory state in the United States was the New Deal experiment with corporatism. Prior to the New Deal, commerce was “regulated” solely on economic grounds almost exclusively through antitrust law, starting with the Sherman Act of 1890<sup>1</sup> and the Federal Trade Commission Act of 1914.<sup>2</sup> Enforced by the Department of Justice and the Federal Trade Commission respectively, these statutes prohibit firms from entering into contracts, combinations, or conspiracies in restraint of trade, and from engaging in anticompetitive behavior and unfair methods of competition;<sup>3</sup> they are not tailored to any specific industry or industries. The New Deal, with its emphasis upon regulation rather than competition and its industry-specific focus, was a

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<sup>1</sup> 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1-7).

<sup>2</sup> 38 Stat. 719 (1914) (codified as amended at 15 U.S.C. §§ 41-45).

<sup>3</sup> See 15 U.S.C. §§ 1, 45(a)(1).

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radical break from orthodox antitrust policy.

The New Deal reached its zenith with the National Industrial Recovery Act (NIRA).<sup>4</sup> The idea of the NIRA was to organize every industry so as to cooperate with government and labor in hope of arresting the then rampant deflation.<sup>5</sup> That is, competition would be limited and prices increased in order to enhance producer surplus, which could then be used first to raise wages, thereby increasing purchasing power and demand, and then to finance the plant expansion necessary to meet that demand. In 1935, however, the Supreme Court held this scheme unconstitutional in *A.L.A. Schechter Poultry Corp. v. United States*.<sup>6</sup>

Although the NIRA failed constitutionally, the industry-specific regimes that accompanied it were upheld after the 1937 “switch in time that saved nine,”<sup>7</sup> when the Supreme Court began upholding New Deal programs in order to stave off President Roosevelt’s infamous court-packing plan. As a result, statutes that might previously have been held unconstitutional were upheld or went unchallenged, including the Agricultural Adjustment Act,<sup>8</sup> the Public Utility Holding Company Act,<sup>9</sup> the Tennessee Valley Authority Act,<sup>10</sup> the Securities Exchange Act,<sup>11</sup> the Glass-Steagall Banking Act,<sup>12</sup> the Civil

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<sup>4</sup> Ch. 90, 48 Stat. 195 (1933).

<sup>5</sup> See A.M. McGahan, *Cooperation in Prices and Capacities: Trade Associations in Brewing After Repeal*, 38 J.L. & ECON. 521, 522 (1995) (The NIRA “was unusual in that it allowed the government to promote cooperation on price in a number of industries for the purpose of combating deflation.”).

<sup>6</sup> *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 537-38 (1935) (“Congress cannot delegate legislative power to the President to exercise an unfettered discretion to make whatever laws he thinks may be needed or advisable for the rehabilitation and expansion of trade or industry.”).

<sup>7</sup> See Barry Friedman, *The History of the Countermajoritarian Difficulty, Part Four: Law’s Politics*, 148 U. PA. L. REV. 971, 973-74 & n.9 (2000) (describing conflicting accounts of origin and wording of phrase); see also *Planned Parenthood of S.E. Pa. v. Casey*, 505 U.S. 833, 998 (1992) (Scalia, J., concurring in judgment in part and dissenting in part) (noting “famous ‘switch in time’”).

<sup>8</sup> Ch. 25, 48 Stat. 31 (1933) (codified as amended at 7 U.S.C. §§ 601 et seq.).

<sup>9</sup> Ch. 687, 49 Stat. 838 (1935) (codified as amended at 15 U.S.C. §§ 79 et seq.).

<sup>10</sup> Ch. 32, 48 Stat. 58 (1933) (codified as amended at 16 U.S.C. §§ 831 et seq.).

<sup>11</sup> Ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a et seq.).

Aeronautics Act,<sup>13</sup> and the Communications Act of 1934,<sup>14</sup> to name but a few. In fact, very substantial portions of the economy – agriculture, finance, transportation, energy, and communications – were subjected to pervasive regulation meant to displace competition by prohibiting or limiting the entry of new firms,<sup>15</sup> regulating prices,<sup>16</sup> and subsidizing certain consumers at the expense of others,<sup>17</sup> all the while co-existing uncontroversially with relatively free markets – e.g., in mining, manufacturing, distribution, and services – in an economy where competition rather than regulation was still presumed to be the norm.

This tolerance for 1930s-style economic regulation persisted into the post-War era, prolonged no doubt by the prosperity of the period. Renewed attention to regulatory economics began only in the late 1960s, as antitrust scholars, both lawyers such as Richard Posner and economists such as George Stigler, schooled to believe that competition is the best “regulator” of markets, entered the field.<sup>18</sup> And competition, of course, maximizes consumer welfare,

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<sup>12</sup> Ch. 89, 48 Stat. 162 (1933) (codified as amended throughout 12 U.S.C.).

<sup>13</sup> Ch. 601, 52 Stat. 973 (1938).

<sup>14</sup> Ch. 652, 48 Stat. 1070 (1934) (codified as amended at 47 U.S.C. §§ 201 et seq.).

<sup>15</sup> See, e.g., Civil Aeronautics Act, Ch. 601, 52 Stat. 973, § 401(a) (1938) (prohibiting any carrier from engaging in air transportation without certificate of public convenience and necessity); see also George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 5 (1971) (analyzing limitations on entry in fields of air transportation and banking).

<sup>16</sup> See, e.g., Richard A. Posner, *Taxation by Regulation*, 2 BELL J. ECON. & MGMT. SCI. 22, 22-23 (1971) (noting price regulation in various industries).

<sup>17</sup> See *id.* at 26-27 (describing indirect subsidies resulting from regulatory pricing systems, particularly with respect to railroads and agriculture); see also Dan Roberts et al., *Deregulation of Fixed Commission Rates in the Securities Industry*, in THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES 151, 152 (Lawrence G. Goldberg & Lawrence J. White eds., 1979) (noting securities reporting requirements “may have the effect of transferring wealth from issuers, brokerage firms, and investors to the securities law and accounting groups”).

<sup>18</sup> See, e.g., Richard A. Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562, 1563 (1969) (describing Sherman Act as “an appropriate weapon to use against noncompetitive pricing in oligopolistic industries”); George J. Stigler, *Mergers and Preventive Antitrust Policy*, 104 U. PA. L. REV. 176, 177 (1955) (analyzing level of “antitrust action . . . necessary to achieve a tolerably satisfactory level of competition”); Richard A. Posner, *The Effects of Deregulation on Competition: The Experience of the*

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not producer surplus.

These scholars observed that many regulated markets were in fact structurally competitive.<sup>19</sup> That is, the regulated markets comprised a large enough number of firms that there was little reason to fear monopoly pricing. In short, there was no obvious economic rationale for their regulation.<sup>20</sup> Such populous but nonetheless regulated industries included: agriculture; airlines; motor carriers; railroads, which although few, faced competition from motor carriers, which were numerous; deposit accounts at financial institutions; stock brokerage; hydroelectric power projects; and, after the technological revolution of microwave and satellite communications, telephone and telecommunications services as well.

Another observation that antitrust scholars made with respect to these regulatory regimes was that private firms are rarely able to sustain cartels or otherwise to collude without the aid of government.<sup>21</sup> In fact, it seemed most plausible to explain economic regulation of structurally competitive industries as merely a device by which government supported industry cartels that

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*United States*, 23 FORDHAM INT'L L.J. 7, 17-18 (2000) [hereinafter *Effects of Deregulation*] (describing benefits of deregulation, including "resulting increases in consumer welfare"); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) (describing price-fixing for brokers' services as "wholly objectionable"). See also Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55, 65 (1968) ("In the case of utilities, . . . It is my belief that the rivalry of the open market place disciplines more effectively than do . . . regulatory processes . . .").

<sup>19</sup> See, e.g., Posner, *supra* note 16, at 38 (noting, "many regulated industries are not monopolistic in structure"); cf. Elizabeth E. Bailey, *Price and Productivity Change Following Deregulation: The U.S. Experience*, 96 ECON. J. 1, 1 (1986) (explaining that, "[e]ven in the presence of natural monopoly characteristics, it is important to isolate those markets which are not yet structurally competitive").

<sup>20</sup> See STEPHEN BREYER, REGULATION AND ITS REFORM 191-314 (Harvard University Press 1982) (demonstrating original economic rationales for regulating each of five industries were generally "mismatched" with the economic reality of these industries).

<sup>21</sup> See MURRAY N. ROTHBARD, MAN, ECONOMY AND STATE 560-660 (Nash Publishing 1962) (maintaining a monopoly or cartel is impossible in the absence of government intervention). Cf. Harold L. Cole & Lee E. Ohanian, *New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis*, 112 J. POL. ECON. 779, 779 (2004) (finding "persistence of the Depression [was due to] New Deal cartelization policies designed to limit competition").

otherwise could not survive and would, in any event, violate the antitrust laws. Indeed, historical research revealed that in many instances, industry-specific economic regulatory regimes had been imposed by government at the request of the industry in question!<sup>22</sup>

The final irony was that the regulated industries did not typically earn monopoly profits under regulation. Instead, regulated firms were either bankrupted by inept regulators, as were the railroads;<sup>23</sup> or they lived a quiet life, as did the AT&T telephone monopoly; or, most commonly, they found loopholes through which to vent their competitive instincts.<sup>24</sup> So it was that in the 1950s and 60s the airlines featured lavish meals, free drinks, first-run

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<sup>22</sup> For example, in 1969 then-Professor Richard Posner wrote:

It is important to note, however, that the reformers and their natural allies (such as farmers and small merchants) might never have succeeded in imposing regulatory controls [of the New Deal] had not many carriers and utilities perceived reasons of self-interest to welcome them . . . as protection against competition. . . . In the late 19th century the railroads in this country attempted to eliminate price competition by forming cartels, but the cartel agreements kept breaking down. Foreseeing – correctly as it turned out – that regulation would dampen price competition by requiring them to adhere to published tariff rates and by limiting discrimination, the railroads threw their weight behind the proposals for an Interstate Commerce Act. The pattern has recurred repeatedly in the history of regulation. . . . The short of it is that regulated firms, perhaps more than their customers, have a powerful economic interest in the continuation of regulation.

Richard A. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 622 (1969) (footnotes omitted). See also Stigler, *supra* note 15, at 3 (stating “central thesis” that, “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit”).

<sup>23</sup> See Staggers Rail Act of 1980, Report of the House of Representatives Committee on Interstate and Foreign Commerce, H.R. REP. NO. 96-1035 (1980), reprinted in 1980 U.S.C.C.A.N. 3978, 3979, 3981-82 (1980) (discussing “financial plight of the railroad industry,” including “huge capital shortfall,” low rate of return on investment, and “[s]even bankrupt railroads [that] created the need for the establishment of Conrail”).

<sup>24</sup> See George J. Stigler, *Price and Non-Price Competition*, 76 J. POL. ECON. 149, 149 (1968) (examining non-price competition in face of uniform price); see also, e.g., Bailey, *supra* note 19, at 2 (discussing the “other forms of competition [that] emerged” when brokers “were not allowed to compete on price”).

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movies, and glamorous stewardesses.<sup>25</sup> By the late 1970s, the regulation of the interest rates that banks could pay to depositors led them instead to attract deposits by giving away everything from toasters to refrigerators.<sup>26</sup>

The New Deal's establishment of industry-specific regulatory regimes presented the federal courts with a dilemma. Courts bore the responsibility of ensuring regulatory agencies complied with applicable laws,<sup>27</sup> yet the courts lacked sufficient industry expertise to determine whether, in a given instance, the agency had adopted a policy or rendered a decision congruent with the aims of the relevant statute(s).<sup>28</sup> In 1946, the Congress enacted the Administrative Procedure Act (APA), the legal framework within which most federal administrative agencies must propose and promulgate regulations.<sup>29</sup>

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<sup>25</sup> See Posner, *Effects of Deregulation*, *supra* note 18, at 18 (describing the “luxurious, glamorous service – symbolized by the piano bars that American Airlines installed in its Boeing 747 airliners”); see also Arthur Donovan, *Intermodal Transportation in Historical Perspective*, 27 TRANSP. L.J. 317, 342-43 (2000) (quoting Alfred E. Kahn, Chairman of the Civil Aeronautics Board, 1977-1978: “Control price, and the result will be artificial stimulus to entry. Control entry as well, and the result will be an artificial stimulus to compete by offering larger commissions to travel agents, advertising, scheduling, free meals, and bigger seats.”).

<sup>26</sup> See Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 303 (1987) (“[T]he government-enforced cartels erected during the 1930s have proven unstable over time due to the tendency of regulated firms to engage in service competition . . . and, most importantly, the incentive of regulated and nonregulated firms alike to innovate around government-created restrictions in order to meet consumer demand . . . .”); See Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 218 (1986) (noting it “was the practice of commercial banks to give premiums, such as free toasters or coffee makers, to new depositors during the era of regulated rates on bank savings deposits”); Eliot N. Vestner, Jr., *Trends and Developments in State Regulation of Banks*, 90 BANKING L.J. 464, 467 (1973) (“The New York newspapers right now carry page after page of full-page bank ads offering toasters, roasters, and many other appliances to the public.”).

<sup>27</sup> See, e.g., Civil Aeronautics Act, Pub. L. No. 75-706, Ch. 601, 52 Stat. 973, § 1003(e) (1938) (providing for “Judicial Enforcement and Review”).

<sup>28</sup> Cf. *Rochester Tel. Corp. v. United States*, 307 U.S. 125, 138-39 (1939) (“Recognition of the Commission’s expertise . . . led this Court not to bind the Commission to common law evidentiary and procedural fetters in enforcing basic procedural safeguards.”).

<sup>29</sup> Pub. L. No. 79-404, Ch. 324, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

Although agency rulemakings are subject to judicial review under the APA, the courts have a very narrow role to play; they are limited to reviewing agency regulations in order to determine whether they are arbitrary and capricious.<sup>30</sup> In practice, this means the courts will defer to an agency's "permissible" interpretation of a statute,<sup>31</sup> and will otherwise approve an agency's course of action unless it is "unreasonable."<sup>32</sup>

## II DEREGULATION

The academic revisionist view of New Deal economic regulation as something that, far from being vaguely protective of the consuming public, was in fact a front for politically powerful industries to shield themselves from competition, was distinctly bipartisan in flavor and enormously influential. Thus, statutory reforms encouraged by the Ford Administration became major legislative successes in the Carter Administration, during which airlines and railroads were substantially deregulated.<sup>33</sup>

But the larger story was not in statutory reform, which is politically difficult to obtain, but rather in the administration of existing statutes. For example, the Securities and Exchange Commission deregulated brokerage commissions in 1975.<sup>34</sup> The Interstate Commerce Commission effectively

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<sup>30</sup> 5 U.S.C. § 706(2)(A); *see, e.g.*, *Sullivan v. Zebley*, 493 U.S. 521, 528 (1990).

<sup>31</sup> *Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984).

<sup>32</sup> *E.g. United States v. Fior D'Italia, Inc.*, 536 U.S. 238, 251 (2002) (considering whether agency action was "unreasonable").

<sup>33</sup> *See* Airline Deregulation Act of 1978, Pub. L. No. 95-504, § 102(a)(10), 92 Stat. 1705 (1978) (policy to "encourage[] . . . entry into air transportation markets by new air carriers . . . so as to assure a more effective, competitive airline industry"); Railroad Revitalization and Regulatory Reform (4R) Act of 1976, Pub. L. No. 94-210, § 101(b)(2), 90 Stat. 31 (1976) (codified at 45 U.S.C. §§ 801 et seq.) (policy to "foster competition among all carriers by railroad and other modes of transportation"); *see also* *Ass'n of Am. R.Rs. v. Surface Transp. Bd.*, 237 F.3d 676, 677 (D.C. Cir. 2001) (noting the 4R Act "largely deregulated railroad rates so that thenceforth the [Interstate Commerce Commission] was authorized to examine a rail carrier's service rate only if it first affirmatively found that the carrier had 'market dominance over such service.'").

<sup>34</sup> *See Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11,203*, 40 Fed. Reg. 7394 (Feb. 20, 1975) (abolishing fixed rates of



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deregulated entry and price for motor carriers.<sup>35</sup> The Comptroller of the Currency even began to allow virtually free entry into banking.<sup>36</sup> The Federal Communications Commission (FCC) allowed intercity telephone competition well before the Antitrust Division of the Department of Justice sought the break up of AT&T.<sup>37</sup> The FCC also deregulated customer premise equipment;<sup>38</sup> threw out its own 1972 regulation of cable television, which had

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commission); *see also* Robert W. Swinarton, *Comment*, in *THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES* 189, 189 (Lawrence G. Goldberg & Lawrence J. White eds. 1979) (praising deregulation as path to a “stronger, healthier, more viable industry”).

<sup>35</sup> *See* Paul Stephen Dempsey, *The Interstate Commerce Commission — Disintegration of an American Legal Institution*, 34 AM. U.L. REV. 1, 4 & n.16 (1984) (citing Commission’s “liberal decisions and rulemakings” and explaining that “[b]y 1979 the ICC was granting ninety-eight percent of the applications filed for motor carrier operating authority”); *see also* William E. Thoms, *Rollin’ On . . . To a Free Market: Motor Carrier Regulation 1935-1980*, 13 TRANSP. L.J. 43, 73 (1983) (whereas in 1970 an application to provide service would, “in all probability, be denied,” by the end of the decade, “the ICC’s emphasis began to change to favor competition”).

<sup>36</sup> *See* Douglas H. Ginsburg, *Interstate Banking*, 9 HOFSTRA L. REV. 1133, 1144 n.31 (1981) (noting that “the average number of new national banks Comptroller Saxon chartered annually during the years 1962-1966 increased to 448% of the average for the years 1957-1961”)(citing G. FISHER, *AMERICAN BANKING STRUCTURE* 212, table 5.3 (1968)). Similarly, in the early 1980s, the Comptroller hastened the entry of nonbanks into the banking industry. *See Developments in Banking Law* 1984, 4 ANN. REV. BANKING L. 1, 1-3 (1985) (“Congress considered, but did not pass, major banking legislation in 1984, leading the Comptroller of the Currency to take further action to deregulate the banking industry by lifting a moratorium on non-bank banks. . . . [For example,] [i]n April 1984, the Office of the Comptroller of the Currency (OCC) approved several charters for the Fleet Financial Group of Rhode Island to set up two new banks in Boston and Hartford. These were the first charters ever approved by the Comptroller under a reciprocal banking system.”) (citing *OCC Approves First New Bank Charters Under New England Regional Compact* [Jan-June] WASH. FIN. REP. (BNA) No. 34 at 716 (April 30, 1984)); *see also* C. T. Conover, Comptroller of the Currency, Remarks Before the Oklahoma Bankers Association (Feb. 8, 1984), in *Comptroller News Release NR 84-10* (advocating deregulation).

<sup>37</sup> *See* Bailey, *supra* note 19, at 4 (discussing FCC decisions from 1959-69 that authorized competitors of AT&T to build networks and noting U.S. Department of Justice did not file suit against AT&T until 1974).

<sup>38</sup> *See Amendment of Section 64.702 of the Commission’s Rules and Regulations (Second Computer Inquiry)*, 77 F.C.C. 2d 384, at para. 161

stifled that technological threat to broadcasters;<sup>39</sup> and relaxed regulation of broadcasting itself, especially regarding so-called “public trustee” functions.<sup>40</sup>

The deregulated markets became increasingly competitive, as predicted by the academic proponents of deregulation and as feared by incumbent managements and labor unions. Real prices declined and innovation increased in air travel, trucking, stock brokerage, and other markets – perhaps most dramatically, in telephone customer premise equipment.<sup>41</sup>

As the tide of deregulation swept away many of the economic regulatory regimes established during the New Deal, orthodox competition policy also underwent a significant change. Before the late 1970s, the federal courts had not agreed upon any single objective behind the antitrust laws.<sup>42</sup>

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(1980) (“We conclude that regulation of carrier-provided [customer premise equipment] under Title II of the Communications Act is no longer warranted.”).

<sup>39</sup> See *Cable Television Program Syndicated Exclusivity Rules*, 79 F.C.C. 2d 663, at para. 1 (1980) (concluding regulation adopted in *Cable Television Report and Order*, 36 F.C.C. 2d 141 (1972) “do[es] not benefit the public and should be eliminated”).

<sup>40</sup> See *Revision of Programming and Commercialization Policies, Ascertainment Requirements, and Program Log Requirements for Commercial Television Stations*, 98 F.C.C. 2d 1075, at para. 2 (1984) (“We find that market incentives will ensure the presentation of programming that responds to community needs and provide sufficient incentives for licensees to become and remain aware of the needs and problems of their communities.”).

<sup>41</sup> See Bailey, *supra* note 19, at 4-15 (noting (1) institutional investors enjoyed price reductions of 50% or more after commissions were unfixed, and small individual investors benefited from “the unbundled (and cheaper) services of discount brokers”; (2) in the airline industry, prices “in the cheaper-to-serve long-haul and dense markets were substantially lowered” and a “diversity of price/service options arose”; (3) in the trucking industry, “[g]oods . . . tended to shift to the least costly mode of delivery, and prices . . . declined substantially” while productivity increased; and (4) in general, “regulatory bureaucrats failed to recognize all of the dimensions in the product-characteristic space, and particularly missed the free-market demand for lower price/lower quality services”).

<sup>42</sup> See Douglas H. Ginsburg, *The Goals of Antitrust Revisited: Comment*, 147 J. INSTITUTIONAL & THEORETICAL ECON. 24 (1991) (noting “the institutionalization of the economic approach” to antitrust law had taken place

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While some courts had focused upon economic considerations, others had been applying the antitrust laws to further socio-political aims, such as minimizing the “helplessness of the individual”<sup>43</sup> and ensuring the “organization of industry in small units.”<sup>44</sup> Even the Supreme Court once made the fate of “small dealers and worthy men”<sup>45</sup> relevant to its interpretation of the Sherman Act. The varied goals endorsed by the Supreme Court were so divisive and contradictory that the famed Judge Learned Hand concluded the Congress had “delegated to the courts the duty of fixing the standard in each case.”<sup>46</sup>

The Supreme Court’s decision in *Continental T.V., Inc. v. GTE Sylvania Inc.*,<sup>47</sup> largely ended the confusion. There the Supreme Court made the maximization of consumer welfare, or allocative efficiency,<sup>48</sup> the chief consideration when applying the antitrust laws.<sup>49</sup>

Because *GTE Sylvania* could be viewed only “as a ringing endorsement of the economic approach to antitrust law,”<sup>50</sup> courts have since

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by “the early 1980s”).

<sup>43</sup> *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 428 (2d Cir. 1945).

<sup>44</sup> *Id.* at 429.

<sup>45</sup> *United States v. Trans-Missouri Freight Ass’n*, 166 U.S. 290, 323 (1897).

<sup>46</sup> *United States v. Associated Press*, 52 F. Supp. 362, 370 (S.D.N.Y. 1943), *aff’d*, 326 U.S. 1 (1945).

<sup>47</sup> 433 U.S. 36 (1977).

<sup>48</sup> In plain terms, “[a]llocative efficiency is present when goods and services are allocated to the uses in which they have the highest value.” *Howard A. Shelanski & J. Gregory Sidak, Antitrust Divestiture in Network Industries*, 68 U. CHI. L. REV. 1, 18 (2001); *see also* PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 148 (McGraw-Hill 16th ed. 1998) (“Allocative efficiency . . . occurs when no possible reorganization of production can make anyone better off without making someone else worse off.”); LLOYD REYNOLDS, *ECONOMICS: A GENERAL INTRODUCTION* 438 (5th ed. 1988) (defining allocative efficiency as “an allocation of productive resources among goods so that price equals the marginal cost for each good produced”).

<sup>49</sup> *Id.* at 54-56; *see also* *N.C.A.A. v. Bd. of Regents of Univ. of Okla.*, 468 U.S. 85, 107 (1984) (“Congress designed the Sherman Act as a ‘consumer welfare prescription.’”).

<sup>50</sup> Timothy J. Muris, *GTE Sylvania and the Empirical Foundations of Antitrust*, 68 ANTITRUST L.J. 899, 900 (2001). *See also* Douglas H. Ginsburg, *The Effect of GTE Sylvania on Antitrust Jurisprudence: Vertical Restraints: De Facto Legality Under the Rule of Reason*, 60 ANTITRUST L.J. 67, 67, 69 (1991) (“[N]on-monopolists have been effectively freed from antitrust

relied heavily upon economic analysis to determine the effect of a practice or proposed transaction on allocative efficiency in the relevant market.<sup>51</sup> With the advent of deregulation, orthodox competition policy, with its focus upon consumer welfare, was applied to industries newly freed from the shackles of New Deal economic regulation.

### III “SYNTHETIC COMPETITION”

Of course, not all sectoral regulation was repealed or even relaxed – particularly in network industries such as electric power and local telephony. In those industries, the deregulatory revolution took the form of scaling back the regulated functions to the perceived practical minimum, that is, to encompass only functions that, with current technology, are thought still to be so-called “natural monopolies,” in which competition would entail duplication of facilities and hence wasteful investment.<sup>52</sup> The result has been what I am calling “synthetic competition”<sup>53</sup> – that is, a market subject to a regulatory regime designed to assure there are multiple sellers regardless whether fewer

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regulation of vertical nonprice restraints” because the court in *GTE Sylvania* focused upon ‘consumers’ interest in efficient distribution.”).

<sup>51</sup> See, e.g., *State Oil Co. v. Khan*, 522 U.S. 3, 15-19 (1997) (engaging in economic analysis before rejecting per se rule against vertically imposed maximum prices).

<sup>52</sup> See ALFRED E. KAHN, 2 *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 123 (1971) (implying deregulation of “natural monopolies” would result in wasteful duplication because “one company can serve any given number of subscribers . . . at a lower cost than two”) (emphasis omitted).

<sup>53</sup> See *U.S. Telecomm. Ass’n v. FCC*, 290 F.3d 415, 424 (D.C. Cir. 2002) (noting the FCC was “unwilling to embrace the idea that . . . completely synthetic competition would fulfill Congress’s purposes”). Some commentators have recognized the synthetic nature of these regimes, but use other terms to describe them. See, e.g., J. Gregory Sidak & Daniel F. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements Under the Telecommunications Act of 1996*, 97 COLUM. L. REV. 1081, 1158-59 (1997) (“Within six months [of the passage of the Telecommunications Act of 1996], . . . it became clear that the legislation could not properly be called deregulation. Rather, it was managed competition or, to coin a new oxymoron, ‘competition through regulation.’”); Jim Chen, *The Legal Process and Political Economy of Telecommunications Reform*, 97 COLUM. L. REV. 835, 836 (1997) (“We are not witnessing the destruction of a legal scheme, but rather a cataclysmic reinvention of economic regulation.”).

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firms, perhaps only one, would be more efficient.<sup>54</sup>

Electric power is one industry in which regulators have attempted to manufacture “competition.”<sup>55</sup> Similar to a local telephone monopoly, a single company typically owns all the wires running into consumers’ homes and businesses in a defined geographic area.<sup>56</sup> Unable efficiently to replicate these and other critical elements of the incumbent utility’s network, potential competitors in the past have been unable to enter wholesale or retail electric markets.

In the 1990s, the Federal Energy Regulatory Commission sought to generate competition in the wholesale markets for power by mandating that incumbents lease or otherwise make available to other utilities certain of their physical assets.<sup>57</sup> Retail electric markets, subject to state regulation, have also

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<sup>54</sup> See Posner, *Effects of Deregulation*, *supra* note 18, at 12 (referencing “industries in which economies of scale are so large in relation to demand that one firm can serve the entire market at lower average cost than two or more firms”).

<sup>55</sup> See J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. REV. 851, 875 (1996) (“[R]egulators recently have been empowered to require an electric utility to transmit power for others – that is, to ‘wheel’ power over its transmission and distribution network that has been generated by competitors.”).

<sup>56</sup> See Kahn, *supra* note 52, at 276 (explaining “[t]he distribution of electricity [is a] franchised local monopol[y]”); Christopher R. Knittel, *Market Structure and the Pricing of Electricity and Natural Gas*, 51 J. INDUSTR. ECON. 167, 169-71 (2003) (describing industry background).

<sup>57</sup> See *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities*, Order No. 888, 61 Fed. Reg. 21,540, 21,541 (order “designed to remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation’s electricity consumers”), *clarified*, 76 F.E.R.C. ¶ 61,347 (1996), *on reh’g*, Order No. 888-A, 62 Fed. Reg. 12,274, *clarified*, 79 F.E.R.C. ¶ 61,182, *on reh’g*, Order No. 888-B, 81 F.E.R.C. ¶ 61,248, 62 Fed. Reg. 64,688 (1997), *on reh’g*, Order no. 888-C, 82 F.E.R.C. ¶ 61,046 (1998), *aff’d sub nom*; Transmission Access Policy Study Group v. F.E.R.C., 225 F.3d 667 (D.C. Cir. 2000), *aff’d sub nom*; N. Y. v. F.E.R.C., 535 U.S. 1 (2002); *see also* The Hon. Richard D. Cudahy & William D. Henderson, *From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons*, 26 ENERGY L.J. 35, 108 (2005) (“In general, wholesale deregulation, as provided by FERC Order 888, has met with deserved success, primarily . . . because of the basic requirement of open access transmission.”).

been re-regulated so as to induce synthetic competition. By 2000, at least 12 states had established regulatory regimes that “included the unbundling of the retail supply of generation services from the supply of distribution and transmission service [thereby] giving retail customers . . . the opportunity to choose their power supplier from among competing retail suppliers.”<sup>58</sup> The central aim of both the federal and state initiatives has not been “deregulation” but the entry of additional providers into local markets to “compete” with the incumbent utility.<sup>59</sup>

Similarly, in telephony, the newly competitive long distance business was separated from local service, which remained monopolistic. With the Telecommunications Act of 1996 (Telecom Act) the Congress acted to introduce competition into local service as well. The Act directs the FCC to require the incumbent monopolists to provide equal access to would-be competitors so they may use, for a fee, the incumbent’s local distribution network, or such elements of that network as they want to lease rather than build their own facilities.<sup>60</sup>

Regardless whether these efforts to introduce “competition” are deemed successful – and the interested parties disagree fervently on this – or whether it is still too soon to know,<sup>61</sup> the new competition-inducing regulatory

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<sup>58</sup> Paul L. Joskow, *The Difficult Transition to Competitive Electricity Markets in the U.S.* 2 AEI-Brookings Joint Center for Regulatory Studies (July 2003); see also Clyde Wayne Crews, Jr., *Electric Avenues: Why “Open Access” Can’t Compete*, CATO POL’Y REP. No. 301 (Apr. 13, 1998) (“The centerpiece of the regulatory changes is called mandatory open access, under which electricity producers have the right to sell to whomever they choose at the retail level across the wires of the incumbent utility.”).

<sup>59</sup> See Richard L. Gordon, *Don’t Restructure Electricity; Deregulate*, 20 CATO J. 327, 351-52 (2001) (warning that the “regulators’ reluctance” fully to deregulate “will severely hinder evolution and overextended battles will prevail”).

<sup>60</sup> See Telecommunications Act of 1996, Pub. L. 104-104, § 251(c)(3), 110 Stat. 56 (codified at 47 U.S.C. § 251(c)(3)) (Incumbent carriers have “[t]he duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory. . . .”).

<sup>61</sup> At present, there is no academic consensus on the success of these regimes of “synthetic competition.” Compare, e.g., Jim Chen, *The Nature of the Public Utility: Infrastructure, the Market, and the Law*, 98 NW. U. L. REV. 1617,

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regimes pose certain challenges to courts when disputes arise between the regulator, on the one hand, and on the other hand, either the incumbent monopolist, would-be new entrants, or consumer representatives. More important, courts are struggling to gauge the appropriate degree of deference to be afforded to agencies administering such regimes. The central problem is that the “competition” induced by regulation may bear only a superficial resemblance to the competition that takes place in an unregulated market – the domain of competition policy as we have known it since 1890.

In a regulated market, the regulator’s goal may be the creation and maintenance of a multi-firm market not because it is necessarily more efficient but for other reasons. To be sure, a market with competing firms seems more likely to achieve productive efficiency, that is, to produce a given level of output at a lower total cost than would a monopolist.<sup>62</sup> But productive efficiency is very different from allocative efficiency, the aim of true competition policy, which is concerned with optimizing the level of output, as

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1706 (2004) (“Whatever its past failures, regulation in the United States is slowly becoming more rational and more effective. . . . [T]he Telecommunications Act of 1996 is a success.”) (footnote omitted) *with, e.g.,* Richard A. Epstein, *Takings, Commons, and Associations: Why the Telecommunications Act of 1996 Misfired*, 22 YALE J. ON REG. 315, 336-47 (2005) (describing “The Structural Flaws of Telecom Regulation”).

<sup>62</sup> The reasons for this, if it is true, seems to be more psychological than economic; a regulated monopolist, after all, has the same incentive to control costs as does a competitor since it can capture the market-wide savings, at least for a time, through regulatory lag. See Kahn, *supra* note 52, at 48 (defining “regulatory lag” as “the inevitable delay that regulation imposes in the downward adjustment of rate levels that produce excessive rates of return and in the upward adjustments ordinarily called for if profits are too low”); see also Paul L. Joskow & Roger G. Noll, *The Bell Doctrine: Applications in Telecommunications, Electricity, and Other Network Industries*, 51 STAN. L. REV. 1249, 1261 (1999) (“Regulatory lag . . . creates a situation where regulated firms can increase their profits from efficiency improvements and increased sales and vice versa.”); Stephen F. Williams, *Deregulatory Takings and Breach of the Regulatory Contract: A Comment*, 71 N.Y.U. L. Rev. 1000, 1001 (1996) (“The price-regulated natural monopolist has relatively weak incentives to be efficient, as any saving in costs will soon be met by a reduction in the ceiling price, and an increase in costs will result in higher ceilings – yet ceilings calculated so as to still allow full recovery of costs even if the price increase reduces sales. The qualifier here, of course, is regulatory lag, which enables the firm to profit temporarily (i.e., between rate cases) from an efficient innovation and forces it to suffer temporarily from any new inefficiency.”).

reflected in the satisfaction of consumer wants.<sup>63</sup>

In synthetic competition, the preferences of regulators – not consumers – are paramount. And merely because the regulator expresses a demand for having multiple providers – so it can give consumers the benefits of choice and perhaps the appearance of efficiency – does not mean the regulator is interested in allocative efficiency. In fact, regulatory agencies may adopt policies that reduce allocative efficiency, either by inducing and subsidizing an inefficient level of entry or by constricting entry below the level that would obtain in an unregulated market.

Yet this should not be surprising; regulation is by nature designed to make firms achieve ends other than those they would pursue in an unregulated market – ends that serve the political goals of the regulator. If this were not true, then there would be no need for regulation in the first place. For example, in local telephony, the political goal of having universal service has always trumped the inefficiency of providing subsidized service to residential users, especially in sparsely populated regions, such as Alaska or the rural West.<sup>64</sup>

Indeed, the current regime of synthetic competition is akin more to a form of “industrial policy” than to orthodox competition policy.<sup>65</sup> Industrial

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<sup>63</sup> See Posner, *Effects of Deregulation*, *supra* note 18, at 18 (“Competition is not a matter of many sellers . . . [but rather is] the state in which resources are deployed with maximum efficiency, and it is not so much the existence of actual rivalry, let alone any specific market structure or behavior, as the potential for rivalry, that assures competition.”); *see also* Stephen G. Breyer, *Antitrust, Deregulation, and the Newly Liberated Marketplace*, 75 CAL. L. REV. 1005, 1010 (1987) (evidence in the airline industry suggests “the reformers were right: Competition has yielded benefits to consumers.”).

<sup>64</sup> See Allen S. Hammond, IV, *Universal Service: Problems, Solutions, and Responsive Policies*, 57 FED. COMM. L.J. 187, 187-88 (2005) (“The federal universal service policy [has been] critical to ensuring affordable access for low income Americans and those living in rural and high cost areas, and on tribal lands.”); Alexander C. Larson & Margarete Z. Starkey, *Unbundling Issues and U.S. Telecommunications Policy*, 6 STAN. L. & POL’Y REV. 83, 92 (1994) (“[I]nefficient pricing was implemented to help meet the universal service goal of the Communications Act of 1934, a goal that largely has been achieved.”).

<sup>65</sup> See James C. Miller III et al., *Industrial Policy: Reindustrialization Through Competition or Coordinated Action?*, 2 YALE J. ON REG. 1, 10-20 (1984) (tracing history of industrial policy in the United States and rejecting



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policy has historically meant shielding firms from the rigors of competition in order to achieve a policy goal, by which I mean not necessarily a more worthy goal but one beyond the capacity, or contrary to the self-interest, of a firm constrained by competition.<sup>66</sup> Competition, after all, leaves no room for cross-subsidization of (politically) favored consumers.

Likewise, with the milder forms of industrial policy known in France by terms such as “indicative planning,”<sup>67</sup> the government’s wishes are carried out by firms through a policy mix of taxes, subsidies, and jawboning. The aim of industrial policy may be mercantilist, as in the protection of “infant” or “strategic” industries,<sup>68</sup> or more overtly geopolitical, as in the nurturing of a “national champion”<sup>69</sup> firm to fly the flag in international markets. The

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the assertion that, “through tripartite (business, labor, and government) cooperation, government can ‘guide’ leading industries to successful growth opportunities.”).

<sup>66</sup> See Mitsuo Matsushita, *The Intersection of Industrial Policy and Competition: The Japanese Experience*, 72 CHI.-KENT L. REV. 477 (1996) (defining “industrial policies as ‘those policies designed to cope with the market failure in the allocation of resources[,]’ [which] includes measures to deal with externalities, anticompetitive structures and conducts, promotion of economy of scale, infant industries, basic research and development (R&D), and elimination of uncertainty in industrial development”) (quoting RYUTARO KOMIYA ET AL., *NIHON NO SANGYEO SEISAKU* 40 (Industrial Policy in Japan) (1984)).

<sup>67</sup> See Miller, et al., *supra* note 65, at 20-27 (discussing “‘indicative planning’ policies” of Japan, West Germany, and France); see also Robert Cooter, “*Can Lawyers Say Anything about Economic Growth?*” *Comment on Frank Cross’s Law and Economic Growth*, 80 TEX. L. REV. 1777, 1777 (2002) (“In recent years . . . states have abandoned not only centralized planning, as in the communist countries, but also indicative planning, as in France.”).

<sup>68</sup> See, e.g., Michael Hart, *The Chimera of Industrial Policy: Yesterday, Today and Tomorrow*, 19 CAN.-U.S. L.J. 19, 27 (1993) (“It is currently fashionable to insist on the merits of ‘high-tech’ or ‘strategic’ rather than ‘infant’ industries and to find much to worry about in trade statistics that show a deficit in such sectors. From an industrial policy perspective, such activities must be promoted and protected by the political authorities because without political intervention, these activities might disappear or fail to materialize, victims of international trade and competition.”).

<sup>69</sup> See Donald Baker, *Antitrust Merger Review in an Era of Escalating Cross-Border Transactions and Effects*, 18 WIS. INTL L.J. 577, 578 (2000) (stating a central aim of “industrial policy” is “preserving the separate identity of leading local companies and creating (or preserving) national champions”); see generally PETER NOLAN, *CHINA AND THE GLOBAL ECONOMY: NATIONAL*

cultivation of national champions, once the policy of European airline regulators, has more recently, it seems, surfaced in other industries, such as pharmaceuticals and natural gas.<sup>70</sup>

Going beyond the comparison to industrial policy, the nature of synthetic competition can be further illuminated by contrasting it with orthodox competition policy. For one thing, competition policy is ordinarily pursued on a law-enforcement paradigm. Under this model, the law condemns certain broadly-defined conduct, such as price-fixing and the abuse of a firm's dominant market position. Firms decide for themselves how to behave and – with the exception of the relatively recent innovation of pre-merger review<sup>71</sup> – the government, or a private party claiming to have been harmed, seeks redress *ex post*. The question whether the firm violated a norm of competition policy is ultimately decided by a court. Hence the law enforcement model: Firms do not need pre-approval, but they do act at their peril.

Synthetic competition, however, follows the model of industrial policy, in that the government's preferences are expressed *ex ante* – in a regulation with which the firms must comply. To bring out the contrast, consider the conventionally regulated local telephone company that must seek permission to change its posted prices or its business practices, or to add or abandon facilities; compare it with an unregulated provider of long-distance telephone service that may do any of these things at will, subject to the possibility that the government (or a competitor) will bring an antitrust suit *ex post* in order to force a change in the practice or price and, in a government case, to impose a fine or, in a private case, to recover damages. A court that

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CHAMPIONS, INDUSTRIAL POLICY AND THE BIG BUSINESS REVOLUTION 218 (2001) (describing the phenomenon in the context of China).

<sup>70</sup> See Anita Raghavan, et al., *Sanofi to Swallow Aventis in a Deal Set at \$65 Billion – French Government Played Pivotal Role in Its Desire for a “National Champion,”* WALL ST. J., Apr. 26, 2004, at A1; *A Magician Loses His Touch; French Industrial Policy*, ECONOMIST, June 24, 2006 (discussing proposed combination of Gaz de France, a state-controlled gas utility, and Suez, a private water and power company, “to create a French energy giant in the name of ‘economic patriotism’ – and, in doing so, pre-empt a possible rival Italian bid for Suez”).

<sup>71</sup> See Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435, § 201, 90 Stat. 1383 (1976) (codified at 15 U.S.C. § 18a) (requiring pre-merger notification and waiting period for certain transactions); *cf.* KY P. EWING, COMPETITION RULES FOR THE 21ST CENTURY: PRINCIPLES FROM AMERICA'S EXPERIENCE, 32-41 (2003) (suggesting reconsideration of pre-merger review).

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views a challenge to a regulatory decision imposed in the name of fostering competition in the same way it would view a challenge to a business practice alleged to be anticompetitive, is in grave danger of enmeshing itself in regulatory policies as to which it has neither expertise nor legitimacy.

With the Supreme Court's adoption of the consumer welfare rationale in the late 1970s, antitrust law has become ever more solidly grounded in economics. Today the concern of governmental authorities is exclusively with the economic justification for prohibiting a business practice or a proposed transaction.<sup>72</sup> The Antitrust Division of the Department of Justice and the Federal Trade Commission have given not only economic reasoning but professional economists a virtual veto over the pursuit of cases unsupported by a persuasive economic theory of harm to consumers.<sup>73</sup> The courts of the EU seem to be trending in the same direction, though at least until recently they have been leading rather than following the enforcement agency.<sup>74</sup>

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<sup>72</sup> See generally William J. Baer & David A. Balto, *The Politics of Federal Antitrust Enforcement*, 23 HARV. J.L. & PUB. POL'Y 113, 120 (1999):

Federal antitrust enforcement has changed considerably since the early 1970s. The main shift in focus has been that rigorous economic analysis of markets and competition has become the norm for both the agencies and the courts. Scholarly research, much of it initiated by the "Chicago School," exposed the inconsistencies and sloppiness of some prior antitrust thinking. Today, courts and antitrust enforcers rely much less on structural presumptions and more on the consumer welfare standard of anticompetitive harm. A case will not be filed unless there is a compelling anticompetitive justification.

<sup>73</sup> See William E. Kovacic, *The Modern Evolution of U.S. Competition Policy Enforcement Norms*, 71 ANTITRUST L.J. 377, 400 (2003) (noting "[t]he elevation within the Antitrust Division and the FTC in the 1970s of the role of economists in the decision to prosecute"); DEP'T OF JUSTICE & FTC, HORIZONTAL MERGER GUIDELINES § 4 (1997) ("The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market. . . . [T]he Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market . . .").

<sup>74</sup> See, e.g., Case T-210/01, *General Electric Co. v. Comm'n of the European Communities*, 2005 E.C.R. II-0000, para. 426 (upholding decision to block the GE-Honeywell merger but acknowledging that the Commission's analysis [was] "vitiating . . . by a number of manifest errors of assessment"); Case T-5/02, *Tetra Laval BV v. Comm'n of the European Communities*, 2002 E.C.R. II-4381 (requiring demonstration of likelihood of competitive harm and holding Commission erred in blocking merger); Case T-342/99, *Airtours Plc*

Synthetic competition cases cannot withstand the same scrutiny for economic justification simply because synthetic competition regimes are not shaped by the single-minded pursuit of economic efficiency. A fitting way to illustrate the problem of courts applying efficiency-driven antitrust law to a market characterized by synthetic competition is to examine the majority and dissenting opinions in the Supreme Court case of *Verizon v. FCC*, the so-called “TELRIC” case.<sup>75</sup>

Local telephony markets, which had remained regulated monopolies through the 1980s and mid-90s while long-distance services were deregulated, became subject to a regime of synthetic competition as a result of the 1996 Telecom Act. That Act directs the FCC to mandate that incumbent local exchange carriers make elements of their network available to competitive local exchange carriers if their not doing so would “impair” competition.<sup>76</sup> Network elements subject to this so-called “unbundling” requirement include any “facility or equipment used in the provision of a telecommunications service.”<sup>77</sup> The most obvious candidate for unbundling has been the copper wire “loop” used to carry telephone calls over the “last mile” into users’ homes.

In addition to responsibility for determining periodically the elements to be unbundled, the Act charges the FCC with regulating the price at which a competitive carrier may purchase or lease unbundled network elements

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v. Comm’n of the European Communities, 2002 E.C.R. II-2585 (noting the Commission’s lack of convincing or cogent evidence and concluding the Commission erred in blocking the merger); Case T-310/01, *Schneider Electric SA v. Comm’n of the European Communities*, 2002 E.C.R. II-4071 (holding the Commission’s reasoning was flawed because it failed to consider, among other things, the competitive effect of vertically integrated sales); *see also* David Fairlamb, *They’re Changing the Face of Europe*, BUSINESS WEEK, Nov. 3, 2003 (noting the European Court of First Instance has “do[ne] battle with the policymakers of Brussels” by rejecting the decisions of European Competition Commissioner Mario Monti “in three big mergers cases,” concluding in one that Commissioner Monti “had not presented a convincing case to support his decision to block” a merger); Paul Meller, *Court Says Commission Was Wrong To Block Tetra Merger*, INT’L HERALD TRIB., Feb. 16, 2005 (discussing ruling of European Court of Justice that European Commission “was wrong to block the merger of two giant European packaging firms”).

<sup>75</sup> *Verizon Commc’ns, Inc. v. FCC*, 535 U.S. 467 (2002).

<sup>76</sup> 47 U.S.C. § 251(c)-(d).

<sup>77</sup> *Id.* § 153(29).

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(UNEs) from the incumbent carrier. The FCC must ensure the prescribed price is “just and reasonable,” which under the Act means the price is “based on the cost . . . of providing the . . . network element.”<sup>78</sup>

Shortly after passage of the Act, the FCC issued a regulation providing that prices for UNEs were to be set in accordance with forward-looking rather than historical costs, by which they meant the expenditures that would presently be required to develop and to maintain the element.<sup>79</sup> More specifically, these forward-looking costs are meant primarily<sup>80</sup> to reflect the “total element long-run incremental cost” (TELRIC) of maintaining an element in an incumbent’s network. The TELRIC calculation is based upon the projected costs of “the most efficient telecommunications technology currently available and the lowest cost network configuration” possible, taking as given the incumbent’s wire center locations.<sup>81</sup> Naturally, incumbent carriers protested the TELRIC methodology because UNE prices would inevitably be lower than the actual cost of maintaining the elements in the network – especially for those incumbents with older, less efficient networks.

The Supreme Court upheld the FCC’s regulation governing the pricing of UNEs on the ground that the Act could not be said to *preclude* the way in which the FCC interpreted the statutory term “cost” as it applied to the elements of an incumbent carrier’s network.<sup>82</sup> Moreover, that interpretation was not shown, as a factual matter, either to deprive the incumbent of a return on its investment or so to discourage investment in facilities by new entrants as to frustrate rather than to further the statutory and regulatory goal of creating a multifirm market in local exchange service.<sup>83</sup>

Even so, the Court made clear that the question “[w]hether the FCC picked the best way to set these rates is the stuff of debate for economists and regulators versed in the technology of telecommunications and microeconomic pricing theory.”<sup>84</sup> Its own task, said the Court, was simply “to ask whether the Commission made choices reasonably within the pale of statutory possibility in deciding what and how items must be leased and the

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<sup>78</sup> *Id.* § 252(d)(1)(A)(i).

<sup>79</sup> *In re Implementation of Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C.R. 15,499, 15,844-15,849 (1996).

<sup>80</sup> Under the regulation, UNE prices comprise, in addition to the TELRIC component, “a reasonable allocation of forward-looking joint and common costs.” *Id.* at 15,844.

<sup>81</sup> *Id.* at 16,218.

<sup>82</sup> *Verizon*, 535 U.S. 467 at 539.

<sup>83</sup> *Id.* at 503-23.

<sup>84</sup> *Id.* at 539.

way to set rates for leasing them.”<sup>85</sup> Because the FCC’s TELRIC methodology was neither inconsistent with the text of the statute nor contrary to its underlying objective of “promot[ing] competition and reduce[ing] regulation,” the Court upheld the Commission’s pricing scheme.<sup>86</sup>

Only Justice Breyer dissented from the Court’s sanctioning of TELRIC, and he did so on what seems to be more a ground of competition policy than of administrative law. Although Justice Breyer “assume[d] that Congress intended to grant the Commission broad legal leeway in respect to the substantive content of the rules,” he contended the FCC had nonetheless acted unreasonably.<sup>87</sup> He argued the FCC’s “regulations entitle the new entrant to a price equal to, or lower than, the price to which any rational incumbent could agree” in leasing UNEs to a new entrant.<sup>88</sup> More importantly, he contended that under TELRIC prices, the “new entrant will uneconomically share the incumbent’s facilities by leasing rather than building or buying elsewhere.”<sup>89</sup> The result, Justice Breyer noted, would be “wasteful” and thus contrary to “the efficiency goal . . . the Act seeks to achieve.”<sup>90</sup>

Of course, a court may be called upon to say whether a regulatory decision is substantively unreasonable. And whether a regulation seems unreasonable must reflect to some extent the judge’s understanding of the underlying economics. For instance, a regulation that is implicitly premised upon the idea that consumers will demand the same quantity of a good at two different prices (e.g., when the price rises to cover a cost imposed by regulation) seems presumptively unreasonable to the economically literate observer.

In *Verizon*, Justice Breyer appears to have assumed that economic principles applicable to authentic competition hold true for “synthetic competition” as well. In an authentically competitive market, TELRIC pricing would no doubt discourage a new entrant from investing in facilities and thus hinder, rather than advance, efficient entry. Several empirical studies, however, suggest that the pricing methodology for UNEs has less influence

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<sup>85</sup> *Id.*

<sup>86</sup> Preamble, Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996); see *Verizon*, 535 U.S. 467 at 539.

<sup>87</sup> *Verizon*, 535 U.S. 467 at 541-42 (Breyer, J., concurring in part and dissenting in part).

<sup>88</sup> *Id.* at 553.

<sup>89</sup> *Id.* at 550.

<sup>90</sup> *Id.*

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upon whether there is entry into a local telephony market than do other factors, such as whether new entrants are likely to achieve economies of scale; potential non-price discrimination by the incumbent carrier; and the difficulty of getting financial backing for a business that depends upon favorable regulation (i.e., low UNE rates) continuing into the future.<sup>91</sup> One such study concludes that because “the level of UNE rates might or might not facilitate competitive entry, it is difficult to see how the Court could . . . [argue] that TELRIC was incompatible with the purposes of the Act.”<sup>92</sup>

A second problem with Justice Breyer’s analysis is his apparent focus upon allocative efficiency to the exclusion of other statutory aims, as would be proper in antitrust law but I think inappropriate when reviewing administrative regulations pursuant to a regime of “synthetic competition.” Though it passed the Act in part “to secure lower prices for . . . consumers,” the Congress primarily sought “to promote competition.”<sup>93</sup> Simply put, the Congress did not empower the FCC merely to deregulate the local telephony market. Rather, the Congress directed the Commission to establish a market comprised of multiple carriers which, in turn, it presumably hoped would provide at least choice and perhaps lower prices for consumers; whether that market would also be efficient was at best a secondary consideration. By construing the term “cost” to mean the forward-looking costs of maintaining a hypothetical, perfectly efficient network, the FCC reasonably believed it was furthering the central objective of the Act, namely, to induce the entry of new carriers into local telephony markets.

The decision in *Verizon* was not the last word on the FCC’s attempt to implement the synthetic competition regime of the Telecom Act. The Supreme Court upheld the pricing methodology pursuant to which the FCC would require incumbent exchange providers to lease unbundled elements to competitors, but it remained for the FCC to determine what elements should be unbundled – a process that would repeatedly bring synthetic competition back into the courtroom. Since 1999, the FCC has made four successive attempts to promulgate a regulation unbundling those network elements without access to which it believed competition among exchange carriers

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<sup>91</sup> Dale E. Lehman, *The Court’s Divide*, 1 REV. OF NETWORK ECON. 106, 114 (2002); see also ROBERT W. CRANDALL, AN ASSESSMENT OF THE COMPETITIVE LOCAL EXCHANGE CARRIERS FIVE YEARS AFTER THE PASSAGE OF THE TELECOMMUNICATIONS ACT 41-42 (2002) (finding “strong evidence that building one’s own network” is more important in determining successful entry than “relying on UNEs”).

<sup>92</sup> Lehman, *supra* note 91, at 114.

<sup>93</sup> Preamble, Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996).

would be “impair[ed].”<sup>94</sup> The Supreme Court rejected the first regulation,<sup>95</sup> and the court of appeals vacated the next two.<sup>96</sup> Only in 2006, a decade after passage of the Act, did the FCC finally prevail in unbundling certain high-capacity loops.<sup>97</sup> Whether the courts have adhered to a consistent level of deference is debatable.<sup>98</sup> With more unbundling likely in the telecommunications and electric power industries and perhaps other network industries, defining the proper role of the judiciary in reviewing synthetic competition regulations has become all the more acute.

What is the conclusion to be drawn? To be sure, the courts legitimately may – and should – continue their drive, in the United States and in the EU, to put real antitrust law on a solid footing of economic theory and to require

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<sup>94</sup> See *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 F.C.C.R. 15499 (1996) (First Report and Order); *In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 F.C.C.R. 3696 (1999) (Third Report and Order); *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 F.C.C.R. 16978 (2003) (Triennial Review Order); *In the Matter of Unbundled Access to Network Elements*, Order on Remand, 20 F.C.C.R. 2533 (2005) (Remand Order).

<sup>95</sup> See *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 389-92 (1999) (rejecting FCC’s impairment standard in First Report and Order as excessively broad).

<sup>96</sup> See *U.S. Telecomm. Ass’n v. FCC*, 290 F.3d 415, 427 (D.C. Cir. 2002) (rejecting revised standard for impairment in Third Report and Order because FCC did not consider, among other things, circumstances “that would make genuinely competitive provision of an element’s function wasteful”); *U.S. Telecomm. Ass’n v. FCC*, 359 F.3d 554, 576 (D.C. Cir. 2004) (holding the “touchstone” of impairment in the Triennial Review Order – “uneconomic” entry – was vague and therefore inconsistent with the Act).

<sup>97</sup> See *Covad Commc’ns Co. v. FCC*, 450 F.3d 528 (D.C. Cir. 2006) (holding FCC’s finding of impairment and decision to unbundle certain high-capacity loops in Remand Order was “reasonable”).

<sup>98</sup> Compare *U.S. Telecomm. Ass’n v. FCC*, 359 F.3d at 570 (criticizing the FCC for not “identifying criteria based, for example, on an [incumbent carrier’s] track record for speed and volume in a market, integrated with some projection of the demand increase that would result from withholding of switches as UNEs”) with *Covad Commc’ns Co.*, 450 F.3d at 543 (“Congress gave the Commission-not the [parties] or this Court-discretion in regulatory line-drawing.”).



## SYNTHETIC COMPETITION

sophisticated economic evidence from the party bearing the burden of proof. At the same time, however, they should recognize that it would be a mistake to review an administrative decision involving synthetic competition with the same degree of scrutiny as they do an antitrust case. The probability of a court improving upon the performance of a synthetic market structured by an administrative agency charged with regulating the industry in question is slim to none. It is my submission that the best a court can do is to enforce procedural regularity and the requirement that regulators offer some reasonable justification for the way they have introduced or structured “competition,” sufficient to show they understand and have considered the likely implications of their handiwork.

The polymath Goethe captured the idea when he stated, “The man with insight enough to admit his limitations comes nearest to perfection.”<sup>99</sup> Translated to the present context, that means courts, when reviewing an agency decision concerning synthetic competition, must acknowledge their own limitations and, in particular, the essential irrelevance of antitrust law and economics. So long as the agency action under review is neither inconsistent with the governing statute nor “arbitrary and capricious,” we should grit our teeth, and if necessary hold our noses, but let it pass through our precincts unmolested.

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<sup>99</sup> JOHANN WOLFGANG VON GOETHE, *MAXIMS AND REFLECTIONS* 151 (Elizabeth Stopp trans. & Peter Hutchinson ed., Penguin Classics 1998).