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FEDERAL TRADE COMMISSION

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WITNESS:

EXAMINATION

None.

E X H I B I T S

FOR IDENTIFICATION

Commission's:

None.

FEDERAL TRADE COMMISSION

In the Matter of:)
)
) Docket No.: P951201
HEARINGS ON GLOBAL AND)
INNOVATION-BASED COMPETITION)

Thursday,
November 30, 1995

Federal Trade Commission
Sixth and Pennsylvania Avenues
Room 432
Washington, D.C. 20580

The above-entitled matter came on for hearing,
pursuant to notice, at 9:18 a.m.

SPEAKERS:

ROBERT PITOFSKY
Chairman, Federal Trade Commission

JANET D. STEIGER
Commissioner, Federal Trade Commission

CHRISTINE A. VARNEY
Commissioner, Federal Trade Commission

BECKY BURR
Attorney/Advisor to Commissioner Varney

SPEAKERS (Continued):

SUSAN S. DE SANTI
Director, Policy Planning

DEBRA VALENTINE
Deputy Director, Policy Planning

MARK WHITENER
Deputy Director, Bureau of Competition

JOHN HILKE
Economist, Bureau of Economics

MICHAEL ANTALICS
Assistant Director for Non-Merger
General Litigation I Division,
Bureau of Competition

WILLIARD K. TOM
Director for Policy and Evaluation,
Bureau of Competition

WILLIAM E. COHEN
Project Director for Innovation,
Policy Planning

THOMAS R. IOSSO
Economist, Bureau of Economics

TIMOTHY BRESNAHAN
Professor, Stanford University,
Sloan Foundation Computer Study

MICHAEL MORRIS
SUN Microsystems

MARSHALL PHELPS
IBM

RUSSELL WAYMAN
Storage Technology

EDWARD J. BLACK
Computer & Communications Industry Association

SPEAKERS (Continued):

EMERY SIMON

Alliance to Promote Software Innovation

STANLEY BESEN

Charles River Associates

L. NORTON CUTLER

US WEST

DUNCAN MacDONALD

Citicorp

JOSEPH OPPER

Assistant Attorney General, New York
Chair, NAAG Payment Systems

MARK ROSENBLUM

AT&T

1 rich variety of firms and organizations, including the ABA
2 Committee on Judicial Administration and the Brookings
3 Institution.

4 In 1969, he served as a member of President
5 Johnson's Task Force on Antitrust Policy and was co-author
6 of the subsequent report which we know as "The Neal Report."

7 He has published articles, truly, too numerous to

1 that activity is to continue.

2 On the other hand, marginal costs, or the cost of
3 incremental usage after the big investment in innovation is
4 completed, historically often approaches zero; and so you
5 have a problem of: Who is it that is to contribute to the
6 amortization of these front-end costs?

7 And, of course, this leads to, sometimes, extreme
8 forms of price competition; and, indeed, in theory, under
9 competitive circumstances there is no way to recover those
10 front-end costs. But, of course, to the extent we can
11 successfully confer intellectual property protection, it
12 will facilitate that recapture; and, indeed, it is precisely
13 to facilitate that recapture that we have intellectual
14 property.

15 That still leaves the very interesting question:
16 Who pays? And I'll come back to that, because there is a
17 standard to which one might at least make reference.

18 When people talk about foreclosure and access, it
19 turns out, often enough, that what they're really talking
20 about is mandatory licensing, compulsory admission, a
21 requirement that the incumbent firm deal with a would-be
22 competitor; and reference is made to such cases as the
23 Associated Press case, Terminal Railway, and more recently
24 the Aspen Skiing fiasco, a case which I'm sure the courts
25 would prefer to forget.

1 The difficult issue, or the central issue, raised
2 by that line of cases is basically the problem of
3 confiscation, incentive dulling. You can't expect people to
4 go on making investments unless there's a reasonable
5 expectation that they will be repaid.

6 And, indeed, I think it is the small prospect of
really hitting the jackpot that drives investment in these

1 leapfrog competition where you don't get competition in the
2 present technology. You get competition for a future
3 technology, and then there is a winner; and the winner is
4 the dominant firm for a period of a couple of years or maybe
5 10 years; and then someone else comes up with a big

1 mind not so much the PC, although, we have seen it there, as
2 the work station Hewlett Packard emergence. And I think
3 we'll undoubtedly see the same thing with respect to
4 Microsoft. Microsoft's operating system really is not a
5 great operating system. It just happens to be the incumbent
6 one, accompanied by a huge amount of lock-in investment.
7 But I have no doubt that we will see it displaced at some
8 point down the road by a truly superior system. I don't
9 think we are going to see prices forced down by competition
10 in the usual sense. Indeed, it seems to me on
11 non-systematic observation that the industries we're talking
12 about are not industries that typically engage in
13 competition through price but rather competition through
14 service rivalries of one sort or another.

15 Two other points I'll make quickly. I see my time
16 has slipped away already.

17 I have long thought it was a mistake to worry
18 about the phenomena of price discrimination in the context
19 of intellectual property.

20 Price discrimination should be regarded as a
21 positive good, I would say more generally, but certainly in
22 the concept of intellectual property where the whole purpose

1 approach zero, there is no coherent definition of price
2 discrimination. If you go back to Harold Hotelling's bridge
3 and you have a Volkswagen and an 18-wheel tractor trailer
4 lined up to cross the bridge, there is no rational basis on
5 which to charge the bug one fare and the truck another.
6 Short-run statics will tell you that the only correct fare
7 is a zero marginal cost fare; but, of course, we all knew
8 that before Mr. Hotelling's bridge was built.

1 rights as chairman to pick on everybody else when they give
2 their talks.

3 Thank you.

4 COMMISSIONER STEIGER: We are not going to let you
5 off that easily. You certainly are not limited by this very
6 brief amount of time. If there is any other thought in your
7 head that we can get out of you before we turn to the other
8 panelists, we are going to get it, Professor. We only have
9 one crack at you.

10 MR. BAXTER: Oh, I'll be here all day.

11 COMMISSIONER STEIGER: Don't let him out of your
12 sight.

13 We will move, then, with the Professor's gracious
14 okay, to the first of a very distinguished panel, indeed.

15 Timothy Bresnahan is Professor of Economics and,
16 by courtesy, of Business, at Stanford University.

17 He also serves as Co-Director of the Stanford
18 Computer Industry Project, Co-Director of the Technology and
19 Economic Growth Program in CEPR.

20 His research interests lie in Industrial
21 Organization Economics, where he has been concerned with
22 econometric measurement of market power and testing of
23 models of imperfect competition; and in the Economics of
24 Technology, where he has been studying the economic process
25 by which raw technology generates value in use.

1 And what a lovely segue you offer us, Professor,
2 from the opening remarks that we have just heard.

3 Would you proceed for us.

4 MR. BRESNAHAN: Very good. Let me say at the
5 beginning that I have stood for some time for the view that
6 the analysis of market power, entry and related phenomena in
7 the world calls for detailed studies of individual
8 industries and of the process of competition and of entry in
9 those industries.

10 I, therefore, applaud the Commission's decision to
11 have a set of hearings like this which are specific to the
12 body of competitive problems we find in information
13 technology industries.

14 But the Sloan-Foundation-funded Stanford Computer
15 Industry Project is an attempt on the part of the University
16 and the Foundation to create a body of knowledge about the
17 computer industry broadly understood, with its purpose
18 primarily to advise people who work either buying or selling
19 in that industry in the course of their normal business. So
20 it's mostly a business policy research shop. There's also
21 the hope that it would become a useful public policy
22 research shop, which is why I'm here.

23 My part of the SCIP has been to talk to, study by
24 database, interview through students, large buyers of
25 information technology.

1 We believe that the buyers of networked computing
2 are not only the place you have to stand to understand
3 competition in networked computing, network computing is a
4 product-differentiated industry.

5 The tastes of buyers for different kinds of
6 networked computer solutions, say old host-based ones,
7 versus new client-server ones are critical for understanding
8 the competitive process in that industry and also the buyers
9 are probably the bottleneck by which the very fecund
10 information technology industry's invention of raw
11 technology is slowed in turning the value in to use. Okay?

12 So I think about competition in this industry from
13 a buyers' perspective, which is slightly peculiar. And I
14 look back at the structure of sellers in information
15 technology, particularly in networked computing, from the
16 perspective of buyers' frustrations with the effectiveness
17 of sellers in supporting buyers' intelligent use well.
18 Okay?

19 And that leads me to a base slide which is -- one
20 should be clear in this forum about intellectual property.
21 This is largely taken from the work of Andy Grove,
22 particularly the vertical and horizontal bars down at the
23 bottom are Andy's.

24 There are two sorts of models of industry
25 structure in computing that we have inherited from the past.

1 These two models influenced both buyers' and sellers'
2 thinking about how computers industry structure ought to be
3 in a first-order way.

4 There's sort of one that comes from the little
5 world, little computers, small buyers, small companies,
6 vertically disintegrated -- that's why it's got these bars,
7 it's the vertically disintegrated one. And the other model
8 of industry structure which comes to people's minds is the
9 big, big, big one. It's got the large buyer enterprise
10 computing proprietary architectures sold by large companies.
11 And rather than having the many points of influence on the
12 direction of technical change which the horizontally
13 organized vertically disintegrated model is said to have, it
14 has platform steering by a lead vendor.

15 Andy Grove calls these the "old" -- vertical one
16 is old -- and "new" computer industry market structure
17 models. I think that's an important misnomer.

18 These two ways of organizing supply have emerged
19 in two very different segments of computing because they
20 were responsive to different customer needs in those two
21 segments. IBM was successful with a very integrated,

1 communication between buyers and sellers that customers
2 turned out to value at that time.

3 A lot of IBM's success as a computer company in
4 forming that vertical model and in attaching its
5 intellectual property, its proprietary intellectual property
6 to standards came because of IBM's understanding of the
7 commercialization process in information technology not just
8 from its understanding of raw technology.

9 Similarly, the customer needs and the wider
10 availability of competencies and expertise, in the personal
11 computer market, permitted a much more rapidly changing,
12 much more vertically disintegrated openish architectures
13 industry structure.

14 Now, I emphasize the responsiveness of these two
15 models of supply to customers' needs because I think the old
16 and new labels are wrong. I think that networked computing
17 in the 90's and the early part of the new century is going
18 to be characterized by elements of the centralization from
19 the vertical model and elements of the decentralization from
20 the horizontal model in a mixture which neither sellers nor
21 we now understand, and that it is not possible, over the
22 imaginable range of competition policies, to force either of
23 these models on the network computer industry of the future.
24 A French competition policy, the most rabid French Diehrgist
25 pro-national champion policy could not create another IBM,

1 nor could the most U.S. anti-success rabid competition
2 policy create another one of these. You just can't do it.

3 Now, so there's sort of the background. What
4 should we do? How should we think about what goes on in the
5 process by which that new industry structure is created?

6 Okay. And here I want to -- I'm going to skip a
7 lot of the long-run because I largely agree with what Bill
8 Baxter said. And I think it's just -- let me just echo what
9 he said on the long-run side in slightly different language.
10 You know, we have concentration in the computer platforms,
11 including the networked computer platforms over which
12 applications run. We have persistence in concentration. We
13 have concentration even when the platforms are open -- so
14 concentration in platforms not in firms -- for long periods.
15 I think that that mostly reflects social costs. It's mostly
16 a fact that comes from the cost function of IT that makes it
17 be true that standards stick around for a long time. They
18 serve social roles. And as a result, in the long run, we
19 have entry processes which are primarily indirect.

20 Historically the long-run and indirect entry
21 processes have been ones where a non-commercial computing
22 capability has grown up and then been turned into a
23 commercial computing capability.

24 So by "non-commercial," I mean, for example,
25 minicomputers for process control sold by engineer to

1 engineer marketing to people who work in plants, or personal

1 wars as anti-competitive acts. Whereas I think the reality
2 of the day-to-day life in the information technology
3 industry is that most of those border wars are acts of
4 competition.

5 Just because server software network operating
6 systems and desktop operating systems appear to be
7 technological complements doesn't mean that they're not in
8 competition in an economic sense. There's constant
9 redrawing of the boundaries -- I pick those two examples
10 advisedly -- of the boundaries of the functionality
11 delivered by those three different kinds of software and
12 competition from improved functionality in the market
13 segment, one over, is very important.

1g C.773131 giis# On The short run, you know, you hear the

1 Or, worse, you know, our functionality -- there
2 used to be a functionality which was a key part of our
3 value-added to customers, and now it's embedded in their
4 product; and so it gets sold, and our business goes away.
5 Now, these are acts of competing on their face. They're not
6 necessarily anti-competitive acts.

7 So I would disagree with Bill on the point. I
8 agree with him absolutely about competition in the long run,
9 that leapfrogging competition is very important in the long
10 run.

11 I think that it is a mistake of too narrow market
12 definition in the short run to think that there are not also
13 important avenues for competition from firms in adjacent
14 market segments.

15 Okay. Now I want to sort of give a large, global
16 example of that, which is pretty contemporary. These are
17 also slides which I use to talk to people in the -- who are
18 both buyers and sellers. Sellers tend to react to the next
19 two slides by telling me that I talk to buyers too much.
20 Buyers tend to react to the next two slides by telling me
21 that I am an apologist for sellers. So I think they're
22 probably right.

23 What I want to talk about is the currently
24 available seller vendor initiatives for resolving the
25 problem of whether we're going to have a vertical structure

1 or a horizontal structure, how much of -- each of which we
2 are going to have early in the new century.

3 For a long time, the most popular model was that
4 all inventors of technology, all people in technology
5 companies would become producers of commodities, where we
6 would have the horizontal model for everything. And then
7 that business process, re-engineering services would be
8 bundled with the integration of information technology in
9 the customer's shop. And the only possible locus of market
10 power would be at EDS or at Anderson. This model was very
11 influential for several years in the early 90's and now
12 seems to be going out of favor.

13 A variant of that, which had strong elements of
14 the old IBM model, was that there should be a technology
15 company -- Oracle comes immediately to mind -- that would
16 bundle the consulting services that advised users on how to
17 buy and use a large amount of IT with their particular
18 technology and create, along Teecean lines, accost specific
19 asset in connection to the customer.

20 And that's now come the full route of an attempt
21 to commodify other people's technology. The Oracle guys now
22 tell us that you don't need a personal computer; you don't,
23 in particular, need Microsoft to collaborate with them. You
24 should have a thin client. You should have a special
25 purpose terminal at the end of the wires out from their

1 product that would cost, say, only \$500.

2 So when I say that these are initiatives to go
3 after the same rents, to attempt to determine the same
4 industry structure that cuts across a lot of vertical lines,
5 I mean that. I would not like to see my friends in
6 Washington convict half a dozen different people of trying
7 to monopolize the same business.

 Now, there's a somewhat less vertically integrated
9 model, again, a service and support model which is sort
10 the rump of former large system companies.

 Anybody here from UNISYS or AT&T? I don't me

ary

1 earn big rents in this business, which is that in the
2 periods when the de facto standard setting process is very
3 easy to influence, it's also very hard to foresee. And the

1 CHAIRMAN PITOFSKY: You're not alone on that.

2 MR. WAYMAN: Right. I guess that's stating the
3 obvious, but that just proves I'm a good lawyer with my
4 instinct for the obvious, as they say.

5 I have been in business for a long time, and I
6 think I'm going to try and give you some thoughts related to
7 my vision of how, or my view of how the computer industry
8 competes.

9 I don't have the ability or the intention this
10 morning to provide you with a thoroughly thought-through,
11 world view as to how the Federal Trade Commission ought to
12 enforce antitrust laws, what they should and shouldn't do.
13 I just thought it might be useful to give you a couple of
14 perspectives that you could use in thinking about your jobs
15 in the environment.

16 I'm reminded a little bit of the old Arsenio Hall
17 show, he used to have a little bit that he did which made
18 people say: Well, hmm. You know, isn't that interesting.
19 And that's kind of my purpose here. I don't pretend to tie
20 this all together into some suggestions for what you need to
21 do next.

22 I'll tell you a little bit about Storage
23 Technology to help set my background. We are a \$2 billion
24 company, and we manufacture huge memory subsystems that hold
25 data for folks like the Social Security Administration and

1 CIA, and insurance companies, and banks. Our systems sell
2 for, on the order of half a million dollars a piece.
3 They're not desktop systems.

4 We do not ourselves manufacture a complete system.
5 All of our products hook up to somebody else's computers.
6 So although our products are very large, the large analogue
7 of the disk drives and tape drives may be attached to your
8 own personal computers. And that's what we do for a living,
9 and to the extent that you want to discount what I say, you
10 might keep that in mind as where we're coming from.

11 The first sort of interesting fact, at least from
12 a perspective that I have that I wanted to take a minute
13 here to talk about, was my view as to two important
14 characteristics of computer companies or, indeed, any
15 high-tech company. And I think these will be not very
16 insightful in the sense that I don't think there will be
17 much controversy, but when you look at how they play off
18 against one another, I think it leads to perhaps some
19 interesting thoughts.

20 High-tech companies are peculiar because one of
21 their principal assets is intellectual property. They are
22 really unique institutions when compared to old-line
23 companies, an oil company or a steel mill, you look at the
24 asset base of that company and what it's worth and what
25 could happen to it and say: Well, it's a blast furnace,

1 it's an assembly line.

2 If you look at a company, I think, a good example
3 of that would be a Microsoft, and you say: Well, what's the
4 asset there? They don't have any capital assets to speak
5 of. I mean, they have some buildings; but that's not the
6 value the company. The value of the company is the software
7 programs. And the software programs are intellectual
8 property.

9 And so, in a sense, the real value of that company
10 is based entirely on intellectual property laws and the
11 ability to protect that property.

12 If there were no laws, the guy that owns a steel
13 mill has a tremendous barrier to entry because you've got to
14 build another blast furnace to get in competition with him.
15 If there were no laws at Microsoft, it wouldn't take very
16 long to be in competition in one sense. But played off
17 against that fact is another, and second, I think, important
18 characteristic of high technology companies.

19 Yes, intellectual property is one important fact
20 of those companies. Another important fact is the rapidity
21 with which the marketplace changes. And, again, I don't
22 think that's a particularly insightful remark. Anybody
23 that's had the pleasure of going out and buying the latest
24 and greatest PC only to find out next week that it's
25 obsolete understands that things are moving very quickly in

1 this arena; and that is, in fact, the nature of the beast.

2 Those two facts are -- when you look, then, at the
3 value of a company and you're saying, well, how do computer
4 companies compete and how much is this company going to be
5 worth if you're going to invest in it, you can look at both
6 of those: How much intellectual property do they have
7 today? And that's one fact that's interesting. And another
8 one is: How quickly are they moving?

9 And that's the second, and I would say, to a
10 significant extent, the most important fact in looking at
11 the value of the company, because this is a race where
12 everybody is running, very, very fast; and it isn't
particularly valuable to you as a potential investor to find

1 because they have a tremendously high level of ability to
2 protect them, or do we want to create an environment in
3 which it's probably the best defense to run like hell and
4 hope you can stay ahead of your competitors.

5 From a consumer welfare point of view, setting
6 aside -- those of us that bought the computer that was
7 obsolete a week later, but from an overall consumer welfare
8 point of view, I think the bias ought to be towards
9 encouraging people to keep moving. And I think that has
10 some implications for what intellectual property regime we
11 ought to look for.

12 The second observation about how computer
13 companies compete and the nature of the -- just sort of the
14 background that I have, and I think it's useful to insert
15 into the debate, again, not because it sets out a whole way
16 that you all ought to enforce the law, but just an important
17 thing to keep in mind in your background and something that
18 isn't often stated -- is the peculiar nature of software.
19 When you look at how it has evolved, as a creature of
20 intellectual property, you look at the fact, that I
21 mentioned earlier, that Microsoft's principal asset -- and I
22 don't mean to single them out. Storage Technology has
23 millions and millions of lines of code in its products,
24 which are one of our major assets, and every company
25 represented at this table is in similar circumstances.

1 But if you look at that intellectual property,
2 that software, and you look at what the landscape looks like
3 now from a legal perspective and compare it with what the
4 landscape looked like back when I first started advising
5 clients about software, I remember having inventors coming
 in to me an lo.7

1 and, therefore, we sometimes think that the examination
2 procedure is not as rigorous as it could be. So you get a
3 lot of patents.

4 So we have a creature today, as I said in my
5 paper, if you're looking at the automobile engine and you
6 say, well, I want to protect some aspect of it, you'd
7 generally try and advise a client to get a patent. If
8 you're looking at a book or a play, you don't think about
9 getting a patent. You say, well, you're protected by
10 copyright. And if you look at a secret formula, you can
11 say, well, we'll just keep that a trade secret.

12 It's almost unique in the intellectual property
13 regime that if a client walks in with a piece of software
14 you say: Well, we'll patent it, copyright it, and keep it
15 is as a trade secret.

16 And that, again, is just sort of as Arsenio hall
17 maybe does, sort of a little "Hmm" you ought to keep in mind
18 as you look at this landscape and think about this industry.

19 The last thing I'd like to talk a little bit about
20 is my perspective on the interfaces. Well, I guess, the
21 best way to say it is that I think that we need to separate,
22 in our conversations, issues about the value of an interface
23 from issues about the value of the assets on either side of
24 the interface.

25 So when we talk, for example, about a person that

1 has gone to the time and expense of preparing and developing
2 a network or an operating system and then we talk about the
3 need for facilitating open, unfettered access to that
4 network or that operating system, it is, I believe, a very,
5 very serious mistake to say if we facilitate access to that
6 operating system, for example, we are then preempting or
7 capturing or denigrating the value of that operating system
8 to the person that developed it.

9 We're not talking about the second person to this
10 theoretical marketplace replicating that operating system
11 and selling his version of it and gathering the rents on the
12 use of that operating system.

13 What we're talking about is the ability of the
14 second person to introduce his own value-added product on
15 the other side of that interface and that own value-added
16 product cannot violate the owner of the operating system's
17 copyright or patent or trade secret right. Nobody's talking
18 about that issue.

19 So I think it's a terrible mistake in this
20 dialogue to say, well, Company A has tremendous costs in
21 starting up this network or this system, which is certainly
22 true; and, therefore, facilitating other people attaching to
23 it is preempting the value of that system. I think that the
24 person who developed the operating system is entitled to
25 gather the economic rents on that system, but nobody's

1 arguing about that.

2 The question is: Can he prevent other people from
3 gathering rents on things which could attach to that system
4 if the interface were available to that second person? I
5 think that's a very different economic issue than saying
6 you're preempting the value of the system itself.

7 Another point that I sometimes make about
8 interfaces, I would like to make here as my last point today
9 is the interesting comparison, as we talk about the
10 availability of interfaces, the availability of information,
11 as to how to attach one product to another or how to make
12 products interoperate.

13 And we talk about folks that say, well, that
14 information ought to be not available at the election of the

1 CHAIRMAN PITOFSKY: Thank you very much.

2 Why don't we have one more presentation and then
3 let's stop for a round of Q and A and some discussion, and
4 then we'll take a short break.

5 Our next speaker is Marshall Phelps, Vice

1 competitive element in our industry.

2 Now, in addition to our view of the vigorous
3 competitive environment in this industry -- and you've heard
4 a lot about that already -- you have asked us to talk about
5 networking and standards.

6 We are coming to the view that networking, a
7 largely unexplored territory of opportunity and challenges,
8 is already exerting a profound influence in our industry,
9 stimulating it to some really new heights.

10 But this question of interoperability,
11 historically of some importance in this industry, as you
12 already know, is crucial for networking to flourish. Thus,
13 the industry has really got to strengthen its commitment to
14 work in a responsible and timely fashion to resolve this
15 question of compatibility between and among programs and
16 devices.

17 Now, international industry standards provide a
18 foundation for solving these interoperability issues, but
19 the process for developing these standards, while it's been
20 shortened in recent years, needs acceleration and even
21 broader industry support.

22 As for how this impacts the FTC, we are going to
23 encourage you to stay the course: to maintain a restraint
24 and deliberateness that you've shown so far, which has been
25 a proven success, rather than embark on new strategies and

1 theories which may turn out in the end to be ill-suited to
2 this most fast-paced and dynamic of industries.

3 Now, our industry has demonstrated a remarkable
4 capability. Practically every decade it redefines itself
5 and concurrently expands the availability of computers for
6 new uses and new users.

7 Barely 30 years ago, our national consciousness
8 awoke to the power of computers when man first walked on the
9 moon. The 1960's and 70's were the industry's initial wave.
10 "Mainframes" made the Apollo missions possible. Businesses
11 centralized company-wide functions like payroll on
12 mainframes. "On-line" transaction-based systems did arise
13 in these years as users at remote terminals communicated
14 with mainframes. But the options available to these
15 terminal users in terms of data processing alternatives were
16 severely limited by the host mainframe. Mainframes were
17 huge; they were powerful; they were enclosed, in raised
18 floors, glassed-in, air-conditioned quarters; and they were
19 isolated from the users.

20 The next era was the microprocessors and the
21 arrival of the personal computer in the early 1980's. The
22 industry completely switched directions. Data processing
23 became decentralized, distributed to individuals with PC's
24 in their offices and homes. Personal productivity increased
25 but generally for the individual user only, as opposed to

1 the mainframe, however, this was technological democracy.

2 Now, we're in a new era already, called "network
3 centric computing." That's at least our term for it. The
4 old paradigms are coalescing and giving birth to a grander
5 vision: Interconnectivity and collaboration across
6 networks, indeed, across the world. This is epitomized by
7 the Internet, that network of networks, where unlimited
8 numbers of people have unlimited access to unlimited
9 information. There are many networks, both public and
10 private; and they link extended enterprises and individuals.
11 They allow electronic communication, interaction, and
12 commercial transactions.

13 Now what has driven these phases in our industry
14 has been an inexorable tide of technological innovation.
15 Time after time, science has overcome technological
16 thresholds to provide faster, cheaper products with greater
17 capabilities. And this is going to continue as far as we
18 can see into the next century.

19 So today, PC's in the home are equivalent to 1985
20 mainframes. And the same computing power in the original
21 guidance system that landed the Apollo mission's space
22 capsule exists in a 1995 Cadillac.

23 IT companies have rushed to provide the benefits
24 of new technology to their consumers, and they have been
25 welcomed generally. Thus, today, unrelenting consumer

1 demands for additional computing capability and techniques
2 -- e.g., Internet access, CD-ROMs, multi-media, whatever --
3 are fueling an impetus for even further innovation by the
4 industry.

5 Consequently, innovation and commercialization of
6 new technologies are proceeding at break-neck pace. Not
7 that long ago, computer products took 5, even 10 years to
8 develop. Today, a year and a half is the norm. And in the
9 PC industry, it's becoming 6 months.

10 Each phase of the industry has expanded
11 competition and vastly increased the number of competitors.
12 Moreover, the arrival of each phase has re-leveled the
13 playing field. The competitive leaders in the previous
14 phase had no particular advantage in the race for leadership
15 in the next phase. In fact, they were arguably at a
16 disadvantage because of their dependence on the status quo
17 to sustain their industry position.

18 In the mid 60's, fewer than 10 companies had the
19 resources to develop and manufacture main frames. You knew
20 them. They were IBM and the "BUNCH." That was Burroughs,
21 UniVac, NCR, CDC, and Honeywell.

22 Today, there are 71,000 competitors in our
23 industry worldwide. I got those figures from IDC, and I
24 attached them to the back of my testimony, if you want to
25 look at those.

1 And we're only in the early stages of this thing
2 called "network-centric computing," that is experiencing yet
3 another explosion of competition and proliferation of
4 competitors to meet the challenges.

5 You already know some of these new companies;
6 although, six months ago you never heard of them. They're
7 the latest darlings of Wall Street, companies like NetScape
8 and Spyglass, which have seen their market capitalizations
9 quadruple in just a few months.

10 As a company whose PE ratio is 9, I really envy
11 Spyglass and NetScape whose PE ratios are somewhere around
12 6,000.

13 Moreover, this is an international phenomenon.
14 Back in the 1970's at the height of IBM's antitrust
15 troubles, we couldn't convince anyone that the information
16 technology market was international. Today, to think
17 otherwise is laughable.

18 For many U.S. computer companies, half of their
19 business is overseas. The Internet is already accessible
20 internationally, and the goal of Global Information
21 Infrastructure is well accepted.

22 I also referred to the marvelous complexity of our
23 industry. From the antitrust point of view, this feature
24 alone makes regulation extraordinarily challenging. Not
25 only are there numerous competitors, but they vary in size

1 and objectives, from hardware component suppliers to
2 mainframe-server manufacturers, from software application to
3 operating systems programming houses. There are groupware
4 programming developers like Lotus, and AT&T. There are
5 telecommunication and network access providers, like Prodigy
6 and America Online and what have you.

7 Products are distributed by manufacturers,
8 component and subsystems integrators, value-added
9 re-sellers, retailers, mail order catalogs, and, now, of
10 course, electronically. There are established entities and
11 a barrage of "start-up" firms. In addition, there are
12 countless combinations, ventures, alliances, and contracts,
13 both domestically and internationally, between firms in the
14 industry and businesses in fields related to the industry.

15 A complexity also results from the number and
16 variety of hardware and software products. Each information
17 processing problem has a range of alternative solutions.
18 For example, we are all very familiar with the attraction of
19 fully functioned PC's with powerful operating systems and
20 processing facilities, speed and memory, to load and run
21 resident application programs.

22 Well, even so, industry seers are foretelling the
23 emergence of a rival new technology -- you heard a little
24 bit about it earlier -- for the same task. One such device
25 would be a simple, low-cost "IPC" or Inter-Personal

1 that has 50 percent more disk storage and nearly double the
2 raw computing power of last year's models." More cost
3 effective solutions mean more consumer problems that are
4 addressable by consumers. And this results in a cycle of
5 consumer demand driving the technological innovation that I
6 mentioned earlier. These are not indicators of a
7 dysfunctional or uncompetitive industry.

8 You have also asked me to discuss the impact of
9 networking on the industry. Well, it's a broad term, and it
10 encompasses all sizes and arrangements of a simple but

1 transparently.

2 The mechanism to achieve interoperability is the
3 development and implementation of open interfaces -- and you
4 heard a little bit about interfaces -- at key "high
5 leverage" points in a network.

6 In our view, an interface is open if its
7 specifications are readily and non-discriminatorily
8 available to all and if applicable intellectual property
9 rights are available on reasonable and non-discriminatory
10 terms. Open critical interfaces enable and catalyze the
11 development of new systems, products, and services built and
12 operated by competing providers and users.

13 This, in turn, results in more competition,
14 increased consumer choice, lower prices, and enhanced
15 accessibility. Already consumers and customers in the
16 marketplace are insisting that vendors provide interoperable
17 solutions; and they are responding.

18 What about standards? Well, standards are vital
19 to our industry because they provide a way out of the

1 standards involves consensus building, which is inherently

1 to be international. Just as we cannot optimize around one
2 manufacturer's view, neither can one country or region
3 impose its view -- or the view of its national champion --
4 on the rest of the world. This calls for increased
5 participation in the development of standards by industry,
6 government users, and other interested parties worldwide.

7 If the de jure system isn't as nimble as it ought
8 to be, what about the de facto standards? Well, they are a
9 fact of life. They are generally adopted by industry
10 consortia or informal groups, and they are appropriate and
11 they are necessary in the proper circumstances.

12 One notable example you may have heard about
13 recently is this Digital Video Disk format which was worked
14 out between two groups developing DVD technology. The
15 developers were at the point of commercializing two
16 disparate approaches.

17 However, the two principal prospective customers
18 of this technology, who happened to be the entertainment
19 world, and the distributors and PC storage manufacturers,
20 put intense pressure on the developers to agree to a single
21 format so these DVD's could be swapped between PC's and DVD
22 players attached to your television.

23 The adoption of a single format avoided a
24 repetition of the "VHS v. Betamax" situation with its
25 confusion and wasted resources. It also eliminated the

1 increased development and manufacturing costs and,
2 ultimately, will lower prices to the consumer.

3 Now, given this perspective, what's a responsible
4 federal agency to do?

5 Well, obviously, we believe the FTC should
6 continue to police the industry for per se restraints of
7 trade, price fixing, market division, Sherman Act section
8 1-type violations, et cetera, offenses under FTC Act section
9 5, and other violations. Similarly, it should continue to
10 investigate mergers, which may also be a vehicle to abuse.

11 Now, the FTC has long pursued what we would think
12 is a relatively judicious approach to antitrust enforcement
13 in our industry. And we think this continues to be

1 Thus, one could assert that the industry has a built-in
2 remedial force. Occasionally, some companies might acquire
3 inappropriate power. But the inexorable march of technology
4 generally has made their grip transitory.

5 Moreover, other industries, such as steel or
6 automotive, pharmaceutical, and banking, to name a few, have
7 a greater incidence of political, regulatory, environmental,
8 or other limitations. The computer industry is restrained
9 only by human intelligence and imagination. It is precisely
10 this paucity of artificial limitations that has spurred the
11 incredible innovation and competition that is the hallmark
of our industry. The importa otUCo995polöTheqResi

1 You may recall that just four years ago, the
2 Clinton administration was advocating a considerable
3 government expenditure for the NII, or National Information
4 Infrastructure. They asserted that without federal
5 founding, the fiber backbone essential for the realization
6 of the NII would not be built. And they were even talking
7 of budgeting \$5 billion dollars to do this.

8 But what's happened in these last four years?
9 Everyone from public utilities, to common carriers, to
10 private corporations, to Joe's corner gas station is now
11 laying fiber in this country so that today there are 20
12 million miles of fiber in the U.S. And this
13 well-intentioned government project, the need and necessity
14 for it, has just evaporated. The Internet has arrived, and
15 the NII and the GII are fast becoming a reality.

16 Likewise, the FTC should not set out to manage the
17 voluntary industry standards process, but should insist that
18 it be operated openly and fairly. There is just no evidence
19 that installing another layer of costly bureaucracy would do
20 anything to speed the process. It will probably just make a
21 slow process even slower.

22 As I mentioned earlier, the private sector is
23 moving rapidly to address these concerns. When governments
24 have tried to meddle in the standards process, the results
25 have generally been disastrous.

1 For example -- I'll give you one example in Europe
2 -- a European industry standards group called ETSI -- it was
3 the European Telecommunications Standards Institute,
4 desperately wanted to avoid the cost of paying royalties for
5 patent rights on innovative technologies.

6 You can guess which country had the innovative
7 technology.

8 With some support from segments within the EU
9 Commission and under the guise of establishing European
10 standards, ETSI attempted, albeit unsuccessfully, to force
11 compulsory licensing of intellectual property rights,
12 including, obviously U.S.-owned rights, as a condition for
13 participating in the standards process and most probably as
14 a condition precedent for bidding qualifications for public
15 procurements.

16 This effort threatened to destroy ETSI.
17 Ultimately, thoughtful leaders in the Commission and ETSI
18 itself recognized that this effort was misguided, and the
19 members overwhelmingly rejected the approach.

20 Not without, I might add, a lawsuit filed on
21 behalf of U.S. manufacturers, many of whom are sitting
22 around here.

23 The FTC should, however, in our view, assist the
24 industry in building an international marketplace. For
25 example, the FTC could advocate international synthesis of

1 antitrust laws or at least a global set of principles for
2 acceptable competitive conduct.

3 If antitrust rules and enforcement were relatively
4 uniform worldwide, our antitrust enforcement activities
5 would not unfairly hamper American firms competing in
6 international markets.

7 No country can operate independently of
8 international forces any more, and any antitrust analysis
9 that denies that is simplistic.

10 So I hope you got somewhat of a picture of a
11 vibrant industry that we're in but one that has a challenge
12 of solving issues of compatibility and interoperability
13 through appropriate actions by, hopefully, the standards
14 bodies.

15 In the belief that competition will continue to
16 flourish and challenges to competition will be surmounted,
17 I've ended with a plea to the government antitrust agencies
18 to continue their judicious approach vis-a-vis our industry.
19 In our opinion, this is policy the FTC should readily
20 endorse.

21 The United States is the clear leader in the
22 worldwide IT industry. There is no other government in the
23 world that has a competition policy -- not Europe, not Japan
24 -- that has done so much for its computer industry as the

1 as a response, has done so much for the world's consumers.

2 Thank you.

CHAIRMAN PITOFSKY: ThanouITITI

1 acquired by a method which was itself illegal, because
2 predatory, within the meaning of section 2 jurisprudence,
3 then I would intervene, but otherwise not.

4 CHAIRMAN PITOFSKY: And, of course, my assumption
5 was, legally acquired. So your response is that you would
6 not intervene?

7 MR. BAXTER: Right.

8 CHAIRMAN PITOFSKY: Any other comments on that
9 particular question or other questions.

10 MS. DeSANTI: Can I just ask as a follow-up: Is
11 that to say that it would make -- that the arguments we
12 heard from, say, Mr. Wayman about the distinction between an
13 API that's an interface versus the underlying code for the
14 underlying product are not distinguishing features for you,
15 that you wouldn't attempt to distinguish between whether the
16 access was being sought by a producer of a complementary
17 product versus a competing product?

18 MR. BAXTER: Well, of course, I don't agree with
19 Mr. Wayman's comments there. I don't see any difference.
20 If I have control of the Net legitimately and he has
21 something that he would like to attach and he seems to me as
22 an appropriate carrier of some of my fixed costs as anybody

1 someone has legitimate control over the Net for whatever
2 reason, including the reason of having himself an attachment
3 that is of such value that it carries the Net with it, that
4 seems to me perfectly appropriate.

5 MS. DeSANTI: Let me ask you, maybe you can take
6 it a step further, yesterday we had some panels on the
7 interface of antitrust and intellectual property protection
8 that led into a discussion of whether firms can take legally
9 acquired dominance or market power in one market and
10 leverage it into another market.

11 And there were some who argued that a distinction
12 should be made in the situation where you need an interface
13 availability to prevent the monopolist in the first market
14 from leveraging its power into the second market.

15 Do you have any comments on that type of a
16 situation?

17 MR. BAXTER: Well, first of all, it's very
18 important to be precise what we mean by leveraging into the
19 adjacent market. People use that expression when all they
20 really mean is that some sort of advantage has been gained
21 by which the firm in the first market makes additional sales
22 in the second market. And that is not what I have in mind
23 when I say "leveraging into a second market."

24 The only time I recognize the existence of a
25 problem is when an independent base of market power is being

1 established in the adjacent market that will be able to
2 collect monopoly rents from people who have no demand in the
3 first market. And that means there must be significant
4 independent uses of the product that constitutes the second
5 market.

6 But under those circumstances, I would be
7 perfectly happy to recognize a violation where an
8 independent base of market power was being established by
9 manipulation of market power in the first market.

10 CHAIRMAN PITOFISKY: Other questions?

11 MS. VALENTINE: Actually, Tim Bresnahan, would you
12 comment on those questions as well?

13 And we may as well stay with the last example that
14 we had of a market power situation in one market, and let's
15 say it's a refusal to license, which then leads to a market
16 power situation in the second market, but it is a
17 complementary product.

18 MR. BRESNAHAN: Yes. I think that in general, it
19 is possible that owners of legal market power in one market
20 attempt to lever it into a complementary market. I dislike
21 Aspen Ski a great deal less than Bill does.

22 In IT in particular, I think that the test for
23 whether it is an efficient leverage attempt or inefficient
24 leverage attempt, market power gaining leverage attempt will
25 often come out for efficiencies.

1 You know, why will the owner of the interface
2 standard -- if, say, it is embedded in a product that is in
3 one of the two complementary markets -- not wish to license
4 it for open interoperability to most people in the adjacent
5 market for interconnect?

6 Typically, owners of intellectual property in IT
7 are very focused on scale economies and on the advantages of
8 positive feedback by the investment of complementary
9 technologies that are complementary to theirs.

10 And in most circumstances, if there is a benefit
11 to their customers of having the connection to the other
12 firm's product, then they will want to do it. Now, why
13 might they not?

14 They might be attempting to create a more valuable
15 monopoly by being in two markets, for example, for price
16 discrimination reasons. It seems to me that that's an
17 investigable question of fact. Or it might be -- and I
18 think this is the one which makes me say that in these
19 particular industries, we shouldn't be too interventionist
20 on these matters -- it might be that the apparent
21 technological complement this year is next year's competitor
22 and that the motivation for the desire for the interconnect
23 is a horizontal competitive one.

24 So I would say that it's often true that we are
25 protecting competitors by forcing licensure of intellectual

1 property rather than by protecting the competitive process
2 in such circumstances.

3 CHAIRMAN PITOFSKY: Bill?

4 MR. BAXTER: Yeah. If I could add just one word.
5 I agree with Tim that the normal incentives here are for
6 licensing, and that certainly is an important reason why the
7 case that you specify so seldomly actually arises.

8 But there's another reason. And that is that if
9 these two things are strong, technical complements and each
10 has market power in the individual separate markets, you run
11 into a problem of double marginalization of successive -- of
12 each company marking up to reflect its market power but
13 starting from a marginal costs number that is already
14 inflated by reason of the market power of the other company.

15 And you get prices that are even higher than the
16 monopoly level and outputs that are even lower so that
17 coordination is needed to bring price down and quantity up.
18 It sounds backwards from all of our intuitions, but it's
19 really quite a common situation.

20 CHAIRMAN PITOFSKY: Other questions?

21 Can I just ask Mr. Wayman, Mr. Phelps, or others,
22 in your experience in the business world, have there been
23 circumstances in which antitrust enforcement or the threat
24 of antitrust enforcement, because the area is so uncertain,
25 have deterred companies from engaging in behavior that you

1 thought would have been efficient?

2 COMMISSIONER STEIGER: Let me add to it, because
3 that was my question of Mr. Phelps, in particular, I believe
4 he suggested that antitrust laws have impeded industry
5 activities abroad; and I would be very interested to hear
6 some expansion of that, if indeed that was your view.

7 MR. WAYMAN: Chairman, we never take any
8 cognizance of the antitrust laws. We just proceed
9 regardless.

10 CHAIRMAN PITOFISKY: Were there deals that actually
11 were scratched or sidetracked, delayed?

12 MR. WAYMAN: Sure. And also deals that were
13 significantly restructured. My first year of practice with
14 the Federal Trade Commission -- I'm aware of the antitrust
15 laws. We pay attention to them. They have an impact on how
16 we do our business.

17 Then this guy --

18 MR. PHELPS: I was just amazed at the question.
19 Because the answer to that is, of course, people are aware
20 of that.

21 God knows we've turned it into an art form, I
22 think, at IBM. It's, thankfully, becoming less of an issue;
23 but it dominated the company for 20 years.

24 There are trade associations in Washington, you
25 might hear from one shortly, that have existed because of

1 the antitrust concerns related to the IBM Corporation.

2 We still live under a consent decree that is so
3 old, it has fuzz on it. It was drafted before the industry
4 even existed. It was 1956. And yet it affects business
5 practices that we have today.

6 We have to have separate subsidiaries for leasing
7 and financing as a result of a 1956 consent decree that, as
8 I say, was put in effect before there was a computer
9 industry. And yet it operates today.

10 So, yeah, there are lots of constraints like that
11 that still exist. We would like to change some of those,
12 obviously.

13 There are lots of deals that don't take place, I
14 would just say, because of concerns over whether or not they
15 are going to pass muster. I'm not sure that that's a bad
16 thing, and I'm not suggesting that it is a bad thing. But
17 there's probably more self-policing that goes on than you
18 would imagine, sitting here, on that.

19 The international issue is there because -- I put
20 it there because I think, especially in Europe, what happens

1 at war with themselves on how they would interpret some of
2 those things. And so you have DG-3 or DG-13 versus DG-4.
3 And what happens to you overseas is somewhat speculative.
4 Now you get to Japan and, my goodness, the Fair Trade
5 Commission in Japan sometimes -- I don't know if they go to
6 work. I don't know what they do. But I do know that when I
7 was living in Japan, the only time they seemed to wake up
8 was when Apple or IBM did something. But the keiretsu
9 structure still exists and, my goodness, you'd have a hell
10 of a time trying to inflict that kind of a structure in the
11 United States upon anybody.

12 So I think the enforcement of it is very spotty
13 overseas and clearly not very consistent, at least I would
14 say that from a business perspective, and I would obviously
15 defer to our academic friends on that.

16 CHAIRMAN PITOFISKY: Well, I can say that in six
17 months' experience here that the questions of coordination,
18 harmonization, procedural cooperation, if they're not moving
19 as quickly as they should, it's not for failure of attention
20 or energy.

21 MR. PHELPS: Right.

22 CHAIRMAN PITOFISKY: There are very difficult
23 problems when you get into the international arena.

24 MR. PHELPS: Yes, there are. But I think the U.S.
25 has been pretty forthcoming trying to get that kind of

1 consistency, and we welcome it.

2 CHAIRMAN PITOFSKY: Good.

3 Well, on that note, why don't we take about a
4 10-minute break, and then we will resume.

(Whereupon, a brief recess was taken.)

1 talk briefly today about a couple of over-arching themes
2 that provided the context for those written remarks.

3 While it is true that the principal American
4 antitrust statutes and case law were developed in the
5 Industrial Age and motivated by concerns over the
6 concentration of economic power in the hands of firms
7 engaged in the production and distribution of physical goods
8 in capital-intensive industries, I believe that the
9 antitrust law has as vital a role to play in the Information
10 Age as it ever has.

11 Ninety years ago, the monopolization of refining
12 capacity or smelting capacity or rail distribution were the
13 main threats to a competitive market economy. In the
14 Information Age, those threats are represented by
15 monopolization of technical standards.

16 Usually, a discussion of this issue revolves
17 around the domination of the personal computer operating
18 system software by Microsoft and the domination of personal
19 computer microprocessors by Intel, the combination popularly
20 known in the industry as "Wintel." Of course, that
21 domination is utterly obvious. But I want to take a
22 somewhat longer historical view.

23 It has often been observed that the
24 Microsoft/Intel domination of the personal computer market
25 was the product of IBM's decision to license the two most

1 critical technologies in the original IBM PC from those two
2 companies.

3 What's important isn't that IBM chose Microsoft
4 over some other outside supplier for its operating system or
5 Intel over some other outside supplier for its
6 microprocessor. What was critical was the fact that it was
7 IBM that was making the decision. After all, Apple invented
8 the first mass-produced personal computer, and it was built
9 around a Motorola microprocessor. Today, Motorola has a
10 tiny share of the personal computer microprocessor business.

11 Apple built its operating system in-house; but
12 even if it had licensed that technology from the outside,
13 such an outside supplier would have been no more successful
14 in establishing its technology as the PC standard than
15 Motorola was on the microprocessor side.

16 My point isn't merely that IBM unwittingly
17 transferred its market domination to Microsoft and Intel in
18 1980. That fact has often been observed. My point, which
19 is less often remarked upon, is that the original monopoly
20 power developed by IBM in the early 50's runs in an unbroken
21 line to Microsoft and Intel 40 years later. This is an
22 amazingly static phenomenon for an industry that is normally
23 characterized as the quintessence of dynamism.

24 I think it is absolutely essential to keep this
25 history in mind because there are many in and outside of our

1 industry who claim that the rapidity of technological change
2 somehow renders antitrust law and policy stultifying at
3 worst and irrelevant at best in the Information Age. And
4 yet for all that change and supposed dynamism, the control
5 by IBM of a handful of key technical standards in the 50's,
6 60's, and 70's created such market power that its decision
7 to cede control of a handful of technical standards to
8 Microsoft and Intel in 1980 conferred the power on those
9 companies to dominate the industry in the 80's and 90's.

10 Many people like to comfort themselves with the
11 thought that the so-called paradigm shift represented by the
12 emergence of the PC in the early 80's, which represented a
13 fundamental technological change from the computing model
14 represented by mainframes and minicomputers, will
15 undoubtedly be repeated and that, when it happens, the
16 apparently unassailable domination by Microsoft and Intel
17 will be subverted, just as Intel and Microsoft subverted
18 IBM's most dominant position.

19 Don't be too sure.

20 In the first place, the concept that a technical
21 paradigm shift can undermine a dominant player is now known.
22 That wasn't the case in 1980 when IBM made its fatal
23 decision to license key PC technologies from the outside.
24 Indeed, not long before IBM entered the PC business,
25 internal IBM studies reportedly suggested that the total

1 available market for PC's would be unlikely to exceed
2 100,000 a year.

3 IBM didn't realize that it was about to get caught
4 in the paradigm shift. Today, by contrast, the IBM example
5 provides proof to anyone with eyes to see that such things
6 can happen. Microsoft, Intel, and every other company in
7 the industry has been on the lookout for the next paradigm
8 shift for the past 10 years. And that shift may be at hand.

9 The explosion of the Internet, the rapid and
10 massive deployment of industry resources to exploit the

1 My answer is: "Not at all." There are a couple
2 of reasons.

3 First, Microsoft is completely aware of the
4 importance of the Internet and the threat it poses to
5 Microsoft's current domination of the computer industry.
6 Bill Gates published a long memorandum to his staff last
7 spring, which has been widely quoted in the press, making it
8 quite clear that the Internet phenomenon will not sneak up
9 on Microsoft in the way the PC phenomenon sneaked up on IBM.

10 Second, one may be sure that today's dominant
11 players will exert every effort they can to leverage their
12 position in order to dominate the world of tomorrow. And
13 there are enough technical hooks and handles available for
14 them to do so.

15 Even though the basic technical standards and
16 protocols that comprise the Internet are in the public
17 domain, it is possible for Microsoft to so tightly integrate
18 its own web browser with its applications and operating
19 software -- and at the same time render similar products and
20 technologies from other companies incompatible -- that it
21 can assure its domination of the information technology
22 business for generations to come. That is clearly their
23 goal.

24 Microsoft sees the Internet as both a huge threat
25 and a huge opportunity, a threat if they don't ultimately

1 dominate the standards, an opportunity if they do ultimately

1 MacIntosh operating system. The phrase "If you love MacOS
2 87, you'll love Windows 95" isn't merely cynical; it's true.

3 In traditional industries, consumers tend to be
4 victimized by monopolies through higher prices. In the
5 computer industry, consumers tend to be victimized by lack
6 of innovation. Apart from the natural tendency of a
7 monopolist to take income to the bottom line rather than
8 spend it on research and development, unless forced to do so
9 by competition, technology monopolists also impede
10 innovation in a whole industry by forcing others to innovate
11 within the very narrow technological band permitted by
12 monopoly-controlled standards. That is why the major PC
13 companies spend very little on research and development.

14 One of the biggest reasons there has been such an
15 explosion of commercial activity and innovation around the
16 Internet in the past couple of years is because it is one
17 area in which the standards and the standard-setting process
18 are free of control by another company.

19 The brilliance of the Anglo-American legal system
20 has always been its adaptability to changed economic and
21 social circumstances. Reasoning by analogy has been the key
22 to this adaptability. There is no obvious reason why, for
23 example, Windows should be regarded as any less an
24 "essential facility," in economic terms, than the only
25 railroad terminal or a ski-lift in town.

1 principal U.S. negotiator on intellectual property in the
2 North American Free Trade Agreement and was the coordinator
3 in the intellectual property negotiations in the Uruguay
4 Round.

1 it is simply copying it and duplicating the software.

2 There are also incentives to get access to
3 intellectual property whether you call it the intellectual
4 property interface specification or whether you call it a
5 subroutine or whether you call it any other portion of a
6 program.

7 To get access to it by competitors on financial
8 terms that are attractive. At some level, the discussion
9 between disclosure and openness of interface specifications
10 and access to interface specifications is really not about
11 access. It's really about the cost at which you get access.

12 And those who would argue -- as Mr. Kohn argued
13 yesterday, for example, for compulsory licensing of
14 interface specification -- are really arguing for ways to
15 reduce the price at which you get access.

16 The tradition today, the system that has evolved
17 in the United States, is voluntary standard setting. Those
18 standards are established. They can be standards which
19 incorporate intellectual property rights, or they can be
20 standards which have no intellectual property rights present
21 at all.

22 In all of these standard setting organizations,
23 the rule has been that if you do have an intellectual
24 property right you agree to license on non-discriminatory
25 commercial terms to all others who would use that. And when

1 you deviate from that, you get into trouble.

2 The issue really is not whether a system should be
3 open, because an open system could also consist of one that
4 is licensed on non-discriminatory terms. The issue is at
5 what cost it should be open?

6 I think that is a very important fact to keep in
7 mind because this debate gets awful confused about
8 interoperability, openness, compatibility, misuse of
9 interface specifications. I mean all those things are nice,
10 easy terms to get a handle on. But at their core, it's one
11 way to get a handle on the concept as a whole. This is
12 really not about promoting competition, this is about
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1 general matter, the industry is functioning pretty well with
2 the existing intellectual property law and with the existing
3 general regime of standard setting that is in place.

4 Departing from those could, frankly, produce
5 disruptions in the marketplace. Some have argued, for
6 example, that once you attain a certain degree of market
7 success, your intellectual property should be diluted, that
8 there should be an inverse relationship between success and
9 between the scope of protection you receive.

10 That makes absolutely no sense. Because then we
11 would have an intellectual property regime that would reward
12 only losers. You get strong protection if you don't succeed
13 in the marketplace. You get no protection if you do succeed
14 in the marketplace.

15 That's the antithesis of what the constitutional
16 concept is all about, which is promoting the science and the
17 useful arts.

18 A second concept that is often advanced here is
19 that somehow those intellectual property rights should
20 become a public good. That once they become widely accepted
21 in the marketplace, they should no longer be subject to
22 ownership or control by the person who spent a lot of time
23 developing it and creating its success in the marketplace.
24 Again, that, too, stands the whole concept of how you
25 promote innovation in this industry on its ear.

1 Now, a little bit about the standard setting
2 process.

3 Standards are clearly necessary in the industry,
4 because without standards, we have total chaos. And, in
5 fact, the industry, driven principally by consumer demands,
6 has been going towards compatibility, has been going towards
7 interoperability, has been going towards integration of
8 systems, because that's what consumers want.

9 That has occurred largely without government
10 intervention. It is entirely unobvious to me how a
11 regulator could figure out what a right standard is in a
12 technology that changes every six months and could go about
13 actually setting that standard and implementing it in a
14 timely fashion.

15 The likelihood is that what you would get is you
16 would get impediments set in the system rather than get the
17 kind of push forward into the system.

18 I'll give you just one example. We have a
19 regulated standard for television screen resolution, and it
20 has essentially been in place since the late 1950's. And
21 you get the same 550 lines of resolution on your television
22 set no matter how many buttons you have.

23 The resolution on a PC monitor has exploded. It
24 has increased over the last decade. It has become sharper,
25 better, bigger, easier because there has been no standard.

1 Because what has been pushing it is the marketplace
2 requiring better and better screen resolution because the
3 products that are being displayed on it do more things; they
4 look prettier, so we want to see it as a prettier thing.

5 That's just one example of many that I could cite
6 where standards have been set. They have acted as an
7 impediment to the technology being pushed forward as opposed
8 to where standards have been really left to the marketplace
9 to drive them have not.

10 I would like to say one other thing. As you
11 mentioned in your introduction, I did spend a lot of time on
12 international matters in my career. And I think Marshall
13 brought up this point, and I think it's a very important
14 one. The ETSI case that he mentioned was a case that I
15 worked on when I was still at USTR.

16 One of the things that we need to be very careful

1 generalize this to the international marketplace, we as a
2 country are principally a producing country and an exporting
3 country.

4 All the major European countries, the Japanese,
5 and many others would like to get into many of the business
6 lines that these industries are now driving forward and
7 pushing.

8 They are constantly on the lookout for ways to
9 alter policy in ways that would not violate their
10 international obligations or in ways that are justified
11 because a precedent has been set already somewhere else
12 maybe in the U.S. We are implementing those policies.

13 And it's, I believe, a true danger that we are
14 sometimes our own worse enemies. Sometimes we implement
15 things here domestically which end up being rationalized by
16 foreigners in ways that do damage to our own interest.

17 The ETSI example that Marshall raises is one
18 example where, essentially, where -- we can talk about it
19 now -- it was a Motorola patent that several European
20 competitors -- Ericksen, Thompson, and others -- were really
21 after. And what they didn't want was Motorola building the
22 digital cellular telephone system in Europe. They wanted to
23 build it. What did they do? They tried to manipulate the
24 standards setting process so that Motorola would be
25 compelled to license their patents to them free of charge.

1 That's not competition. That's theft. Very
2 straightforward.

3 In different circumstances, Japanese industry has
4 been very straightforward in talking about their goal is to
5 avoid redundant investment in existing technologies and that
6 the way to get there is to dilute the intellectual property
7 for that existing technology. What they are trying to do is
8 replicate, duplicate, actually displace successful U.S.
9 products. That, too, is a standard setting process.

10 In the context of the telecommunications debate
11 that's been occurring internationally -- and there was a big
12 ministerial meeting in Brussels just about a year ago --

1 in the international context, and it's important that as we
2 work through these issues in our domestic context -- and we
3 should -- that we do it fully conscious of the fact that it
has implications for the long-term competitiveness

1 different than many other industry groups whose membership
2 reflect a more narrow niche in the marketplace.

3 CCIA is comprised of top executives from companies
4 which represent a very broad cross-section of the industry,
5 small, medium, and large companies representing many
6 segments of the computer and communications industry.

7 As a result, our Association's views and scope of
8 work tend to be broader, longer range, and more strategic in
9 orientation.

10 We have a long history of supporting public policy
11 which encourages vigorous competition in our industry.
12 Therefore, CCIA also advocates a balanced approach to
13 intellectual property rights in high technology markets,
14 seeking to ensure a proper remuneration for creativity while
15 preserving the ability of newer innovative companies to
16 compete in the market.

17 We applaud the FTC for holding hearings on the
18 appropriate role of antitrust enforcement and competition
19 policy in our increasingly global, innovation-driven
20 economy. Particularly in our industry, the pace of
21 innovation, the increasing importance of network
22 externalities in the development of product lines, and the
23 important role of interfaces and interoperability, make it
24 essential to reexamine how antitrust law and antitrust
25 enforcement agencies should approach this industry in order

1 to ensure that antitrust law performs its essential role of

1 IBM's dominant position was recognized early by
2 the Justice Department which clearly understood the
3 potential anti-competitive practices. Thus, IBM came and
4 remained under the close supervision of the Justice
5 Department for several decades.

6 Now how does this historical experience relate to
7 the present day? CCIA believes that the FTC and the
8 Department of Justice must remain at least as vigilant today
9 as you were in the past.

10 The economics of the industry have changed, but
11 certain fundamentals remain the same. These include the
12 network effects of large numbers of users adopting de facto
13 industry standards. And the sunken costs associated with

1 property rights or assert excessive or over-broad
2 intellectual property rights.

3 To achieve this end, two steps are in order:

4 Antitrust principles must inform decisions by
5 Congress and the courts as to the appropriate scope of
6 intellectual property rights. The FTC should take an active
7 role in providing informed views on competition policy to
8 those that define the proper sweep of intellectual property
9 rights.

10 Antitrust authorities must rethink the appropriate
11 role that antitrust laws should play in addressing key
12 issues affecting competition in our industry, including the
13 scope of intellectual property rights in computer
14 interfaces, the cumulative impact of networks that derive
15 their value from third-party investments, the problem of the
16 control of interfaces by one or two companies.

17 What policies work and should be retained?

18 What policies need to be changed or fine-tuned to
19 address innovation-based competition?

20 And what new ideas are needed to ensure that
21 intellectual property is rewarded and protected but does not
22 unnecessarily and inappropriately stifle competition in our
23 industry?

24 I would like to reiterate the features of our
25 industry that must be kept in mind in assessing competition

1 in our industry.

2 We must recognize the important role of standards
3 in our industry. Software developers, applications
4 developers, peripheral manufacturers, network suppliers, and
5 many other of the 71,000 that Marshall made reference to,
6 all recognize the importance of industry-wide standards in
7 enhancing the value of all aspects of computing.

8 Interoperability is a central factor to the maturation and
9 continued growth of the computer industry.

10 Second, one should recognize that the creation of
11 standards occurs, for the most part, through product
12 acceptance. Formalized standards-setting plays a limited
13 role in our industry. Many standards are de facto
14 standards. De facto standards often arise through the
15 adoption of the standard by others -- network externalities.

16 As a result, the assertion of intellectual
17 property rights in such de facto standards as an interface
18 or network protocol poses troubling and complicated issues
19 for antitrust authorities. Should firms be rewarded for
20 actively encouraging the acceptance of their products as a
21 de facto standard and thereafter asserting intellectual
22 property rights on the interface to attempt to control
23 competition against firms that have already committed their
24 efforts to the standard?

25 Finally, as mentioned previously, I want to remind

1 you of the sunken-costs issue in this industry. At all

1 consistently, neither is subservient to the other.

2 I think it is now generally accepted that
3 intellectual property laws and antitrust laws share the
4 common purpose of promoting innovation and competition in
5 the high-technology markets. Prudent enforcement policy
6 dictates that the FTC should seek to harmonize these laws, a
7 view I hope Commission shares.

8 However, in fulfilling their responsibilities, the
9 enforcement agencies cannot be lax in this vitally important
10 area. The agencies must be effective advocates of
11 competition policy in connection with legislation and
12 litigation in which the scope of intellectual property
13 rights are defined.

14 Current antitrust thinking on intellectual
15 property-antitrust issues generally involves two steps. In
16 the first step, the agencies seek to determine if the
17 conduct being construed is within the scope of the patent or
18 copyright holder's exclusive right.

19 If the conduct amounts to no more than the
20 unilateral exercise of a patent or copyright holder's
21 exclusive right, then the conduct is normally thought to
22 pass muster under the antitrust laws. Only if the conduct
23 is beyond the rights conferred by the intellectual property
24 laws does antitrust analysis proceed to the second step of
25 assessing the reasonableness or lawfulness of the conduct

1 agencies will be left with the more difficult job of
2 returning the horse to the barn.

3 Innovative antitrust enforcement approaches are
4 possible, but the enforcement agencies' foremost mission
5 ought to be to become effective voices for pro-competitive
6 policies in the definition of intellectual property rights.

7 Let me suggest just a few examples of areas where
8 the FTC and the body of antitrust law, generally, could be
9 more active in assuring that concerns are heard in the
10 definition of IP rights.

11 With regard to patents, one striking example comes
12 to mind. The Patent and Trademark Office recently issued a
13 detailed document describing the basis and principles that
14 will apply in allowing patents covering computer
15 program-related inventions. In general, the regulations
16 will result in more patents being issued on computer
17 programs. And in recent years, thousands are being issued
18 each year.

19 Were the competitive concerns related to these
20 rules adequately considered by the PTO?

21 What antitrust consideration was given to those
22 rules?

23 Wholly apart from the outcome of the rule-making,
24 I wonder if the competitive concerns related to the issuance
25 of patents on software-related innovations were adequately

1 addressed in that process.

2 If they were not, has not the opportunity largely
3 been lost?

4 While admittedly the issues involved in the
5 granting and the scope of patent rights are often difficult,
6 arcane, and intricate, the intelligent and coherent
7 consideration of antitrust policy clearly does have a role
8 in this debate.

9 With regard to copyrights, the situation is
10 perhaps more pressing. The courts today are grappling with
11 the proper scope of protection that computer programs are
12 entitled to under the copyright laws. It is a very hard
13 process, one that Judge Boudin in Lotus v. Borland compared
14 to trying to put a square peg in a round hole.

15 One important issue, at the core of what we are
16 discussing today, is the copyright protection available to
17 computer interfaces and to software that implements computer
18 interfaces.

19 Can authors secure exclusive rights to the
20 interoperability of their programs with other programs or
21 control computer interfaces or networks through the
22 assertion of copyrights? These issues are central to the
23 competitive process in our industry. Many aspects of
24 competition are going to be affected by the answer to these
25 questions.

1

However, the battles are not being fought as

1 considering the scope of copyright protection over the
2 programming language interface of spreadsheet programs.

3 Further still, in applying the widely accepted
4 Computer Associates test to identify protectible elements of
5 computer software, the courts must filter out unprotectible
 interfaces and o

1 unprotectible subject matter in computer programs.

2 The competitive implications of this legislation
3 ought to be considered by the antitrust authorities before
4 legislative action occurs.

5 Likewise, the FTC should consider intervening in
6 the appropriate cases where the question of the scope of an
7 intellectual property right poses legitimate competitive
8 issues, such as Atari and the Sega case. The courts would
9 benefit from the Commission's views in such cases, and
10 harmonization of IP and antitrust law would be furthered.

11 Finally, I suggest that it would be appropriate
12 for the FTC to issue a white paper itself, or other such
13 document, setting forth its views on the competitive issues
14 that arise in various areas such as the application of the
15 "fair use" doctrine to computer programs.

16 Another point I would like to make relates to the
17 way in which the FTC needs to rethink its policies in order
18 to ensure their relevance to the computer industry. I would
19 like to applaud the steps the Commission has taken to date
20 and encourage such creative thinking in the future.

21 These hearings are a very important statement that
22 the FTC intends to remain an effective, vibrant force in
23 competition policy in innovation-based industries like mine.

24 Likewise, the recent consent decree in the Dell
25 case recognized the importance of standard-setting processes

1 in promoting innovation and increasing competition by
2 assuring access to industry-accepted interfaces.

3 This is true whether the standard is created in
4 formal standard-setting bodies or if the standard is a de
5 facto standard generated by network externalities, such as a
6 large installed user base. Access to interfaces promotes
7 competition and enhances consumer choice and, thus, consumer
8 welfare.

9 We, again, applaud the FTC's efforts to protect
10 competition in this regard.

11 The attention that the Commission has given to the
12 R&D markets, to innovation markets, and the consideration of
13 the novel ways of using its jurisdiction under section 5 all
14 bespeak the correct view: That it is necessary to rethink
15 and reinvent, if necessary, the approach the Commission
16 takes to innovation-based competition, generally, and the
17 computer industry in particular.

18 Let me suggest a few additional areas for your
19 consideration:

20 Attention needs to be paid to the undue
21 anti-competitive restrictions in software licenses. For
22 example, cases such as Sega v. Accolade, recognize that
23 reverse engineering in a computer program to ascertain its
24 unprotectible elements constitutes a fair use under the

1 However, dominant firms -- arguably, all authors
2 -- should not be permitted, in the absence of open
3 distribution practices, to impede the exercise of this right
4 and stifle competition by imposing license terms that
5 prohibit a fair use analysis for the purpose of developing
6 non-infringing, interoperable products. There are obvious
7 anti-competitive effects here that warrant your scrutiny.

8 Moreover, we need to bear in mind in this regard
9 that the dominant purpose of the copyright laws is the
10 dissemination of information. Rewarding the author is a
11 secondary concern. Conduct that impedes the dissemination
12 of unprotectible information is contrary to the purposes of
13 both the antitrust laws and the copyright laws.

14 Likewise, the Commission needs to consider the
15 question of the assertion of over-broad or unjustified
16 threats to enforce intellectual property rights on
17 competition in innovation-driven markets.

18 Invalid or over-broad threats of litigation can
19 have a very chilling effect in this industry. Assertion of
20 an invalid property right in an interface, for example,
21 could chill scores of small software developers from writing
22 applications for that interface and thereby entrench
23 established players at the expense of competition.

24 What role does antitrust have to play in the
25 dissemination of interoperability information relating to

1 networks, interfaces, and the like?

2 Are there circumstances where a dominant firm can
3 improperly impede competition by refusing to make interface
4 information freely available?

5 Is section 5 an effective remedy in such cases?

6 Another area we would urge you to explore relates
7 to the question of networks and other environments where
8 substantial network externalities are present.

9 Where a large portion of the value of a network or
10 interface is driven by network externalities, what
11 limitations, if any, does that place on firms that control
12 access to the network or define the interface through
13 software that becomes a de facto standard in the industry?

14 For example, can firms affirmatively induce the
15 creation of interoperable applications and, at the same
16 time, seek intellectual property protection over the aspects
17 of the application on which the industry must rely?

18 Is this type of conduct fundamentally any
19 different from the conduct challenged in the Dell case in
20 the context of more formalized standard setting bodies?

21 While I suspect that even on this panel the views
22 are divergent, the issue is important and needs to be
23 discussed.

24 Finally, you may wish to think about the role of
25 the essential facilities doctrine in the innovation-driven

1 industries.

2 Despite the fact that it is well established in
3 Supreme Court jurisprudence, the application of essential
4 facilities doctrine to unilateral conduct remains
5 controversial.

6 However, given the structure of the computer
7 industry, including the prevalence of de facto standards and
8 the problem of sunk costs, the FTC needs to consider whether
9 there may be a role for the essential facilities doctrine in
10 this industry and to assess whether certain practices of
11 copyrighted works constitute "essential facilities."

12 All of these questions, I submit, are important,
13 regardless almost of the conclusions that individual panel
14 members here might have on the question.

15 More generally, it is vitally important that we
16 continue to rethink how antitrust doctrines apply to
17 innovation-driven markets.

18 What works?

19 What doesn't?

20 What new competitive forces are at work?

21 And what responses are needed to these changes?

22 The computer industry does not need ad hoc
23 antitrust rules or special principles to apply. What we do

1 conditions in the market as it has in many other markets
2 over the past 100 years.

3 One final note on global competitiveness. This is
4 a subject where our industry is tremendously involved and
5 concerned.

6 The primary purpose of the antitrust laws is to
7 protect competition in the U.S. However, a prudent
8 antitrust enforcement policy must take into account the need
9 of U.S. firms to compete globally. We believe that the best
10 way to ensure U.S. firms are able to compete globally is to
11 have a strong, competitive market in our country. I believe
12 that vigorous domestic competition is the best assurance
13 that U.S. firms will have the competitive edge in the
14 foreign markets.

15 We reject intellectual property protectionism.

16 Thank you.

17 CHAIRMAN PITOFSKY: Well, thank you. You
18 certainly hit all the bases and the issues that led us to
19 hold these hearings in the first place.

20 Let me make a comment and then ask you a question.

21 The comment is this: I think you're absolutely
22 right that people who care about antitrust policy have to
23 pay more attention to the scope of intellectual property
24 rights. And I think that's in the works, and I think you'll
25 find changes occurring in which that very kind of

1 participation intervention will occur. And that's the
2 long-term strategy and I think a useful one.

3 But in the short-term, while intellectual property
4 rights are defined as they are, I thought I heard you say at
5 the beginning of your comments that you thought either under
6 section 5, or under the antitrust laws more generally, there
7 is a role to ensure reasonable open access.

8 Is that your position, that the antitrust can play
9 that role?

10 MR. BLACK: Yes.

11 CHAIRMAN PITOFSKY: We have, I think, today, as we
12 did yesterday, a difference of view on this; and probably it
13 reflects a difference of view in many circles in the
14 country, whether by ensuring open access we diminish
15 incentives to such a great extent that it's not useful.

16 And what are the practical problems of ensuring
17 open access? Who sets the reasonable royalty? Who decides
18 compulsory licenses and so forth?

19 It's not an easy set of questions.

20 Perhaps some of the people who spoke earlier this
21 morning have comments on later discussion.

22 Bill Baxter.

23 MR. BAXTER: Yeah, I would like to make two
24 points.

25 One is the fact that the investment that users

1 make that is complementary to the Net is a real cost. I
2 mean there are real social costs involved, and they can't be
3 ignored.

4 If a single company owned the Net and all the
5 applications, it would take into account, in deciding when
6 to go to the next technology, the fact that it was
7 obsoleting all of those applications; and nothing is changed
8 by the fact that the applications are in two hands rather
9 than in one.

10 So, first of all, the rate at which technology
11 should turn over in these industries is slower by reason of
12 those applications investments.

13 The second thing, getting back to the question you
14 just raised -- about equal access or confiscation, however
15 you like to think about it -- it is important, I think, to
16 remember that in the real world one does not license patents
17 or copyright. One essentially licenses technology for the
18 most part. And that means there will be know-how provisions
19 and show-how provisions; and we'll be sending technical
20 people back and forth to one another's plants to teach their
21 people on their premise how to do this and we'll send over
22 the guy who explains that when it doesn't work right, you
23 kick this machine down near the lower left-hand corner and
24 that usually does the trick.

25 There are very complex arrangements. And,

1 consequently, for the courts to issue remedial orders that
2 will be effective involves very extensive, judicial
3 regulation of the kind that we saw for these last 10 years,
4 for example, in telecommunications under the MFJ.

5 And I would think one would want to take a deep
6 breath and think very carefully before stepping into that
7 situation.

8 CHAIRMAN PITOFSKY: Bill, you're not telling me
9 that you have second thoughts about the AT&T case and the
10 MFJ?

11 MR. BAXTER: The opportunity for re-litigation of
12 the MFJ was greatly changed by Judge Green after I wrote my
13 version.

14 CHAIRMAN PITOFSKY: Other comments or questions?

15 MR. PHELPS: I would like to make a quick comment.

16 CHAIRMAN PITOFSKY: Yes.

17 MR. PHELPS: It seems to me, if there is a
18 problem, it really is a bottleneck and it really is a
19 problem, I don't know what in the law isn't there to go fix
20 it.

21 Now, I really worry about the point Emery Simon
22 made, and you should all worry about it, too. We have a
23 hell of an industry in this country. And the authorities
24 and the competitors around the world watch hearings such as
25 this and say, ah-ha, the American Government is worried

1 about the very same things we're worried about for the very
2 same reasons, only difference is it happens to be a U.S.
3 industry. And there's a real opportunity for us here to
4 take the exact same words and apply them in the context of
5 Europe or Japan or whatever and really get our hands on some
6 stuff we otherwise couldn't get our hands on.

It is not an idle possibility. ETSI is just one

1 And I think that's a very difficult task.

2 CHAIRMAN PITOFSKY: Questions?

3 MR. SIMON: I guess I would like to make a short
4 comment about what you were talking about, the increasing
5 role of antitrust authorities and looking at intellectual
6 property laws.

7 Ed raised a number of cases that have been
litigated recently, the Sega

1 diluting all of the intellectual property, you're not just
2 hurting the company that has been abusive or the company
3 that's the bottleneck. You're hurting the entire industry.

4 And that strikes me as an irrational approach to
5 the problem. If you've got a player who's being abusive,
6 you've got someone who's misbehaving, then you address that
7 problem. You don't condemn the industry as a whole.

8 It strikes me that a lot of what Ed was talking
9 about, which is, you know this whole re-examination of the
10 scope of intellectual property from a purely antitrust
11 perspective. I mean, the intellectual property law
12 contained all those balancing notions in it already. And it
13 has not evolved, you know, out of a blossom in 1995. It has
14 evolved over 200 years, and those competition considerations
15 have been active throughout its history.

16 So to somehow say that the law in the area of
17 intellectual property has gone amuck and there are no
18 competition considerations that play in it is simply
19 counter-intuitive and counter-factual.

20 You've got to be very careful about this stuff.

21 MR. BLACK: If I could?

22 I think, again, we ought to take a look at some
23 reality of what's going on. We view -- and I agree with
24 everything Marshall said. We have a tremendous industry
25 here. It has grown up in a certain environment. And part

1 of that environment included significant intellectual
2 property protection. But it was a balanced system.

3 What we are facing in the real world, as we have
built up intellectualtec

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1 When they get set successfully -- as was the case
2 with the Internet -- they get set at a point in time when
3 nobody cares about them. When everybody starts to care
4 about them, it becomes impossible to set them.

5 I mean Sun has been involved -- I think Sun is a
6 member of virtually every industry standards body that
7 exists.

8 And it seems to me that almost every time when we
9 start to discuss a standard in which people actually have an
10 economic stake, the politics get really ugly.

11 And I'm sure we even play them. I mean, I'm not
12 suggesting we are innocent parties here.

13 On the other hand, when the emerging technologies
14 are really emerging and nobody yet has an economic stake or
15 can't figure out what their economic stake might ultimately
16 be, it's a lot easier to come to agreement.

17 This is apart from the fact that the distinction
18 between things like, you know, what's an interface versus
19 what's an implementation, what is interoperability versus
20 what is compatibility, are not perfectly obvious. We
21 frequently use those terms in this industry as though the
22 definitions were perfectly obvious and then you'd have to be
23 either an idiot or acting in bad faith and deny it.

24 The fact is that, you know, the definition of
25 terms is important. One of the reasons we have supported

1 the recent movement of the courts of appeal in this country
2 in connection with this question of what's copyrightable in
3 terms of intellectual property, particularly computer code,
4 is because we believe they've hit upon a methodology for
5 figuring out the right answer, the filtration issue and so
6 forth, where you separate the parts that are functional from
7 the parts that are expressive. That issue now is before the
8 Supreme Court in the Lotus v. Borland case.

9 We've supported the -- virtually every appellate
10 court which has reviewed this question has said: No, there
11 is a distinction. And here's the way you figure out what it
12 is.

13 There are other people in the business that are on
14 the other side of that case and would like to eliminate what
15 we think are kind of standard garden variety distinctions of
16 the copyright law, or at least make them not apply in the
17 way we believe they ought to, to computer software. We
18 think that's wrong. And we think what that ultimately will
19 do is confer or enable other people to maintain monopoly
20 power on really critical pieces of technology to the
21 detriment of the industry as a whole.

22 We are not advocating, at Sun, changes in the law.
23 We don't think the law needs to be changed. We think there
24 are plenty of tools available to the antitrust enforcers and
25 under the intellectual property laws to provide a balance

1 plug. And that's been mentioned here.

2 On the one hand it gives incentives for inventors
3 and developers and authors, and it keeps the industry moving
4 forward; but at the same time, it doesn't permit one or two
5 parties to get a strangle hold on a choke point and derive
6 monopoly rents out of it.

7 COMMISSIONER STEIGER: May I just add a question
8 at this point, because I think you can answer it as well.

9 Looking at intellectual property as a part of an
10 antitrust analysis, would you distinguish between copyright,
11 patent, and trademark in an analysis? Or do you consider it
12 all of a piece?

13 MR. MORRIS: I distinguish it simply because there
14 are different rules that apply to the different parts.

15 And so you have to -- I mean, as the lawyer, I
16 have to distinguish it because the rules are different. You
17 can't avoid those kinds of distinctions.

18 One of the problems that we believe the White
19 Paper that was introduced by the PTO recently tends to
20 confuse copyright and patent law and make the former the
21 latter, which that's a mistake, because it tries to do that
22 without imposing some of the limitations and tests that
23 copyright law imposes on -- or patent law imposes on patent.

24 They are distinctive, there is no question. They
25 form the entire piece -- or the entire body of intellectual

1 property law. But they are enacted -- but the statutes are
2 different. They were enacted for different purposes. So we
3 think you have to distinguish. You can't avoid it.

4 MS. VALENTINE: Mr. Wayman, on the standard
5 setting?

6 MR. WAYMAN: Yeah, on the standards you -- a
7 couple of comments which hopefully will be responsive.

8 As I look at the debate on standards, I think
9 that, to some extent, it's really off on a wrong track.
10 When I look, I think you had the Commissioner -- an attorney
11 that works for ANSI talk, and I read her remarks.

12 You know, I don't think we should be worried about
13 examining the standard setting process in any great deal.
14 It is subject to abuse. The situation that you have with
15 Dell is such an abuse. But I don't think that that's a very
16 leading-edge kind of an issue to be worried about in these
17 hearings. It seems to me that the laws are reasonably well
18 settled there and that the Dell case was a reasonably
19 predictable outcome. And that's not what we ought to be
20 focusing on in these hearings.

21 I think the real issue is the standards that don't
22 get set. The question of, you know, yes, sometimes ANSI
23 comes up with good standards and, to agree with Mr. Morris,
24 sometimes they're too late and it's too political.

25 The thing we need to focus on is: What are the

1 points at which standards need to be established? And what
2 are we going to do to facilitate that process?

3 If it happens to be facilitated by a voluntary
4 program, that's terrific. But I think the antitrust law
5 needs to be worried about the standards that aren't being
6 set and the interfaces that aren't being admitted as
7 interfaces.

8 And let me just surface one very important problem
9 when we talk about interfaces. And Mike used the term that
10 one man's interface is another man's proprietary location of
11 his devices.

12 You need to understand, in our company in
13 particular, we have devices which have functional
14 characteristics which are unique when compared to the person
15 that owns the network or the operating system. And he says,
16 well, you can attach this device here; well, that means this
17 device has to work in that way.

1 One problem with voluntary standards, particularly
2 as to devices or products that are not really very high
3 tech, is that I've seen several instances where it seemed
4 fairly clear to me that what was going on was really a
5 reduction in the complexity of the set of goods that was out
6 in the marketplace for the purpose of facilitating price
7 coordination in a concentrated industry.

8 A second question really in response to Janet's
9 question about the different systems, copyright, patents,
10 and trademarks. I think there's a lot of confusion about
11 trademarks or incomplete thinking about trademarks.

12 I've seen again and again in literature the
13 statement that, well, copyrights and patents are intended to
14 induce investments and innovation; but trademarks are just
15 consumer protection to keep consumers from being deceived.

16 But that has an opposite side of a coin. If you
17 can make your trademark stick and enforce it effectively,
18 you have an incentive to engage in quality control, quality

1 COMMISSIONER STEIGER: Thank you for that. I
2 think it is interesting, just on an anecdotal level, that if
3 you are considering value of assets, even though the value
4 may be amorphous, the trade name frequently is mentioned as
5 substantial assets.

6 MR. BAXTER: Yeah, one of the more interesting
7 fights actually in the telecommunication context was who got
8 the name "Bell." It was obviously regarded as having
9 enormous value by the parties.

10 CHAIRMAN PITOFSKY: Other questions?

11 MR. SIMON: I just want to make a very short
12 comment about the point that Mr. Morris brought up, which is
13 the definition of terms, which is really critical, because I
14 think every company and industry licenses interfaces or what
15 somebody else would call a critical interface.

16 And the question is: What's the critical
17 interface? The one that I own, which of course is not
18 critical because then I can license it. Or is it the one
19 that he owns, which I want for free; so, therefore, it
20 should be critical.

21 Everybody licenses technology, everybody licenses
22 interface specifications, everybody shows others where to
23 attach their product.

24 Because, frankly, all these companies and all the
25 companies are driven to work together and one of the ways

1 they do that is by licensing each other.

2 The key here, or the debate is: How do you pick
3 the ones which you shouldn't be able to license? And that's
4 not an intellectual property issue. That's a competition
5 issue. And to phrase it as an intellectual property issue,
6 frankly, confuses it beyond necessity. It doesn't work in
7 that realm.

8 One very small point, too, about patents and
9 trademarks and copyrights.

10 Yesterday, you talked quite a bit about compulsory
11 licensing. Under international law, as I understand the
12 compulsory licensing of copyrights is not permitted. You
13 can, under limited circumstances, compulsory license the
14 patents still under the international agreements under the
15 World Trade Organization.

16 But compulsory licensing of copyrights is not
17 permitted. That's from your perspective as you look at that
18 -- or have looked at that as one of the ways that you remedy
19 situations, that's not an option to you in the copyright
20 area without violating international law.

21 CHAIRMAN PITOFISKY: Thank you.

22 MR. ANTALICS: I did have a question for Professor
23 Baxter.

24 I was just wondering if you saw any limits on the
25 types of agreements that a dominant operating system holder

1 and also holding the interface -- any limits on the types of
2 agreements that they could enter into with companies in the
3 complementary market that might affect their dominance in
4 the operating system market, exclusive agreements or things
5 of that nature?

6 MR. BAXTER: Well, sure I can imagine, although I
7 have never seen, a circumstance where you would have
8 sufficient leverage to really execute foreclosure. I don't
9 think foreclosure is a logical error. It may be an empiric,
10 empty set.

11 But there certainly would be circumstances where
12 there were substantial economies of scale at the adjacent
13 level where there was a company at the adjacent level that
14 had a very large -- you need very large market shares; you
15 need significant entry barriers at both levels. And it's a
16 form of predation. You have to buy more than
17 proportionately at the adjoining level to preempt the

1 agreed with him that there was a lot of monopoly power at
2 Microsoft. I agreed with that instantly.

3 But I asked him sort of the dog and fire truck
4 question, which is I think what Bill is after, which is:
5 What are you going to do with it when you catch it exactly?

6 COMMISSIONER STEIGER: Thank you. There's got to
7 be one like that in every crowd.

8 Yes, Susan.

9 MS. DeSANTI: We have been talking a lot about the
10 proper role for antitrust enforcement.

11 I'm wondering whether any of you have thoughts on
12 a possible role for the Federal Government as a large
13 purchaser of computer products in terms of moving -- or
14 influencing the development and implementation of standards
15 that might facilitate entry and competition.

16 MR. PHELPS: Yeah, I actually mentioned that when
17 I talked. If you -- the government is a huge purchaser.
18 And one of the ways you can inflict -- any large purchaser
19 can inflict their view of interoperability on the industry
20 pretty easily is through that kind of a mechanism, it seems
21 to me. And you can drive the industry towards
22 interoperability faster than it might otherwise get there
23 because it's in a common interest to do so.

24 And I would absolutely encourage the government to
25 do that kind of thing, all governments. I mean, that's on

1 the purchasing side. But there is absolutely no rule that
2 says you can't also participate in the standards process
3 itself as a large customer; and you should do that as well.

4 So I would encourage it.

5 MS. DeSANTI: Bill?

6 MR. BAXTER: I was just thinking, we now have two
7 agencies enforcing the antitrust laws. I'm not sure I want
8 a third, fourth, and fifth. If we are going to contemplate
9 legislation of that kind, I would have these activities
10 conducted only at the instruction of one of the existing
11 agencies.

12 I'm reminded, not very many years ago, work at
13 universities that was financed by the government could not
14 be licensed -- or if it was licensed, the proceeds had to be
15 turned over to the Federal Government.

16 Essentially, no licensing occurred during those
17 years; and we had a terrible battle getting that law changed
18 so that the universities could have licensing programs and
19 give exclusive licenses, which, of course, turned out to be
20 essential as a foundation for investment.

21 When we finally got that done, the success of
22 universities, generally, in executing licensing programs
23 changed quite fantastically.

24 So I don't know that having the government be the
25 de facto owner of the Net would be a very good thing. If

1 you are going do it, maybe what you should do is maybe sell
2 off, as soon as you get your standard system established,
3 get the government out of that picture. Because I expect it
4 would have sort of the same effect it did back in the 70's
5 when we were trying to get licensing started in the
6 universities.

MR. BLACK: If I could ma 0198 36.

1 to be open?

2 And I was also struck by Mr. Wayman's comment that
3 you need not equate access to interface with diminishing the
4 value of the system itself.

5 And my question on that is, rather than thinking
6 about sort of the application versus interface distinction,
7 ought we to be thinking about a process distinction?

8 And is access what we're talking about?

9 And if so, what sort of access is enough?

10 COMMISSIONER STEIGER: Who wants to respond to
11 one, two, or three of that question? All of them are
12 extremely important to us.

13 MR. BRESNAHAN: Let me buy us some time by going
14 back to the last topic for a second, while we chew on those
15 very difficult ones.

16 I think there is a large thing missing from the IT
17 industry now which is a vendor neutral forum for buyers to
18 influence the direction of technical change by their voice
19 as well as by their buying behavior.

20 And the old vendor-specific ones, the share and
21 guide committees that were aligned with IBM a generation ago
22 were very useful in doing it.

23 And now vendors are trying to start up
24 vendor-specific -- Microsoft and IBM still has them -- are
25 trying to start vendor-specific committees to get feedback.

1 The government could play a very useful role as a
2 buyer by instituting the formation of a vendor-neutral
3 committee.

4 On the other hand, you know, it seems to me --
5 I've read the Department of Defense's definition of "open
6 systems." It took me a little over two hours.

7 The DoD procurement is just not designed in its
8 intent of producing competition in purchasing to produce
9 actual competition in purchasing in an industry that changes
10 as rapidly as IT. It seems having the governments per se do
11 it is a bad horse to ride. Having the government facilitate
12 it is a great idea.

13 COMMISSIONER STEIGER: Stanford is fortunate to
14 have a speed reader on its distinguished faculty.

15 Who else wants to respond here to Becky's
16 questions?

17 MR. WAYMAN: If that question had an easy answer,
18 I'd give it to you, I guess, is one answer to tell you. I
19 mean that is a tremendous problem, you know. But I do feel
20 strongly that we are not talking about an appreciable part
21 -- we should not, in order to be talking properly about
22 interfaces, we should not be talking about an appreciable
23 part of the intellectual property investment of the first
24 mover being captured by the person who has access to the
25 interface.

1 I mean, if that is, in fact, the case let me use
2 the essential facility cases which, if you claim that a
3 football stadium is an essential facility and you need to
4 get use of it, you're claiming rights to a huge investment
5 that somebody else made.

6 But if you claim that one guy installed a set of
7 railroad tracks and they have a certain gauge or width and
8 you want to build your own network of railroad tracks and
9 you want to copy the same gauge, you know, the whole
10 economic equation is completely different.

11 And I'd be interested in Professor Baxter's -- he
12 commented to Chairman Pitofsky's question about: If the
13 first mover has a monopoly in a certain area, is it
14 appropriate for him to extend that monopoly -- as I
15 understood it -- or to charge a rent on use of that facility
16 in the next area?

17 Would it be your answer if the first guy built a
18 set of railroad tracks that if he could protect the gauge of
19 that track -- that he was entitled to extract a rent on that
20 gauge equal to the value of the second set of railroad
21 tracks?

22 MR. BAXTER: Yes. And, of course, that's one
23 reason why a gauge would not be protectible unless it had
24 some extraordinary unpredictable characteristics. It would
25 be not protectible.

1 But I would see a substantial difference between
2 the situation where I want to attach my gadget to your Net
3 and you say, well, yeah, at a price. And I find the price
4 unsatisfactory, at which point I become a true believer in
5 open access.

6 Someone said that war is merely an extension of
7 diplomacy. And open access is merely an extension of
8 bargaining over the price of access.

9 Now, if I take the analogy to your second railroad
10 and I don't want access to your system at all, all I want to
11 do is use some of the features of your system and build an
12 independent circumstance, that, of course, is a completely
13 different case.

14 What's the nature of your intellectual property
15 that would enable you to keep me from doing that?

16 MR. WAYMAN: Okay. Let me give you an example.
17 How about the QWERTY keyboard?

18 That probably, under current copyright law would
19 be protectible for the guy that invented it.

20 MR. BAXTER: The QWERTY keyboard?

21 MR. WAYMAN: Yes, sir

22 MR. BAXTER: I don't expect that -- oh, you mean
23 so that current people would still be paying?

24 MR. WAYMAN: I develop the keyboard and I build a
25 bunch of typewriters, and now another guy wants to build

1 some typewriters and he wants to use the same keyboard. And
2 I say, fine, give me the profits you're going to make on
3 your typewriters.

4 MR. BAXTER: Well, for the life of the
5 intellectual property that is involved, I guess I have no
6 problem with that.

7 MR. WAYMAN: Okay. I really do.

8 MR. BLACK: I think what the Professor raises,
9 though, again gets to the issue that's so important is to
10 focus on the scope of protection. I mean, should it be
11 allowed to cover the gauge in this metaphor? And I think
12 we're saying that is not a critical element that should be
13 protectible.

14 In the copyright world, we have a unique situation
15 with an electronic copying process that creates a copy that
16 subjects certain processes to intellectual property law in a
17 way that a railroad gauge has never been subjected. And
18 that isn't captured. Computer software is.

19 COMMISSIONER STEIGER: We have one more respondent
20 to this line of questions, and then we will --

21 MR. PHELPS: I really think the examples are so
22 simplistic as to not even be useful. And I don't think it's
23 even possible to set rules here that you could even apply
24 generally without a disaster.

25 It all depends from whose perspective you are

1 looking at this. From the interface provider's perspective,
2 unless it's ever in that person's economic interest to
3 promote interoperability, they're always going to provide
4 less than the interface receiver wants.

5 And so to try to define rules for that is really
6 amazing. Because if I'm on the receiving end of this thing,
7 I'm going to define my interface needs that big (gesturing).
8 And the interface provider is going to provide that much
9 (gesturing).

10 Now, I don't know where you're going to try to --
11 how you're going to administratively try to draw where that
line really ought to c5.6or

1 interject a question?

2 MR. TOM: Yeah, I have two related questions. One
3 is a follow-up to Professor Baxter's answer on the railroad
4 gauge.

5 That is: Do you see a distinction between a
6 patent regime in which the railroad gauge, unless somehow
7 tremendously inventive, novel, and non-obvious, would not be
8 protected and a copyright regime in which conceivably it
9 could be protected without showing that degree of novelty
10 and non-obviousness?

11 And my second question really relates to something
12 that Emery Simon said, which is that these are competition
13 questions which ought to be handled in an antitrust regime
14 and that we shouldn't meddle with respect to the scope of
15 intellectual property protection.

16 And my question is: Can you be more specific as
17 to how that kind of problem can be dealt with under
18 antitrust doctrines as opposed to taking close looks at what
19 really is protectible and what is not?

20 MR. BAXTER: Well, I'll try to answer the first
21 half of that and not the second because I really didn't
22 understand the second point.

23 But as for the first part, yes, I think we have
24 gotten ourselves in a rather bad situation, because the
25 copyright laws really are not appropriate in their

1 fundamental characteristics to do the job we expect them to
2 do in the intellectual property area.

3 I mean, essentially we want protection of
4 functionality. And the copyright laws were not designed to
5 provide protection of functionality. So they've sort of
6 been forced and bent out of shape in order to do a job they
7 were never intended to do.

8 And I think that sooner or later, before we really
9 get good answers in this area, sensible answers, we're going
10 to have to have a legislative amendment that brings into
11 existence a form of intellectual property that is
12 appropriate to the task that we are trying to impose on it.

13 Now, having said that, I don't understand the
14 point that Emery made; so I'm going to let him deal with
15 that.

16 MR. SIMON: I guess it's sort of the answer I was
17 going to give to Becky's question as well, which is, if you
18 focus on definitions of what's an interface or what is an
19 API and whether or not that is protectible, ultimately I
20 think that that's an uninteresting question because those
21 things are protectible. We know that many aspects of those
22 things are protectible. And whether Professor Baxter is
23 right or wrong about the copyright law not doing the job
24 that it's supposed to be doing, it's a law that we have
25 today.

1 The issue is not whether that thing within the
2 parameters of the copyright law meets its criteria. The
3 question is whether the right holder is exercising that
4 property right in a way that violates the antitrust laws.
5 And I think that's the issue that you need to focus on.
6 It's not whether the subject matter is protectible. You're
7 not trying to invalidate protection from an antitrust
8 perspective. You may ultimately view that as your solution;
9 that is, you may -- yesterday there was a lot about
10 compulsory licenses or confiscation.

11 As a solution, you may want to confiscate that
12 property right. But the issue that you should be looking at
13 is not whether a property right exists but whether it's
14 being misused, whether it's being, you know, whether the guy
15 is doing bad things with it.

16 So I think that's the concept that I was trying to
17 get at, which is different than whether or not, as a matter
18 of copyright law, it is a good thing or a bad thing or an
19 indifferent thing for the copyright law to protect user
20 interfaces or to protect -- whatever.

21 MR. TOM: I get a little nervous when I hear the
22 word "misuse." Probably because I don't really understand
23 the nuances of that doctrine.

24 But to take the specific example we were working
25 with, that is the railroad gauge, it has been the general

1 approach of antitrust law to take the property rights as
2 given and to accept the fact that a person can legitimately
3 gain a monopoly. And intellectual property rights are
4 usually treated as legitimately acquired monopolies, in
5 cases where they even amount to a monopoly.

6 And so it's not clear in my mind how we would
7 treat a situation in which the law has awarded to the first
8 railroad developer an intellectual property right over the
9 gauge of the railroad track.

10 There doesn't seem to be anything in antitrust law
11 that would clearly deal with the natural consequences that
12 would flow from awarding that intellectual property right.

13 I mean, to call it a "misuse" is sort of to define
14 the problem away, I would think.

15 MR. WAYMAN: What about the facilities --

16 MR. TOM: Well, I would be interested in hearing
17 Professor Baxter's --

18 COMMISSIONER STEIGER: Excuse me. I don't think
19 the reporter got the question.

20 MR. WAYMAN: He said there doesn't seem to be
21 anything in antitrust law that would help us solve that
22 issue, and I asked about the essential facilities doctrine.

23 And without mentioning the Aspen case, Professor
24 Baxter is going to tell us what he thinks.

25 MR. BAXTER: Without mentioning the Aspen case?

1 MR. WAYMAN: I was just kidding.

2 MR. BAXTER: Well, if you go back through the
3 essential facilities cases, you have a hard time finding one
4 where there was an essential facility.

5 In Associated Press, there were several other
6 press services. In the railroad case, contrary to popular
7 fashion, it was not a gauge problem or the only bridge over
8 the Mississippi River. It was switching facilities on the
9 St. Louis side of the river. And the Supreme Court,
10 essentially, handed that problem over to the Interstate
11 Commerce Commission to solve as a regulatory matter. So it
12 never got resolved in the courts at all.

13 You sort of joked about the Redskin's use of the
14 stadium. I think the JFK Stadium is probably the best
15 example of an indispensable facilities case that there is.

16 And there the problem was pretty clear that you
17 did not have a profit maximizing entity who was doing the
18 bargaining on the other side, so you were running into a
19 political block rather than an economic problem.

20 So I just say that the essential facilities
21 doctrine, so called, doesn't make any sense to me in the
22 abstract; and until I see a case that actually involves the
23 problem, I'm going to take the position there is no such
24 thing.

25 MR. BRESNAHAN: This discussion, to me, has the

1 flavor of trying to find a technical definition which will
2 solve a rule of reason problem.

3 And the inherent complexity and malleability of
4 software -- and most hardware and software -- means that any
5 technical definition of what's an interface can be quickly
6 evaded by designers of interfaces, designers of software
7 products that have anti-competitive goals. Add modest costs
8 to development to whatever the technical definition of a
9 thing that should be open and that shouldn't be protectible,
10 there just won't be any of those any more.

11 And I mean, it seems like there's going to be an
12 impossible problem here of defining something where the
13 respondent -- I think of the attempts, for example, to
14 define an open airline reservation system. Think of that
15 where the degrees of freedom to the designers of the system
16 are vastly more complex than the degrees of freedom to
17 American on how to order flights were, and you get some sort
18 of idea of the regulatory problem that comes by trying to
19 define the thing that should be open.

20 I mean, ultimately what happened in the airlines
21 case was an outcomes test, which we don't have access to
22 here either.

23 COMMISSIONER STEIGER: I saw a lot of heads
24 nodding at the statement that we were trying to create a
25 hard and fast rule for a rule of reason problem. I think we

1 have got time for one more comment.

2 Who wants to chime in?

3 MR. WAYMAN: The other person may want -- I'll
4 just say, sure, my head was nodding only because, you know,
5 I agree it may be that you all thought you were looking for
6 a per se solution. I never thought one was realistic, and I
7 do not think that any of my ideas would lead one to some
8 sort of per se kind of solution.

9 So I agree with you that rule of reason may be the
10 appropriate analysis, but I don't agree with a point you did
11 make, which is that no antitrust analysis is appropriate at
12 all. I think it is.

COMMISSIONER STEIGER: Ed?

1 changes in the scope of intellectual property coverage is,
2 that the fundamental motivation for it is, we think, largely
3 competitive and anti-competitive. And that's why we urge
4 you to be very active in the policy.

5 COMMISSIONER STEIGER: With that, our thanks to
6 all of you on behalf of the Commission for a most
7 stimulating and, for our purposes, a useful morning.

8 We will resume at 1:30. And we hope those of you
9 who can stay will chime in.

10 (Pause in proceedings.)

11 All right. We have now decided to give you 15
12 more minutes to eat a hotdog. We are going to resume at
13 1:45.

14 (Whereupon, at 12:33 p.m., the hearing was
15 recessed, to reconvene at 1:45 p.m., this same day.)

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1 AT&T's recent announcement to go through at least one more
2 restructuring in 1995 and 1996 -- following on the somewhat
3 more famous one we went through in 1982 through 1984 -- I
4 guess mainly from an antitrust perspective. And I thought
5 long and hard about what that would be. And I think the
6 short answer -- which I will give you first -- is, from our
7 perspective, there is virtually no antitrust significance to
8 AT&T's latest announcement and AT&T's latest series of
9 transactions that it set for itself.

10 And in that respect, it's very different from the
11 transaction AT&T went through, moving the integrated Bell
12 system in 1982, to the divested eight companies that now
13 make up the regional companies and AT&T largely as a result
14 of antitrust litigation.

15 I've submitted written comments which go into the
16 subject in somewhat greater detail and, in particular,
17 explains what I do think is the antitrust significance from

1 a complete range of wireless services, manufacturing the
2 telephone equipment that you might buy for your homes and
3 your offices, and manufacturing the telecommunications gear
4 that telephone carriers across the world buy to put in their
5 networks and make the networks function, tying all of that
6 together, of course, with the research and development arm,
7 Bell Laboratories.

8 And that integration was seen to be a source of
9 great advantage for AT&T in terms of the research, in terms
10 of the economies of scope and scale, and just in terms of
11 being able to offer to the marketplace what amounts to
12 one-stop shopping for all the telecommunications needs.

13 I think our decision in 1995, to go ahead with
14 this restructuring maybe reflects a judgment either that
15 this advantage that we thought we had either wasn't
16 attainable or, if it was, is no longer sustainable.

17 And so what we plan to do is split ourselves up
18 yet again, this time into three stand-alone, completely
19 separately owned and operated corporations.

20 The one that will retain the name "AT&T" is what
21 is now our services business. And the new AT&T will combine
22 the long-distance and the wireless services and any other
23 telecommunications service business that we get into,
24 domestically and internationally. It will also include the
25 credit card and financial services Universal card.

1 Roughly speaking, there will be a second large
2 corporation which currently has no name. We refer to it as
3 S&T for "Systems and Technology." And that will be the
4 conglomeration of all of AT&T's current equipment businesses
5 on the telecommunication side. That would be the customer
6 premise equipment, the network equipment, and virtually all
7 of what is now AT&T Bell Laboratories as the research and

1 I guess the term that comes to my mind to describe
2 our rationale finally for doing this in 1995 is "dis-economy
3 of scope." The economies of scope that we thought that we
4 were going to derive from this integration within our
5 various telecommunication businesses turns out, at least in
6 1995, now to be negative. And it actually costs us
7 efficiency to try to have this very broadly integrated
8 corporation operating under a common ownership. It is not
9 clear whether it was ever possible to do it otherwise, but
10 this reflects our judgments now that it's not.

11 I will tell you that within AT&T, almost annually,
12 since the mid 1980's, the question has come up: Can we
13 continue to sustain? Can we continue to benefit from the
14 integration of the equipment and the services business?

15 And just as regularly the answer, after
16 deliberation, has come back: Yes, we must. It must be
17 right.

18 And, candidly, it was just this year that the
19 answer came back: Nope, let's throw in the towel. And the
20 reason for it is the increasing business conflict that we
21 think is inherent between our equipment business, on the one
22 hand, and our services business on the other.

23 It turns out that it costs a lot of money to run
24 an equipment business. There are very few niche markets on
25 the network equipment side that are easy to penetrate with

1 little capital investment. A very large customer base is an
2 essential component for success. And it follows from that
3 and our experience, that AT&T, to be successful as a
4 supplier of network equipment, absolutely must be able to
5 compete for the business of at least the major local
6 exchange telephone companies in this country and, indeed,
7 many major foreign telecommunications carriers in the rest
8 of the globe.

9 And we have been finding increasingly that no
10 matter the price, quality, value, and innovation of our
11 products, the major customers for those products see
12 themselves as being actual or potential competitors of AT&T
13 on the services side in the very near future. They have
14 been increasingly reluctant to commit their network
15 infrastructure purchases to a firm that they see as a
16 network competitor of theirs.

17 Our equipment entity, for its part, has been
18 extremely concerned about AT&T's services business not
19 making market moves or taking even public policy positions
20 that would irritate their prospective customers. And
21 increasingly the amount of management time and attention
22 that has been required to hold these conflicting parts of
23 AT&T's business together has begun to outweigh even our
24 wildest dreams of potential benefits.

25 And in a nutshell, I can tell you that is the

1 rationale for having made the decision to separate the
2 equipment and the services businesses.

3 I think the rest of the transaction was just sort
4 of, if we're going to do this, we may as well do it right
5 and create three new corporations with very different
6 markets and very different potential market focus needs so
7 that each new company can be relatively free to focus its
8 management time and focus its business and investment
9 decisions on the part of the business that it operates in
10 without having to worry so much about either the conflicting
11 strategies of other parts of the entity or even the
12 conflicting capital needs or financial positions of other
13 lines of business unrelated to their own.

14 And so that's why we have these three new
15 corporate entities coming out of the old new AT&T.

16 Trying hard to find some antitrust significance to
17 this, I confess, I really can find none, again, unlike in
18 1984 when the structural remedy of separating the Bell
19 system into its competitive and non-competitive parts was
20 the damages, if you will, sought by the United States
21 antitrust case. And the perception, at least in the Bell
22 system, at the time was that if we did not do something as
23 dramatic as divestiture, we would continue to face certainly
24 antitrust litigation and likely antitrust exposure.

25 There are no such aspects to the current

1 restructuring by AT&T.

2 I don't think for a moment there is any basis to
3 think that AT&T would be more or less vulnerable to
4 antitrust exposure with or without this kind of a
5 transaction. And I know that's not any part of our
6 consideration in this regard.

7 Nor, frankly, do I think it suggests any generic
8 model rule of economics or business judgment for industry
9 generally. I think that it is not necessarily true that
10 smaller is better than bigger. It is not necessarily true
11 that economies of scope turn negative after a certain point.
12 I think it merely reflects in AT&T's case -- and maybe the
13 telecommunication industry -- it's a blurring of the lines
14 between customers and competitors and a blurring of lines
15 between products and services and just a strategic and
16 managerial difficulty that connotes for trying to hold
17 together a very broadly integrated company.

18 And so I'm sort of embarrassed to report, you
19 know, that the news is none for purposes of the FTC's, I
20 think, quite laudable objective here. I wish I could be
21 more upbeat or more didactic for you. But to tell you the
22 truth, we haven't even figured out for sure how we're going
23 to do this although, we are pretty sure about why we have
24 chosen to do it.

25 So at least until we have gotten through it and

1 seen the result, it's certainly premature to assign any
2 broad significance to this disintegration as a strategy.

3 But I'd be happy to answer questions about what we
4 think we're doing. And if the day moves along as I suspect
5 it will, I imagine I'll have a chance to address what I do
6 think is quite different about the 1984 restructuring in
7 that it does have tremendous antitrust significance still.

8 Thank you.

9 CHAIRMAN PITOFSKY: Thank you very much. And if
10 antitrust is irrelevant, it's best that we know it going in.

11 What we could do is have clarifying questions if
12 there are any and save a general policy discussion for a
13 little later in the afternoon.

14 All right. Let's move on to one of these
15 potential competitors who you had in mind.

16 Norton Cutler is Corporate Counsel in the advocacy
17 section of U.S. West, a position he has held since 1993.
18 Before that, Mr. Cutler served as General Attorney in the
19 Litigation and Regulatory Section of NCR. And before that,
20 he was Associate Chief Counsel, Senior Counsel, and Senior
21 Attorney.

1 U.S. West to create the information superhighway.

2 Mr. Cutler.

1 the Antitrust Division, one of which I approved of then, one
2 of which I thought was very silly. I've changed my mind
3 about the second decision.

4 My observation is that he concluded that if you
5 left the computer industry alone -- i.e., if you don't do
6 anything about IBM -- whatever power they may have had in
7 that time frame would eventually sort of work itself out in
8 the free marketplace.

9 Apparently it has, and I congratulate Professor
10 Baxter for a very smart decision which I didn't agree with
11 at that point in time.

12 His second decision was that in the telephone
13 business, some sort of structural solution was necessary in
14 order to open up the network and create a lot more
15 competition. And, obviously, he pursued the AT&T case very
16 hard and brought about the divestiture on January 1, 1984.

17 A recent New Yorker article observed that the
18 shareholders of IBM perhaps should have wished that
19 Professor Baxter had pursued that lawsuit. But IBM is back
20 fairly strong now, so maybe the shareholders are perfectly
21 happy.

22 Generally, we in the local telephone companies
23 have reached a few conclusions, I believe, about how
24 networks should be structured and what the hints are for the
25 computer industry. And perhaps beyond that, as I'm sure you

1 all know, U.S. West is very interested in, let's call it the
2 information highway, cable, telephony, the Full Service
3 Network, whatever you want to call it, which we are
4 developing in conjunction with Time Warner in many areas.

5 First of all, we strongly believe that open
6 networks are good and that exchange of traffic and
7 interconnection, well defined interfaces, whatever you want
8 to call it, stimulate competition. And the telephone
9 industry is a perfect example of how that can work.

10 We have concluded, as a child of the Bell system
11 that -- and without being pejorative at all -- the old Bell
12 system way of providing everything from soup to nuts in a
13 closed structure, perhaps, is not as effective as the new
14 method where there are at least, you know, 15 different
15 companies that can provide some degree of the telephone
16 service.

17 Obviously, creating seven RBOCs provided lots of
18 new sources of innovation and solutions to old problems.
19 The changes in the CPE business since the Carterphone
20 decision, which I think was in the late 1960's, are just
21 dramatic as to what you can buy in a telephone today
22 compared to what was available then when the Bell systems
23 said you couldn't hook anything onto the telephone network.

24 I think that's a very important lesson to be
25 learned about open architecture and interconnection of

1 computers or video network.

2 The next point is what I will call exchange of
3 traffic and services.

4 Computer companies, I think for a long time, first
5 probably -- and these are things that I experienced. In the
6 IBM world, the peripheral companies came along in the late
7 1960's, and there were lots of arguments about what could be
8 attached, when and where and whatever.

9 I think that's pretty well passed now. But I can
10 imagine that Russell Wayman had something to say about that
11 on the previous panel, being from Storage Tech. But those
12 issues are sort of gone. The telephone business has always
13 exchanged traffic and services.

14 A base point about a telephone is, it's only as
15 good as how many people the user can reach. The telephone
16 business, since the beginning of time, even with the
17 integrated Bell system, exchanges traffic with all kinds of
18 independent telephone companies.

19 Now, in the last 20 years, there's been an
20 enormous growth, first in the long-distance business of
21 various companies like Sprint and MCI, which obviously

1 of all that.

2 We are obviously beginning to see that in the
3 local telephone business. And there are a number of issues
4 yet to be decided there. And I probably -- I guess Mark was
5 saying he was planning to comment on this later this
6 afternoon. We at U.S. West call them AT&T's "Nine Points Of
7 Light." He'll probably call them something else. But,
8 obviously, the subject of interconnected and unbundled is a
9 very interesting question which has to be decided in the

1 observed that, too.

2 Another important issue is what I'll call resale
3 and piecing out. One of our own people asked me what does
4 "piece out" mean. And it was a familiar term when I was
5 doing antitrust cases in the late 1970's.

6 Basically, in the telephone business, for a long
7 time you had permitted competing carriers who would buy
8 pieces from us and fill out their networks so they didn't
9 have to build the whole thing. That's, obviously, very
10 similar to a computer industry on a network question there.
Do you have to provide an entire computer system the way

1 really are: How far do you go in interconnection and what
2 you pay for it?

3 I understand there was a long discussion of
4 essential facilities this morning, and I'm not trying to
5 stimulate it again. U.S. West's position is, number one,
6 the things that should be resolved should be services and
7 not pieces of equipment.

8 One of the current fights, without naming names,
9 certain people would like us to basically come in and say:
10 I want that element in your switch in that LATA; and I want
11 to buy it.

12 And our position is: No. We would prefer to sell
13 you a service. What do you want? Do you want to buy Caller
14 ID for your customers from us? We'll sell you that. We
15 don't want to sell you the actual switch.

16 The other issue in there is defining where you
17 interconnect. I know that was a big issue in the computer
18 industry. One of IBM's famous comments always is, well, so
19 and so copied us so badly, they stole the SNIGLET's, which
20 are BOCs, and the best places to interconnect in their
21 computer programs. And there were always fights about
22 whether or not you could actually interconnect wherever you
23 wanted to in someone else's computer system or computer
24 network.

25 And, did you have to take what they are offering?

1 It's going to be similar in the telephone business
2 if an interconnecting carrier says I want to connect at the
3 X spot, which will require a ton of technical work to make
4 that happen, and dislocate everything else in our own
5 network. What's the appropriate solution?

6 That's going to be a difficult question. The

1 wholesale discount below the already below-cost rate. This
2 is probably a transitional issue that's going to go away in
3 a number of years, but it's a very important issue for us.

4 The next important question I think is: How do
5 you resolve these disagreements?

6 We are not naive to think that we can sit down
7 with AT&T or any other interconnecting carrier and always
8 solve everything consensually. So the question becomes:
9 Who's going to resolve the dispute?

10 I guess our recommendation is that we start with
11 private discussion. I noticed that one of the other
12 speakers here is going to talk about ONA. One of our
13 observations about ONA is while we do agree that it was a
14 good idea making the telephone network into smaller and more
15 sort of granular pieces that people could buy, particularly
16 the enhanced service providers, maybe we started backward.

17 U.S. West is already providing interconnection to
18 a number of competing local telephone carriers, particularly
19 in Iowa, Washington, and Oregon. The way we have dealt with
20 them so far is basically ask them: What do you want? And
21 then we talk about the best way of providing the services
22 which they want and what are the right interfacing. And,
23 obviously, we have to have price negotiation, and those are
24 perhaps tougher than anything else. But we at least know
25 what that carrier wants.

1 Whereas in ONA, our observation is that we
2 created, I don't know, I'm sure it's 100 basic service
3 elements; and very few of them have ever been bought by
4 anybody. A lot of work went into that.

5 The enhanced service sort of outside business
6 really is a disappointment, I think, to everyone in that it
7 just didn't grow up the way people thought it would.

8 So our recommendation would be that we have
9 private negotiations. Then when you can't resolve that, the
10 next step from a technical point of view is probably the
11 standards organization.

12 There are a number of standards organizations
13 working on all kinds of telephone standards now. That's
14 obviously an important interconnection and open systems

1 differences between NCR before and after AT&T took it over
2 was we all sat in cubes prior to AT&T taking over. So you
3 learned how to talk very softly in a cube for fear of
4 disturbing your neighborhood. And I guess I don't -- I
5 should think of you all as my children, and then I would
6 raise my voice high enough and it would be taken care of.

7 So that's an important issue there, as to how to
8 resolve technical differences.

9 Then the next question is what's the next step to
10 solve that, and our recommendation would be if the consensus
11 process cannot come to a conclusion -- and you should hang
12 with it for a long time. And by the way, there is an
13 argument going on in the industry now with MCI about when
14 should arbitration be called on in a standard setting
15 environment. We think that eventually that's probably the
16 right step, but we really would like to try very hard for
17 consensus.

18 And that is simply because usually if you -- it's
19 kind of like -- and having been a resident of Dayton, I can
20 observe this -- when you make the Bosnians go stay in a
21 place like Dayton as opposed to Paris, perhaps, for a month,
22 they'll come up with an agreement in the end. And that's
23 the best way to set standards.

24 However, arbitration is probably a reasonable
25 resolution of some of these standards issues after a very

1 long consensus effort.

2 Then the question is, you ought to have to go some
3 place after that. And we do recognize a role for regulatory
4 agencies to resolve interconnection disputes, and that's
5 very important. We have a number of them going on now,
6 again, in Iowa, Washington, and Oregon. We do think that we
7 should call upon the expertise of these agencies who have
8 dealt with telephone systems for a very long time. We
9 presume that similar types of agencies would be worked out
10 for computer and broadcast networks; although, obviously the
11 expertise might not yet be there.

12 And then I guess, as a last and final step, we
13 assume that people are going to go to court because they do.
14 One observation about the current legislation is that it
15 does seem to be badly missing some kind of immunity in that
16 what happens is you go through a long discussion with
17 various people and go to a regulatory agency and everything
18 else and after the regulatory agency makes a decision how
19 you should interconnect, you get no immunity in there and
20 there's basically an invitation to sue any telephone company
21 you don't like for -- I think it's up to \$500 million in
22 penalties. And we kind of think that's double dipping.
23 But, at any rate, there does need to be a dispute
24 resolution.

1 now to deal with an obvious issue of how do we transition
2 from a monopoly to competition in interconnecting, you
3 should recognize the transitional rules are, indeed,
4 transitional. We expect there will be a day when U.S. West
5 will have what we think are no more essential facilities and
6 there will be enough competition that we don't need a lot of
7 rules, and unbundling and the marketplace will solve these
8 problems.

9 We would observe that AT&T was treated as a
10 dominant carrier by the FCC a lot, lot longer than was
11 probably appropriate and congratulate the FCC for the recent
12 decision to treat them as non-dominant, basically let them
13 be controlled by the marketplace. And we encourage that
14 whatever mechanism is put into place to facilitate this
15 telephone transition also have some kind of sunset at the
16 end.

17 Thank you.

18 CHAIRMAN PITOFSKY: Say a little more about
19 arbitration. That's a thought that's new to these
20 discussions.

21 What do you -- you don't have binding arbitration
22 in mind, do you?

23 MR. CUTLER: Well, with the preface that for seven
24 years I did nothing but try computer arbitrations for NCR
25 and I have a great deal of faith in the process and I'm

1 horribly biased on that subject, certainly, as a private
2 citizen, I don't see why not.

3 I do believe that you might have an appeal to the
4 regulatory agency under similar principles that are used in
5 other arbitrations.

6 Obviously you want to have some kind of an appeal
7 if only to follow what I recall as being Professor Lon
8 Fuller's views that laws have to have some minimum morality.
9 People won't accept what's going on as useless. So people
10 do want to appeal.

1 and on the editorial board of Information Economics and
2 Policy.

3 Dr. Besen also is a member of the Office of
4 Technology Assessment Advisory Panel, and he has taught at
5 Rice University, Columbia University and was a colleague of
6 mine when we were both at Georgetown University.

7 Mr. Stan Besen.

8 MR. BESEN: Thank you, Mr. Chairman.

9 The topic of today's session is: What can we
10 learn from the telecommunications industry about possible
11 ways to assess pro- and anti-competitive behavior in other
12 networks industries?

13 I thought I should start with my conclusions since
14 I don't know if I can actually get through my whole talk.
15 And if I have time, I'll give you the conclusions twice.
16 But I'll just sort of state this basically in the form of
17 what might even be considered four aphorisms.

18 First, access to technical specifications may be
19 as important for competition in network -- excuse me.
20 Access to technical specifications is important for
21 competition in network industries, but it's not everything.

22 Second, competition in network industries may be
23 affected as much by the number of different networks as by
24 the openness of any particular network.

25 Third, which interfaces are available may count as

1 much as knowledge about their technical specifications.

2 And, finally, the price of access to key
3 interfaces can be as important as the availability of
4 technical information about them.

5 Now, the organizing sort of principle for my talk
6 here today is based on the FCC's Computer III decision, in
7 particular the portion of it referred to as open network
8 architecture.

9 I'm not going to provide a complete evaluation of
10 ONA, and I'll not even be particularly concerned about
11 determining whether or not the problem to which the ONA
12 policy was designed to deal was an important one or whether
13 ONA was an appropriate response.

14 I have a more modest objective, that is to
15 highlight the major issues with which the policy sought to
16 deal in order to draw some lessons for the treatment of
17 similar issues in other industries.

18 I think all of you are probably familiar in a
19 general way with ONA. It was one of a series of efforts
20 engaged in by the FCC over many years in which the
21 Commission sought to permit competition and supply
22 telecommunication services in the face of what it perceived
23 to be monopoly control by the local exchange carriers, or
24 LECs, of certain key inputs.

25 The policy concern was the LECs would discriminate

1 in favor of their own downstream affiliates in provision of
2 these inputs unless certain restrictions were placed on
3 their behavior. Initially, the FCC permitted the LECs to
4 offer competitive services through fully separated
5 subsidiaries.

6 Later, under the MFJ, there were line of business
7 restrictions placed on the LECs. The ONA policy basically
8 resulted in a conclusion on the part of the FCC that the
9 separate subsidiary requirement was inappropriate. The
10 Commission began its own ONA proceedings.

11 The policy was a retreat from the previous
12 policies and was based on a belief that these policies
13 prevented or limited efficient entry in the supply of
14 enhanced services by the LECs.

15 The FCC continued to accept the view that certain
16 elements of the communication system would necessarily
17 continue under the control of the LECs, but it tried to make
18 it possible for others to compete in the provision of
19 services that required connection to those elements while at
20 the same time permitting the LECs to exploit whatever
21 economies of scope existed between basic and enhanced
22 services.

23 In the Commission's words: "...non-structural
24 safeguards could protect competing enhanced services
25 providers from anti-competitive activity by the BOCs while

1 avoiding the inefficiencies associated with structural
2 separation."

3 In this particular case, of course, the example
 was the concern about access by information service

1 themselves. The open network architecture policy was
2 designed to deal with that issue.

3 I want to talk about four aspects of the ONA
4 policy, and they track the four conclusions that I gave
5 earlier: disclosure of technical information, uniformity
6 among networks, the definition of the interfaces, and
7 pricing.

8 I would emphasize before I talk about ONA in these
9 regards that not all of these elements will be present or
10 present in the same degree in every network industry.

1 The fear was that without such a requirement, the
2 LECs might use frequent and unannounced changes in these
3 specifications to disadvantage their rivals, a story we have
4 heard, obviously, in other industries.

5 These rivals would be disadvantaged, of course, if
6 the changes in specifications made it costly or impossible
7 for them to combine their products and services with those
8 provided by the local exchange carriers.

Now, again, quoting the Commission: "Network

1 Second, the policy has the effect of reducing the
2 returns to innovation by the LECs, because the lead over
3 their rivals is reduced by early disclosure. If we believe
4 that most changes in specifications were intended solely to
5 disadvantage rivals, then we wouldn't much care about this.
6 However, if changes in specifications typically involved
7 significant technical advances and if the LECs could be
8 expected to be sources of innovation, presumably one would
9 be willing to shorten the lead time in order to promote
10 innovation.

11 This, of course, is a familiar sort of trade-off
12 to students of antitrust policy where one is concerned about
13 the trade-off between widespread access on the one hand and
14 the promotion of innovation on the other. Quite familiar in
15 standard sort of problems.

16 Geographic uniformity, the second topic I want to
17 deal with.

18 The issue of information disclosure focuses on the
19 relationship between a single LEC and its rivals.

20 However, competition may also be affected by
21 whether different LECs adopt different specifications to key
22 interfaces.

23 To draw an analogy in a different setting, even if
24 IBM and Apple both have open systems so that rival hardware
25 and application software providers could supply either

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1 different firms offer different open systems. As a result,
2 in assessing whether behavior is competitive, it is not
3 enough to focus simply on the openness of any particular
4 system.

5 This has been a point, by the way, of considerable
6 controversy in the case of telecommunication. One set of
7 commentators has noted that: "there was considerable
8 variation in the services available and the terms of
9 offerings among the seven regional BOCs' ONA plans.
10 [Enhanced Service Providers] decried the lack of national
11 uniformity, finding that just 27 of the 102 requested
12 services would be available under ONA in all areas of the
13 country."

14 The next topic concerns the question of sort of
15 how early or how granular the network has to be. The topic
16 I have here is called: What is an interface?

17 I have been somewhat vague to this point about the
18 definition of an interface, treating it as well-defined;
19 but, of course, that's not necessarily the case.

20 Indeed, perhaps the most controversial aspect of
21 the FCC's ONA policy and the one that is often regarded as
22 the least successful is the way in which it requires -- and,
23 again, I'll quote the Commission -- it requires: "...BOCs
24 to unbundle elements of the networks and allow [Enhanced
25 Service Providers] to purchase specific services that are

1 useful for their enhanced services."

2 Under the policy, the LECs are required to make
3 available what the Commission calls Basic Service Elements,
4 or BSEs. These are essentially building blocks of a
5 telecommunication network. The significance of these
6 elements is, of course, they define the interfaces at which
7 rivals can connect their services to those of the LEC.

8 From the point of the would-be rival, it makes no
9 difference whether it cannot connect to the network of an
10 LEC because it does not know the technical specifications of
11 the interfaces or because the interface is somehow inside
12 the service element that is being offered by the LEC.

13 Put somewhat differently, the ability of rivals to
14 compete depends both on the accessibility of interfaces and
15 knowledge about their specifications.

16 Initially the FCC proposed what it referred to as
17 fundamental unbundling, which would have required the LEC to
18 offer any Basic Service Elements that were requested by
19 independent Enhanced Service Providers. Under such a
20 policy, the ESPs will be free to purchase as much or as
21 little of the LEC network as they wish in order to provide
22 their own services.

23 Over time, this requirement has become less
24 stringent. And the Commission has moved to a policy which
25 it describes as an "evolutionary" approach to unbundling the

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1 at which the service elements that rivals do not want to
2 purchase themselves are available.

3 I'm an Enhanced Service Provider and I want to buy
4 A and B, but I want to buy C from the telephone company.
5 All I care about is the price of C.

6 An ESP can have all the necessary information
7 about the specification of the interfaces. It may have
8 access to many such interfaces, but entry may still be
9 impossible or at least difficult if the cost of access to
10 those interfaces that are most desired by ESPs is especially
11 high.

12 The FCC has adopted a companion -- or has listed a
13 companion proceeding -- instituted a companion proceeding
14 called a Joint Cost Proceeding specifying procedures by
15 which the LECs were required to separate their costs between
16 regulated and unregulated service. Any regulated services
17 used to provide unregulated services, such as basic services
18 provided under CEI or the ONA rules, had to be transferred
19 at tariff rates. The Commission has also hoped to limit
20 cost shifting by applying price cap regulations of these
21 services.

22 I won't go into much detail. Obviously everyone
23 here knows the whole question of exactly how these Basic
24 Service Elements are priced is a big, big problem, one
25 unlikely to go away very soon.

1 Again, let me just get to the summary again. I
2 just sort of reminded you that I told you what I was going
3 to say; I've tried to say it; and I will tell you what I
4 think I said.

5 First, access to technical specifications is an
6 important issue. You've got to know how to connect at the
7 interfaces. But it's certainly not the total solution.

8 Second, the number of different networks makes a
9 difference. You can have a number of open networks, but
10 that will produce a less competitive environment or at least
11 to some dimensions than one in which there is some
12 uniformity in the various networks.

13 Third, which interfaces are available may count as
14 much as the knowledge about the technical specifications.

15 And, finally, of course, price is important.

16 Let me stop here.

17 CHAIRMAN PITOFSKY: Thank you. I must say when
18 you put it that I way, access seems like a rather formidable
19 challenge for a regulatory group.

20 Debra Valentine reminds me that the first three
21 speakers have concentrated on telecommunications and then we
22 will be moving on to emphasize financial markets. So maybe
23 this is a good point to stop and have a little bit of a
24 discussion.

25 And I can't resist inviting Professor Baxter, if

1 he wants to, to comment on what we have heard so far.

2 MR. BAXTER: I really don't have anything. I
3 agree -- no disagreement I can perceive among the speakers,
4 and I basically agree with everything they have said.

5 MR. BESEN: It's a different Bill Baxter than I
6 know.

7 CHAIRMAN PITOFSKY: Any other questions?

8 MR. ANTALICS: I just had a question for Professor
9 Baxter. If you see providing the interface technology in
10 this industry as pro-competitive, why do you see required --
11 what's the difference between this industry and other
12 industries?

13 MR. BAXTER: This was a regulated industry. If it
14 had been free to profit maximize, I think the arrangement
15 would have been as good as any other. But because it was a
16 regulated industry, it was driven to maximize in perverse
17 ways. And it was only the sub-optimalization savings driven
18 by regulations that made me think divestiture was an
19 improvement.

20 MS. VALENTINE: I just had a somewhat related
21 question, which is: Where do you see this all going? At
22 what point will this industry, if ever, or when will a
23 network industry that was regulated, operate on a market
24 basis?

25 And when will pricing and access be done among the

1 parties?

2 And if we start compulsory licensing in other
3 instances, are we going to get into problems with getting
4 back to a market-based system?

5 MR. CUTLER: Well, I would comment, as I did
6 earlier, about AT&T. I think we have some decent rules that
7 the FCC came up with initially on: When is a carrier
8 dominant and when isn't a carrier dominant.

9 And I'm not an expert in that field, but I think
10 that the Commission has dealt fairly well with AT&T. Again,
11 our observation is they waited a little too long there but
12 that if similar principles are applied -- and the current
13 bills do have even a direction to keep reexamining where the
14 local networks are and when you should stop doing so much
15 regulation -- then I think the principles are there.

16 Exactly when? I think it depends on -- I think
17 there is a test that AT&T phrased about contestibility in
18 the recent proceeding about what happens to AT&T pricing if
19 one of the other competitors does something -- and I would
20 ask, maybe Mark could explain that one -- but some
21 percentage difference or something like that.

22 But that's the basic principle.

23 MR. ROSENBLUM: Well, I think I'll address the
24 question in a slightly different way.

25 I think the -- surprisingly, I also found nothing

1 particular to disagree with about Mr. Cutler's presentation.

2 And I think the important question is: When will
3 the transitional regime end? And that's sort of a question
4 that I think needs to be answered almost on a case-by-case
5 basis.

6 Fundamentally when the formerly monopoly business
7 or formerly essential business now faces choice and
8 consumers of that business have a choice of suppliers, you
9 know, clearly the time for transition is passed and you can
10 get rid of some of those rules.

11 In the telephone industry, in my view, we are not
12 at that point yet because, fundamentally, folks don't have a
13 choice of local exchange providers.

14 On the long distance side, oddly, we saw maybe the

1 discounted volume services from AT&T or MCI or Sprint and
2 have at least the option to re-sell part of that network to
3 other users and then recoup some of their purchase price.

4 So the requirement that is initially imposed only
5 on the Bell system and only on AT&T as a means helping their
6 fledgling competitors now has become a marketing feature
7 that all the major facilities-based long-distance carriers
8 are required by the market to make available.

9 MR. BESEN: You asked a good question. I think
10 it's so good that it's really basically impossible to
11 answer.

1 complements to what they're offering.

2 In general, we expect most firms like to have
3 people who supply complements to them be able to do so
4 because they can sell more of the thing that it's a
5 complement to.

6 And the danger is -- or the concern is that
7 somehow we have created a set of skewed incentives which, in
8 fact, induce people, contrary to what most economics would
9 teach us, to in fact want to disadvantage people who supply
10 complements.

11 But figuring out when to let go, I think, is --
12 and exactly how to do it -- is not a straightforward matter.
13 And there are dangers in either letting go too soon or too
14 late. And I don't think there's a simple answer to that
15 question.

16 MR. BAXTER: Well, of course one would like to
17 give the answer that the time to let go is when the industry
18 can now function competitively.

19 And that implies that somehow or other we have
20 overcome the local loop problem, which is, in some ways, the
21 heart of the problem.

22 But it's going to be a very, very long time, in my
23 estimation, before anybody over builds the local loop.

24 One can imagine -- although, I don't believe it
25 myself -- that there will really turn out to be a demand for

1 500 channels of television and then the circumstances, it
2 may be that having more than one local loop in place was
3 reasonably cost effective. But that doesn't really seem to
4 be in the cards for a very long time to come.

5 One can imagine some sort of a radio signal or a
6 laser light system where you have a little gadget on your
7 roof and it is capable of sending a signal to a receiver of
8 AT&T, MCI, and Sprint and if you get mad at one of them, all
9 you have to do is press the button on the wall down below
10 and you refocus your radar transmitter.

11 Well, that brings the marginal cost of switching
12 suppliers down to a reasonable level but not the total cost.
13 It would still be necessary that my radar gadget cost less
14 than a thousand dollars, let's say, to install because
15 that's about the cost of putting in a local loop.

16 So I don't see any time soon when the telephone
17 business is going to be competitive; and, therefore, I don't
18 see any time soon when there's a distinctive answer to the
19 question: When should we let go?

20 CHAIRMAN PITOFSKY: Any comment on that?

21 I just might mention that we saw quite a
22 presentation here a couple of weeks ago. I agree that
23 rebuilding the local loop is unlikely. But the presentation
24 had to do with the convergence of over-the-air TV, cable TV,
25 computer technology, and the telephone.

1 And the prediction was -- with no firm date, of
2 course. The prediction was that this convergence is really
3 gaining steam right now and that we are likely to see
4 telephones facing competition through interactive cable TV
5 and vice versa.

6 Any of you care to comment on when you think
7 that's in the works?

8 MR. CUTLER: Well, I would observe that U.S. West
9 is currently building a full competitive local telephone
10 service in Atlanta, Georgia. The switch will go into
11 operation in the second or third quarter of 1996. And any
12 citizen passed by our cable system there, which is pretty
13 coextensive with the metropolitan area, will be able to be
14 switched to the service from U.S. West.

15 Obviously, it has to interconnect with the Bell
16 South system because most of the customers are going to be
17 on Bell South. But I do think it's a little closer than
18 Professor Baxter thinks, at least in Atlanta.

19 I would point out that, obviously, there are other
20 places where things aren't going quite as quickly. But we
21 expect the same thing to happen in our own area. And we are
22 facing increasing competition every day of the week in our
23 major cities.

24 And a third comment I think is really on resale.
25 And that's why it is important. There are plans currently

1 on file. And the current legislation, obviously, is going
2 to talk about a lot of resale. And I think AT&T is
3 currently offering resold competitive service in Rochester
4 and intends to begin that in -- I think three cities chosen
5 by Ameritech: Chicago, Grand Rapids, and whatever the third
6 one is.

7 So it probably isn't here immediately, but it is
8 sure coming quickly.

9 MR. BESEN: My impression is, in the UK, the cable
10 systems have, in fact, gotten a significant number of
11 telephone subscribers there.

12 Is that correct?

13 MR. CUTLER: The most interesting statistic I have
14 observed from U.S. West operations called TeleWest, which is

1 reducing the existing copper wire that goes to most people's
2 home today.

3 And I don't know to what extent, Norton, you feel
4 free to comment on this, but I know you folks have started
5 this project in Atlanta, the one you referred to.

6 Is this something that you believe is economically
7 viable as a local exchange alternative in the short term?

8 MR. CUTLER: With the caveat that I'm a poor
9 lawyer and not an engineer, yes, our belief is we can
10 compete effectively in that marketplace. And I'll toot our
11 own horn here, if we get the right to sell a package of
12 services which needs to include exchange traffic which we
13 have a current waiver pending, and one of the bills would
14 allow us to do that anyway.

15 But, yes, we think we can do it.

16 MR. BAXTER: Well, of course, one interesting
17 question, Norton, is: How much are you going to pay the
18 existing Bell company for interconnection at the edges of
19 your system?

20 The answer, of course is: Well, of course, that's
21 a regulated number. But it also means that your competitive
22 service -- I don't want to say is essentially meaningless in
23 competitive terms, but it is totally dependent upon the
24 ability of the incumbent, complete system to pull all the
25 consumer surplus from under your demand curve, which, of

1 course, is the role of the re-sellers historically.

2 CHAIRMAN PITOFSKY: Stan?

3 MR. BESEN: Yeah. Just one other observation.

4 The point about the ability of the two separate networks to
5 connect, the example is, in fact the moral or economic
6 equivalent of the geographic uniformity point.

7 And part of the question -- one of the issues in
8 determining how easy it will be for the rivals to grow at
9 the expense of the RBOCs will, in part, depend on the very
10 issue of the extent to which people on one network can
11 interact with the folks on the other.

12 And for obvious reasons, one party may have
13 greater interest in achieving compatibility -- if you want
14 to use that term -- than the other.

15 MR. CUTLER: I really don't think that that's a
16 new problem. It has previously been an end to end problem
17 in, geez, for 100 years, the Bell system interconnected with
18 -- despite what people think, the Bell system had probably,
19 I think, maybe even less than half the telephones in the
20 United States in 1984. But certainly there were a lot of
21 phones that were not in the Bell system, and they were
22 interconnected on an end to end basis.

23 MR. BESEN: My point is a different one. Do you
24 have an incentive to interconnect with somebody in an
25 adjacent service you're offering complements to?

1 It's a different story when you're operating
2 substitutes.

3 MR. CUTLER: That was going to be my next point.

4 It's definitely a new issue when you are, indeed,
5 connecting with a direct competitor. But I think as long as
6 we follow those precedents -- and Professor Baxter raised an
7 excellent question, which was pricing; and that is an
8 extremely difficult problem. U.S. West, obviously, wrestles
9 with both halves of that problem and is in a sort of unique
10 situation as to how do you see it when you have most of the
11 customers and how do you see it when you don't?

12 And we are working extremely hard on what the
13 correct formula is here.

14 MR. BAXTER: As a point of information, in 1980, I
15 think Bell had about 80 percent of the telephones; GTE had
16 about 12 percent; and about 8 percent were little, tiny
17 independents. And they were connected into the system by

1 will resume these discussions.

2 COMMISSIONER STEIGER: Well, again, we are
3 fortunate to have a very able wrap-up crew for the last part
4 of our afternoon session.

5 We will begin with Joe Oppen. He is the Assistant
6 Attorney General in the Antitrust Bureau of the New York
7 State, Department of Law where he has been since 1985. He
8 has been Deputy Bureau Chief since 1990.

9 In addition, he serves as the Chair of the Payment
10 Systems Working Group of the National Association of
11 Attorneys General Antitrust Task Force, a group that this
12 Commission and the Justice Department are pleased to work
13 very closely with.

14 The Payment Systems Working Group was formed
15 following "Entree" litigation, that is, the State of New
16 York, et al, v. VISA USA, Inc., to monitor competitive
17 developments in the payment systems industry.

18 And we are most anxious to hear from the NAAG on
19 this.

20 MR. OPPEN: Thank you very much, Commissioner.

21 I'm very pleased to be here today to discuss the
22 topic: How should antitrust enforcers assess foreclosure,
23 access, and efficiency issues related to networks and
24 standards?

25 I believe the short answer to that question is:

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1 Very carefully.

2 I must also take care to preface my comments with
3 a public servant's caveat that the opinions I express are my
4 own and do not necessarily reflect the views of the Attorney
5 General of the State of New York nor any other state
6 attorney general.

7 Among the topics listed for today's discussion are
8 several that state attorneys general have confronted as
9 antitrust enforcers:

10 How do networks and the financial service
11 industries affect competition?

12 Under what circumstances can two or more networks
13 compete?

14 What can we learn from the financial service
15 industry that may be relevant to competitive issues and
16 other networks?

17 In 1989, these first two questions were directly
18 addressed by 14 states, including New York, when they filed
19 an antitrust action in the Southern District of New York
20 against VISA and MasterCard. That complaint asserted claims
21 under section 1 and 2 of the Sherman Act and section 7 of
22 the Clayton Act and alleged that the two credit card
23 associations had conspired to monopolize and control the
24 development of the emerging point-of-sale debit card market
25 through a joint venture known as "Entree."

1 A point-of-sale debit card is really nothing more
2 than an ATM card that is accepted by retailers at the
3 point-of-sale. Unlike a credit card, however, a debit card
4 draws on the bank and accesses a cardholder's checking or
5 demand-deposit account. And it does not require an
6 extension of credit by the issuing bank.

7 Entree was to be the super deluxe model of
8 point-of-sale debit cards because it was "on-line
9 real-time." Each transaction would require the cardholder
10 to use their PIN number and, therefore, would be
11 instantaneously authorized and fully guaranteed. Any risk
12 in the system would be virtually eliminated.

13 The critical inquiry from the states' perspective
14 was whether the joint venturers were collaborating to offer
15 a product or service that neither could offer separately.
16 Entree was, in fact, a joint venture network of competing
17 joint venture networks, MasterCard and VISA. The
18 competitive relationship between the two bankcard networks
19 was already somewhat compromised by the existence of
20 duality, that is, virtually every bank that was a member of
21 MasterCard was also a member of VISA.

22 As the states' investigations progressed, it
23 became clear that the answer to our inquiry was, no. In
24 fact, to the contrary, we learned that both VISA and
25 MasterCard had planned to enter the point-of-sale debit card

1 market independently, that each had previously rejected a
2 combined effort involving the other, and that both were
3 committed to offering competing debit card products outside
4 of the United States where duality is prohibited.

5 In fact, during the formation of Entree, when it
6 appeared that VISA and MasterCard might not be able to reach
7 a final agreement, VISA had prepared secret contingency
8 plans to launch its own debit card program to compete with
9 the delayed but real and anticipated entrant from
10 MasterCard.

11 Well, then, under circumstances where the two
12 networks explicitly recognized and acknowledged that they
13 could compete, why would they choose not to do so?

14 The states believed that the reasons were
15 anti-competitive. The complaint alleged that a primary
16 purpose of the combined Entree venture was to retard and
17 control the development of the emerging point-of-sale debit
18 card market so as to minimize any losses to credit card
19 profits.

20 The concern was not merely that point-of-sale
21 debit might replace certain credit card transactions but
22 that the lower interchange fee and pricing structure of
23 point-of-sale debit would cause merchants and other
24 participants to question the high fee structure for credit
25 card transactions.

1 The bankcard associations, of course, asserted a
2 different rationale for justifying Entree. They claimed
3 that unless there was a single, combined product,
4 point-of-sale debit would never find a receptive market.

5 In 1990, the lawsuit was resolved by a settlement
6 agreement that required VISA and MasterCard to terminate the
7 Entree program.

8 MasterCard and VISA were also required to notify
9 the states prior to entering into any similar venture or
10 commencing separate point-of-sale debit card programs in
11 which duality was not explicitly prohibited.

12 Following the Entree settlement agreement, both
13 bankcard associations launched their own independent
14 point-of-sale debit card programs.

15 In 1991, VISA formally acquired 100 percent
16 ownership and control of Interlink, a regional point-of-sale
17 network, and announced its plan to take Interlink national.

18 Then MasterCard launched the Maestro program,
19 which was affiliated with several regional ATM and
20 point-of-sale networks.

21 The states viewed the launch of these two highly
22 competitive independent point-of-sale debit card programs as
23 extremely pro-competitive and as an affirmation of the
24 states' decision to challenge Entree.

25 The benefits of aggressive intersystem competition

1 are evident from the different pricing and marketing
2 strategies that the two bankcard associations have adopted.

3 Both associations have different interchange and
4 switching fees. Interlink imposed annual card service fees
5 and merchant location fees while Maestro did not.

6 Of particular significance, Interlink charged a
7 "transaction service fee" of two cents on each transaction
8 conducted by an Interlink cardholder and an Interlink
9 merchant, even though the POS transaction was processed by a
10 regional point-of-sale network instead of Interlink.
11 Maestro imposed no such "bypass" fee. Soon after Maestro
12 announced its pricing, Interlink eliminated its "transaction
13 service fee."

14 And I also noticed just last week that the
15 Interlink program reduced or eliminated a start-up fee that
16 was assessed against ISO's or third-party processors in
17 response to Maestro's -- the Maestro program, which had no
18 such fees.

19 Both associations have also aggressively and

1 Maestro intended to amend its membership rules to permit
2 issuing duality. In other words, MasterCard would allow
3 banks that issued Maestro cards to also issue Interlink
4 cards, Maestro's direct competitor.

5 After reviewing how intersystem competition
6 between VISA and MasterCard products had flourished
7 following the demise of Entree, the states were unable to
8 assure MasterCard that the elimination of its prohibition
9 against issuing duality would not lead to an enforcement
10 action.

11 The states were particularly concerned that debit
12 card services, unlike credit card service necessarily
13 require access to the consumer's demand deposit accounts.
14 Therefore, it is unlikely that any viable, non-bank
15 competitor, such as an American Express or a Discover card,
16 could enter the debit card market and provide additional
17 intersystem competition to the bankcard associations.

18 While antitrust enforcers assess foreclosure and
19 access issues and the circumstances under which two or more
20 networks can compete, they must not overlook joint action
21 reflected in network standards and operating rules that may
22 inhibit competition in the name of efficiency or
23 convenience. This task may be difficult when a network is
24 just getting started, as it may be hard to discern or
25 anticipate the likely effect of a particular rule or

1 practice.

2 The interchange fee enshrined by the bankcard
3 associations in their credit card systems and introduced
4 into ATM and point-of-sale debit card networks may be such a
5 competition inhibiting rule.

6 In virtually every credit card transaction, the
7 card-issuing bank gets a commission. The bankcard
8 associations' rules require the retailer's bank or the
9 merchant bank to pay the card-issuing bank or cardholder's
10 bank a percentage of each retail transaction.

11 This percentage fee, the interchange fee, is fixed
12 by the member banks of each bankcard association. The
13 ostensible justification for the interchange fee is to
14 reimburse the card-issuing bank for actual costs incurred in
15 extending credit to its cardholders, such as losses from bad
16 credit risks or to cover the float or grace period for
17 convenience users.

18 By making the other parties involved in the credit
19 card transaction pay these discreet issuer/cardholder
20 transaction costs, however, the pricing structure of the
21 entire system is pre-determined and distorted.

22 The merchant bank discount fee, the fee the
23 merchant bank is paid by the retailer, must exceed the
24 interchange fee paid by the merchant bank; or the merchant
25 bank will operate at a loss.

1 The retailer, in turn, must factor in the discount
2 fee it pays the merchant bank in determining the retail
3 price.

4 To the extent the interchange fee accurately
5 reflects actual costs to the issuing bank, the retailer
6 becomes, in essence, the issuing bank's collection agent,
7 and non-credit card users are taxed part of the cost. To
8 the extent the predetermined interchange fee is a revenue
9 generator for the issuing banks, the issuing banks are
10 engaged in horizontal price-fixing.

11 In 1984, a District Court in Florida rejected a
12 price-fixing challenge to the interchange fee in an action
13 brought by a third-party processor in the NaBanco case. In
14 NaBanco, the District Court found, first, that the product
15 market in which credit cards competed consisted of all
16 payment services, that is, all general purpose and
17 proprietary credit and travel and entertainment cards,
18 merchant's open book accounts, travelers checks, ATM cards,
19 check guarantee cards, checks, and cash.

20 In such a broad market definition, it is hard to
21 think of any combination of card products or networks that
22 would raise antitrust concerns. The District Court found
23 further that the interchange fee was necessary for the
24 existence of the credit card product and, therefore,
25 pro-competitive.

1 The decision was affirmed by the Eleventh Circuit.

2 If the case were to be brought today, it is not at
3 all certain that the result would be the same. In the first
4 place, even VISA has conceded, as it did in the VISA/Dean
5 Witter-Discover litigation, that general purpose credit
6 cards constitute a distinct product market.

7 Secondly, challenges to the interchange fee
8 structure in ATM networks suggest that the interchange fee
9 is no longer considered sacrosanct. In the First Texas
10 arbitration, presided over by Professor Thomas Kauper, a
11 bank challenged the Plus ATM network's interchange fee and
12 rule prohibiting surcharging.

13 Professor Kauper determined that the interchange
14 fee was not essential to the existence of the ATM network,
15 and that a "free market" approach in which each ATM owner
16 independently determines the fee to charge the ATM user was
17 preferable, but that the ATM owner's ability to surcharge
18 and/or offer a rebate was an effective means to ameliorate
19 any pricing restraints imposed by the interchange fee.

20 Similarly, in the Valley Bank case, the Ninth
21 Circuit held that the Plus ATM network's interchange fee
22 structure and its prohibition against surcharging were not
23 so critical to the network's operation to invalidate, on
24 commerce clause grounds, a statute prohibiting prohibitions
25 against surcharging.

1 I also note recently that VISA has eliminated its
2 rule prohibiting member banks from surcharging.

3 The need for an interchange fee in point-of-sale
4 debit card networks is even less compelling.

5 The Entree program itself included only a very
6 small interchange fee denominated the "funds guarantee fee."
7 Significantly Interlink, as well as several established
8 regional point-of-sale debit networks that existed before
9 Entree, did not have an interchange fee.

10 The perverseness of the interchange fee becomes
11 apparent when the bankcard association's off-line and
12 on-line point-of-sale debit card products are compared.

13 VISA and MasterCard off-line debit products, which
14 do not require a PIN, rely on a check-like clearance process
15 and are technologically inferior to their on-line products.
16 They cannot provide immediate authorization or full
17 guarantees for each transaction.

18 Yet, the bankcard associations are pushing their
19 off-line programs which carry higher interchange fees than
20 the on-line programs, as the superior debit product because
21 of the greater interchange fee revenue. Indeed, it is only
22 recently that the bankcard associations adopted an
23 interchange fee for their debit off-line products that was
24 lower than the credit card fee.

25 For years, merchants and, ultimately, consumers

1 were paying the banks the credit card rate on debit card
2 purchases even though credit had never been extended.

3 The third question for today's discussion asks:
4 What can we learn from the financial services industry that
5 may be relevant to competitive issues and other network
6 industries?"

7 I believe what we can and have learned is
8 valuable. Though other network industries may look very
9 different, critical competitive issues that may arise in
10 each will likely be the same.

1 And so on.

2 While the significance of the answers may vary
depending on the nature of the industry, I firmly believe

1 retail side of Citicorp. He has considerable expertise in
2 issues such as consumer protection, antitrust, data
3 protection, and interactions of markets within regulatory
4 frameworks.

5 He has published many articles on the legal
6 profession, legal writing, banking law, and is the author of
7 legislation on, among other things, consumer banking law.

8 Thank you very much. Would you give us your
9 wisdom?

10 MR. MacDONALD: I'm over here, by the way.

11 COMMISSIONER STEIGER: Well, with one set of
12 glasses I could tell you that. This one, I can't see that
13 far.

14 MR. MacDONALD: That was my old resume. I want to
15 take the antitrust part off in light of what I'm about to
16 say.

17 But, like Joe, what I say will be my comments; and
18 you'll see why as I get going.

19 I represent a bank. And I noticed that the FTC
20 put down that I worked for Citicorp. And I assume that was
21 to assert jurisdiction over me.

22 But I'm not paranoid.

23 What I'd like to do is start off with a maxim and
24 then get into some, what I'll call, "learning points."

25 And the maxim is anchored somewhat in history.

1 And essentially it goes like this: Since the diminishment,
2 so to speak, of the role of government in the economy since
3 the 1980's, the goals of the antitrust laws, and in
4 particular, the Sherman Act have been achieved fairly well.

5 If the goals, in fact, were the creation of more
6 products, more competitors, better products, lower prices,
7 et cetera, et cetera, I would argue that has happened. But
8 it happened explosively and that resulted in abundance.

9 I would argue just on the lower prices thing that
10 an argument can be made that because of competition and
11 because that goal has been achieved, it has played a role in
12 stabilizing a role -- not the role, but a role in
13 stabilizing even inflation since the 1980's. And it also
14 has played a tremendous role in invention and innovation.

15 With that said, to pick what we can learn and what
16 we have learned, it would be 80,000 things, it could be
17 100,000 things. But by necessity, I have selected a few.
18 I'll go through them somewhat rapid fire. They are

1 certainly many also: MasterCard, VISA, and several ATM
2 networks to name some.

3 But let me start off with the point that when all
4 is said and done, they're very fragile. Joint venture
5 networks are very fragile. They take a long time to
6 succeed. They require continued investment and tremendous
7 investor patience.

8 It's best if they limit their interference with
9 their member's competitive practices. They should not
10 compete with them. They have a higher chance of succeeding,
11 which is to say to survive, if they're pulled together, in
12 my opinion, because of necessity, as opposed to opportunity.

13 Necessity, I will describe proudly as saying, in
14 effect, they come together because there may be restrictions
15 against them in the marketplace, legal restrictions
16 prohibitive costs, specialized industry challenges which
17 they cannot deal with perhaps because of their legal status,
18 et cetera, et cetera and most of all, overwhelming consumer
19 demand.

20 It's best, based on our experience that the
21 members of the joint venture be alike, banks, for example,
22 as opposed to having in the joint venture banks and farmers.

23 Another point is that government will be
24 suspicious of these kind of joint ventures. And we start
25 off with the premise any time competitors get together,

1 everybody gets a little bit nervous -- and government
2 probably gets more nervous than anybody else -- but that
3 government suspicions of these forms of industrial
4 organization can create a mess if they are acted upon too
5 soon.

6 The hold of a joint venture network, when all is
7 said and done, to put it somewhat in the antitrust
8 philosophy is not to fix prices, not to set markets, limit
9 production, et cetera, et cetera. And, in fact, if that was

1 Which, by the way, with the philosophy the way it
2 is today on this and, in fact, is the way people say things
3 should have gone; but there was an attitude back in the 70's
4 that created a situation where government looked at the
5 thing. A little bank came along in Arkansas and said, we
6 don't want to be condemned just to being a member of one of
7 the associations; we want to be more competitive; let us be
8 in both. And after some litigation and skirmishing and so
9 on, the government shrugged its shoulders and said, in so
10 many words, why not?

11 I'm told, by the way, that one of the lawyers who

1 Government, being somewhat paternalistic, looks at
2 it and says, well, why not, you know. The people want it.

3 When, in fact, the government could say: Move
4 away from the stream. Pay for insurance. Take care of it
5 yourself. Self-reliance. Read Walt Whitman -- I'm sorry.
6 Not Walt Whitman. Emerson.

7 What happens? They build a dam, and 20 years
8 later an ecology movement takes place and the
9 environmentalists come along and say: You're killing the
10 salmon. You're killing the birds. You're killing the
11 trees. You're killing the bears, et cetera, et cetera. You
12 got to dismantle the dam.

13 And then all of a sudden, the government is
14 standing there scratching their heads saying: What do we do
15 this time? And it's not all that easy.

16 The question, or the temptation is: Do we stick
17 our hands in again and perhaps meddle again; and will we
18 replace this problem with a true solution; or will we just
19 replace it with another problem?

20 This is something that government has to deal with
21 all the time. And it's one of the reasons why I suggest
22 that there ought to be caution in dealing with this thing
23 called "joint venture networks."

24 With respect to joint venture networks, we should
25 recognize that because of the antitrust laws and perhaps

1 even because of our common law, players will use the
2 antitrust laws either to promote the joint venture and, in
3 many cases, to erode it from the outside because maybe
4 someone who came along later and would be viewed by someone
5 as a free rider or to erode it in the inside because their
6 affection for the joint venture no longer exists and they
7 feel they have developed, perhaps, a better mouse trap and
8 they don't want to play by the rules of the association.

9 Well, there's always a process that's going on, in
10 any event, inside of a joint venture that calibrates its
11 lifecycle. And there are always opportunists who look at
12 this and also the membership folks who decide they want to
13 graduate out of it but may be stuck within the joint venture
14 because there's a contractual basis; and they look to the
15 antitrust laws to help them out.

16 Also, another point is a learning -- a point on
17 this thing here is that if there is an essential facilities
18 doctrine, it's somewhat nebulous and in a confused state.
19 It's something that members of joint ventures and like
20 companies that are in them often raise their hands and say:
21 Don't let someone come in because this is not an essential
22 facility and when all is said and done, my suspicion is that
23 the understanding of the economic dynamics of these things
24 is just as bad as the status of the essential facilities
25 doctrine. Not many people really know that much about it.

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1 points.

2 One, as I implied before, government should be
3 patient about these animals and on a probability basis
4 perhaps assume, not that the bad is that competitors get
5 together but that the odds are in favor that the joint
6 venture won't survive. So presume less.

7 Secondly, don't over-read or over-apply the
8 antitrust standards because of the, what I'll call, the
9 upstream dam problem. You may just replace one problem with
10 another.

11 The government should allow membership
12 restrictions to promote stability, safe investing,
13 invention, no free riding. In effect, to allow the
14 entrepreneurs or the owners to use their property as they
15 see fit. That is as fundamental in our constitution as
16 perhaps the opposite in our thinking is in the Sherman Act.

17 They should also allow experimentation within the
18 joint venture over time, experimentation with rules,
19 markets, pricing, membership changes, et cetera, et cetera.

20 From the literature and things I have seen and
21 heard over the years, from time to time, you get the
22 impression that some people would feel comfortable that the
23 initial joint venture stays that way forever and no dynamic
24 company would ever be held to that standard and neither
25 should a joint venture.

1 Trust that if there is sufficient transparency
2 which is understanding in the marketplace about what's going
3 on that consumers, entrepreneurs, inventors, and so on will
4 do your work for you. They will make the best decision. It
5 will be the optimal efficient decision.

6 Government also should take a position with
7 respect to joint ventures in supporting free market pricing.
8 Profits are a must for the joint ventures. There are
9 suspicions that revenue streams that members of the joint
10 venture and the joint venture creates are bad because, as
11 Joe brought up -- he raised the issue on interchange and
12 that perhaps by eliminating the interchange that will make
13 the amount go away.

14 But it doesn't work that way. At the end of the
15 day, we are talking about revenue streams and profits. And
16 more profits means more jobs, more investment, more taxes,
17 et cetera, et cetera.

18 It's good.

19 Joint ventures of the type of MasterCard and VISA

1 security of, like, a refrigerator. And today that product
2 has gone away. And it's the result of competition that has
3 ushered in, by the creation of these wonderful joint
4 ventures, which now provide a much better product, a much
5 more efficient and global product at half the price and no
6 security.

7 It's a phenomenon and something that should be
8 applauded.

9 And last but not least on that point, one thing to
10 look at about joint ventures that succeed and especially
11 these in particular is that they are an American phenomenon
12 and something that we ought to be proud of and something
13 that we ought to nurture. But, once again, if they are
14 fragile, we ought to be as much supporters as we are
15 tinkers.

16 In looking at the benefits of a joint venture
17 network, there are a few other points that I would like to
18 bring up.

19 If you look at the history of the development of
20 the bankcard industry as a joint venture, you'll see that,
21 one, they have had a tremendous effect on pricing, product
22 distribution, product development, et cetera, et cetera.
23 Look back on them and see what existed X number of years
24 ago. I gave you one example. But the learning experience
25 will tell you that they came frontally against the T&E

1 cards, the retail cards, the oil cards, the travel cards,
2 travelers checks, and on and on and on. And they have
3 shaped the face of the planet and have given consumers a
4 better product. They spurred development of the alternate
5 systems and improvement of existing systems.

6 They have had a tremendous effect on debit cards
7 so that when Joe talks about debit cards and the way they're
8 going, just remember debit cards are a development, or
9 child, of the growth of the bankcard industry. It's a plus.
10 And it's working well.

11 They have redefined "currency," not just
12 domestically but globally. When I see Helmut Kohl or
13 Jacques Chirac talking about creating a common currency for
14 Europe, I sit back and I say to myself: We have already
15 done it. An American joint venture network has gone global
16 and has affected the attitude toward currency for perhaps 20
17 or 30 percent of all payment transactions in the world
18 today. And if it's not that high, it's going to get that
19 high. That's a tremendous result of government's debate
20 over it and private industry creating it.

21 They have spurred technological development,
22 computer software development. They have promoted mobility
23 for consumers. They have given consumers freedom of choice.
24 They have promoted commerce in a thousand little ways.

25 When you think of mobility and freedom of choice,

1 another example is if you look at the -- just one example,
2 the department store industry and the shake up that it's
3 gone through in the last 10 or 15 years. I know with my
4 parents, going back in time, they all had these private
5 label cards and they were captives of department stores, in
6 my case, downtown Brooklyn, and so on.

7 Along came the bankcard industries with the
8 retailers standing up in the early days and saying: Keep
9 them out; they're trouble, et cetera, et cetera. And
10 instead of dealing with them, through innovation and perhaps
11 creating joint ventures themselves, they just said: Stay
12 away.

13 And little by little, these joint ventures
14 developed a critical mass and a strong brand so that, in
15 time, doors had to come down, doors had to open, and
16 consumers had the ability to buy in a number of places. And
17 that resulted in a shake up.

18 For those of you who are old enough to remember
19 the Kerner Commission report on crime in the 60's, one of
20 the things they pointed out was that people in the
21 inner-city ghettos are captive of a credit system that
22 cheats them. The private creation of these joint ventures,
23 in fact, the market, in fact, eliminated that problem. You
24 couldn't have a Kerner Commission report today and talk
25 about the same issues.

1 In short, as my voice perhaps goes, these joint
2 ventures affected competition by challenging old ways,
3 eroding old systems, providing consumers with economic
4 mobility, choice, and quality at a lower cost. And they are
5 revolutionary. Their success bred emulation, entry,
6 investment, and competition.

7 I will close with just a couple of comments on
8 globalization because I think it enters into it in terms of

1 can work in a number of ways. Sometimes it's government
2 using foreign companies to affect legal practices in another
3 place. And sometimes it's business using local law to
4 affect government policy in another place. And then there
5 are variations on the theme on that. Those are the kinds of
6 things we are learning about and, because of the global
7 economy, have to come to grips with.

8 We also know that companies, in fact, can go
9 global. They can do it by themselves. But at least some
10 types of companies, especially banks, if they are to do it,
11 probably in a number of instances are going to have to do it
12 through network joint ventures and other types of joint
13 ventures.

14 Governments can't go global when all is said and
15 done. We're not there yet. Maybe a 1,000 years from now,
16 but we're not there yet.

17 And yet in order to achieve their goals and also
18 the rule of law, without which there would be no free
19 enterprise system, they have to find ways, in effect, to
20 become joint venturers themselves, with other governments
21 and perhaps in cahoots with the business community. I don't
22 know where that goes, but it's something that we have to
23 care about.

24 Governments also will never be able to resist and

1 with respect to whether or not to promote them in the
2 national interest or whether interference in them will, in
3 fact, harm the national interests. And we know of examples
4 of that.

5 Which leads me to one conclusion, of which there
6 could be thousands, and that is that perhaps when all is
7 said and done, the old fashioned enforcement, which is now
8 being harmed by budget considerations in the government
9 agencies, is going to have to shift, at least with respect
10 to global matters, to more of setting transparency standards
11 and education standards and, in effect, some of the points
12 that were brought out before, not just private standards but
13 collaboration on standards between business communities and
14 the global players.

15 I don't know how many minutes I took, but I'll
16 leave it at that. Uncontroversial.

17 COMMISSIONER STEIGER: Nicely done.

18 I think we ought to ask our other participants of
19 the afternoon whether they would like to make a comment on
20 our two last speakers.

21 At least one direct question was posed for
22 Professor Baxter.

23 I don't know if you would want to respond to it.

24 MR. BAXTER: What question was that? I don't
25 remember now.

1 COMMISSIONER STEIGER: The essential facilities
2 matter, I believe, was brought up one more time.

3 MR. MacDONALD: I think I said it was in a
4 confused state. But I implied that we worship at its altar.

5 MR. BAXTER: Well, not all of us.

6 COMMISSIONER STEIGER: I think you gave us a
7 resounding answer on your view that you have yet to see an
8 essential facilities case where there is an essential
9 facility. But did you want to expand on that as it applies
10 to the financial networks?

11 Are they any different? Is there a possibility
12 that a financial network, due to declining costs with scope
13 and scale, are a natural kind of monopoly?

14 MR. BAXTER: No. But I think the local loops in
15 telephone systems are natural monopolies. It's not that
16 natural monopolies don't exist. But here was an example
17 where VISA and MasterCard, for example, could have gone
18 their own way, did go their own way, the net of the other
19 was not an essential facility for either.

20 But I certainly agree with Duncan that the credit
21 cards, in general, in their history, have been really quite
22 remarkable.

23 I started representing VISA in the early 70's, I
24 guess, only 20 years ago; and they have really changed the
25 world in many senses, changed all of our behavior, changed

1 the density of distribution of branch banks. I think it's a
2 marvelous example of the power of competition and of
3 innovation. And it's been a fascinating industry to watch
4 and to work for.

5 Perhaps the most widely misunderstood thing is the
6 interchange fee. And the critical factor to understanding
7 interchange fees is to understand that each bank has an
8 incentive to overcharge. Once it gets its hands on the
9 merchant paper, there's no other source; it has an enormous
10 incentive to overcharge. And the interchange fee is a
11 ceiling. It is a horizontal price-fixing agreement in a
12 sense; but it's a horizontal price fixing agreement about
13 maximum prices, not about minimum prices.

14 And as such, it is good for consumers. Now, I
15 realize that we maintain a per se rule in that context, too.
16 But it's an idiotic per se rule, and one ought not to trot
17 it out when one is not forced to do so.

1 COMMISSIONER STEIGER: Always provocative. I love
2 that per se that we should keep under the desk.

3 What of our other panelists from earlier in the
4 day have a comment to make on our last two speakers?

5 MR. CUTLER: I would just like to observe that I
6 think one of the truisms stated by Duncan is that joint
7 ventures probably should be looked at very differently from
8 other things in the antitrust laws.

9 But certainly joint ventures which face
10 competition should be looked at very differently in the
11 banking industry, where most of the ATM networks face
12 significant competition, and so do the credit cards. I
13 think we're going to see some joint ventures in the
14 telecommunications industry quite soon because all of the
15 players are going to be allowed to invade each other's turf.

16 And the Commission should look very carefully at
17 the amount of competition that each one of these ventures is
18 facing when trying to figure out whether or not even the
19 limited rules applied to joint ventures should apply when a
20 joint venture is facing quite a bit of competition.

21 COMMISSIONER STEIGER: Other comments?

22 MS. VALENTINE: Well, actually, Stan Besen, you
23 had a comment earlier -- bye-bye, Professor Baxter. We all
24 thank you very much.

25 MR. BAXTER: I have got to make the plane.

1 MS. VALENTINE: I hope you make your plane, right.
2 You had an earlier comment about -- it was phrased
3 in terms of geographic uniformity; but it was about network
4 uniformity and how, in the context, where you have
5 complementary products, it often may be good to have really
6 one network or one entirely uniform system so that people
7 could reach economies of sale in providing components to
8 that network.

9 And I think what I'm hearing now is that often
10 it's good when networks compete.

11 I think Duncan MacDonald's message was duality was
12 something that the government imposed on us, and we would
13 have been far better off as two competing networks.

14 MR. MacDONALD: I didn't say that. Sometimes
15 we're grateful to the government.

16 And I didn't mean that either.

17 MS. VALENTINE: Okay.

18 Well, are there times when we want to be looking
19 for situations where networks compete? Are there times when
20 we want a single network to optimize our efficiencies and
21 economies of scale?

22 MR. BESEN: In the first place, just to be clear,
23 it's not a single network.

24 MS. VALENTINE: Right. That are all uniform.

25 MR. BESEN: Uniform, or at least where there's

1 compatibility where you are talking about networks that --
2 you think of the network of IBM users and the network of
3 Apple users, compatibility or the equivalent of the
4 geographic uniformity, there is the ability to use software
5 written for one network and have it run the other because of
6 sufficient similarities.

7 I didn't want to suggest that it's always
8 desirable to have a single network. But I also think I want
9 to suggest that there may, in fact, at times be incentives
10 on the part of the parties to, in fact, promote
11 incompatibility when consumers would be better off by
12 uniformity.

13 The best kind of examples are the obvious ones
14 where we have a large existing network with a large
15 installed base which might have a desire to disadvantage a
16 new entrant whose ultimate success depends on access to that
large installed base. If you can, in fact, assure some

1 This shows up in lots of different places. I
2 don't want to suggest that one network is always the right
3 answer. But I don't think one wants to assume there's some
4 invisible hand theorem that says that leaving the parties
5 alone will always lead to an optimal outcome.

6 MR. MacDONALD: Could I comment on that?

7 If I could paraphrase Voltaire somewhat --

8 MR. BESEN: In French?

9 MR. MacDONALD: No. I can only do that after a
10 good bottle of French wine.

11 If the evolution, whether voluntary or government
12 imposed, creates the one network, we will expect Bill Baxter
13 to break it up again.

14 Then, in effect, to create an old fashioned AT&T,

1 back to the point I brought up before about the dam
2 downstream and the duality of the little bank and so on.
3 It's easy to get sympathetic and look and say, you know,
4 someone's knocking on the door, let them in. These are
5 membership rules that are restrictive or anti-competitive.

6 And that's government causing the thing to happen.
7 But if the members, one of the members of -- I'm sorry, if
8 one of the joint ventures were to go to the media and
9 announce that they want to invite all the other joint
10 venturers to merge with them, to become one big joint
11 venture, I have no doubt that everyone's philosophy would go
12 out the window because of the psychology of it in terms of
13 looking at it in a different perspective. They would
14 fundamentally say: This is crazy and the injunction from
15 Joe would come, people would come, and so on; and you'd say
16 this is a bad thing.

17 But, on the other hand, we psychologically tend,
18 through our sympathies, to accept the idea that this is sort

1 about, then the better thing to do is to watch it and to
2 applaud it.

3 COMMISSIONER STEIGER: Yes, Joe.

4 MR. OPPER: Yeah. If I could just make three
5 points.

6 I would like to say that I am certainly second to
7 none in my admiration of the bank card association for the
8 new and innovative product that it may have come out with in
9 terms of how it has enhanced convenience and it has

1 proposes the risk and the cardholder who gets the benefit of
2 the 30-day grace period and the card-issuing bank, which
3 extends the service.

4 There is no need to institutionalize that
5 transaction cost in the entire system.

6 COMMISSIONER STEIGER: I know you probably have
7 another point to make, but I would like to interject a
8 question here.

9 As a matter of analysis, why shouldn't we see fees
10 as an ancillary restraint -- fees and their allocations --
11 as a necessary ancillary restraint to allow the joint
12 venture to bring forward a new product and, therefore, not
13 be unduly concerned about it?

14 MR. OPPER: Well, if they are truly ancillary and
15 necessary for the existence of the product, then I think it
16 should be allowed.

17 I think the key question with the interchange fee
18 and the bankcard networks is whether truly this is an
19 ancillary fee or whether it's a revenue-ensurer or
20 revenue-generator, you know, for the issuing banks. And
21 rather than negotiated independently with the cardholders,
22 it's certainly much more convenient for there to be a
23 uniform fee that is institutionalized in the transaction.

24 COMMISSIONER STEIGER: Thank you very much.

25 Does that pose a response?

1 MR. MacDONALD: Yeah. Let me start off with the
2 broad maxim, and that is to get back to what I would say one
3 of the things that would ensure success of a network joint
4 venture would be that there should be discipline, there
5 should be policing, there should be uniformity.

6 And you could focus in too much on something like
7 interchange. You know, but pricing is a golden word in the
8 antitrust laws. But there are a gazillion other things, for
9 the joint venture to work, the members have to develop
10 uniform behavior. And, arguably, any one of those maybe
11 would cause some shivering in the night.

12 But when you look at a thing like interchange,
13 again, it's like the dam up the river. And this, by the
14 way, is a fairly big issue that's emerging in Europe. And
15 among the things that have been proposed as a government
16 solution is, one, to require one-to-one negotiation of the
17 so-called interchange fee within the system, which, on its
18 face, is virtually impossible when you have tens of
19 thousands of players and hundreds of thousands of merchants
20 and gazillions of transactions and so on, maybe that could
21 work; or maybe that would just kill it. But if it were to
22 work, it would raise the price to everybody. And I don't
23 see how government, coming in with that kind of solution, is
24 going to do anybody a favor if the price gets higher.

25 The other solution is to eliminate the fee because

1 it smells. It's price-fixing, you know, in the classic
2 sense perhaps.

3 But if you eliminate the fee, it doesn't mean that
4 the revenue stream by the entrepreneur is going to be
5 eradicated. And it doesn't mean that the thing is going to
6 go away.

7 If the net is that some retailers, perhaps through
8 the system are paying part of the fee just as you may pay a
9 la carte in a restaurant instead of a price-fixed kind of
10 meal or pay for tinted glass when buy your car instead of a
11 rounded up price, if you eliminate the fee, the cost is
12 going to be passed on to consumers. And when they wake up
13 in the morning and instead of paying X price, they're going
14 to pay 250 basis points more, some people will scratch their
15 head and say, did government do me a favor, because of a
16 specialized principle that's tied to some words that were,
17 you know, important in the rule of law and go back a century
18 ago. But at the end of the day we know we have to be
19 flexible.

20 Interchange is awkward. But at the end of the
21 day, it's entrepreneurs getting together and creating
22 something that does work. And in the moral scheme of
23 things, I don't think a case could be made that it's harming
24 people or the system in a way that justifies government
25 interference.

1 the perfect competitive market, that makes a lot of sense.
2 But as an antitrust enforcer and as a consumer, I'm not
3 particularly comforted by the fact that economic theory says
4 that if the banks take it away in the first instance they're
5 going to give it to me back, you know, somehow sometime
6 later.

7 MR. IOSSO: Do you have a response also?

8 MR. MacDONALD: Yeah. Let me take an easy way out
9 and say I agree with what I think your question was and not
10 answer it, perhaps.

11 I have a different thought, and it relates to
12 something that Joe had said.

13 And we're not talking past each other, by the way.
14 We've been in the same room before and done fine.

15 One of the points that Joe brought up before is
16 this issue about legislation that's been passed to allow
17 surcharges on ATM's. And there are a lot of good reasons
18 for it. And as far as I'd be concerned, either way the

1 and saw things in a different way and decided to seek
2 legislation -- I saw the eyebrows go up -- to seek
3 legislation to allow the surcharge.

4 I would guess -- and I may be dead wrong on this
5 -- but that, at least initially, the net of that is that the
6 consumer is going to end up paying more so that the role of
7 the government played is that more costs got hit on
8 consumers. I think, over time, competition will take care
9 of that, and there will be a self-correction in there.

10 But, perhaps, to get back to what I suspect your
11 point was, is, in fact, that one way or the other, there are
12 benefits that come from the interchange and that it's simply
13 wrong -- that interchange ought to be viewed as a revenue
14 stream. And I would argue that, as long as it's not an
15 immoral revenue stream, it doesn't matter if it's illogical.
16 As long as it's not an immoral revenue stream, then to
17 affect it or to try to make it go away is not to save
18 anybody any money, because entrepreneurs will find a way to
19 change their pricing to achieve the same revenue objective.

20 And I suspect that Bill Baxter would agree with
21 that. But he probably knew I was going to say it, so that's
22 why he left.

23 COMMISSIONER STEIGER: Yes, Becky.

24 MS. BURR: I would like to see if we can bring
25 this back a little bit to the topic that we started out with

1 efficient solution, because they know more about their own
2 technologies than the regulator ever will.

3 The other point I think is that particularly with
4 networks -- and the same thing, frankly, applies even in
5 yellow pages, which are a very sort of crude form of an
6 information network -- is that there doesn't seem to have
7 been much of a problem once we got over the copyright issue
8 that everybody would exchange information and put each
9 other's listing in the phone books, because if your phone
10 book isn't complete, no one will use it.

11 It's the same way with sort of a network solution
12 in that, soon enough, the incumbents will realize that they
13 must interconnect with the new people because they're not
14 going to have all the customers any more.

15 And I guess the question is that at some point you
16 have to decide when the marketplace can take over that,
17 because if they reach a solution, each one of them is sort
18 of left like being -- and this is probably -- I'm glad the
19 computer people aren't here -- they're both left like being
20 DEC and Apple: They have a small, isolated part of the
21 universe and can't get any bigger.

22 So I think that the answer is, yes, in the
23 beginning the regulator might have to supervise in the end.
24 But after a while the networks are big enough, they have
25 enough power countervailing each other. I think maybe ATMs

1 is a good example. There are very big ATM networks who have
2 figured out how to interchange information with one another.

3 MR. IOSSO: I have a similar-type of follow-up or
4 looking from a different direction. And I'll ask this to
5 Dr. Besen.

6 You talked about how, in a more regulated-type of
7 setting, there are a lot of pitfalls to try to get to the
8 open interface and ways to work around it.

9 If we were to look at an unregulated type of
10 center with some type of bottleneck, how do you see
11 antitrust -- the effectiveness of antitrust opening it up?

12 How could it avoid these pitfalls?

13 Do these pitfalls call into question in some way
14 the whole exercise?

15 MR. BESEN: Let me start by saying that the
16 standards, interoperability or compatibility questions we
17 are talking about here, I think are among the most
18 fundamentally difficult public policy questions that are
19 around.

20 I once had an occasion at a conference to remark
21 that economists who study standards aren't even very good at
22 predicting the past, by which I mean, when an outcome
23 occurs, it's not always the case that we can actually tell
24 with any great confidence why what happened actually
25 happened. This is a lot of the -- you people have been

1 reading about path dependence or sort of related concepts
2 here.

3 This is an extraordinarily difficult industry or
4 set of problems in which to make policies.

5 I guess I were -- I wish I were as confident as
6 some of the people around the table here about the ability
7 of the various institutions that exist that try to deal with
8 these problems that, in fact, they will work.

9 The theorems the economists have generated in this
10 area, have generally been of the sort that, in fact, there
11 is certainly no confidence that, in fact, private
12 non-cooperative activities, the sort that occur in ordinary
13 marketplaces, are guaranteed -- or even likely -- to produce
14 the right outcomes.

15 We get back to this business of the small network
16 and the large network. If I'm a large installed base and I
17 have a choice of letting you in and having the two of us
18 compete like hell on price or keeping you out and having a
19 slightly smaller network, I might well choose a slightly
20 smaller network. And, in fact, sometimes that's the right
21 answer.

22 There is a remarkable set of institutions that are
23 around to deal with these problems. There are a variety of
24 industries. We're talking here basically about the private
25 markets non-cooperative, behaviorally and the way those

1 processes worked and we talked about regulation.

2 There's a whole set of private voluntary standards
3 bodies that try to deal with this. These are all
4 extraordinarily imperfect mechanisms for dealing with the
5 problems that we're talking about here.

6 I don't have really great confidence that any of
7 them is going to produce anything approaching the optimum.
8 But I guess I can't really -- I guess the short answer is,
9 given the kind of difficulties I have identified before, is
10 that we are going to muddle through. I mean, these are all
11 very fact-specific. There are no sort of general principles
12 that guide these. The answer might be different in banking
13 networks than it is in telecom. So I don't think there's
14 kind of the sort of general principles that this system will
15 work everywhere and always.

16 But I think there will always be extraordinarily
17 difficult problems to try to solve, because there are really
18 not very simple answers.

19 I know that's not a satisfactory answer, but I
20 think it's a truthful one.

21 MR. CUTLER: Can I make one more marketplace
22 observation that I think sort of underscores my faith that,
23 particularly with networks -- it doesn't work so well with
24 computer systems and some other things because
25 interoperability is probably not vital in that situation.

1 But it works in networks.

2 And that is that in the UK, BT went around the
3 country when TeleWest got all these customers -- and I think
4 TeleWest has 230,000 telephone customers and only 240,000
5 cable TV customers -- which I still think is a fascinating
6 statistic -- BT went around and ripped out all the local
7 loops of all of our customers as sort of a retaliatory
8 measure for having left BT.

9 Now, obviously, what that means is, we've got them
10 forever, basically. Because now in order to get back there,
11 BT has to spend the \$1,000 -- assuming that's the right
12 number in the UK -- to get to them.

13 And obviously they stopped doing that because they
14 realized what a bad competitive move it was. It's like when
15 they switched, they're gone forever. And I really think
16 that telephone companies are going to recognize that type of
17 a situation. And because of the way a network is only as
18 good as its size, it will continue to interoperate because
whether or not they lose a customer, their other customers

1 in your statement that if standard setting bodies can choose
2 between competing technologies, competition for the market
3 may partially substitute for competition within the market.

4 And I'm wondering if you would like to comment on,
5 you know, what you see as limits on this ability to
6 substitute for competition within the marketplace, based on
7 possible imperfections in knowledge before a standard is
8 adopted or limitations on ability to enter long-term

1 behavior of these bodies that people tend to think of as
2 primarily dealing with technical standards is they worry
3 about price a good deal. That shouldn't be surprising to
4 economists, and I think it does serve as a useful function.

5 Is it a perfect mechanism? Of course not. But I
6 think it's useful, and it's useful to remember that, in
7 fact, this is one way in which private parties, dealing
8 through, again, non-market, non-governmental institutions,
9 in fact, try to deal with the kind of problems we have
10 identified here, which is not being held up by the party
11 that's got the bottleneck, try to anticipate who it's going
12 to be and try as best you can to get them to guarantee a low
13 price.

14 COMMISSIONER STEIGER: Are there any more
15 questions for our very distinguished group or any more
16 comments from them before we wrap up this afternoon?

17 Well, then, it is, indeed, a great pleasure for us
18 to have had the opportunity to meet with all of you. And on
19 behalf of the Commission, our thanks for your contribution
20 to the record and this exploration of antitrust in the
21 global world.

22 Thank you.

23 (Whereupon, at 4:12 p.m., the hearing was
24 recessed.)

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C E R T I F I C A T E

DOCKET/FILE NUMBER: P951201
CASE TITLE: GLOBAL AND INNOVATION-BASED COMPETITION
HEARING DATE: November 30, 1995

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED: November 30, 1995

SIGNATURE OF REPORTER

GREGG J. POSS
(NAME OF REPORTER - TYPED)