Contents

Preface
Acknowledgments

Introduction
A. The Changing Network Economy
B. A Fundamental Shift in Regulatory Policy
C. The Limits of Existing Scholarship
D. Network Law and Economics
E. Distinguishing among Different Types of Access to Networks
F. Toward a Market-Based Approach to Access Prices

PART I. THE ECONOMICS OF NETWORKS

1. The Structure and Functions of Networks
   A. Types of Networks
      1. Communications, Transportation, and Distribution Networks
      2. Social and Business Networks
   B. The Structure of Networks
      1. Describing Networks
      2. The Shapes of Networks
   C. The Output of Networks
   D. Access to Networks
      1. Retail Access
      2. Wholesale Access
      3. Interconnection Access
      4. Platform Access
      5. Unbundled Access
   E. A Coasian Theory of Networks
2. **The Design and Costs of Networks**

   A. **The Optimal Design of Networks**  
      1. Choosing the Network Configuration 41  
      2. Cost-Minimizing Network Design 43  
      3. Cost-Minimizing Design of a Cycle Network 44  
      4. Network Configurations with Economies of Scale in Links 45  
      5. The Max-Flow/Min-Cut of a Network 47  

   B. **Production Functions of Networks**  
      1. Production Functions and Engineering 51  
      2. Production Functions for a Single-Output Network 53  
      3. Production Functions for a Multioutput Network 58  

   C. **Cost Functions of Networks**  
      1. Derivation of the Cost Function 61  
      2. Economies of Scale 64  
      3. Multiproduct Cost Functions 66  

   D. **The Cost of Unbundled Access to Networks**  
      1. Allocating Multiproduct Costs 69  
      2. Long-Run versus Short-Run Costs 71  

3. **Pricing Network Services**

   A. **Network Capacity and Pricing**  
      1. The Basics of Pricing with Scarce Capacity 78  
      2. Pricing Capacity under Uncertainty 83  
      3. Time-of-Use Pricing of Capacity 84  

   B. **Network Capacity Pricing under Asymmetric Information**  
      1. Vickrey Auctions of Capacity 88  
      2. Reliability Pricing of Capacity 90  
      3. Priority Pricing of Capacity 93  

   C. **Network Capacity Pricing with Congestion and Quality of Service**  
      1. Blocked Calls 95  
      2. Information Loss 100  

   D. **Demand for Capacity: Substitutes and Complements**  
      1. Substitutes and Network Capacity 107  
      2. Complements and Network Capacity 112  

   **PART II. THE REGULATION OF NETWORKS**

4. **Network Regulation Basics**

   A. **Economic Justifications for Regulating Networks**  
      1. Natural Monopoly 119  
      2. Network Economic Effects 120
3. Vertical Exclusion 122
4. Ruinous/Managed Competition 125

B. Basic Regulatory Instruments 126
   1. Tariffing 126
   2. Structural Separation 130
   3. Unbundling 132

C. Analyzing the Rationales and Regulatory Instruments 135
   1. Natural Monopoly 135
   2. Network Economic Effects 138
   3. Vertical Exclusion 143

Economic Effects of Regulating Access to Networks 152

A. Classifying Types of Access to Networks 153
   1. Retail Access 153
   2. Wholesale Access 154
   3. Interconnection Access 155
   4. Platform Access 156
   5. Unbundled Access 158

B. Capacity and Configuration Effects of Access Regulation 159
   1. Retail Access 160
   2. Wholesale Access 163
   3. Interconnection Access 168
   4. Platform Access 169
   5. Unbundled Access 171

C. Transaction Cost Effects of Access Regulation 173
   1. Retail Access 173
   2. Wholesale Access 174
   3. Interconnection Access 181
   4. Platform Access 181
   5. Unbundled Access 182

D. The Possibility of Regulatory Arbitrage 184

E. Markets and the Design of Networks 186

6. Pricing of Access to Networks 190

A. The Economic Case for Market-Based Pricing of Network Access 192
   1. Market Prices, Regulated Prices, and Efficiency 192
   2. The Difference between Market Prices and Unit Costs 194

B. Determining Market Price 195
   1. Pricing Based on External Market Transactions 195
   2. The Second-Best Solution in the Absence of External Markets 196
   3. The Efficient Component Pricing Rule 198
### Contents

C. The Consistency between Network Costs and Market Pricing 200
   1. Economies of Scale and Scope 201
   2. Sunk Costs 203

D. Regulatory Approaches to Setting Rates in Regulated Industries 205
   1. Direct Cost 205
   2. Excess Capacity and Zero Opportunity Costs 207

7. **Constitutional Limits on the Pricing of Access to Networks** 210
   A. The Distinction between Physical and Nonpossessory Takings 210
      1. The Emergence of the Nonpossessory Takings Doctrine 210
      2. *Loretto* and the Distinction between Physical and Regulatory Takings 214
      3. *Florida Power* and the Distinction between Physical Takings and Confiscatory Ratemaking 216
      4. Toward a Possible Synthesis of Regulatory Takings and Confiscatory Ratemaking Doctrine 217
      5. The Importance of the Shift to Access Regulation 219
   B. Physical Takings Jurisprudence Applied to Network Access 220
      1. Determining Whether a Taking Has Occurred 221
      2. Determining Just Compensation 221
      3. Partial Takings of Utility Property 227

**PART III. POLICY APPLICATIONS**

8. **The Regulation of Local Telephone Networks** 233
   A. The History of the Regulation of Local Telephony 233
      1. Early State and Federal Regulation and the Communications Act of 1934 233
      2. The Emergence of Competition in Complementary Services 234
      3. The Emergence of Competition in Local Telephony 237
      4. The Telecommunications Act of 1996 238
   B. The Rationales for Regulating Local Telephone Networks 241
      1. Natural Monopoly 241
      2. Network Economic Effects 244
      3. Vertical Exclusion 246
      4. Managed Competition 248
   C. The Different Types of Access to Local Telephone Networks 254
      1. Retail Access 255
      2. Wholesale Access 257
      3. Interconnection Access 260
      4. Platform Access 268
      5. Unbundled Access 272
      6. Regulatory Arbitrage 276
D. Constitutional Arguments in Favor of Market-Based Pricing 277
   1. Physical Collocation 277
   2. Virtual Collocation 280
   3. Wireless Interconnection 281

9. Antitrust as Applied to Network Industries 282
   A. The Origins of the Essential Facilities Doctrine 283
   B. A Critique of the Essential Facilities Doctrine 288
      1. The Economics of Vertical Exclusion 289
      2. The Allocation of Authority between Antitrust Courts and Regulatory Agencies 299
   C. The Impact of Trinko 308
      1. The Economics of Vertical Exclusion 309
      2. The Allocation of Authority between Antitrust Courts and Regulatory Agencies 311
      3. Trinko's Implications 312
      4. The Impact of Trinko's Varying Interpretations 314
   D. The Different Types of Access under Antitrust Law 315
      1. Retail Access 316
      2. Wholesale Access 319
      3. Interconnection Access 322
      4. Platform Access 327
      5. Unbundled Access 331

10. The Regulation of Last-Mile Broadband Networks 334
    A. The History of Last-Mile Broadband Regulation 334
       1. Regulation of Cable Modem Systems 335
       2. Regulation of Digital Subscriber Lines 339
       3. The Debate over Network Neutrality 343
    B. The Rationales for Regulating Last-Mile Broadband Networks 348
       1. Natural Monopoly 348
       2. Network Economic Effects 351
       3. Vertical Exclusion 352
       4. Managed Competition 354
    C. The Different Types of Access to Broadband Networks 356
       1. Retail Access 357
       2. Wholesale Access 358
       3. Interconnection Access 360
       4. Platform Access 362
       5. Unbundled Access 367
    D. Arguments in Favor of Market-Based Pricing 369
11. The Regulation of Broadband Networks and the Internet: Network Neutrality versus Network Diversity 373
   A. The Economic Case for Network Diversity 376
      1. Vertical Exclusion and Network Neutrality 378
      2. Network Diversity and Static Efficiency 382
      3. Network Diversity and Dynamic Efficiency 390
   B. Noneconomic Justifications for Network Diversity 394
   C. Institutional Considerations 397

12. The Regulation of Broadband Networks and the Internet: Network Neutrality versus Network Capacity 405
   A. Sources of Congestion on the Internet 409
   B. The Economics of Congestion 412
      1. Congestion and the Choice between Flat-Rate and Usage-Sensitive Pricing 412
      2. The Impact of Transaction Costs on the Choice between Flat-Rate and Usage-Sensitive Pricing 413
      3. Coasian Proxies as an Alternative Solution to Congestion 419
   C. Implications of Congestion Economics for Network Neutrality 420
      1. Prohibitions on Reselling Bandwidth or Acting as an Internet Service Provider 422
      2. Restrictions on Home Networking 422
      3. Restrictions on Attaching Devices 423
      4. Restrictions on Operating File Servers 424
      5. Discrimination against Particular Applications 425
      6. Discrimination against Particular Content 425
      7. The Potential Insufficiency of Capacity Expansion and Metered Pricing as Alternatives 427
   D. A Broader Perspective on Consumer Welfare 429

Conclusion 433

Bibliography 439
Index 473
Table of Cases 487