FEDERAL TELECOMMUNICATIONS LAW:

A LEGISLATIVE HISTORY OF

THE TELECOMMUNICATIONS ACT OF 1996

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INCLUDING

THE COMMUNICATIONS DECENCY ACT

Volume 2
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INTRODUCTION

AN OVERVIEW OF THE TELECOMMUNICATIONS ACT OF 1996

The "Telecommunications Act of 1996," signed into law on February 8, 1996, opens up competition between local telephone companies, long-distance providers, and cable companies; expands the reach of advanced telecommunications services to schools, libraries, and hospitals; and requires the use of the new V-chip technology to enable families to exercise greater control over the television programming that comes into their homes. This Act lays the foundation for the investment and development that will ultimately create a national information superhighway to serve both the private sector and the public interest.

President Clinton noted that the Act will continue the efforts of his administration in ensuring that the American public has access to many different sources of news and information in their communities. The Act increases, from 25 to 35 percent, the cap on the national audience that television stations owned by one person or entity can reach. This cap will prevent a single broadcast group owner from dominating the national media market.

Rates for cable programming services and equipment used solely to receive such services will, in general, be deregulated in about three years. Cable rates will be deregulated more quickly in communities where a phone company offers programming to a comparable number of households, providing effective competition to the cable operator. In such circumstances, consumers will be protected from price hikes because the cable system faces real competition.

This Act also makes it possible for the regional Bell companies to offer long-distance service, provided that, in the judgment of the Federal Communications Commission (FCC), they have opened up their local networks to competitors such as long-distance companies, cable operators, and others. In order to protect the public, the FCC must evaluate any application for entry into the long-distance business in light of its public interest test, which gives the FCC discretion to consider a broad range of issues, such as the adequacy of interconnection arrangements to permit vigorous competition. Furthermore, in deciding whether to grant the application of a regional Bell company to offer long-distance service, the FCC must accord "substantial weight" to the views of the Attorney General. This special legal standard ensures that the FCC and the courts will accord full weight to the special competition expertise of the Justice Department's Antitrust Division--especially its expertise in making predictive judgments about the effect that entry by a bell company into long-distance may have on competition in local and long-distance markets.

Title V of the Act is entitled the "Communications Decency Act of 1996." This section is specifically aimed at curtailing the communication of violent and indecent material. The Act requires new televisions to be outfitted with the V-chip, a measure which President Clinton said, "will empower families to choose the kind of programming suitable for their children." The V-chip provision relies on the broadcast networks to produce a rating system and to implement the system in a manner compatible with V-chip technology. By relying on the television industry to establish and implement the ratings, the Act serves the interest of the families without infringing upon the First Amendment rights of the television programmers and producers.

President Clinton signed this Act into law in an effort to strengthen the economy, society, families, and democracy. It promotes competition as the key to opening new markets and new opportunities. This Act will enable us to ride safely into the twenty-first century on the information superhighway.

We wish to acknowledge the contribution of Loris Zeppieri, a third year law student, who helped in gathering these materials.

Bernard D. Reams, Jr.
William H. Manz

St. John's University
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Jamaica, New York
April 1997

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S. HRG. 104-218

HEARING ON TELECOMMUNICATIONS POLICY REFORM

HEARING

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MARCH 2, 1995

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HEARING ON TELECOMMUNICATIONS POLICY REFORM

THURSDAY, MARCH 2, 1995

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The committee met, pursuant to notice, at 9:50 a.m., in room SR-253, Russell Senate Office Building, Hon. Larry Pressler (chairman of the committee) presiding.

Staff members assigned to this hearing: Donald McClellan, counsel, and Katherine A. King, counsel; and John D. Windhausen, Jr., minority counsel, and Kevin Joseph, minority professional staff member

OPENING STATEMENT OF SENATOR PRESSLER

The CHAIRMAN. Turning to the hearing before us, I am pleased to welcome the many distinguished witnesses to the Senate Commerce Committee. All of us are here today to discuss long overdue action to reform Federal law on telecommunications.

Our challenge is to overthrow the old regime of heavy regulation in these markets and replace it with a true market system.

The burgeoning of the new technologies and the recent growth of the telecommunications industries in America is awesome. This sector now represents at least 10 percent of the U.S. economy.

It would be a costly mistake, however, to be complacent about this success. Old laws and regulations that serve no reasonable economic or social purpose are holding back American telecommunications firms from creating more jobs, offering new products and services, and cutting costs to consumers.

It seems to me that we are faced with a very challenging time in terms of telecommunications. I guess the ultimate goal is to get everybody into everybody else's business if we can.

We have had the three apartheid economic areas of the long distance companies, the regional Bell companies and of the cable companies, plus several smaller entrepreneur groups such as burglar alarm people and so forth.

But a rewrite of the 1934 Act would provide a road map for the next 15 years until we get into the wireless age if we can get it done.

People tell me that if there is such a road map, if there is certainty, there will be an explosion of investment and an explosion of new devices. Truly, we will enter the information age.

Right now, it is my judgment that there is a lot of paralysis. People are waiting for something definite. I know that Senator Hollings did a great job of trying to lead a consensus last year. We are trying to reach that still.

I am going to place the rest of my statement into the record. If other Senators have opening statements, they are most welcome.

[Prepared statement of Senator Pressler follows:]

PREPARED STATEMENT OF SENATOR PRESSLER

I am pleased to welcome the many distinguished witnesses to the Senate Commerce Committee. All of us are here today to discuss long overdue action to reform federal law on telecommunications markets. Our challenge is to overthrow the old regime of heavy regulation in these markets and replace it with a true free market system.

The burgeoning of new technologies and the recent growth of telecommunications industries in America is awesome. This sector now represents at least 10 percent of the U.S. economy. It would be a costly mistake, however, to be complacent about this success. Old laws and regulations that serve no reasonable economic or social purpose are holding back American telecommunications firms from creating more jobs, offering new products and services, and cutting costs to consumers.

Our most heavily regulated telecommunications industries are not gaining the kind of investment growth their freer counterparts in other countries are winning. Our own telecommunications investment markets are artificially closed to most potential foreign investment. Meanwhile we're seeing U.S. investment capital—even from some of our own telecommunications companies—go abroad to freer markets.

The power of the growing free markets abroad offers us a challenge: establish a true free market system for telecommunications in the United States.

Some still seem to think the impact of reform legislation is to change some of the boundaries of the old system of carved-out market enclaves. Some may even think it is worth halting reform legislation—thwarting establishment of a true free market system for telecommunications in America—because some government-guaranteed monopoly might be lost.

I consider that the height of folly. The big players in the older, heavily regulated parts of telecommunications need to understand something fateful for them and their supposed rivals: If we all don't hang together, we'll all hang separately—in artificially weakened condition as competitors in the world economy.

The CHAIRMAN. I will ask our witnesses this morning to summarize their statements to 5 minutes. We will put your full statement in the record.

And we will have questions from a variety of Senators who are arriving at a variety of times this morning because of the caucuses that are going on or at least the caucus on one side. I don't know about what else is occurring this morning. But there are mark-ups in other committees.

So with that, I am going to call on Senator Hollings, the ranking member of this committee.

STATEMENT OF SENATOR HOLLINGS

Senator HOLLINGS. Thank you, Mr. Chairman.

I apologize to the colleagues and witnesses for being tardy.

I think the real point here is to once again flesh out what we can with respect to the basic differences. This bill involves, of course, every ramification of communications and computerization.

And with that in mind, you have got the newspapers, the broadcasters, the long distance, the cellular, the RBOCs, the burglar alarm, Dunn and Bradstreet. You keep on and on and on.

We were successful last year in getting a strong bi-partisan majority to agree to report a bill. And under the leadership of our chairman now, we hope to do the very same.

There is no rhyme nor reason if we cannot get that bill out. But you will find the jockeying for position. This town, just like this budget matter here, they treat it like spectator sport and who is on top.

With respect to communications, everybody figures they represent a certain entity and interest. And they want to get the best deal.

And with that in mind, you find that, for example, we passed a manufacturing bill with three-quarters of the U.S. Senate 4 years ago, Senator, bi-partisan.

And we said we were trying to deregulate. And the Bell Companies at that time said their primary interest, for example, was manufacturing.

So we all got together and said, "Look. There is no reason for the RBOCs with the billions that they have to be investing in New Zealand and Buenos Aires and Mexico. We want jobs. We want investments and advancements in telecommunication right here in this country."

So that—we said no longer than within a year the RBOCs should get into manufacturing and sooner if some of them are ready.

Now, comes the bill, and of course, some said, "Well, not for 3 years."

Well, we know a certain interest is not wanting competition.

And so they said, "Well, give us at least three more years to try to develop our almost monopolistic control."

So under the auspices of deregulating, we are re-regulating backwards from where we were 4 years ago.

These are the kinds of things that the distinguished Chairman and I and other Senators have to contend with. And we have to have hearings. Everybody wants to be heard. But I hope we can limit the hearings, Mr. Chairman, generally speaking, get to the main problems.

Our rural friends, they say, "We are happy. Leave us alone."

If we left them alone, it would be all right for a while. There is no inducement financially, really, to get into these rural areas. And some have taken the risk and succeeded and are serving.

But the rural areas are not, let us say, large enough to support more than one server in a sense. And if you left them alone then 3, 5, 10 years from now, they would be out of the information resolutions. There would not be any interconnection.

So we have a problem of trying to recognize the leadership given at the rural level and yet understanding that they cannot just be left alone. We have got to get competition there.

The RBOCs will hold on until death do us part to their monopoly. They are my best friends. I have worked with them very closely. But they have got no idea. And they will work us until the last minute.

And I think if we work this bill through, Mr. Chairman, passed it through the House and the Senate, and had a conference, they would have another notion because they like what they have got.

For example, in my area, it is growing. So they have got growing pains. And they do not want to have superimposed competition pains. So they want to just take care of the growing pains.

And they are busy enough there because they are down in Buenos Aries and in Mexico also. And so they have got enough problems.

So while they talk, articulate competition and deregulation, they are as happy as clams. It is hard for the Chairman and I and other Senators to get past this nonsense. But we are going to do it.

I think under Senator Pressler and his bill, that we can move forward. And I thank you very much.

The CHAIRMAN. Thank you.

Do any of our other colleagues wish to make an opening statement here this morning?

STATEMENT OF SENATOR BURNS

Senator BURNS. Mr. Chairman, I would just reiterate that the Chairman and the ranking member know that no subject—we have danced more with this subject than any subject in the world and never made it to the alter. But I think we might get it done this time.

So I have no opening statement but I look forward to working with all of you, everybody on this.

STATEMENT OF SENATOR ROCKEFELLER

Senator ROCKEFELLER. Chairman, I will just submit a statement for the record and hope, as I am sure that we all do, because this is such a monumental subject with the implications just beginning to unfold, most of the implications yet unknown to the American consumer, that we really can do this in a non-partisan way.

The CHAIRMAN. Thank you very much. Go right ahead.

[Prepared statement of Senator Rockefeller follows:]

PREPARED STATEMENT OF SENATOR ROCKEFELLER

I commend you, Chairman Pressler, Senator Hollings, and other members of this committee for continuing the hard work of this very complex task—restructuring the framework for the communications industry as it moves rapidly into the next century.

I also would like to express my belief that we made a very wise investment of time last year in crafting and revising S. 1822, which members of the Commerce Committee reported out by a strong vote of 18-2. The solid principles of that legislation—sustaining and advancing "Universal Service;" strong but fair measures to promote competition in all communications services; and the deregulation of competitive markets—are serving as the foundation for the bipartisan legislation that we are now trying to prepare for committee action this year. I am sure we all agree that actual competition is the key to genuine deregulation.

Mr. Chairman, I appreciate your assurances that you are seeking a truly bipartisan effort to produce legislation that will help foster and guide the explosive changes in telecommunications.

This legislation is incredibly important to American consumers and business. I am sure it can help promote the economic growth that the people of West Virginia are eager for, which makes me determined to be involved in this process.

And I believe the promising vision of an advanced telecommunications infrastructure lies not only in its potential to help public and private institutions prosper, but also in its capacity to improve how our children—along with adults—learn at school, in libraries and at home.

Because of the far-reaching impact this legislation will have, we cannot afford to let partisan politics creep back into the process. It is critical that we listen to one another, learn from the hearings planned by the Chairman, and work in the best faith for consensus. I know I have more to learn. Given the stakes of this legislative endeavor, truly working together looks like the best way to serve our own constituents and the national interest.

I look forward to continuing to work with you, Mr. Chairman, and my colleagues, on what I hope will be an effective bill in encouraging fair competition, safeguarding the public interest, and continuing to provide incentives for investment in the telecommunications networks of this nation. American industry and workers have reason to be very proud of what they have achieved in developing this incredible array of products and possibilities, and we need to respond with the changes in policy whose time have clearly come.

STATEMENT OF SENATOR HUTCHISON

Senator HUTCHISON. Mr. Chairman, yes. I would very just like to submit a statement for the record, but say that I was one of those that was really hesitant to get into deregulation because, as an outsider looking at Congress, I always felt like Congress got into deregulation and got into more regulation, more harassment and more problems.

But I am totally convinced that the technology has moved so far beyond the present regulatory structure that we must move forward.

And what pleases me about the draft that we have before us which I hope everyone will feel free to work on and have input into, but nevertheless, I think it is an effort to balance all of the competing interests with the goal of more competition.

And second, it attempts to take away regulatory enforcements if it is not absolutely necessary that we have those. So I think those are two very good goals.

And I think this industry, in particular, is going to be the job creator of the future for our country. So it is most important that we have competition and a good working environment to promote that.

And I thank you very much.

PREPARED STATEMENT OF SENATOR HUTCHISON

The telecommunications legislation that this committee is formulating will have long-term economic effect. The economic scope of the U.S. telecommunications industry has been estimated at several trillion dollars. The productivity potential in industry research and development, manufacturing and deployment is enormous; the industry will be one of the largest job creators in the next century.

We must "get it right"—that is, spur technological innovation and investment, develop new services and deliver them efficiently and cheaply to consumers. The aim of legislation pending in, the Senate Commerce Committee is to reform this framework to ultimately permit any vendor to offer any communications service to anyone, anywhere, using any technology. I commend the Chairman for moving ahead with a framework that achieves these aims through competition, not regulation.

The existing framework of telecommunications regulation emanates from statutes, court decisions, and Federal Communications Commission (FCC) and State public utility commission rules. This framework was originally developed in a monopoly environment and has received patchwork updates. As one could expect, technology now has galloped ahead of the regulatory framework. Technology has "converged" in such a way that the providers of almost any telecommunications service can now deliver all of them.

However, some potential market participants find themselves prevented from competing because of the statutory and regulatory framework. What regulators may permit, courts may prohibit; what some States permit, others do not. We need to re-write the rules and create a comprehensive framework for promoting competition. If we do so, competition in most areas will be a certainty and consumers will reap the benefits that competition brings in all markets where it is permitted to flourish: greater consumer choice and lower prices.

However, when necessary, we must also protect competition. There must be appropriate safeguards and transition mechanisms to ensure that no competitor is disadvantaged as a result of the monopolistic, highly regulated policies of the past.

The CHAIRMAN. Thank you very much. Senator Ashcroft.

STATEMENT OF SENATOR ASHCROFT

Senator ASHCROFT. Mr. Chairman, transitions are the most difficult but the most important aspects of our development. And this is a challenge in transition, how we move from regulation to competition, how we move from a narrow band of services to a very broad band of services.

And this is a serious matter of great challenge. And I look forward to working together with all of the members of the Committee to get it done and done well.

STATEMENT OF SENATOR PACKWOOD

PREPARED STATEMENT OF SENATOR PACKWOOD

Mr. Chairman, I hope we can pass a bill this year which ensures that every segment of the communications industry, whether it be long distance, cable or local telephone, will be able to compete in other markets. There is no point in trying any longer to regulate the communications industry because regulation cannot keep up with technology.

I favor what has been called a "Le Mans Start," a calendar deadline by which all markets shall be open for competition. Yesterday the WEFA Group reported that if Congress were to pass legislation that simultaneously opened all communications markets to competition on January 1, 1996 we would create 2.1 million new jobs by the year 2000. The study also found that delaying full competition by three years could cost 1.5 million new jobs by the year 2000.

Everybody says they are in favor of deregulating the communications industry. However, long distance companies, cable companies and others say we cannot open all markets at the same time because some companies have particular advantages over others. Long distance and cable have asked to be able to get into the local phone business before the Bell operating companies can get into their markets. I'm reluctant to do that. However I do agree that in order to get into the local telephone business long distance companies, cable companies and others have to be able to interconnect with the existing local telephone network.

Mr. Chairman, I am reasonably confident we can pass a reasonably good bill. As I have said on many occasions, the challenge before us is to pass a bill that is as deregulatory as possible.

By and large all of the deregulations of the last two decades have worked very well. I have not found one yet that did not benefit the consumer. Big and small competitors have also benefited. Our experience is not that the deregulated industry is dominated by a few giants, but rather that competitors come along and devise ways to run circles around the giants. Competition thrives. I am confident there is not going to be a loser in a heavy-weight fight between AT&T and the Bell operating companies—not AT&T, not the Bells and certainly not the consumer.

The CHAIRMAN. Thank you.

Our first panel consists of the Honorable Anne K. Bingaman, Assistant Attorney General for Anti-trust, Department of Justice; the Honorable Larry Irving, assistant secretary for communications and information, the National Telecommunications And Information Administration; and the Honorable Kenneth Gordon, the Chairman of the Massachusetts Department of Public Utilities.

I would ask witnesses if they could summarize their statements. We will place their entire statements in the record. I call on the Honorable Anne Bingaman.

STATEMENT OF ANNE K. BINGAMAN, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE

Ms. BINGAMAN. Mr. Chairman, members of the Committee, it is a great honor to appear before this distinguished panel on such an important subject that has been the life work of the Antitrust Division of the Department of Justice for 25-plus years now.

We have labored in this as this Committee has. We are devoted to competition as the Chairman and other members of the Committee are. And let me recount briefly where we stand on this.

We believe, and the administration believes, that the role of the Congress is critical and vital and crucial to moving this country forward to the next phase in competition in telecommunications. As you know better than I, the Congress has been at loggerheads for a decade and over now.

This country needs your leadership. This country needs it now. It needs it this year. It needs legislation. It needs legislation that is comprehensive, that is national in scope, and that opens the local loop of the Bell Companies to competition.

If that is done, and if it is done properly, and if, in fact, there can be and is interconnection at all of the points in the network so that cable companies, long distance companies, entrepreneurs, any company, can access the local loop of what is now and still the Bell Company monopoly in the local network, we believe along with this Committee that this country can see an explosion of competition, lower prices that we have never seen before. We say this because we have done this once.

We took the first step by separating long distance from the local loop in the modified final judgment in 1984.

That was not a popular move. The Department of Justice led that. It led it under the succession of administrations. The Nixon Administration began the investigation of AT&T. The Ford Administration filed the case. The Carter Administration prosecuted it. The Reagan Administration, under my former law professor and Mr. Irving's, Bill Baxter, brilliantly settled it with the break up of AT&T.

It was not popular at the time as this Committee remembers. What we have seen is that competition works. It has worked in long distance. Consumers today have paid 50 percent less than they did in 1982 for long distance services.

We have seen fiber optic networks laid across the country. We have huge excess capacity in fiber optics, but only in the long distance segment, because that is where competition has worked. Sprint, MCI, AT&T and Wiltel have laid this fiber optic cable.

What we need now is competition in the last mile. We need competition in the local loop so that the digital network that we have across the country can be laid to every home in this country.

And we can leap-frog the rest of the world as we already have. We can export products. We can have lower prices. We can bring education, medical books, textbooks, the whole Library of Congress to the home of every American in the foreseeable future, if the Congress acts and acts now to bring competition to the local loop to open this up.

So the future is literally in the hands of this Committee. It is in the hands of the Congress. Jobs depend on it. Exports depend on it. The prices, the products available to American consumers depend on it.

As the Committee recognizes, it is a matter of the most profound national importance.

We in the administration stand ready to work with you closely and continually to achieve this goal because it is so important to the future of this country.

We commend the Chairman for his leadership, commend the ranking member for the leadership last year. And we stand ready to work with all of you at any time and in any way possible to make this happen for all Americans.

[The prepared statement of Ms. Bingaman follows:]

Department of Justice

STATEMENT

OF

ANNE K. BINGAMAN

ASSISTANT ATTORNEY GENERAL

ANTITRUST DIVISION

BEFORE

THE

COMMITTEE ON COMMERCE

UNITED STATES SENATE

CONCERNING

TELECOMMUNICATIONS REFORM LEGISLATION

PRESENTED ON

MARCH 2, 1995

Mr. Chairman and Members of the Committee:

I am pleased to be here today to testify on behalf of the Administration about the vital issue of telecommunications reform. I applaud this Committee and its leaders, Senator Pressler and Senator Hollings, for their attention and important effort to foster serious telecommunications reform. I understand that members of the Committee are formulating comprehensive legislative proposals, which are so far reflected in drafts.

The health and vitality of this important sector of the economy has received so much attention from this Administration not only because it will make a difference in the way our citizens live and work, but because it is critical to America's prosperity in the 21st Century. The key test for any telecommunications reform measure is whether it helps the American people by providing benefits to consumers and by spurring economic growth, including higher incomes and job creation. The Administration believes that the way to achieve those goals is through real competition. Real competition provides consumers with lower prices, higher quality and more choice -- as the history of long-distance competition illustrates. Real competition also is critical to the continuing competitiveness of U.S.

companies, which will create jobs and power America's continued leadership as this sector grows at home and abroad. As the President's Council of Economic Advisers concluded last year, federal legislation along the lines urged by the Administration in its White Paper could add several hundred thousand new jobs here in three years.

The Administration's fundamental vision for the telecommunications future is simple to state, but breathtaking in its implications: Every company will be permitted to compete in every market for every customer. We want that day to come as soon as possible. We would be naive, however, if we expected an uncomplicated transition from the regulated monopolies that characterize many segments of the telecommunications industry to fully competitive markets. To paraphrase Thomas Jefferson, we cannot expect to be transported from monopoly to competition in a featherbed.

Vice-President Gore put it best at the Federal-State-Local Telecommunications Summit held earlier this year: "Competition is always better than monopoly. But monopoly power must never be confused with competition. Two enemies of competition are monopoly power and unwise government regulation. We must remember, after all, that the goal we seek is real competition. Not the illusion of competition; not the distant prospect of competition."

There is today, we believe, a broad, bipartisan consensus in favor of moving telecommunications policy out of the courts and into the statute books so that Congress, representing the public, can craft the kind of comprehensive framework for competitive telecommunications that the nation deserves. The Administration is eager to work with members of both Houses of Congress to achieve this important goal. Until passage of such legislation, the Department of Justice will move forward under the Modification of Final Judgment to promote local telephone competition as a basis for easing the restrictions on the Regional Bell Operating Companies. But I cannot emphasize enough that moving forward in court is a second-best alternative. Comprehensive, competition-promoting reform legislation is by far the better course for the country.

In the balance of my testimony, I would like to cover three areas:

- First, I would like to put the discussion of telecommunications competition into context, by explaining how we got here and how the nation has benefitted from the competition in telephone markets that has occurred thus far;

- Second, I would like to suggest why providing even greater competition in both telephone and cable television markets is critically important for American consumers and industry;

- Finally, I will identify the fundamental challenges that policymakers face in promoting telecommunications competition.

The Break-Up of AT&T and the Telecommunications Revolution

The telecommunications revolution -- the merging of voice, video and other data transmission and the proliferation of new telecommunications products and services -- has been one of America's leading technological and economic success stories. At bottom, the key reason is the economic climate of competition that nourishes the creative genius of scientists, engineers and businesses.

An indispensable element in freeing that creative genius to innovate and bring new products and services to market has been a public policy generally dedicated to promoting competition. Nowhere is this more evident than in the case of long-distance telephone services, where through the efforts over two decades of the Justice Department and Judge Harold Greene, and the work of the FCC, competition has made enormous progress. We should not forget, however, the hurdles that effectively slowed competition before the success in 1982 of the Justice Department's antitrust suit. Long after competition in long distance service and communications equipment became technologically and economically feasible, AT&T frustrated consumer choice and actual competition through abuse of its monopoly control over local networks.

This story is not merely a matter for the history books. It is a cautionary tale that illustrates the persistence of monopoly in telecommunications markets. And it refutes the unsubstantiated notion that telecommunication monopolies can only exist if the coercive power of government keeps out competitors. In fact, AT&T for many years proved itself quite adept, through use of its local monopoly, at keeping competitors out of the long distance and equipment manufacturing markets, in spite of the best efforts to the contrary of regulators, the Justice Department and the competitors themselves.

The Persistence of Monopoly

AT&T used the local monopoly to discriminate against competing long distance carriers in terms of the type, quality and price of interconnection with the local network, preventing most consumers from buying service at lower prices from AT&T's competitors and inconveniencing consumers who did. For instance, consumers who used a competitor had to dial 23 digits to complete a long distance call, while AT&T customers only had to dial ten or eleven digits. Similarly, consumers who preferred other manufacturers' equipment discovered that they could not connect that equipment to the local telephone network. Moreover, the Department found that AT&T's manufacturing subsidiary, Western Electric, was overcharging the Bell system for equipment. Because these overcharges contributed to the Bell Companies' rate bases, they had the effect of inflating the prices that captive ratepayers paid for phone service.

Competitors detected AT&T's anticompetitive conduct and fought it in the courts and before regulators. The result more often than not was one step forward, one step back -- incremental progress that rarely could keep up with AT&T's ability to find new ways of impeding access to the local networks or disadvantaging other equipment manufacturers. As long as AT&T controlled the strategic bottleneck of a local telephone monopoly, litigation and regulation could not hope to promote free competition in long distance and equipment markets or protect captive ratepayers from inflated prices.

Indeed, the problem was related partly to the nature of regulation itself. With regulation constraining rates and profits in the local market, AT&T had the incentive to use the local monopoly to increase profits in the long distance and equipment markets. As long as consumers had no choice of local service provider, structural separation that prevented the regulated monopolist from participating in the other markets was necessary to prevent the abuses that plagued the industry and thwarted competition.

Regulators and would-be competitors were not the only ones stymied by the problem of the AT&T telecommunications monopoly. The Justice Department sued AT&T twice, in 1913 and in 1949, before bringing the suit that resulted in the MFJ. Those first two efforts to protect competition in telephone markets ultimately failed, because the relief obtained was not comprehensive enough.

But the third time it worked. The case filed against AT&T in 1974 was a nonpartisan undertaking to vindicate the principle that underlies the antitrust laws and, indeed, our economic system: Open competition on the merits is superior to regulated monopoly. The Department began its investigation in the Nixon Administration, filed suit during the Ford Administration, then pursued the case through the Carter Administration and into the Reagan Administration, with AT&T fighting every inch of the way. AT&T ultimately came to terms with Assistant Attorney General Bill Baxter and agreed in 1982 to the entry of the consent decree that we now call the MFJ.

As you know, the structural separation of the local exchange from other telecommunications activities was the essence of the MFJ. It required AT&T to divest itself of its local exchange businesses, resulting in the creation of the seven Regional Bell Operating Companies, sometimes called the RBOCs or Bell Companies. These Bell Companies -- independent of each other and of AT&T -- retained local telephone monopolies within their respective regions, subject to the requirement that the Bell Companies provide consumers equal, nondiscriminatory access to the long distance company of their choice.

The complete divestiture of the Bell Companies from AT&T's long distance and equipment operations removed AT&T's ability to use the local monopoly to thwart competition in the long distance and equipment markets. The MFJ also removed the RBOCs' incentive to impede competition in those markets through its "line of business" restrictions, which continue to prohibit the Bell Companies from providing long distance services and from manufacturing communications equipment. These restrictions protect against the recurrence of the specific harm that the MFJ remedied -- use of the regulated local monopoly bottleneck to hurt competition in other markets.

The MFJ retained the historically complementary roles of the FCC and the Department of Justice. Since its creation in 1934, the FCC has had Congressionally assigned responsibility for establishing the "rules of the road" for the telecommunications industry. Therefore, after entry of the MFJ, the FCC established the specific rules for implementing the decree's equal access requirements and created a process by which consumers could presubscribe to their preferred long distance carrier, both vital to facilitating the competition made possible by the MFJ. The FCC has continued to help open the long distance and equipment markets to competition.

The Benefits of Competition

The MFJ has benefitted the country spectacularly. Separating the long distance market from the local monopoly has increased competition dramatically, as MCI, Sprint and hundreds of smaller carriers have vied with AT&T to provide long distance service to businesses and residences. The New York Times recently reported that in 1994 more than 25 million residential customers changed long-distance carriers -- spotlighting the MFJ's incredible success in bringing real choice to consumers. Residential long distance rates have fallen some 50 percent since the break-up. Because of these lower prices, Americans are communicating with each other, by phone, fax and computer, more than ever before. We are closer to each other and in better touch with each other, for business and pleasure, because of the MFJ and its benefits. The impact of this change cannot be measured, but it unquestionably is profound and has changed the nation for the better.

Improvements in quality have accompanied lower prices and increased output: The United States now has four fiber optic networks spanning the country, another by-product of competition. Incidentally, AT&T lagged behind its competitors in building a fiber optic network -- not surprising given that monopolists often are not the most innovative companies. These networks make possible all kinds of new services and enhance others, including the Internet. Similarly, businesses and consumers enjoy lower prices, more choice and better quality in communications equipment, as competition has eroded AT&T's power in that market and forced it to compete for customers.

In short, the MFJ has enabled the United States to maintain its technological leadership in telecommunications. Nations that have stuck to the old monopoly model of telephone services have fallen behind. That is why many are now trying to emulate us, rather than the other way around.

But we also should never lose sight of the fact that there is always room for more competition; line-of-business prohibitions should continue only as long as necessary.

The Need For And Benefits Of Even Greater Competition

Now is certainly not the time, however, for America to rest on her laurels. Much more needs to be done to promote competition in telecommunications. For instance, competition has a long way to go in video services. To be sure, consumers now have an unprecedented degree of choice in video programming, as the spread of cable technology has introduced competition with traditional broadcasting. But, with a few exceptions, cable television operators enjoy monopoly franchises in each locality.

These monopolies, however, are not "natural," and I am hopeful that their days are numbered thanks to technological advances. For example, a number of the Bell Companies have announced plans for upgrading their telephone networks to deliver video programming. Continuing advances in satellite television likewise promise a challenge to cable monopolies.

Competition also has yet to reach local telephone service. Here, too, technological innovation offers foreseeable challenges to monopoly control.

Just as telephone networks can be upgraded to provide video service, cable television systems are expected relatively soon to carry telephone traffic. In addition, wireless services such as cellular and specialized mobile radio, while currently relatively expensive, are growing rapidly throughout the country. The FCC has begun to auction off additional spectrum for yet another form of wireless communication, Personal Communications Services (PCS). Still, it is important to keep in mind that these alternatives are largely prospective. They are not yet widely available and affordable, and it is not yet clear when they will be. And even consumers who eventually choose to replace their local telephone company with a wireless or a cable-based alternative will continue to need to interconnect with the old phone company to complete most of their calls. The kind of competition that develops depends on the terms of that interconnection.

Technology by itself will not be enough to break down the barriers to competition in video and voice, for the simple reason that not all of the barriers are technical. Some of the most formidable, in fact, are legal and economic.

Policy Challenges Ahead

Thus, the challenge confronting all telecommunications policymakers -- in Congress, in the Executive branch, and the states -- could not be more clear: To encourage greater competition throughout the telecommunications industry in a way that does not distort the marketplace or pose dangers to consumers. In particular, as long as the RBOCs have a monopoly over local phone service, they will have -- in the absence of the MFJ line-of-business restriction or adequate safeguards provided for by legislation -- the incentive and the ability to hurt competition in other markets through cross-subsidization and discrimination.

Ultimately, effective competition in local telephone markets will provide the best protection against the RBOCs' ability to leverage their local telephone monopolies into other markets. Until local telephone markets are competitive, entry tests and structural safeguards -- such as separate subsidiaries that help regulators analyze pricing, cross-subsidization and discrimination -- are necessary to ensure that local telephone customers are not charged with the costs of long-distance service and manufacturing and that the other markets are not distorted by the RBOCs' local monopoly.

Promoting Competition in Local Telephone Markets

Let me emphasize that the point is not how to keep the RBOC's out of other markets, but rather how to let them in as quickly as possible without endangering competition in those other markets. The way to achieve that goal is to promote real competition in the RBOCs' own local markets. At this point, there appears to be a growing consensus about the steps that are appropriate for fostering competition in the local telephone markets. First and foremost, of course, legal and regulatory barriers to competition must be removed. Comprehensive federal legislation is uniquely capable of accomplishing that step.

Other steps that are supported by the Administration and that are becoming widely agreed upon include:

- implementation of arrangements for mutual compensation and interconnection that allow entrants to compete on a level playing field with the RBOC;
- implementation of unbundling and other arrangements for resale of local services on terms that make competition in local markets feasible;
- implementation of local dialing parity;
- implementation of number portability so that customers can switch local service providers as easily as they already can switch long distance carrier; and
- implementation of arrangements for access to poles and conduits.

The Administration strongly supports the inclusion in legislation of such steps to open the local loop. Likewise, the Administration supports legislation that would give the FCC the responsibility for formulating, within a specified time after passage, rules for the implementation of steps to open the local loop. Although it is appropriate for states to have a role in actual implementation -- since one size may not fit all -- there still needs to be a national policy creating the basic framework.

The Administration supports provisions that would apply unbundling and interconnection requirements only to carriers with market power. Because the threat that concerns us arises from market power, it would be needlessly regulatory to apply requirements in the absence of market power. The Administration also believes that the RBOCs should be permitted in comprehensive legislation to offer "incidental" long-distance service to facilitate the provision of wireless, cable and certain other services, along the lines provided for in last year's bill, S. 1822.

Even though there is broad agreement on the necessity of these steps, however, there remains the question of when the Bell Companies should be allowed to offer long distance services and on what terms. At one extreme is the idea that the Bell Companies should not be allowed to foray into other markets, such as long distance, until after they experience enormous losses of market share in the local markets over which they now exercise monopoly control. This approach, however, could sacrifice for too many years any benefits in added competition and innovation that the RBOCs might be able to bring to the long distance and other markets. It also conflicts with our fundamental vision of allowing every company to compete in every market.

At the other extreme is the idea that restrictions on the RBOCs should be lifted on a certain, preordained date, no matter what actually happens in the marketplace. By assuming without any basis in experience that competition eventually will come to currently monopolized markets, this approach would seriously endanger the progress of the last ten years in opening the long distance market to competition.

We think neither extreme is correct. We support the middle ground of competition. In our view, it would be too great a risk to competition to let the RBOCs enter the long distance market immediately upon the first halting steps toward meaningful local competition. Entry should come only after an assessment made within 180 days of application in the market under a standard such as Section VIII(C), a responsibility that should be delegated to the Department of Justice, the agency that has applied that standard for many years.

Although the steps that I listed should foster the emergence of local competition, it would be unwarranted to assume that competition will in fact emerge or how fast it will emerge. On the one hand, the steps may not be sufficient. On the other hand, competition may flourish before some are fully accomplished. There simply are no guarantees as to whether and how fast local competition will develop. By applying this market-based test for long distance entry, we increase the incentive to open up local markets to real competition quickly and effectively.

The ultimate efficacy of these steps depends on the resolution of dozens and dozens of complicated implementation issues. To say that unbundling must take place, for example, begs the questions of the price of the unbundled network elements, the relation between those prices and the retail price of the bundled service and what sort of volume discount structure can be applied to either set of prices. The answers to these questions in turn will determine the marketplace effectiveness of the unbundling.

Some legislative proposals contemplate requiring resolution of implementation issues primarily through private negotiations between the RBOCs and would-be interconnectors, hopefully numbering in the hundreds and even thousands, with ultimate review by state commissions on a case-by-case, issue-by-issue to resolve disputes. Although the option of private agreement on interconnection is appropriate, we believe it would be a mistake to place primary reliance on such a mechanism and attempt to require it. It would be a lawyer's dream, replacing a unified, national approach with dozens or even hundreds of negotiations and administrative and perhaps court litigation in each state, each addressing new and complex issues. And if the fragmented negotiation approach is coupled with automatic RBOC entry into long distance on a fixed date, in the midst of all this will be a clock ticking inexorably toward RBOC long distance entry, without regard to the emergence of local competition.

The complexity of these implementation issues is exacerbated by the tremendous leverage that the RBOCs as monopolists would bring to any negotiations on interconnection terms. They can in myriad ways favor certain classes of competitors or individual competitors at the expense of others. They can resolve issues that matter to certain competitors and not others since companies have different needs. Smaller competitors in particular could have a difficult and expensive time negotiating and taking appeals.

The underlying point is that we cannot assume that taking some series of specified steps will result inevitably in the development of local competition. The real test will be what is happening in the marketplace itself: Have competitors been able to enter? Are they able to serve a variety of customers in the geographic area that the RBOC seeks to serve? Is the availability of such competing service expanding? Are competitors encountering significant barriers to such expansion?

The policy should not be a test based on market share, but a judgment, based on market facts, whether the RBOC entry presents a substantial possibility of impeding competition in other markets. The responsibility for making that judgment should be assigned to the Department of Justice, based on the expertise in and understanding of competition in telecommunications markets that we have developed over the quarter of a century since the beginning of the AT&T investigation. Additionally, the FCC should review proposed entry under a public interest standard, based on the expertise and understanding of telecommunications that it has developed since its creation in 1934.

Legislation that does not include such a review of actual market developments risks putting the RBOCs' incentives entirely in the wrong place -- encouraging them to obstruct and delay the emergence of meaningful competition until the gun sounds to allow them to race into other markets. Then, still enjoying the advantages of a monopoly over local service, they would be in a position to reduce rather than increase competition in those other markets.

A penalty scheme alone may not appreciably change these incentives. Such a scheme entails a considerable amount of uncertainty as to whether there would be sanctions imposed and, if so, how significant penalties would be. The balance of uncertain high penalties against the certain and enormous financial benefit of keeping the local loop closed illustrates that the RBOCs retain the incentive of maintaining their control of local telephone. Moreover, given that the underlying requirements may be very qualified or worded in the negative, it may be difficult to prove a violation under any conceivably reasonable standard.

This is not to say that penalties should not be available to the FCC and to state regulators for failure to comply with interconnection requirements. It is to say that the stick of penalties is an inadequate

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substitute for the carrot of conditioning RBOC entry into long distance on the development of local competition. An excessive reliance on penalties would spawn more litigation and less interconnection.

If, on the other hand, the RBOCs must demonstrate to the Department real marketplace facts before they are allowed into long distance and to the FCC that it is in the public interest for them to enter long distance, they have incentives to cooperate in the opening of the local loop. The consideration of RBOC applications for entry by the two agencies, of course, should be simultaneous and subject to specified time constraints -- such as the 180-day period provided in the legislation last Congress -- in order to avoid unnecessary delay and uncertainty.

This approach enjoyed widespread, bipartisan support last year. The legislation that this Committee reported out on a 18-2 vote included an entry test to be applied by the Department of Justice, as did the bill passed by the House with more than 420 votes. A judicious combination of carrots and sticks is the best way to achieve our common goal of providing consumers the benefits of competition rather than the protection of a regulated monopoly.

Let me add, however, that omitting a market review from reform legislation does not mean that review will not occur. It means, rather, that such review will occur in the form of scores of AT&T-type antitrust suits filed in courts across the country. Resources that should be devoted to building the NII will be diverted to piecemeal litigation, which quite possibly will yield inconsistent results in the end -- assuming such litigation does end. That is why the Administration strongly supports a comprehensive national approach that takes advantage, in advance, of the Department's two and half decades of intensive experience of assessing competition telecommunications markets.

With regard to RBOC entry into equipment manufacturing, as opposed to long distance, there are a number of proposals. The dialogue on this issue is constructive in reaching our ultimate goal of allowing RBOC participation without threatening the burgeoning competition that exists in this segment of the industry. The Administration supports RBOC entry into manufacturing as long as it is accompanied by appropriate safeguards, including a strong requirement for use of a separate subsidiary. The Administration believes that the RBOC monopoly business should be separated from other RBOC businesses, but not that there need be multiple separate subsidiaries. The Administration also has supported a notificationand-waiting-period procedure under which an RBOC would submit relevant information about its proposal to the Department of Justice, which could investigate and sue to enjoin the proposed entry.

Promoting Competition in Video Services

Local telephone is not the only market in which reform can replace regulated monopoly with open competition. Legislation should encourage competition to cable television from other firms and technologies, which will reduce the market power that existing cable operators maintain in their markets throughout the country. Statutory and regulatory restrictions that prevent such competition should be removed, but in conjunction with appropriate safeguards and removal of all actual and effective legal barriers to cable company competition for local telephone service (and promulgation by the FCC of interconnection requirements). We encourage legislation that allows telephone company provision of video programming in their local service area upon removal of local telephone entry barriers and promulgation of interconnection requirements.

We recognize that the local telephone companies have challenged, with some success, the prohibition on providing video programming in their local service areas in court, even while enjoying, in most instances, continued protection of their local telephone monopolies from competition by cable operators. Nevertheless, comprehensive and balanced legislative reform with appropriate safeguards -- not piecemeal litigation -- is the fairest, most sensible and most orderly way to move forward.

The Administration endorses inclusion of provisions in the legislation that would prohibit telephone and cable television companies from acquiring each other within the same service territory. Public policy should promote competition between methods for delivering telecommunications services, and the existence of "two wires" going to each home remains crucial at this time to such competition. For this reason, the Administration believes that for a limited time there should be a general prohibition on mergers in the same service territory, subject to certain limited exceptions, such as for rural areas. Any exception should be subject to ordinary antitrust review. We look forward to working with the Committee on this issue.

Conclusion

The time has come to do what only effective legislation can accomplish: Move telecommunications policy out of the courtroom and into the hands of the two expert agencies charged with protecting the broad public interest in telecommunications (FCC) and competition in particular (DOJ, which helped launch the telecommunications revolution with its suit against AT&T).

The Administration looks forward to continuing to work with the Congress in a bipartisan fashion on an expeditious basis to provide the fair and competitive environment for the telecommunications industry that its participants and consumers deserve. The time to pass legislation is now. The nation needs a legal framework governing the telecommunications industry that promotes open competition as vigorously as possible. Removing existing legal barriers to entry in various markets is essential, but we should not ignore the lessons of history in this vital sector. Truly effective competition requires a truly level playing field, where no competitor is able to use its monopoly or market power in one market, such as local telephone services, to disadvantage competition in other markets. Ultimately, competition, not regulation -- and certainly not unfettered monopoly -- will provide the best guarantee of better quality, lower prices, more jobs, expanded export opportunities and more rapid innovation in the telecommunications industry.

The CHAIRMAN. Mr. Irving.

STATEMENT OF MR. LARRY IRVING, ASSISTANT SECRETARY FOR COMMUNICATIONS AND INFORMATION, NATIONAL TELECOMMUNICATIONS AND INFORMATION ADMINISTRATION, DEPARTMENT OF COMMERCE

Mr. IRVING. Thank you, Mr. Chairman and members of the Committee. And I thank you for this opportunity to testify before you today on this issue of telecomm reform.

We believe the Congress has the opportunity this year to enact legislation that will open all telecommunications markets to vigorous competition, produce clear, flexible and limited government regulations, and ensure that competition is robust and fair.

By promoting competition, as my colleague Ms. Bingaman has stated, we can create jobs and provide consumers with lower prices, higher quality and greater choice.

Mr. Chairman, it is equally important, of course, that any legislation maintain our nation's historic commitment to universal service.

Several States already have adopted innovative regulatory reforms. And those reforms can serve as models for the benefits that competition can bring to consumers.

But we cannot build this system one State at a time. We need a national vision and a national system. I would like to offer, as briefly as possible, the views of the administration on legislative reform proposals currently being discussed in this body.

The draft bills propose reforms in many areas that we agree need to be addressed. They include, for example, lifting of the cable/teleco ownership ban, preempting State barriers to competition in local phone service, reexamining broadcast ownership and spectrum rules, and providing a process for reviewing the need for continuing regulation.

We support these efforts and hope to have the opportunity to work with this Committee on the details of these proposals.

And I would like to focus my remarks this morning on five areas, local competition, BOC entry into long distance and manufacturing, universal service, cable regulation and foreign ownership.

A critical area for reform is ensuring local competition. We share the goal of promoting local competition and simultaneously minimizing government regulation.

But we do have concerns about the proposed negotiation process. There are legitimate questions about whether private negotiations, even with credible threat of government intervention, is the best method for expeditiously facilitating completion of interconnection and unbundling agreements.

Another critical provision in your draft bill is the date certain provisions, 3 years after enactment for elimination of the AT&T consent decree.

Assistant Attorney General Bingaman in her testimony has outlined the administration's reservations about this provision.

I will add only this: A date certain undoubtedly will erode the BOC's incentives to conduct and conclude interconnection negotiations expeditiously.

We share this Committee's commitment to the implementation of new universal service policies for the information age.

And we agree, specifically, with the need to establish a Federal-State joint board, particularly the principles that should form the basis for the FCC's and the joint board's efforts; just, reasonable and affordable rates; a coordinated universal service funding system; equitable and non-discriminatory contributions; and improved consumer choice.

I would also like to address some concerns we have with respect to language that would eliminate government regulation of cable television rates beginning 1 year after enactment.

The 1992 Cable Act rests on the sound principle that rate regulation will cease immediately in markets where there is effective competition.

The years following passage of the 1984 Cable Act demonstrated, we believe, the perils of deregulating on the promise of potential competition rather than the existence of actual competition.

It is not to say that the administration opposes any changes to the 1992 Act. The administration has indicated a willingness to work with Congress and industry to minimize the burden of government regulations.

We cannot and will not, however, support deregulation of monopolies before the arrival of actual competition. As long as monopolies continue to exist, consumers must be protected.

And we also agree with the Committee's interest in reexamining Section 310(b) to help foster open telecommunications markets.

Just last weekend, the Vice President, at the G–7 Conference noted that the administration joins many in Congress in supporting lifting of 310(b) in markets that also open their telecommunications markets to U.S. companies.

We suggest that a determination of whether this goal has been achieved for a particular country should be made by the executive branch.

This would be an interim step until multi-lateral talks with other nations resulted in reciprocal agreements on access worldwide.

We would not, however, move to lift the restriction with regard to broadcasting at this time. The administration believes we should not be too hasty in lifting restrictions on the amount of foreign influence over or control of our broadcast licenses, particularly in light of the editorial discretion that we repose in broadcasters.

Mr. Chairman, let me close by reaffirming my central message. Both your reform proposal and that put forth by Senator Hollings have considerable merit.

The administration does have some concern about specific provisions. But there is much with which we agree.

Working together, Congress, the administration, other interested parties, particularly affected industries, can forge telecommunications reform policy promoting objectives to which we all are committed, competition, investment, consumer welfare, reduced government regulation and universal service.

And I thank you, again, Mr. Chairman and members of this Committee, for the opportunity to testify. And I will be delighted to answer any questions.

[The prepared statement of Mr. Irving follows:]

TESTIMONY OF LARRY IRVING

ASSISTANT SECRETARY FOR COMMUNICATIONS AND INFORMATION

U.S. DEPARTMENT OF COMMERCE

ON

TELECOMMUNICATIONS POLICY REFORM LEGISLATION

BEFORE THE COMMITTEE ON COMMERCE,

SCIENCE AND TRANSPORTATION

UNITED STATES SENATE

MARCH 2, 1995

Mr. Chairman and Members of the Committee:

INTRODUCTION

Good morning. Thank you for this opportunity to testify before you today on the issue of telecommunications policy reform. The Administration shares your interest in promoting the advancement of a modern telecommunications and information infrastructure in a procompetitive manner that benefits all Americans.

Congress has the opportunity this year to enact legislation that will open all telecommunications markets to vigorous competition, produce clear, flexible, and limited government regulations to ensure that such competition is robust and fair, and link the introduction of new products and services to producer initiative and consumer demand. Such legislation, in short, can unleash the promise of the Information Superhighway for all Americans.

The key test for any telecommunications reform measure is whether it helps the American people. Legislation should provide benefits to consumers and spur economic growth by ensuring competitive telecommunications markets. Competition will provide consumers with lower prices, higher quality, and greater choice. The continuing competitiveness of U.S. companies will create jobs as the telecommunications sector grows. Only competition -- not monopoly -- will enable us to achieve these goals.

The Administration looks forward to working with you and your Committee to ensure that a complete, integrated set of telecommunications reform proposals moves forward.

THE NEED FOR LEGISLATION

An advanced information infrastructure will transform everyday life for every person in the United States in the near future. Projects are underway that are changing the way we work, educate our children, receive medical services, and interact with our family and neighbors. For example, in your home state of South Dakota, Mr. Chairman, the Rural Development Telecommunications Network is connecting 47 schools to networks and providing distance learning programs.

It would be a mistake, however, simply to "let nature take its course" and allow change to proceed under the existing legal regime, whose underlying structure was established 60 years ago. This is true for three essential reasons.

First, we need legislation to promote innovation and competition. Information transmission increasingly is the life blood of all our industries. Archaic rules or entrenched monopolies that inappropriately retard innovation by telecommunications firms are detrimental to the international competitiveness of the private sector, inhibiting industrial productivity and job creation. Legislation that reforms these outdated structures and supports entry of new competitors will enhance competitiveness and spur the creation of good new jobs.

Second, the existing regulatory structure discourages private investment. It places artificial barriers on firms that, due to technological advances, are now in a position to be competitors. The regulatory structure has created an uneven playing field that favors some companies or industries over others. This, in turn, inappropriately skews the growth of industry sectors and retards the development of the National Information Infrastructure (NII). Accordingly, legislation is needed to eliminate such unwarranted regulatory disparities.

Third, we need to be sure that our telecommunications policies are fully responsive to the needs of the American people as a whole, and, in particular, poorer and disadvantaged Americans. As Secretary of Commerce Ronald H. Brown has emphasized, we cannot "become a nation in which the new information age acts as a barrier, rather than a pathway, between Americans" -- a nation divided between the information rich and the information poor. Yet, while the universal provision of "plain old telephone service" has long been a national goal, the existing regulatory structure may not be sufficient to ensure that all Americans benefit from the broader range of information services that will become available under the NII. Accordingly, legislative reform is urgently needed to address this shortcoming. I will have more to say about the Administration's views on universal service.

Several states have already adopted innovative regulatory reforms that seek to open up local competition. These states serve as models for the benefits that competition can bring to consumers. But we can't build a system one state at a time. We need a national vision and a national system.

THE SENATE'S LEGISLATIVE REFORM PROPOSALS

I would like to offer, as briefly as possible, the views of the Administration on the legislative reform proposals currently being discussed in the Senate. I commend the Committee for tackling these difficult issues.

The draft bills propose reforms in many key areas that we agree need to be addressed. These include, for example, prompt lifting of the cable/telco crossownership ban, preempting state barriers to competition in local phone service, reexamining broadcast ownership and spectrum rules, and providing a process for reviewing the need for continuing regulation. We support these efforts and hope to have the opportunity to work with the Committee on the details of these proposals.

This morning, I would like to focus my remarks on five areas: (1) local competition, (2) BOC entry into long distance and manufacturing, (3) universal service, (4) cable regulation, and (5) foreign ownership.

<u>Local Competition</u>

A critical area for reform is ensuring local competition. Your draft bill, Mr. Chairman, would permit the details of interconnection and unbundling -- implementation of which is crucial to the development of local exchange competition -- to be determined in negotiations between incumbent local exchange carriers and prospective entrants.

While we share your goal of promoting local competition, while simultaneously minimizing government regulation, the Administration has concerns about how effective the negotiation process will be. And here, Mr. Chairman, experience is instructive. The local interconnection agreements that have been finalized to date are, in most cases, the fruit of difficult, contentious bargaining processes that have exceeded significantly the four-month period contemplated in your draft bill. The recently-announced agreement between NYNEX and Metropolitan Fiber Systems -- which some hail as an exemplar of the negotiation approach -- was two years in the making. In short, there are legitimate questions whether the proposed private negotiations -- even with a credible threat of government intervention -- are the best method for expeditiously facilitating completion of the interconnection/unbundling agreements essential to the growth of local exchange competition.

In the five years since New York State first mandated local exchange interconnection, agreements have been finalized in a number of other states as well. These pacts provide strong evidence of the interconnection terms and conditions that are acceptable to both local exchange carriers and their potential competitors. The FCC, with assistance from the States, could use those agreements as the model for uniform, nationwide, minimum regulations concerning interconnection and unbundling. The Administration believes that nationwide regulations would have the clear advantage of informing local competitors everywhere of their basic rights and responsibilities. This would make it easier and quicker for new companies, particularly smaller ones, to enter the local exchange markets and deliver the benefits of competition to consumers.

BOC Entry into Long Distance and Manufacturing

In addition, Mr. Chairman, the negotiation approach to interconnection/unbundling in your draft bill will require incentives to ensure that parties negotiate in good faith. This brings me to another critical provision in your draft bill: the provision setting a date certain -- three years after enactment -- for elimination of the AT&T Consent Decree and guaranteed BOC entry into long distance and manufacturing. Assistant Attorney General Bingaman has ably outlined the Administration's reservations about that provision. I will add only this: a date certain will undoubtedly erode the BOCs' incentives to conduct and conclude interconnection negotiations expeditiously.

Your draft bill recognizes this fact and attempts to mitigate the potential consequences by authorizing stiff penalties in the event that the BOCs do not comply fully with their interconnection/unbundling requirements. However, the very severity of those penalties may reduce the likelihood that they are ever imposed. More importantly, the threat of sanctions for bad conduct is, in general, a poor substitute for strong incentives for good conduct.

As Assistant Attorney General Anne Bingaman has outlined, the better approach is to establish the preconditions for BOC entry, including a careful assessment by the Department of Justice of the state of competition in the local exchange market. The Administration will work with the Committee to develop an approach that meets this objective while giving the BOCs incentives to comply with their interconnection and unbundling obligations.

Universal Service

The Administration shares the Committee's recognition that implementation of new universal service policies for the information age is of profound public policy significance. We are pleased that both the Chairman's and Senator Hollings' proposals seek to ensure universal service.

The Administration supports efforts to develop a new concept of universal service that will serve the information needs of the

American people in the 21st century. Indeed, the full potential of the NII will not be realized unless all Americans who desire it have easy, affordable access to advanced communications and information services, regardless of income, disability, or location.

We welcome the continued bipartisan Congressional support for universal service. A major concept on which all agree is the need to establish a Federal/State Joint Board to make recommendations to the FCC on both the evolving definitional and funding elements of universal service. There is also agreement on many of the principles that should form the basis for the FCC's and the Joint Board's efforts. These include:

- providing quality services at just, reasonable, and affordable rates;
- establishing a coordinated Federal and State universal service funding system administered by an independent, non-governmental entity;
- requiring telecommunications services providers to contribute to the preservation and advancement of universal service on an equitable and nondiscriminatory basis; and
- permitting consumers to exercise choice among telecommunications carriers.

Such a broad framework of general principles can form the bedrock upon which the FCC and the states can establish universal service policies for the future. The Administration wishes to work closely with the Committee on this framework.

We also hope to work with the Committee on legislative provisions to facilitate the connection of all our classrooms, libraries, hospitals and clinics to the NII by the year 2000. Universal access to the NII will promote U.S. competitiveness, create new jobs, and ensure that all citizens realize the benefits of the information revolution. We want to work with the Committee in exploring all possible methods of accomplishing this goal.

Cable Television

I would also like to address some concerns the Administration has with the draft bill with respect to the language that would eliminate government regulation of cable television rates beginning one year after enactment. Mr. Chairman, the Administration believes that this approach would not serve the public interest.

The 1992 Cable Act rests on the sound principle that rate regulation will cease immediately in markets where there is effective competition. However, today fewer than 1 percent of households nationally have Direct Broadcast Satellite service and virtually none have a choice of wired video provider. Without the disciplining effects of such competition, deregulation will rarely, if ever, benefit consumers. And while it is true that competition in the video marketplace is increasing with the advent of Direct Broadcast Satellite service and the prospect of video dialtone, it remains to be seen whether and to what extent these potential competitors will become actual alternatives to entrenched cable systems. The years following passage of the 1984 Cable Act demonstrated the perils of deregulating on the promise of potential competition rather than the existence of actual competition. The Administration believes that we should not repeat that experience.

That is not to say that changes to the 1992 Cable Act should not be made. I understand that the National Cable Television Association has proposed a number of amendments to that Act's definition of "effective competition," which would deregulate cable operators more quickly with the advent of competition in local markets. The Administration has indicated a willingness to work with Congress and industry to minimize the burden of government regulation without sacrificing cable subscribers. We will not, however, support deregulation of monopolies before the arrival of actual competition. As long as monopolies continue to exist, consumers must be protected.

Foreign Ownership

We also agree with the Committee's interest in reexamining Section 310(b) to help foster open telecommunications markets worldwide. As reflected in the Vice President's speech at the G-7 Conference, the Administration joins many in Congress who support lifting the Section 310(b) restrictions for countries that have also opened their telecommunications markets to U.S. companies. We suggest that a determination of whether this goal has been achieved for a particular country should be made by the President, based on the advice of the appropriate Executive Branch agencies. This would be an interim step until multilateral talks with other nations resulted in reciprocal agreements on access.

Clearly, in revising Section 310(b), we must recognize that many countries are in the process of change, but progress will be varied among countries and will evolve over time. We do believe, however, that once a critical mass of countries with open telecommunications markets is achieved, the momentum and demand from both national and multinational companies, as well as global alliances, will create a powerful force to push the remaining countries toward competitive and open markets.

We would not, however, move to lift the restriction with respect to broadcasting at this time. The Administration believes that we should not be too hasty in lifting restrictions on the amount of foreign influence over, or control of, broadcast licenses due to the editorial discretion of broadcasters over the content of the transmissions.

The Administration thus welcomes the opportunity to work with the Congress to reform 310(b) to help achieve our mutual goals of continuing to open telecommunications markets around the globe to facilitate participation by U.S. companies. This will help boost economic growth, create jobs, and ensure that U.S. companies remain world leaders in the global telecommunications marketplace.

CONCLUSION

Mr. Chairman, let me close by reaffirming my central message. Both your reform proposal and that put forth by Senator Hollings have considerable merit. Although the Administration has concerns about specific provisions, there is also much with which we agree. I remain convinced that if we work together, Congress, the Administration, and the many other interested parties can forge telecommunications reform policy that promotes the objectives to which we are all committed -- competition, investment, consumer welfare, and reduced government regulation. Thank you again for the opportunity to testify, and I will be happy to answer any questions.

The CHAIRMAN. Mr. Kenneth Gordon, Chairman of the Massachusetts Department of Public Utilities.

STATEMENT OF MR. KENNETH GORDON, CHAIRMAN, MASSACHUSETTS DEPARTMENT OF PUBLIC UTILITIES

Mr. GORDON. Good morning, Mr. Chairman, members of the Committee.

I am appearing this morning on behalf of the National Association of Regulatory Utility Commissioners. We appreciate this opportunity to comment.

I would like to begin by commending the Committee for the dispatch and effort that has already gone into work in this area. We, too, hope that legislation will be successfully achieved this term.

States and State regulators which, just a few years ago, were regarded as obstructions to competition by some, are now in the forefront of creative reform in this industry.

New York, Washington, Illinois and Maryland and, I am happy to say, Massachusetts as well as others have adopted more flexible regulatory approaches and opened entry into these markets to a degree that was just unimaginable a few years ago.

In this process, we are seeing exactly the kind of creative Federalism that has often given a bow but too often overtaken by the desire to move ahead quickly to a single solution.

We need to recognize in this process that each State's market is different and that the States are trying to move in response to these markets. As a result, not every State is moving at the same pace.

And different States are adopting different approaches to competition. But we are learning from that process and from each other.

In my judgment, the States have led the competitive process in the last few years. And this is as it should be as the focus of competition shifts from the inter-exchange market and the equipment market to the local exchange once thought to be the ultimate monopoly.

We at the NARUC agree fully that regulatory and legal barriers to competition at the local level should be removed. This is the linchpin of today's telecommunications policy. It is important for foreign as well as domestic reasons.

The other day, Assistant Attorney General Bingaman had some of us State regulators over to her office.

And she said while we were there, "We are the competition people, not the regulators."

Those of us in the States surely will regulate where we have to. But we think we are the competition people also; in fact, so much so, in the case of telecommunications that a little less than a year ago the NARUC took an action which I think is unique in our history.

We acknowledged formally the legitimacy of preempting State limitations on the ability of new entrants to participate in telecommunications markets.

As I said, we are the competition people. We do believe that we have to, at least for the time being, retain authority to set terms and conditions in order to give effect to the strong stake that we have in making sure efficient competition and effective competition develops.

It will be, in large part, State regulation that provides the underpinning.

Second, policies designed to assure that universal service is sustained in ways compatible with competition can and should be dealt with by the same State authorities that are overseeing that process.

I believe that the goals of universal service can be sustained in an increasingly competitive environment. But it needs to dovetail with the competitive approach in each State. And these processes are not identical nor do they have to be.

We also need to be able to set rates in pursuit of a fair and reasonable transition to competition. I am talking about the need to protect customers and the transition process to competition at the same time.

Several years ago, the Massachusetts Department of Public Utilities recognized the possibility of local competition and determined that our particular rate structure was not likely to be compatible with a competitive environment.

And so we began a process, still underway, of reducing some rates and raising others, both to facilitate the emergence of local competition and to ease the burdens on customers during the transition period.

I mention this experience not to be parochial but to suggest that open entry policies are more likely to bear fruit if States retain the freedom to both manage and accommodate the process.

In Massachusetts today, we have four carriers with local service tariffs on file in addition to Nynex, one of them contemplating residential offerings.

Just and reasonable rates extend to interconnection. Competitive carriers are also customers of the traditional service providers.

And we recognize that the terms and conditions of interconnection are a critical complement to open entry policies. But as in the case of other rates and conditions, States need to retain authority and flexibility in setting the specific parameters under which the interconnection takes place.

Comparability, efficiency and competitive parity will not be found in a one-size-fits-all approach. An increasing number of services can already be classified as competitive.

And we agree that the States, as well as the FCC, should have the ability to modify or even forebear from regulation when a provider lacks significant market power.

One last regulatory flexibility issue, alternative regulation: Price regulation, price gaps, rate gaps, revenue sharing, rate-based stay outs and a host of other variations that break away from cost-based regulation have been adopted by or are under consideration by almost every State.

Each is different. Each one tries to fit that State's needs, and even different companies' needs within the same State.

This ground, while certainly not unplowed, has not yet provided us with enough experience to decide which approach works best, which details are critical and which are not. A rigid mandate for price regulation could curb useful current experiments and foreclose others entirely.

The level of activity now underway in the States strongly suggests that no mandate is, practically speaking, necessary.

A word about universal service: Whatever its faults, the current regulatory framework led to the highest levels of penetration in the world. Maintaining that penetration, even as we take advantage of competitive opportunities is and will remain an important goal of State regulators.

We acknowledge the legitimacy of establishing a basic level of universal service below which no State should fall.

The task we all have is to retain the goals we have pursued and achieved under monopoly while opening the market to new players and taking advantage of new opportunities.

The NARUC believes that carriers engaged in interstate or foreign communications should contribute to any Federal program deemed necessary for the achievement of universal service goals, and that carriers engaged in intrastate communication should contribute to any State programs.

We oppose Federal collection and management of intrastate funds. Indeed, believing as we do that State officials are likely to have a better grasp of their own citizens' needs than the Federal bureaucracy, the administration of universal service assistance from whatever sources derived may better be put to use at the State level.

NARUC is currently exploring an approach to universal service funding that incorporates a State block grant concept.

A brief word in conclusion about the relationship between the economic regulatory structures that I have described and the critical goal of advanced infrastructure development: The goal the framework described, indeed, I think by all of us, is a market open to competition with fair opportunities and flexible regulation for all participants.

Where we decide burdens must be imposed, they should be imposed in a competitively neutral way and similarly for benefits.

In such circumstances firms' investment decisions can be driven by market forces, especially customer demand not regulatory mandate.

In an open, competitive framework it is reasonable to rely on private incentives to drive investment. Mandates, which as a practical matter, would fall most heavily on the traditionally regulated firms, are unnecessary or worse.

Much of the investment in the infrastructure of the future will, of course, be made by long-established firms. But as much, or perhaps even more will come from new and essentially unregulated firms.

We have to remind ourselves that none of us knows what the right investment proportion or type of investment is. We do not know who, specifically, will or should make any particular investment. But that is, in the end, why we wish to rely on markets and to allow competition in these markets.

To mandate a particular outcome is to reject the reliance on competition that is the fundamental purpose of this exercise.

Thank you very much, Mr. Chairman. And I will be happy to answer any questions as well.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Gordon follows:]

Testimony on
Federal Telecommunications Legislation,
on behalf of the
National Association of
Regulatory Utility Commissioners
by
Kenneth Gordon
March 2, 1995

Good morning Mr. Chairman, and members of the Committee. My name is Kenneth Gordon and I am Chairman of the Massachusetts Department of Public Utilities. I am appearing this morning on behalf of the National Association of Regulatory Utility Commissioners. I appreciate this opportunity to comment on the proposed federal telecommunications legislation.

The telecommunications industry, already quite competitive in some markets, is becoming more competitive every day. With the right state and federal policies, including appropriate legislation, this industry can be even more broadly competitive than it is today. Policies that ensure fair terms of entry into all telecommunications businesses to all potential players, and at the same time allow full competitive flexibility to all players, have the best chance of ensuring an efficiently configured, consumer responsive industry to carry us into the information age that has clearly already begun.

It is worth noting, just to keep some perspective, that much of the change that is taking place is beyond the reach of policymakers. The revolution that is underway in the information and telecommunications industries will go on with or without our help. But I am convinced that good policies can accelerate and facilitate, and make more equitable, the outcome of this process.

States, and state regulators, which just a few years ago were regarded as obstructions to competition by some, are now in the forefront of creative reform in this industry. New York, Washington, Illinois, Maryland and, I am happy to say, Massachusetts; as well as others, have adopted more flexible regulatory approaches and opened entry in these markets to a degree unimaginable a very few years ago. In this process we are seeing exactly the kind of creative federalism that is often given a bow, but too often overtaken by the desire to move ahead quickly to a single solution.

We need to recognize that each state's market is different, and that states are trying to move in response to these markets. As a result, not every state is moving at the same pace, and different states are adopting varying approaches to competition. We are learning from that process, and from each other. In my judgment, the states have led the competitive process in the last few years. This is as it should be, as the focus of competition shifts from the equipment and interexchange markets to the local exchange, once upon a time thought to be the ultimate monopoly.

We at the NARUC agree fully that regulatory and legal barriers to competition at the local level should be removed. This is the lynchpin of today's telecommunications policy. It is important for foreign as well as domestic policy reasons. The other day, Assistant Attorney General Bingaman said of her office, "We are the competition people, not the regulators". Those of us in the states will without doubt regulate so as to protect customers where still necessary, but we think we are the competition people as well. In fact, so much so in the case of telecommunications, that a little less than a year ago we took an action that I believe to be unique in NARUC history. We acknowledged the legitimacy, should it prove necessary, of pre-empting state limitations on the ability of new entrants to participate in local telecommunications markets. As I said, we are competition people too.

We do believe that, at least for the time being, states must retain the authority to set terms and conditions for those operating in the intrastate telecommunications arena. First, we have a strong stake in ensuring that effective and efficient competition develops. It will be in large part state regulatory policies that provide the necessary underpinning. Second, policies to assure that universal service is sustained in ways compatible with competition can and should be designed by the same state authorities that are overseeing that competition. The goal of universal service can be sustained in an increasingly competitive environment, but it needs to dovetail with each state's competition approach. As I have already noted, these will not all be identical, nor should they have to be.

State regulation that promotes public safety and welfare and ensures that service quality continues at high and reliable levels will be necessary until customers have a degree of choice that allows them to express their dissatisfaction by moving to another company rather than calling me up.

We also need to be able to set rates in pursuit of a fair and reasonable transition to competition. I am talking about the need to protect customers <u>and</u> the transition process to competition at the same time. Several years ago the Massachusetts Department of Public Utilities recognized the possibility of local competition and determined that our particular rate structure was not likely to be compatible with a competitive environment. We began a process, still under way, of reducing some rates and raising others, <u>both</u> to facilitate the emergence of local competition and to ease the burdens on customers during the transition period. I mention this experience not to be parochial, but to suggest that open entry policies are more likely to bear fruit if states retain the freedom to both manage and accommodate the process. In Massachusetts today we have four carriers with local service tariffs on file, in addition to Nynex, one of them contemplating residential offerings.

Just and reasonable rates extend to interconnection service. Competitive carriers are also customers of the traditional service providers. We recognize that the terms and conditions of interconnection are a critical complement to open entry policies. But, as in the case of other rates and conditions, states need to retain sufficient authority and flexibility in setting the specific parameters under which all carriers interconnect with each other. Comparability, efficiency and competitive parity will not be found in a "one size fits all" approach.

An increasing number of telecommunications services can already be classified as competitive. We agree that the states as well as the FCC should have the ability to modify or even forbear from regulation when a provider lacks significant market power. One aspect of this is pricing flexibility that allows reasonable responses to competitive forces by all participants in a market.

And one last regulatory flexibility issue: alternative regulation. Price regulation, price caps, rate caps, revenue sharing, rate case stay-outs and a host of other variations that break away from cost based regulation have been adopted by, or are under consideration by, almost every state. Each is different, each one tries to fit that particular state's needs--indeed different companies' needs <u>within</u> a state.

Cost based, rate of return regulation has serious deficiencies that many people acknowledge. It does not promote operational efficiency and, as well, contains incentives that are not conducive to fair competitive behavior. Well designed alternative approaches may be able to alleviate those problems and promote a more efficient investment environment. But this ground, while certainly not unplowed, has not yet provided us with enough experience to decide which approach works best, which details are critical and which are not. A rigid mandate for price regulation could curb useful current experiments and foreclose others entirely. The level of activity now under way in the states strongly suggests that no mandate is, practically speaking, necessary.

The last issue I will address is universal service. Whatever its faults, the current regulatory framework led to the highest levels of telephone penetration in the world. Maintaining that penetration, even as we take advantage of competitive opportunities is, and will remain, an important goal of state regulators. We acknowledge the legitimacy of establishing a basic level of universal service, below which no state should fall.

The task we all have is to retain the goals we pursued and achieved under monopoly while opening the market to new players and taking advantage of new opportunities. The process must meet universal service goals while preserving competitive opportunity.

The NARUC believes that carriers engaged in interstate or foreign communications should contribute to any federal program deemed necessary for the achievement of universal service goals, and that carriers engaged in intrastate communications should contribute to any state programs that may be found necessary. We oppose federal collection and management of intrastate funds.

Indeed, believing as we do that state officials are likely to have a better grasp of their own citizens' needs than the federal bureaucracy, the administration of universal service assistance from whatever sources derived, may better be put to use at the state level. NARUC is currently exploring an approach to universal service funding that incorporates a state block grant concept.

Just as important as equitable funding is competitively neutral payment mechanisms. Whether funding is directed to customers directly or through carriers, all providers should be eligible to receive support payments. Only in this way will the support mechanism be compatible with competition.

A brief word about the relationship between the economic-regulatory structures I have described and the critical goal of advanced infrastructure development. The goal of the framework described is a market open to competition, with fair opportunities and flexible regulation for all participants.

Where we decide burdens must be imposed, they should be imposed in a competitively neutral way, and similarly for benefits. In such circumstances, firms' investment decisions can be driven by market forces--especially customer demand--not regulatory mandate. In an open competitive framework it is reasonable to rely on private incentives to drive investment. Mandates, which as a practical matter would fall most heavily on the traditionally regulated firms, are unnecessary--or worse. Much of the investment in the infrastructure of the future will of course be made by long established firms--but as much or perhaps even more will come from new--and essentially unregulated--firms. We have to remind ourselves that none of us knows what the right investment proportion, or type of investment is. We do not know who, specifically, will or should make any particular investment. But that is, in the end, why we wish to rely on markets, and to allow competition in these markets. To mandate a particular outcome is to reject the rationale for reliance on competition which that is the fundamental purpose of this exercise.

Thank you very much. I will be happy to answer any questions you may have.

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The CHAIRMAN. For the information of Senators, we are trying to get two more Senators back so that we would be able to make that quorum vote.

Let me begin by thanking each of you. And I shall ask two questions and then move on to my colleagues. I think we will limit these, the first round, if we could, to 10 minutes per Senator.

Mrs. Bingaman, in your speech to the Press Club earlier this week, you outlined a number of specific steps that had to be taken before Bell Companies could be allowed into long distance.

But you also said these steps alone were not enough, that there would still have to be more analysis, market tests and so forth. I guess that I would address this question to you and to Mr. Irving to get the feel of the administration and if you would like to comment.

But in your prepared testimony you seemed to focus on the question of Bell Company entry into the long distance market to the exclusion of the plethora of other subjects contained within the Senate draft legislation.

So the Committee fully understand the administration's position, will you clarify what your position is vis-a-vis the manufacturing and cable/teleco issues? For instance, do you favor a date certain approach for Bell Company entry into manufacturing and cable?

A few years ago the Senate passed Senator Hollings' manufacturing bill which, I believe, contained a date certain. If as the Senate did, you favor a date certain approach for manufacturing and cable, how and why do you distinguish long distance?

Are not the dual anti-competitive concerns of cross subsidy and discrimination the same whether discussing long distance, manufacturing or cable?

Ms. BINGAMAN. Mr. Chairman, our testimony last year, which we support here, was that the provisions of the bills last year which we testified on extensively which had a 1-year wait for entry into manufacturing with the ability of the Department of Justice to challenge under 8(c) entry into manufacturing during that year if it determined that there was a substantial possibility that entry could impede competition, remains our view today.

That is, we believe that the Department of Justice should have a role in manufacturing as it does, in our view, properly should have a role in long distance. That is that the crucial test is whether entry by the Bell Companies into these adjacent, competitive markets has a substantial possibility of impeding competition.

So our view on that is comparable I believe. We believe the test is the same. And that is our position.

The CHAIRMAN. Well, now, do you believe the detailed set of preconditions you proposed for long distance entry should also apply to manufacturing and cable relief?

Ms. BINGAMAN. We believe that—yes, we believe that the interconnection requirements should be applied. We believe that the interconnection requirements are important because it is critical that the Bell Companies not have the ability to impede competition in adjacent markets.

And it is opening up the local loop that is the best guarantee ultimately against the ability to cross subsidize or harm competition in adjacent markets.

So our view is that ultimately it is eroding the local monopoly. It is eroding the local monopoly power which—and having competition in that market as well as adjacent markets.

Our vision, Senator, let me say very straight, is that any company can offer any service to any customer. And to achieve that vision, which is true in a lot of markets but has not been true in this heavily regulated market, it is necessary to open the local loop so that any company can offer any service to any customer in the local loop.

And when that is done, there is—the corollary is any company can offer any customer any service in adjacent markets.

So these two things are inextricably tied. The reality is the Bell Companies have had a monopoly in the local loop for decades and decades because that is the national policy we followed. That is what has happened.

As you have seen competition grow in the adjacent markets and the Bell Companies getting into adjacent markets, that is where we have gotten into the issues about "How do you balance competition in adjacent markets by Bell Companies when they still have monopoly control of their local market?"

And that is—those are the tough issues that the country is struggling with and that this Committee is struggling with.

But to make it work, the local loop has to be opened. It has to be opened to competitors. And the Bell Companies, when that happens, should be able to get into adjacent markets.

The CHAIRMAN. Now, if you believe the details that are the precondition you proposed for long distance entry should also apply to manufacturing and cable, how do you square that position with the string of recent court cases striking down the cable/teleco prohibition on First Amendment grounds?

Ms. BINGAMAN. Mr. Chairman, as you may know, the Department of Justice opposed those court decisions. And we have under consideration right now possible further actions in those cases. So I cannot discuss specifically. But I can tell you that we opposed the court decisions.

The CHAIRMAN. Good. Now, Ms. Bingaman, you also stated that the test of local competition should be based not on market share but a judgment based on market facts, as I understand it.

If a Bell Company has taken the prescribed steps to ensure that its network is fully opened to competition, yet no competitors enter, should the Bell Company still be allowed to enter the long distance or equipment manufacturing or cable market?

Ms. BINGAMAN. Mr. Chairman, I think, No. 1, that is not a likely scenario. I think competition will occur.

But taking your question just at face value, if you have these interconnection requirements on the books, but no one chose to enter so the Bell Company still had a monopoly in fact and wanted to get into this other market, I would have concerns. And I will tell you why.

I would question—because I believe so firmly that competition will come if interconnection is, in fact, open, I would question if there were not competition in fact. I would question the premise that, in fact, there was an open local loop, because I believe, and

I believe the experience in Rochester has shown—Mr. Gordon knows.

Chairman Gordon mentioned that we met with NARUC. We had about 15 leading State commissioners in our office on Tuesday of this week. We had a very interesting exchange.

Lisa Rosenblum of the New York Public Service Commission said that in Rochester, which recently opened up—and New York has led the way in this with—in Rochester Telephone in its experiment, opening up the local loop.

They have got a provision where any company can buy and resell local service from Rochester at 95 percent of retail rates. So it is a 5-percent discount.

And she told us that AT&T had taken out a one-page ad 1 day and signed up 4,500 customers out of a possible 100,000. That is almost 5 percent of the market was gone in a day because the local loop really was open.

And I think what that says to you is there are a lot of competitors out there waiting to enter the local market. And the Bell Companies, in exchange, once that happens, can get into their markets. That is only fair. That is what it is about.

So I guess what I would say to you is if no one entered, I would look very, very hard at whether the local loop was really open, because I think there will be entry. I think the experience in Massachusetts which Mr. Gordon can tell you about, and the experience in New York were just at the beginning stages of this.

But I believe with all of my heart this will happen. And we should move forward to make it happen.

The CHAIRMAN. Good.

Well, following that up, Mr. Irving, given the economic reality that a competitor will not enter a market where the incumbent provider is pricing service below cost, how can the concept of subsidized universal service be reconciled with the desire to promote local competition?

Mr. IRVING. We believe that there is going to have to be, for some people in some places in this country, continued assistance with regard to ensuring that they stay on the telephone network.

We also concur, Mr. Chairman, however, with I think what this Committee believes, that if we promote competition, we are going to drive down the price and improve consumer choice.

So we believe that, for most consumers universal service will be less of an issue because increased competition should reduce prices. As we have noted in long distance, it is reduced by about 50 percent.

We hope the competition in local markets, if consumers really had a choice as to who provided their local telephone service, that we would get the same kind of benefits.

For those consumers who still, because of geography or economics have a problem, we need to find a way to ensure that all of the various players, carriers in the telecommunications market contributed to assuring universal service.

Mr. Chairman, if I could, I would like to correct something for the record with regard to my colleague's comments with regard to cable. She is absolutely right with regard to manufacturing and long distance.

The administration strongly believes that the AT analysis by the Department of Justice and the public interest tests by the FCC is necessary.

With regard to cable, however, there is a slightly different analysis. This administration believes we should permit the telephone industry to provide video services through a separate subsidiary.

We would want to make sure that there is no possibility of cross subsidization, that monopoly rate payers are not subsidizing what is happening in the cable marketplace.

But we do agree that we should open up the video marketplace on a nearer term and under a different analysis than in the manufacturing and long distance. And I just wanted to clarify that.

The CHAIRMAN. I shall now call on the ranking member, Senator Hollings. I want to thank Senator Hollings and his staff, and the staff of all Senators who might be somewhat bleary-eyed.

I think they worked through the week—they are working through the weekends. And I thank you very much.

Senator HOLLINGS. I thank you, Mr. Chairman and your staff. We are all working together.

There is a fundamental misunderstanding here with respect to a date certain, I noted from the Chairman's questions.

It said, "Wait a minute. You put in a date certain for manufacturing. Why not put in a certain—date certain here for the RBOCs to get into long distance?"

Well, there is a big difference. There is no monopoly in manufacturing. Thousands of telecommunications manufacturers all over this country and all over the world—in fact, the Germans and the Dutch and the French and everybody else are coming in here, and Canadians, and taking it over.

So we have got more than viable competition with respect to manufacturing. And what we were doing not dealing with the monopoly to get into markets—here, with the RBOCs, you have got a monopoly that will persist as a monopoly under a date certain.

If I was going to run Bell South, I would tell you how to run that thing. You give me a date certain, I will have appeals, motions, meetings. We will have lunch. I will come to see you. I will explain it. [Laughter.]

Senator HOLLINGS. And we will keep having lunches. We will have Christmas parties and everything else. [Laughter.]

Senator HOLLINGS. And then let us say a date certain 2 years from now, hey, boy, I will take my monopoly and do exactly what General Bingaman pointed out in her full statement. I wish that full statement could have been read.

Under the time limitations, I agree with you, Mr. Chairman.

But out of that full statement is a sense of history of what we have experienced.

And it is back to the old game of "Watch what they do, not what they say."

And AT&T with the RBOCs—I heard the talk before the Press Club. And I thought she was going after the AT&T folks.

But, you know, on second thought, that was the RBOCs and AT&T. And brother, they would not give up at all. They tried every trick in the book.

And finally, we had to come with Judge Greene. We tried. They tried, and everybody else. And they finally consented. And it is under consent decree.

Now, that sense of history should be understood. And similarly, what Mr. Irving has pointed out, I am the author of the deregulation of cable in 1984.

I knew it at the time, but I went along with the majority.

I said, "Do not give this thing to the cities. I am sitting in the Capitol City. And three-quarters of our Capitol City still does not have cable because they cannot get together with the City Council."

That was the situation.

But the other thought prevailed, "Give it to the cities."

And that is why we had to come back in 1992, and even override the President of the United States' veto to get back, at least, at the rates, because we know that deregulated as they were, with monopolistic situations in the municipalities of America, the prices were soaring through the ceilings; three times the price was going up.

So we now are working from hard experience, having listened to what they say but then watching what they have done.

And I hope—I am sure that the full statement of General Bingaman will be included in the record.

The CHAIRMAN. It is.

Senator HOLLINGS. I thank the Chair.

With respect to Mr. Gordon and the public utilities, I know you folks did not like us preempting State entry, because I am more or less a State's rights man. But we have got to get the information superhighway.

If President Eisenhower had come in 1955—that was what he was working with, the State Highway Department. I can show you the place in Georgia where you are bound to get arrested. I used to train down at what they called Camp Stewart at that time. I do not care how fast you were driving.

So we just could not trust the highway departments of the several States. And that is why we have had through hard experience, Mr. Gordon, come to the preemption.

But with respect to the central role of actually rendering universal service, you have got to take a part. You are the principal part there of maintaining that universal service, because we do not want to go the way of the airlines where they are all broke.

And thank heavens for the foreign regulated entities coming in here and financially bolstering our deregulated. We have come full circle where the regulated are now taking over the unregulated. And we are all smiling and thanking them. [Laughter.]

Senator HOLLINGS. Mandatory price caps, why do you object to mandatory price caps, Mr. Gordon?

Mr. GORDON. Senator Hollings, we believe that the template on which incentive regulation is going to be done is not so well established or so well known that there is a good single model that could be done.

Virtually every State in the country is trying to achieve something in this regard or has already achieved something. If there are exceptions to the proposition that people are, at least, working on it in the middle of proceedings, I do not know what they are.

The fact is that there are different circumstances in different States. And in a State as large as New York, it may well be desirable to have different plans for different companies.

I know of no State that is not looking at the issue, does not see it as a necessary adjunct to allowing proper incentive, investment incentives.

And so, I simply think that the work is being done, that mandating something that people are already doing is an exercise that is more likely to constrain their flexibility and their ability to tailor what they want than it is to make them do something that they would not otherwise want.

If I could add to that, where we do see clear interstate interests at stake and broad national, and in the case of entry, even foreign policy considerations at stake, we have stepped up to the bar, Senator, and said, "Go ahead and preempt us."

And that is on the fundamental issue of entry itself.

Senator HOLLINGS. Very good. So you like the flexibility. In other words, where price caps are desirable, fine; where rate of return is desirable, fine, is that right?

Mr. GORDON. I am personally deeply skeptical that rate of return is the right model for the long-term as this industry becomes more competitive.

In my own State, we are in the middle of drafting an order on that topic at that moment. And I suspect that, if properly designed, a price regulation mechanism is probably—will probably prove superior. But we, in Massachusetts, need the ability to do it our way.

Senator HOLLINGS. Very good.

General Bingaman, with respect—I like the expression "access" because we started out, which gave misgiving to our RBOCs friends when we said "Actual and demonstrable competition."

They came with the obvious rejoinder.

They said, "Wait a minute. We can open it up. If nobody comes in, we still cannot do business. We just have to wait."

So then we went to the 8(c) test which they had agreed to, under Judge Green's modified final judgment whereby there was no possibility of—substantial possibility of using their monopoly power to impede competition.

And they then said, "Well, what does that mean?" because they testified here.

The Bell Atlantic president, on behalf of the seven companies said, "Oh, yes. We agree with 8(c)."

And then we got into really months of the Chairman's staff, mine and all of the others fashioning the words "unbundling" when what we really mean is give them access.

Can you elaborate on that and the background of your—of the Department of Justice's experience, that that is a quid pro quo to really bringing about the information superhighway?

Ms. BINGAMAN. Senator, it is a crucial quid pro quo. And you are asking me to recount experience. I am very glad to do it. Let me give you 25 years in 2 minutes of the Department of Justice and AT&T.

We started this entire thing in the mid-1960's when——

Senator HOLLINGS. Now, that is when AT&T had the RBOCs.

Ms. BINGAMAN. I am talking 30 years ago. Thirty years ago the Department of Justice started the whole telecommunications revolution by filing a petition with the FCC that led to the Carter Phone decision in 1968.

And the Department of Justice said, "Wait a minute. Why should AT&T," which was one huge company with Western Electric as its manufacturing sub, "Why is it that they are the only guys who can sell a telephone to a consumer? Why does that make any sense? Telephones do not have anything to do with the local monopoly. This ought to be a competitive business."

This is in 1965 I am talking about. My gosh, we can hardly remember that. That is when this whole thing started.

The Department of Justice said to the FCC, "Break off telephone sets."

Remember the black sets? "Let somebody else invent a better telephone."

The FCC said, "Dog gone, that makes sense. We are going to tell AT&T they have got to let competitors make telephones."

In 1968 that happened. All right. Do you know what AT&T did next? They were not dead. Then ensued 13 years of fights over interconnection of this equipment to their network.

And the whole thing they were saying—they said, "All right. Some other guy may be able to make a better telephone, but we have got the network. And we are going to say it degrades the quality of the network to hook up your telephone to our network. You might hurt our wires. You might hurt our equipment. You might do this and that."

And we had 13 years of dogged litigation by all kinds of private companies, competitors, trying hard to sell a better mouse trap, a better telephone. They could make it. They could sell it. It just could not be hooked up.

That is part of what led to the breakup of AT&T because the conclusion was the mine demand cannot get through slogging litigation with rate-based telephone company lawyers paid for by ratebase. You will never beat then.

That is, basically, what led to the breakup, that, plus their ability to cross-subsidize.

In 1982, Judge Greene, having heard several years of testimony on this, all kinds of witnesses, said at the recommendation of Bill Baxter and the Reagan Administration, "There is no way to regulate this. There is no way. There is not enough tens of thousands of man hours in the world to fight the phone companies over their network. We have got to just split it up. We have got to break up," because the second part of it, of course, was long distance.

They were not letting long distance companies hook in, just like they were not letting competing equipment companies hook in. And they were cross-subsidizing. It was those three things.

So, Senator, you are exactly right. There was a huge history to the breakup. And it was a history of obstructionism, obfuscation, dogged trench fighting against deep, deep, deep pockets and litigation. And that is what led to the breakup.

What happened after that was the long distance market became competitive. Sprint ran its pin-drop ads, laid the first fiber optic cable. AT&T had never done that. Sprint did it. MCI followed.

AT&T was the last one to do it. That led to the fiber optic revolution.

I do not think there is any question that competition in long distance and the competition spurred by breaking off Western Electric from AT&T has been a tremendous success.

We have got tremendous—we are ahead of the world in equipment, on the equipment side. We are ahead of the world on fiber optics. We are ahead of the world on faxes. We are the envy of Japan.

I mean, there is nobody like us. And it is that competition.

The problem is, having learned from that history, if you do not get this interconnection right, if you let these guys slug it out in State commissions or in courts, you are back to 15 years of fighting while they are over there in long distance.

And that is the game. That is the game that is being played. And you understand it, Senator, that history, as you say.

Senator HOLLINGS. My time is up. But when you use the expression "slug it out in court," that is, as I see it now, the distinguished Chairman's bill.

He says, "Let them negotiate in good faith, and penalize them if it is not in good faith."

I do not know how in the world you would come down, for example, under the baseball strike and say, one negotiated it in good faith and the other did not.

I mean, you would have to be King Solomon. And there are still negotiating. So I mean, not—to negotiate in good faith translates a.k.a. slug it out in court. We have been through that before.

Ms. BINGAMAN. Slug it out—not only that, Senator. But you are going to slug it out on every single negotiation. Negotiate in good faith as to what? You have got hundreds and hundreds of negotiations in every State. It is a lawyer's dream. We have got to build some more law schools here. [Laughter.]

Senator HOLLINGS. Thank you, Mr. Chairman. At least we got some more lawyers.

The CHAIRMAN. Senator——

Mr. GORDON. Could I add a brief point to that? The interconnection issue is well recognized in the States as a tough issue, an absolutely essential issue.

But States like New York and Illinois, Washington and my own State have made some substantial progress on this. The State regulatory commissions are not unaware of the critical issue. It absolutely has to go in tandem with the open entry policies. We recognize that.

And frankly, a number of us are not waiting for the legislation or for preemption by some other regulatory agency to get going on this issue.

If the commissions want to move ahead, the companies will move ahead with them.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. I have no questions.

The CHAIRMAN. Thank you. Let me ask Ms. Bingaman one further question. It seems a central issue is a monopoly in the local telephone market.

And if one decides that due to monopoly in the local telephone market, there should be no date certain for entry into long distance, that same analysis, due to fear of cross-subsidizing or discrimination would apply with equal force to entry into manufacturing and cable.

That is, unless someone can explain how or why—to distinguish between long distance, manufacturing, cable or other prohibited businesses. How do you make that distinction?

Ms. BINGAMAN. I would say, as I said before, on the manufacturing side of this, we supported last year a bill which would have what they called a passive 8(c) test.

That is, application would be made to the Department of Justice which would have a year to decide whether or not to challenge in court under the manufacturing provision.

So we believe that that is important. It is important that there be no substantial possibility of impeding competition through cross-subsidies on the manufacturing side. We agree with the Senator on that.

Under the bill last year, as I told you, we believe a passive 8(c), as it is called, test, administered by the Department of Justice because of our long history in this—on the cable situation, it is a different question because, basically, you have cable companies which have a monopoly right now on these other competitive markets that the Bell Companies seek to enter. There are not monopolies.

The long distance market is not monopolized. It is not as competitive as we wish it to be. And the Bell Companies could help this. We believe, properly done, they should be in long distance. We do not have a problem with that.

Manufacturing is not monopolized on that side of it. Cable, by and large, is. It is a fundamentally different market situation. So——

Mr. IRVING. Mr. Chairman, if I could: I think that both the drafts you have seen also recognize that difference. I think both the Hollings draft bill and the Pressler draft bill treat the cable industry and entry into video programming differently then they would treat manufacturing and long distance, we think, for basically the same sound policy reasons.

If you make sure that interconnection and unbundling requirements are imposed on the telephone companies, and you ensure that they cannot cross-subsidize, they do not have monopoly power. And they cannot leverage their monopoly power in the video marketplace, to the same extent we fear they could and would in manufacturing or long distance.

The CHAIRMAN. All right. Let me ask all three of you, would you support a date certain and a passive 8(c) test for long distance?

Ms. BINGAMAN. I think it could be made to work. I would put it that way. We have not considered this. I think it is critically important that the Department of Justice have a role analyzing this interconnection and what has, actually, happened market by market, because, as Chairman Gordon points out, it is going to differ State to State.

There is not a blanket thing that is going to happen across the country. You have got seven RBOCs. You have 50 States. You have a lot of different ways State commissions can handle this unbundling. There are different speeds.

And that is why it is vitally important for the Department of Justice to look at each market and to determine whether, in fact, there is competition in that market and whether unbundling has happened, because this is a complex situation which is going to differ State to State. There is no question about that.

As to your specific question, as long as the Department of Justice has a role, can challenge it and can go to court to stop entry in a particular market, that is the key thing.

And truthfully, we would be glad to work with the Senator on approaches of some kind that maintain that crucial role.

Mr. IRVING. Mr. Chairman, if I could, since you asked us both: We have a concern that the date certain could be both too long in some instances and too short in other instances.

We prefer to give incentives to the RBOCs to open up their local loop. When they take care of things like unbundling and interconnection and number portability, when they can pass an 8(c) test and when the FCC passes them—gives them a clean bill of health on a public interest test, let them then get to the activities.

That could be 6, 9, 12 months. It might, in some instances, be 45 months or 48 months. But it is going to vary.

Those companies, those RBOCs that open up their markets, we should allow them the benefits of going into manufacturing and long distance.

Those companies that do not open up their markets, there is no reason we should give them the benefits of knowing that, in 3 years, irrespective of whether or not they have comported themselves well, they are still going to have the benefits that other companies have gained.

Mr. GORDON. Mr. Chairman, it seems to me the cardinal principal here that we are trying to apply is open entry. And if you are going to have open entry in one market, you need to have open entry in all markets.

And so, at some stage of the process, there is no question that everybody has to be able to get into everybody else's business, including people who have traditionally held strong market power positions.

The interconnection issue is a critical one. There really does have to be the ability to get around the local loop bottleneck in this process.

The way the date certain fits in there, it seems to me, could be awkward. It could be helpful.

I confess to a little bit of ambivalence about this. If you have no end game in mind, you may never get there.

And so I have some sympathy for those who are suggesting dates. At the same time, it seems to me there does need to be some kind of an understanding and assessment that the markets really are open.

It may be that the best function of some kind of a date out there, whether it is a date certain or some variation on it, is to have us focus our minds and have the participants focus their minds to get about the business of doing the pre-conditions so that you can get in—get these markets open on a legitimate basis.

Senator HOLLINGS. Mr. Chairman, may I?

Mr. Gordon, maybe it could be a date certain for unbundling, interconnection and number portability. Once you get it open, there is no doubt about this competition is going to come in. Everybody is going to court now and making motions and everything else.

The development, wonderful, is ahead of the Congress in the law. And like your State and in New York, they are ahead. And I commend it.

But it is not a date certain for entry. It is a date certain for access, a date certain for a competitive environment. If you can develop that by a date certain, fine business.

I will go along any minute there if you want to have a date certain tomorrow, if you can do it in a day, unbundling, interconnection, number portability. Once you have got that, get the Congress, the FCC and everybody else out of the way, and let the competition ensue.

Mr. GORDON. Senator, my comment really went to the tactics of how you would get everybody convinced that they have to achieve those goals.

Senator HOLLINGS. Yes. But there should not be any ambivalence on entry. Entry is when it's able to entry, namely, as the General said, access. That is the key word.

If you can get access, which is—encompasses namely the unbundling, the interconnection and the number portability, then you are on easy street. Everybody go there.

Ms. BINGAMAN. Could I just make one comment here to Chairman Pressler because this is such a key and vital part of this thing?

The problem is you need to rely on carrots not on sticks. You have to give the incentive to the Bell Companies to move forward. You have to make them want something because they have it in their power to litigate forever.

And if you are litigating over punitive damages because they did not negotiate, you can do that for 10 years. If you are litigating over whether, in fact, they opened up and Department of Justice is suing them because they did not do it, you can do that for 10 or 15 years. We have already done that.

The trick to this is to make them want to do it by giving them a reward for doing what we want them to do. And the reward is long distance entry, which they desperately want and which we do not object to, and the country needs. And it can inject competition into long distance.

But you have to make them want to do that. They have got to—they are the ones who have it in their power to do it.

And I—the simplest way is to say, "Give them a carrot. Do not threaten them with a stick."

That is where the incentive needs to be.

The CHAIRMAN. I have one final question. And that is: Isn't it true that two former Bell System companies, Cincinnati Bell and Southern New England Telephone, as well as Sprint—which is a $12 billion a year company—are in the local, long distance and cellular markets today as I understand it?

Are any of you aware of any complaints about the activities of these particular companies? Should all of the safeguards of separate subsidiaries, interconnection, unbundling, number portability, resale, et cetera, also apply to Sprint and these other companies?

Should Sprint and the other local exchange carriers currently providing long distance service be required to do so only through a separate subsidiary, or might we even contemplate the forced divestiture of local telephone operations?

If we make distinctions, how do we propose justifying such distinctions? The potential anti-competitive activity of cross-subsidy and discrimination are the same, is that not true?

Would you like to comment on that general area?

Mr. GORDON. Well, I will take a crack at it. The central issue here is the structure of the local market. And I think in every local market people need to be able to get in. There needs to be comparability and access across the full range of companies.

I think State regulatory commissions are looking at those issues. I do not want to speak particularly about Southern New England or Cincinnati because I do not have any direct knowledge of it.

But the structural issue is similar whether it is a company that extends over seven States or whether it is a company that has one portion of a State.

If you look at the New York example, the Rochester Telephone Company is a good instance where some major steps were taken in order to assure open access to the market.

It does not seem to me that it requires divestiture necessarily or any structural, sort of, solution. Companies may choose to do that as a convenient may to meet the open access requirements.

But I think what you will see and are seeing is things that are tailored to the individual circumstances. The access issue is addressed. But it is not addressed, necessarily, through drastic structural kinds of means.

State regulators do understand that, in each instance, people have to be able to get access to markets. That can be done in a wide variety of ways. And I think the Rochester example is one good example.

There are examples in the Ameritech region, in Washington. We hope to have an order out in my State in the relatively near future that will deal with the terms and conditions.

And so I think the issue is one of the particular market, not a one-size-fits-all again.

Ms. BINGAMAN. Mr. Chairman, I would simply add two sentences. From our perspective of 15 years of litigation before the consent decree over the issue of cross-subsidization, we believe there is a real need for separate subsidiaries to separate the local monopoly operations from competitive businesses.

And it can be either way that the competitive businesses can all be in one separate subsidiary. That is not a problem, or the local monopoly can be. But there is a real serious issue of cross-subsidy. And it seems to us that is the cleanest way to address that.

The CHAIRMAN. OK. I want to thank this panel very much.

And we will call forth our next panel at this point.

Mr. IRVING. Thank you, Mr. Chairman. [Pause.]

The CHAIRMAN. We will proceed. Our first witness will be with us live from New York, as I understand it. We do have a 5-minute summary we are asking—we have the lights on here.

I do not know—Peter Huber, can you hear me? Are you prepared to come in for us for 5 minutes here and give us a summary?

Mr. HUBER. Yes. I would be glad to.

The CHAIRMAN. Great. All right. We will proceed with Peter Huber, Senior Fellow, Manhattan Institute. Proceed.

STATEMENT OF PETER W. HUBER, SENIOR FELLOW, MANHATTAN INSTITUTE

Mr. HUBER. Thank you very much, Mr. Chairman. I do appreciate the efforts of your staff bringing me in here from Sixth-seventh Street, New York.

I asked the studio manager how they get people like me down to Washington, and he said, "Well, we could use a Nynex line to get to the Empire State Building, or we can use a IDB line, or a Teleport line, or we can go direct by microwave, and then off to a satellite."

So he had four or five ways he could have gotten my picture down to you this morning.

I listened to the Assistant Attorney General's testimony, and I read a news wire report of a recent speech she gave. I was struck by how the news wire—the story said that the Assistant Attorney General is preparing for a piecemeal approach that will take time, but she feels that the department has an obligation under the MFJ to "peruse" this course while legislation is pending.

I suspect that the Assistant Attorney General, who I count as a personal friend, did not use the word "peruse." But basically the news wire got it right.

"Peruse," of course, implies take your time, do not be in any hurry. We have been perusing telecomm reform for at least 10 years—indeed, for a couple of decades.

For example, in 1984, the divesture decree said nothing about regional Bell companies operating out of region. In 1987, the Department thought it might be a good idea to let the Bells attack each other out of region. That issue has been "perused" for 8 years now. It is still not permitted.

The cable operator where I live in Bethesda happens to be owned by Southwestern Bell Corporation. Yet, if Southwestern Bell attempted to use the existing cable network to compete head to head with Bell Atlantic in Bethesda, where Southwestern Bell has no phone bottleneck—if Southwestern Bell did that, it would be in criminal contempt of the divesture decree today.

Of course, Justice is not alone in the "perusing" business. Several years ago, the FCC announced that it would like to see phone companies offer "video dial tone service" to compete directly with cable. Under the 1992 Cable Act, in fact, price regulation of cable will end once this kind of competition comes along.

It is widely to be desired. Yet, after several years of perusing, we have yet to see any serious number of video dial tone applications approved by the FCC.

The FCC has, likewise, been perusing the line between computers and telephone networks since 1966—29 years. Yet that line is still being litigated.

The rules change every few years, and we are still trying to police a line between phone networks and computers that simply is not policeable. The two inherently belong together.

Back in 1988, after many years of back and forth, the information service restrictions were gradually relaxed somewhat. In very short order, a billion-dollar industry for voice mail alone sprang into existence, as the regulatory barriers come down.

"Perusing" even the simplest waivers through the Justice Department today takes typically 2 to 4 years. I have a table on this in my written testimony.

If this Committee and this Congress do nothing else, they should at the very least deal with, and set dates certain, for some of these easy issues, like video, like manufacturing, like the wireless markets. In those markets the problems of interconnection and so forth have clearly been solved.

Now, it has been suggested, and it has been suggested again this morning, that the leisurely pace of moving forward is necessary to protect competition. We do not need to speculate about this any more.

We have tried local phone company involvement in other markets. Sprint itself, one of the main competitors for the Department of Justice, so often extolled as a major contributor to the health of competition in the long-distance industry, serves 6 million local subscribers.

Sprint is a *local* exchange company. It was a local exchange company, affiliated with GTE at the time, that pushed the deployment of fiber optics into the long-distance market.

The Assistant Attorney General and others have seriously suggested that if we open up entry here, we may, in fact, see a decline in long-distance competition.

Now, there is a single accepted economic measure for assessing the State of concentration and competition in a market. That is the Hertendahl Index. At the moment, the long-distance market, despite all the hand waving, is a very concentrated market.

AT&T has over 60 percent, perhaps closer to 70 percent of that market. I think it is inconceivable that by opening up entry we are ever going to get a single company with more than 60 or 70 percent of the market.

If an RBOC is going to get that percentage, I would like to know which one, because there will be seven of them fighting for this market share.

When I completed my study for Justice in 1987, I felt strongly that Bell entry into information markets was already desirable at that time. Subsequently the courts and the FCC agreed. Market evidence has abundantly confirmed that Bell entry in to information markets was procompetitive, that it spurred competition, that it has built up new industries.

We have tried competition in other markets, in CPE markets, in wireless markets, and so on. AT&T's willingness to bet $17 billion in acquiring McCaw testifies to its confidence that it can compete head to head with Bell companies in today's market conditions.

While we postpone letting our own domestic providers into these markets, we see who the new entrants are. I think they should be welcome, but let us face it, they are British Telecomm, France Telecomm, and Bell Canada.

These are the companies that are now forging the alliances that our own domestic providers are not allowed to forge.

Mr. Chairman, broadcast, cable, and telephone, local and long distance, wireline, wireless, and computers—these technologies are all converging. They can compete in the same market, they will, if regulators and Congress lets them.

We should stop "perusing" these questions and get on with "pursuit." Thank you very much.

The CHAIRMAN. Thank you very much.

[The prepared testimony of Mr. Huber follows:]

Testimony of

Peter W. Huber*

Before the

Committee on Commerce, Science, and Transportation

United States Senate

March 2, 1995

* Senior Fellow, Manhattan Institute for Policy Research; Of Counsel, Kellogg, Huber, Hansen & Todd. Peter Huber is the author, most recently, of Orwell's Revenge (Free Press 1994). He is also a coauthor of Federal Telecommunications Law (Little Brown 1992 & Supp. 1993) and Federal Broadband Law (Little Brown, forthcoming, 1995), and the author of numerous other books and articles.

The best way to promote competition is to forbid it.

Articulate, well-intentioned federal officials have been taking that position before this Committee for six decades. Forbid this set of players to play in this market. And that group over there -- make sure they don't invade this forbidden territory. At least not for another few years. Not until we get some more rules in place. And keep those other guys quarantined too, at least for now. This is the "mañana" theory of competition. It's always less competition today, with a promise of all the more tomorrow. But when tomorrow arrives, there's always some other reason to wait a while longer.

In my view, it's time to promote competition by permitting it.

* * *

In 1986, I was hired by the Department of Justice to conduct the first major study of competition in the telephone industry after the Bell breakup.[1] Justice had promised a comprehensive review of this kind every three years, to reassess the provisions in the divestiture decree that confined the Baby Bells to local exchange telephony.

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[1]Peter Huber, The Geodesic Network: 1987 Report on Competition in the Telephone Industry (1987)

Eight years have passed. On the basis of that first review, the Bells were allowed to provide "information services" like voice-mail and electronic yellow pages.[2] But bans on Bell-supplied long-distance service and manufacturing remain firmly in place. So do dozens of other line-of-business restrictions. Broadcasters may not reconfigure their transmitters to provide cellular phone service.[3] The 1984 Cable Act bars phone and cable companies from challenging each other's markets.[4] Interstate carriers need state and local approval to provide in-state service. The FCC still labors to separate "basic" phone services from "enhanced services" and "terminal equipment."[5]

All of these structural rules are at least a decade old; many are based on federal laws written in 1927 and 1934. They predate microprocessors, fiber-optic glass, cellular phones, direct broadcast satellite, and the rapid rise of companies like TCI, MCI, and Sprint. Structural regulation that carves up the telecom industry is now

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[2]United States v. Western Elec. Co., 767 F.Supp. 308 (D.D.C. 1991), aff'd 993 F 2d 1572 (D C Cir 1993)

[3]A 1992 FCC Office of Plans & Policy study found that if a UHF television station in Los Angeles were to shut down and transfer its spectrum to a third cellular provider, the overall public gain would be about $1 billion Evan Kwerel and John Williams, FCC, Office of Plans and Policy, Changing Channels: Voluntary Reallocation of UHF Television Spectrum (Nov. 1992).

[4]47 U S.C A. §533(b) (1994).

[5]Regulatory and Policy Problems Presented by the Interdependence of Computer and Communications Services and Facilities, 28 F.C.C.2d 267 (1971) (First Computer Inquiry); Amendment of §64.702 of the Commission's Rules & Regulations, 77 F C.C.2d 384 (Second Computer Inquiry), modified on recons., 84 F C C 2d 50 (1980), further modified on recons., 88 F.C.C.2d 512 (1981), aff'd sub nom., Computer and Communications Industry Ass'n v. FCC, 693 F 2d 198 (D.C. Cir. 1982), cert. denied, 461 U.S. 938 (1983), aff'd on second further recons., No. 84-190 (F C.C. May 4, 1984); Amendment of §64.702 of the Commission's Rules & Regulations, 104 F C.C.2d 958 (1986) (Third Computer Inquiry), modified on recons., 2 F C C. Rec. 3035 (1987); further modified on recons., 3 F.C.C. Rec. 1135 (1988), vacated on other grounds, California v. FCC, 905 F.2d 1217 (9th Cir. 1990).

obsolete. Last year I helped three Bell companies prepare a motion to vacate the divestiture decree. If Congress doesn't pass legislation in 1995, this motion will be decided by Judge Greene and the D.C. Circuit Court of Appeals in 1996. I should emphasize, however, that my remarks here reflect my own views, no one else's.

* * *

Key trends in the industry are not in dispute. Broadcast and telephone, once separate, are being brought together by digital, broadband technology. Wireline and wireless media can provide competing services. Sooner or later, consumers will dial up video on their telephones, place phone calls through their televisions, and be entertained by their computers. As services converge, they will compete.

Most policy-makers also agree that once competition takes hold, regulators should let go. The quarrel is over the details. Here, the disagreements remain paralytically intense. Bill Baxter, Ronald Reagan's Assistant Attorney General for Antitrust and principal architect of the Bell breakup, firmly believed (and still believes) that the Bells should be kept out of all other businesses until their own markets were fully competitive. Baxter's decree even barred the Bells from getting into real estate or dairy farming, or from providing long-distance service between Moscow and Paris. The concern was that monopolists allowed to enter adjacent markets will suppress competition, not promote it.

Many of the other structural divisions of the telecom industry have similar origins, and are still defended with similar conviction. The strict separation of "broadcasting" and "common carriage" reflects a commitment by the 1934 Congress to prevent the old, monopolistic AT&T from taking over the comparatively competitive business of broadcasting.[6] The ban on phone companies providing cable service dates back to a 1970 FCC rule put in place for similar reasons.[7] The structural divisions between telecom and on-line electronic services originated in the 1960s; they were intended to stop AT&T from swallowing up the computer industry. (The main beneficiary was IBM, which was itself then accused of swallowing everything.)

* * *

When I completed my study for Justice eight years ago, the dust from divestiture was still settling. Some policy changes seemed immediately in order, but not others. I was mystified (and still am) by a rule that forbade Bells from competing freely outside their home territories: unleashing Bells to attack Bells can only promote competition. Excluding such things as storage and electronic translation capabilities from the public network, as both the divestiture decree and the FCC did at that time, also seemed senseless. The FCC and the courts eventually agreed.

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[6]See FCC v Sanders Bros. Radio Station, 309 U.S. 470 (1940); Findings of Fact and Conclusions of the Commission, Metropolitan Broadcasting Corp. et al., 8 F C.C. 557 (1941).

[7]Final Report and Order, Applications of Telephone Companies for §214 Certificates for Channel Facilities Furnished to Affiliated Community Antenna Television Systems, 21 F.C.C.2d 307, 312, 324 (1970), adopting 47 C.F R. §63.54. See also 47 U.S.C.A. §533(b).

Bell entry into long-distance from their home markets was a more difficult proposition. MCI and Sprint were still young and weak. Some Bells hadn't fully deployed the software needed to give "equal access" to all long-distance carriers. Most state regulators remained hostile to local competition. Where they were allowed to operate at all, competing local transport companies like Teleport and Metropolitan Fiber Systems were only just beginning to offer service. Justice therefore decided not to remove the long-distance quarantine at that time.

I missed lots of important trends in 1987: cable's remarkable growth, the imminent explosion of wireless services, and how quickly influential state regulators, like California's and New York's, would come around to embrace competition. But mine was only intended to be the first of many periodic reviews. A second comprehensive study was scheduled for release in 1990. And a third in 1993.

Growth of Local Competition

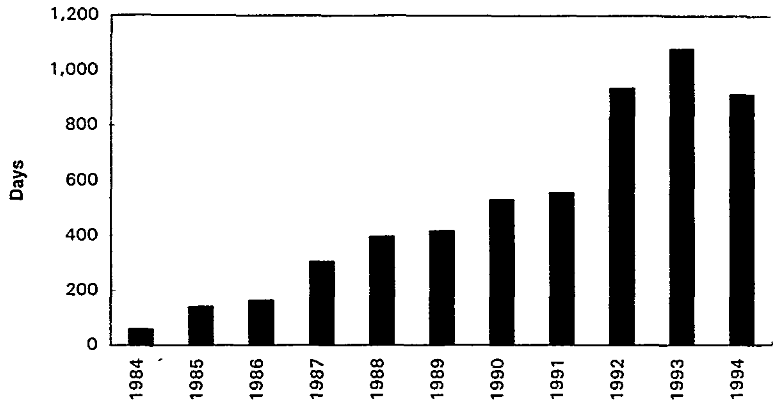
	1982/1984	1995
Competitive Access Providers (CAPs)	Did not exist	72 cities 133 networks
Wireless	92,000 subscribers	25 million subscribers
Cable	29 million subscribers 35% homes passed	59 million subscribers 95% homes passed
PCS	Not contemplated	$10B investment in spectrum

Neither was ever conducted. After 1987, Justice sank into a quagmire of detail and delay from which it has never emerged. The Bells have filed requests for relief in specific areas such as international services and wireless services; newspapers, long-distance companies, alarm monitoring services, and hundreds of other interest groups have deluged Justice and Judge Greene with responsive paper. Judge Greene has ruled on over 200 service-related requests for specific relief. In at least fourteen separate orders he has approved service to individual customers who happened to settle down on the shady side of one of the decree's local/long-distance lines.[8] Requests for decree relief now languish with the Department an average of two and a half years. Another two years or more then elapses before Judge Greene rules.

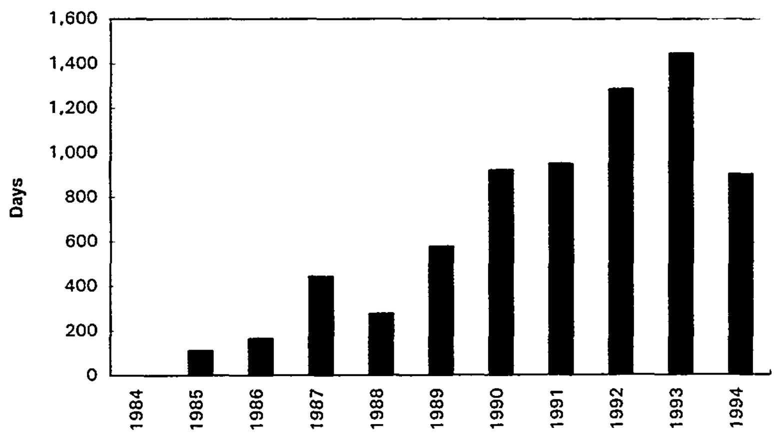
When it comes to lowering structural barriers, the paralysis is just as bad elsewhere. Phone companies have waited much too long for the FCC's (grudging) permission to provide "video dialtone" service in direct competition with cable. (Meanwhile, the FCC pours resources into re-regulating cable rates -- rates that will automatically be deregulated when video dialtone is deployed.) Rezoning the airwaves for new uses takes years; the FCC required over a decade to allocate

[8] United States v Western Elec. Co., No 82-0192 (D.D.C. Nov. 29, 1993), United States v Western Elec. Co., No 82-0192 (D D.C. Sept. 7, 1993); United States v. Western Elec. Co., No. 82-0192 (D D C June 22, 1993), United States v. Western Elec. Co., No. 82-0192 (D D C. June 22, 1993), United States v Western Elec. Co., No. 82-0192 (D D.C Apr. 1, 1993); United States v. Western Elec. Co., No. 82-0192 (D D C Dec 23, 1992), United States v Western Elec. Co., No. 82-0192 (D D C Nov. 17, 1992); United States v Western Elec Co., No 82-0192 (D.D.C. July 29, 1992); United States v. Western Elec. Co., No 82-0192 (D D C. June 17, 1992), United States v. Western Elec. Co., No. 82-0192 (D D C. Mar. 24, 1992); United States v Western Elec. Co., No. 82-0192 (D.D.C. Sept. 10, 1991); United States v Western Elec. Co., No 82-0192 (D D C. June 22, 1990), United States v. Western Elec. Co., No. 82-0192 (D.D.C. July 24, 1989); United States v. Western Elec. Co., No. 82-0192 (D.D.C. May 18, 1989).

Average Age of Waivers Pending Before DOJ
(Year-End)



Average Age of Waivers Pending Before District Court
(Year-End)

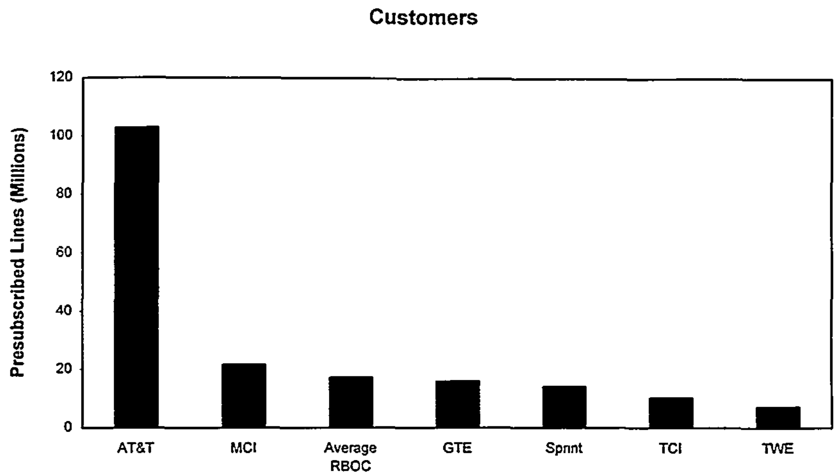


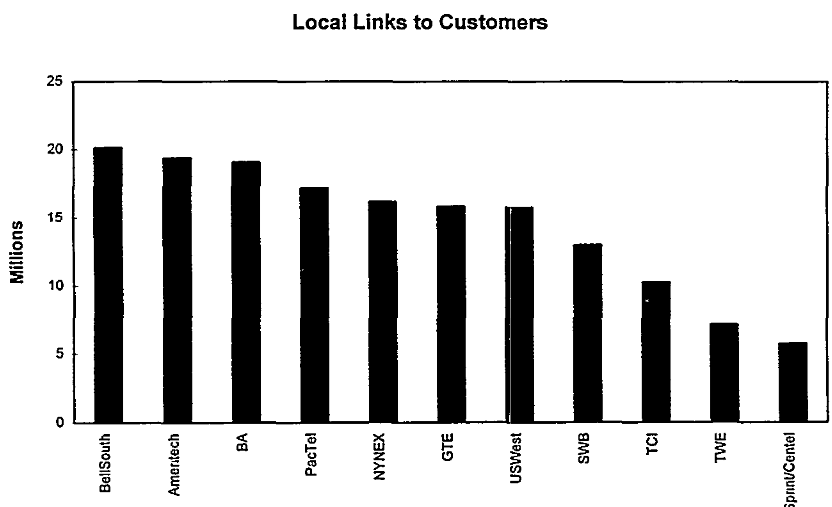
spectrum for cellular telephony, which then quickly blossomed into an $11B industry. Cable companies, long-distance providers, and competitive access providers have to work their way through fifty state commissions to compete locally, and these proceedings, too, can drag on for years.

* * *

It is time to put an end to all this regulatory apartheid in the telecosm. Dividing the most important industry of our economy into segregated townships and gerrymandered homelands makes no sense.

Long-distance companies, for example, are the most logical challengers in the $14B short-haul toll market, which many state regulators currently allocate to local carriers. Long-distance companies are also promising challengers in local markets -- the $40B market for basic service, and the $26B market for transporting calls from end-users to and from long-distance carriers. That's why AT&T bought McCaw, and why Sprint has teamed up with three large cable companies -- TCI, Comcast, and Cox. For their part, local phone companies are the most natural new entrants in the long-distance market -- an industry that generates $34B, net of local charges. Sprint, the third largest long-distance carrier, also provides local service to six million customers.


Customers
Presubscribed Lines (Millions)
120
100
80
60
40
20
0
AT&T
MCI
Average RBOC
GTE
Sprint
TCI
TWE


Local Links to Customers
Millions
25
20
15
10
5
0
BellSouth
Ameritech
BA
PacTel
NYNEX
GTE
USWest
SWB
TCI
TWE
Sprint/Centel

Equally important is the opportunity to find new, more productive uses for old media. Nextel's ambitious entry into wireless phone service was made possible by letting taxi dispatch companies re-tool their spectrum to provide high-tech digital phone service. A decade ago, microwave was used mainly for long-distance telephony (hence the "M" in MCI); in that market, microwave has been displaced by glass, but it is now being used for local wireless services. Satellite started as a carrier of long-distance telephone calls; today it is used mainly to distribute video to cable. Cable started as a community antenna for retransmitting broadcast television; today it is an important programmer in its own right; tomorrow its most lucrative business may well be as a carrier of voice and data. Ordinary copper telephone wires couldn't deliver video, until microprocessors offered cheap, powerful compression.

Even more important are the industry-redefining opportunities at the interfaces between traditionally separate markets -- markets that aren't being developed at present, for much the same reason that only weeds grew on prime real estate in the shadow of the old Berlin Wall.

Fifteen years ago, for example, the FCC forced telephone companies to rip voice-mail capabilities out of their networks; the Bell decree reiterated the ban. The rules were finally changed in 1988. Today, some ten million consumers use voice-mail: this billion-dollar-a-year market was resurrected by removing just one, counter-productive regulatory barrier between phones and computers.

The voice/video interface may be worth $50B. Voice is a much thinner medium than video, but telephone is two-way and interactive: as a result, telephone generates twice the revenues of broadcast and cable combined. From both sides of the voice/video divide, there's a huge new market to be built by combining voice's two-way capabilities with video's bandwidth. As regulatory walls come down, we can expect a surge of new, hotly innovative rivalry between broadcast television ($26B), cable ($29B), movie theaters ($5B), video rentals and sales ($14B), the newly deployed direct broadcast satellites, and telephone company "video dialtone" services.

Many competitive raids across the traditional dividing lines entail only modest new costs for the raider. Local phone companies could easily provide region-wide toll service over existing facilities. Long-distance carriers could immediately enter the $14B short-haul toll market without laying a single new wire. Cable will have to invest more heavily to add voice and data capabilities to video wires, but far less than any other would-be entrant that doesn't already have a network in place. (Backed by U.S. phone companies, cable operators are already offering competitive local phone service in Britain; business is booming.) The same holds true for telephone companies moving into video.

Such cross-border raids are sometimes denounced as "cross subsidy," and a conspiracy against ratepayers. Most of the time, however, they're just plain efficient. Casio makes both calculators and digital watches cheaply because both use the same liquid crystal displays. Similar powerful economies of scope are there to be seized along all the interfaces between voice, video, and data. And consumers plainly benefit when established providers invade each other's turf.

Complacent, sheltered incumbents don't. This explains why so many players in the industry find much to love in the maze of structural walls that cut across the industry. If private companies divided up phone and cable or broadcast and cellular markets in a private agreement not to compete, they'd be put in jail. When government divides markets for them, competition itself becomes the crime.

No one seriously doubts any more that the walls are coming down. The argument is whether Congress, federal courts, or state regulators should get to sound the trumpet, and when. Some members of this Committee just want to set a date. A calendar cannot substitute for a rule book, Vice President Gore replies. But a comprehensive rule book is already in hand. It covers connections between long-distance companies and local:[9] AT&T and MCI compete head to head for Sprint's six million local phone customers without problem. It covers connections between local phone companies:[10] AT&T trusted these rules enough to spend $17B on McCaw. The rules, set out in hundreds of pages of the Federal Register and thousands of pages of legal precedent developed under the "equal access" mandates of the divestiture

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[9]MTS and WATS Market Structure, Phase III, 100 F.C.C.2d 860, 877 (1985); Investigation into the Quality of Equal Access Services, 60 Rad. Reg. 2d (P & F) 417, 419 (1986).

[10]Inquiry Into the Use of the Bands 825-845 MHz and 870-890 MHz for Cellular Communications Sys., 86 F C C 2d 469, 496 (1981), modified, 89 F.C.C.2d 58, 80-82 (1982), further modified, 90 F C C 2d 571 (1982); The Need to Promote Competition & Efficient Use of Spectrum for Radio Common Carrier Servs., 2 F.C.C. Rec. 2910 (1987); 4 F.C.C. Rec. 2369 (1989). See Kellogg, Thorne, and Huber, Federal Telecommunications Law (Little Brown 1992 & Supp. 1993) §13.3 (hereinafter FTL), Report and Order and Notice of Proposed Rulemaking, Expanded Interconnection with Local Telephone Company Facilities, 7 F.C.C. Rec. 7369, 7381 (1992) (special access), Memorandum Opinion and Order, 9 F.C.C. Rec. 5154 (1994) (switched access). See FTL §12.12.

decree, address connections for pay phones,[11] private switches,[12] paging switches,[13] and on-line information services.[14] They cover access to cable-created video programming,[15] utility poles and conduits,[16] and 800-number databases.[17] New problems undoubtedly will keep cropping up – hot issues at the moment are number assignments, signaling protocols, and "co-location" on telephone company premises. But these are precisely the kinds of details to leave to industry committees and expert agencies. The more Congress tries to micromanage them, the worse things get.

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[11]Policies and Rules Concerning Operator Serv. Access and Pay Telephone Compensation, 6 F.C.C. Rec. 4736 (1991). See FTL, supra note 10, §5.3.1.

[12]Furnishing of Customer Premises Equipment by the Bell Operating Companies and the Independent Telephone Companies, 2 F.C.C. Rec. 143 (1987); on recons., 3 F.C.C. Rec. 22 (1987), petition for review denied, Illinois Bell Telephone Co. v. FCC, 883 F.2d 104 (D.C. Cir. 1989). See FTL, supra note 10, §10.7.3.

[13]Amendment of Part 21 of the Commission's Rules with Respect to the 150.8-162 Mc/s Band to Allocate Presently Unassignable Spectrum to the Domestic Pub. Land Mobile Radio Serv. by Adjustment of Certain of the Band Edges, 12 F.C.C.2d 841, recons. denied, 14 F.C.C.2d 269 (1968), aff'd sub. nom., Radio Relay Corp. v. FCC, 409 F.2d 322 (2d Cir. 1969). See FTL, supra note 10, §13.3.3.

[14]See Amendment of §64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), 104 F.C.C.2d 958, 1080-86 (1986), vacated on other grounds, California v. FCC, 905 F.2d 1217 (9th Cir 1990). See FTL, supra note 10, §§11.6-11.9.

[15]47 U.S.C.A. §548(b).

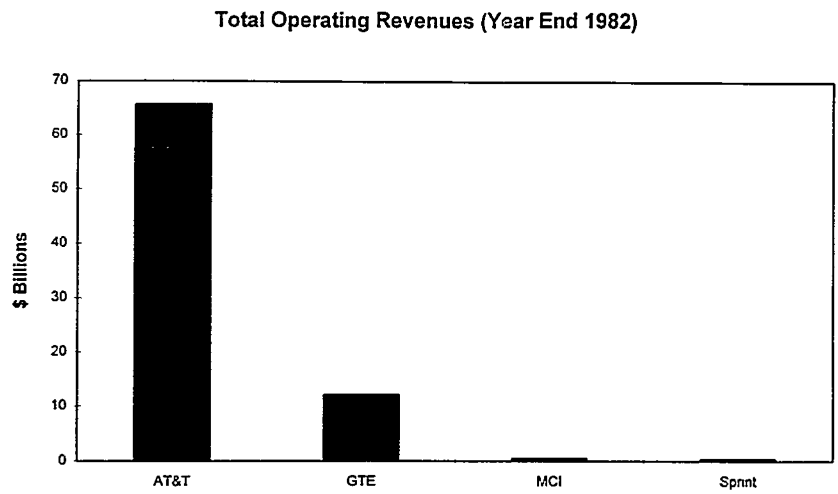
[16]Pole Attachment Act of 1978, Pub. Law No. 95-234, codified at 47 U.S.C. §224.

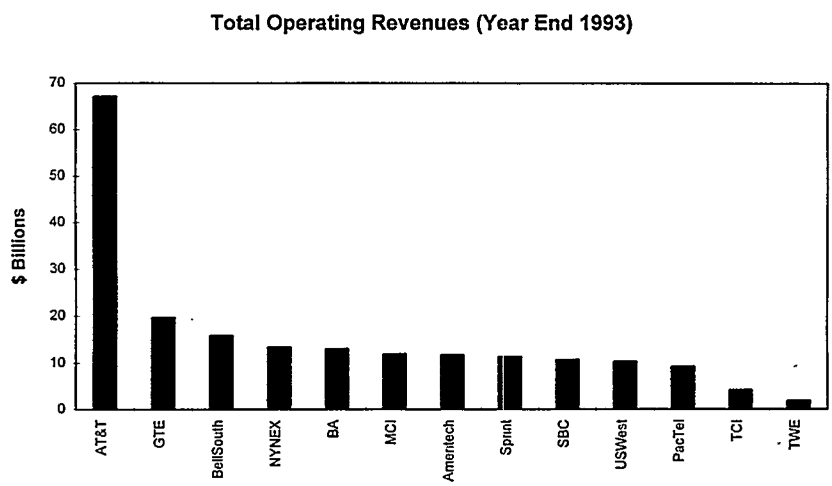
[17]Provision of Access for 800 Services, 6 F.C.C. Rec. 5421 (1991).

FCC Interconnection Rules	
Long Distance Carriers[1]	1985
Information Service Providers[2]	1986
Cellular Carriers (Type II)[3]	1987
Customer Premises Equipment[4]	1987
Competitive Access Providers[5]	1992

1 MTS and WATS Market Structure, Phase III, 100 F C C.2d 860, 877 (1985) 2 Amendment of §64 702 of the Commission's Rules and Regulations (Third Computer Inquiry), 104 F C C 2d 958, 1080-86 (1986). 3 The Need to Promote Competition & Efficient Use of Spectrum for Radio Common Carrier Servs., 2 F C C Rec. 2910 (1987). 4 Furnishing of Customer Premises Equipment by the Bell Operating Companies and the Independent Telephone Companies, 2 F C C Rec. 143 (1987) 5 Report and Order and Notice of Proposed Rulemaking, Expanded Interconnection with Local Telephone Company Facilities 7 F C C Rec 7369 7381 (1992). Memorandum Opinion and Order, 9 F C C Rec. 5154 (1994).

It's equally clear that today's telecom providers can fend for themselves. When the wall between telephony and broadcast was erected in 1934, AT&T towered over the infant broadcast industry. Today, NBC is a subsidiary of General Electric; together they earn $62B a year, in the same league as AT&T's $67B. When the wall between telephony and cable was erected in 1970, cable was one-fiftieth the size of AT&T. In 1982, when the Bell decree restrictions were drafted, MCI was a tiny thorn in the side of enormous AT&T; today MCI's $12B in revenues exceed SBC's ($11B) and PacTel's ($9B). MCI is now 20 percent owned by British Telecom ($20B). Sprint ($11B) is joint venturing with TCI ($4B), Comcast ($1B), Cox ($3B), France Telecom ($24B) and Deutsche Bundespost Telekom ($35B). US West ($10B) is allied with Time Warner ($15B) to provide phone service to the latter's seven million cable subscribers outside US West's home territory. These companies can take care of themselves.


Total Operating Revenues (Year End 1982)
$ Billions
70
60
50
40
30
20
10
0
AT&T
GTE
MCI
Sprint


Total Operating Revenues (Year End 1993)
$ Billions
70
60
50
40
30
20
10
0
AT&T
GTE
BellSouth
NYNEX
BA
MCI
Ameritech
Sprint
SBC
USWest
PacTel
TCI
TWE

* * *

Many of the labyrinthine structural barriers in our telecom industry today were put in place by policy-makers who embraced the views of a deeply pessimistic British socialist. He in turn had formed his opinions about the telecom industry in the 1930s, in the shadow of Stalin and Goebbels. George Orwell's Nineteen Eighty-Four is still magnificent literature -- so magnificent that I pirated a lot of it in my own recent book, Orwell's Revenge. But as analysis or prophecy, Orwell's vision is worse than useless. When Orwell's great novel was published in 1949, his "Ministry of Love" -- Big Brother's ultimate telecom monopoly -- was already in decline. Congress enacted its first (and only) comprehensive federal telecom law in the 1930s as well.

It's time for a new one. In today's environment, the best way to promote competition is to permit it.

89-306 O - 95 - 4

The CHAIRMAN. Mr. George Gilder, Senior Fellow, The Discovery Institute, we would like to hear your testimony. If you could summarize—each of the panelists, the suggested ground rules today are if you can summarize your statement, we will put your entire statement in the record.

If you could summarize it in 5 minutes, we would much appreciate it, so we will have time for questions.

STATEMENT OF GEORGE GILDER, SENIOR FELLOW, THE DISCOVERY INSTITUTE

Mr. GILDER. Thank you very much, Senator Pressler.

I want to congratulate this committee for taking major steps forward toward what I believe and what The Discovery Institute is estimating to be a $2 trillion opportunity for the U.S. economy.

During the 1980's, the convergence of new technologies, led by the microchip, and the general mood of deregulation and tax reduction yielded a $1.5 trillion advance in the asset values of American companies, in real terms.

I believe that these technologies are accelerating today, and that with a full opportunity for deregulation, we can have at least $2 trillion in new asset values of American corporations created by the turn of the century. I think that is a feasible goal, if true deregulation is enacted.

My theme has always been listen to the technology. Here we talk about perusing, but the technology doubles its cost-effectiveness every 12 months. That is the pace of technological change today.

Every time this technology is blocked, or its natural fulfillment is stifled, you lose many of the benefits of this doubling of technology cost-effectiveness.

So I think that there is not time to waste. Time costs money. Time can cost trillions of dollars of lost opportunities for the U.S. economy over the next decade.

This is a technology of sand, oxygen, and aluminum, which are the three most common substances in the crust of the earth.

This is the microchip, a silicon sliver the size of your thumbnail, inscribed with a logical pattern as complex as the street map of America, switching its traffic in trillionths of seconds.

We are soon going to have billion transistor chips. A billion transistor chips could contain 16 super computers on it, or 41 telephone company central office switches on it. This kind of technology will be available shortly after the turn of the century.

This is a technology that wants to be free, it wants to be universal, and it can be, if this huge edifice of obsolete regulations can be removed.

I think something crucial to the information superhighway is that a true competition be permitted. And true competition is not competition that keeps all the existing contestants on the field.

If we have deregulation, and 5 years from now we still have RBOCs, and long-distance carriers, and cable companies, and broadcasters, all these categories in the current zoo of communications, we will have failed desperately, because this technology demands an integrated broadband network, with no such distinctions between long distance, and short distance, and video, and voice, and all these distinctions dissolve in the digital bit streams of the new era.

Now, there are two issues that have been much of a concern for this committee, and one is universal service. Now, I believe that over the last 50 years, with various cross subsidies, and mandates, and special reserves, we have now achieved something near universal service in the telephone industry, that is to say, there is 95 percent of American households with telephone service.

Meanwhile, the technology itself, lowering the price of a variety of products, particularly components in television sets and enhancing their capabilities, has produced 98 percent coverage for television, with no requirement for universal service.

Moreover, just last summer, General Motors Hughes and Hubbard Broadcasting produced a direct broadcast satellite system that created utterly universal service across the whole country far superior to any service delivered by cable companies anywhere today.

In other words, cable, last year, re-regulated as a monopoly, this year is desperately fighting for its life from direct broadcast satellite service that is far superior in every respect, audio quality, resolution coverage, everything. And it is absolutely universal. Rural areas get better service today than urban areas.

And the same thing is happening in digital wireless telephony. Digital will reduce the cost of wireless telephony tenfold over the next three or 4 years, and it will completely close the gap between the costs of serving rural customers and urban customers.

The technology will do it, Senators, and, frankly, perpetuated regulations will not. Thank you.

[The prepared statement of Mr. Gilder follows:]

Testimony of George F. Gilder,
Senior Fellow, Discovery Institute
Before the Senate Commerce Committee
March 2, 1995

S U M M A R Y

New technologies are overthrowing the logic of regulation and offering Americans a much improved life. The "law of the microcosm" and "the law of the telecosm" are responsible for an economic transformation that provided over a 1.5 trillion dollar stimulus to the US economy in the 1980's -- as research by Michael Jensen at the Harvard Business School shows -- and that can provide a two trillion dollar boost to the present, languishing economy of the 1990's. The nascent telecosm also will empower individuals and families in work, education, entertainment, medicine and even politics. But innovations such as the "teleputer," which can be adopted within three years, will be delayed an additional five to seven years if Congress fails to de-regulate the field of telecommunications now. A "freedom model" of de-regulation would allow all existing companies--and new ones yet to be created -- to buy and sell and enter each others' businesses without undue government interference or delay, granting only common carrier status in return. It would remove restrictions to cross-ownership of cable and telephone lines. It would not force companies to separate their functions unnaturally -- and unprofitably -- in subsidiaries and it would not impose delayed entry schedules and other invidious tests upon competition; and it would not demand universal service or other unnecessary and hidden entitlements. Central to new technologies

such as the teleputer is establishing broadband connections to the home. Cable TV companies are under tremendous pressure by DBS (Direct Broadcast Satellite) and will fail to survive unless Congress frees them to find new uses for their connections. Regional telephone companies also are being threatened by new technologies, and need cable TV broadband connections to the home. These existing private concerns, and others that may be created, offer the means to enter the telecosm without government subsidies or guarantees. But they cannot make the needed investments if a restrictive regulatory regime makes the changeover unprofitable.

Universal service is another example of how technological change continually defies government's ability to manage issues of equity or efficiency through regulation. At a time when all voice telephony is rapidly moving to wireless, new digital cellular systems soon will lower the price of wireless telephony tenfold and totally close the gap between the costs of serving rural and urban customers. Once again, the freedom model is most in the public interest, while regulation threatens to thwart progress.

Testimony of George F. Gilder,
Senior Fellow, Discovery Institute
Before the Senate Commerce Committee.
Washington, D. C., March 2, 1995.

Congress' Two Trillion Dollar Opportunity

Mr. Chairman and members of the Senate Commerce Committee, thank you for inviting me here today during what is a golden, though probably brief, moment of opportunity for the American economy and civilization. Thanks to the nature of new technologies and a dawning political awareness that these technologies have overturned the logic of regulation, Congress has the chance to free American industry to lead the world into what I have called the "telecosm." Ahead is forming an environment of unprecedented hospitality for individual creativity, family authority and economic growth. What this telecosm requires from the government now is bold deregulation -- a freedom model -- of telecommunications.

Should Congress fail to adopt a freedom model and persist in the illusory hope that government can shape the future through regulation, America will lose up to two trillion dollars of new economic activity -- stock market values, incomes and job growth. Specifically, unless telephone and cable companies are allowed to merge or directly collaborate with one another to create fiber optic systems and digital services in the phone companies' existing territories, and unless entitlement subsidies and other artificial regulatory requirements are ended quickly and decisively, financial obstacles to investment will delay introduction of the pending communications revolution by five to seven years. Not only will our languid economy lose the massive two trillion dollars stimulus I am predicting, but America also will lose its worldwide leadership in telecommunications.

I arrive at the two trillion dollar estimate by comparing opportunities for high technology advances in the 1990's with those of the 1980's, as illuminated by research conducted by Michael Jensen, recent president of the American Financial Association, and his students at the Harvard Business School. Jensen's research reveals how a de-regulated environment aided in the industrial revitalization that produced such new or reorganized companies as McCaw, TCl, MCI, Time-Warner, Disney, Turner, and Viacom, and gave a one and a half trillion dollar boost to the US economy. An even stronger opportunity awaits the field of telecommunications.

In several books and articles I have described the "law of the microcosm" which ordains that the price-performance of microchips rises by the square of the increase in the number of transistors on a single chip. Thus, distributed single-chip systems grow exponentially more efficient than centralized multi-chip machines, epitomized by the mainframe computer. It is this law of the microcosm that has revolutionized technological change in the past fifteen years, and through it, our economy.

Now the law of the microcosm is converging with the "law of the telecosm." This law ordains that the value and performance of a network of computers rises apace with the square of the increase in the number of computers linked to it. As these forces fuse, the world of computers and communications rides an exponential rocket.

Among the wonders awaiting us in the telecosm is, for example, a "teleputer" that combines, in one unit, interactive video and telecommunications. It will replace today's televisions and telephones and lend the users access to a vast world-wide network of other teleputers: mass communication when desired, but, more often, highly personalized entry to libraries of texts, libraries of films, Internet-style forums, teleconferencing from home to home or home to office, interactive distance learning, virtual family gatherings, telemedicine and huge new business markets -- all brought within the reach of ordinary Americans, not just the rich. By making the choices we want, moreover, rather than the choices someone in a studio or bureaucracy wish to impose upon us, the frustrated American citizen will gain new authority and enthusiasm about his ability to affect his work, entertainment, education and even his government. For merely one small example: just as C-Span circumvents broadcast producers and brings certain events in Congress directly to viewers, in the telecosm the viewer will decide on his own which floor action and which of many committees to "attend" via his teleputer -- including hearings like this one.

Participation in the telecosm will be affordable for ordinary citizens. But the initial structural investments will be large for the system developers. The most expensive part of the conversion to the telecosm is establishing broadband connections to millions and millions of homes, where, not coincidentally, the bulk of the new personal computers are to be found. Fortunately, the United States, almost alone in the world, already has these connections in place in the form of cable TV.

But cable TV is not likely to survive long in its present state. New technology -- DBS (Direct Broadcast Satellite), in this case -- is going to blow away the existing cable companies unless Congress permits them to operate freely. Currently, cable is a classic example of outdated government regulation wrongly premised on the danger of monopoly. Cable's hope is to find a new use. And that new use, in fact, is available, thanks to the needs of telephone companies -- whose own monopoly of local service is already disappearing, also in the face of new technologies. Telephone companies require a way to enter the home to provide broadband connections to the teleputer and other services, but duplicating cable's connections is an obvious waste of years of time and hundreds of billions of dollars. New technology thus closes off old monopoly advantages and opens opportunities for free market collaboration.

Bringing broadband digitally switched services over cable wires to the home will still require investments of $100-300 billion, but these can be and should be provided by the private sector, without government subsidies or guarantees. There is no knowing in advance which companies will succeed in the telecosm and it is futile and counterproductive for government to guess. The once-legitimate concern about communications monopolies has been silenced by the centrifugal force of the computer chip. Bigness no longer assures success in telecommunications, and trying to protect one industry or company against another when no one can tell which one will survive, in any case, will only make the needed investments unpromising financially and set back the movement into the telecosm by five to seven years, well into the 21st century. On the other hand, if Congress will stop focusing on how to fine tune regulations and focus instead on eliminating them more completely, we can have the teleputer and similar revolutionary devices within the next three years, which -- I might mention -- is within the [illegible] of many of you in this room. The secret, as Cal Tech Professor Carver Mead says, is to "listen to the technology."

The futility of regulation is further underscored by the likely creation of new companies outside any presently foreseen regulatory framework. Either these information service newcomers will have a government-sanctioned advantage over regulated companies or the government will find a way to draw the newcomers into its regulatory grasp -- and perhaps with them, whole previously unregulated areas of the economy, such as computers and software.

Government regulation supposedly claims to protect competition, of course, but it is the kind of competition where nobody wins and nobody loses. Such guarded competition will prevent the restructuring and profit incentives that must be available to make large investments possible. Only competition that permits robust rivalries will bring the teleputer and other inventions on-line swiftly.

Mr. Chairman, last year I was concerned that the Congress was still trying to develop a regulatory regime based on an outdated belief in natural monopolies in telecommunications. But, this year I am more hopeful, particularly after production of the discussion draft advanced recently by Republicans members of this Committee. Now, indeed, it seems that almost the whole federal government, including the Executive Branch, is beginning to hum the music of telecom's de-regulation. But it is not altogether obvious that all of them have bothered to learn the words. One test of whether claims of de-regulation are valid is to see whether a proposed law has been adjusted to acknowledge emerging technologies or whether it still tries to force new technologies to fit old government regulations. Even the admirable discussion draft the committee majority produced, I think, should be examined in this light.

For example, consider the issue of universal service. The basic problem of universal service is that with current wireline telephony and cable TV, it costs many times as much to serve rural customers as urban customers. But, new wireless digital technologies have overthrown this problem. At a time when all voice telephony is rapidly moving to wireless, new digital cellular systems will soon lower the price of wireless telephony tenfold and totally close the cost gap between rural and urban customers. This removes the need for either cross subsidies or universal service requirements.

Meanwhile, as I mentioned, Direct Broadcast Satellite (DBS) already delivers service superior to cable TV with supreme universality across the entire continent and completely discredits the idea that cable TV is a monopoly or that hundreds of channels of video will be restricted to favorite areas.

All these examples of technology rendering regulations obsolete should lead us to the conclusion then, that the only sound telecommunications policy is the freedom model. A freedom model would allow all existing companies -- and new ones yet to be created -- to buy and sell and enter each others' businesses without undue government interference or delay, granting only common carrier status in return. It would remove restrictions to cross-ownership of cable and telephone lines. It would not force companies to separate their functions unnaturally -- and unprofitably -- into subsidiaries. It would not impose delayed entry schedules and other invidious tests upon competition. And, of course, it would not demand universal service or other hidden entitlements.

A freedom model, however, would restrict the powers of state public utility commissions to regulate investment and depreciation rules, to ensure rate re-balancing and pricing flexibility. Both cable and telephone companies should be free of pricing restrictions to encourage investment and to eliminate the current cross subsidies that discourage competition and the introduction of new services. Mr. Chairman, the freedom model of de-regulation is not likely to be any company's or industry's first choice. Each, of course, would like to preside over a government-protected monopoly and to enjoy government restrictions on its competition. That is human nature. But since you cannot possibly grant special advantages to everybody, it would seem logical that free and open competition should be accepted as each lobby's second choice. But for the public interest, I would suggest, the freedom model should be acclaimed as the logical first choice -- and adopted, accordingly, by this Committee and the Congress.

The CHAIRMAN. Mr. Clay Whitehead, President of the Clay Whitehead Associates.

STATEMENT OF CLAY T. WHITEHEAD, PRESIDENT OF CLAY WHITEHEAD ASSOCIATES

Mr. CLAY. Thank you, Mr. Chairman. It is a pleasure to be here with you and your colleagues today. The last time I appeared before this committee was some 20 years ago, when I was director of the Office of Telecommunications Policy in the Nixon Administration.

In thinking back over the intervening years, and how I might be of use to you, I thought it might be useful to recall the shape of things when I began to wrestle with telecommunications policy back them.

Twenty-five years ago we had the Bell System, an entity that not so much dominated telecommunications, as it was telecommunications, three television networks that dominated the television industry, a fragmented community antenna television industry, a small two-way radio business, and a fledgling monopoly satellite industry.

Some of this structure had evolved from the technology and economics of the past, but most of it, frankly, had been cast in concrete by obsolete legislation and regulation.

The presumption in those days, which has persisted in some quarters even to today, was that complex technology, spectrum limitations, and capital requirements combined to make telecommunications inherently a monopoly industry.

But technology was even then beginning to erode the foundations of that assumption, but even so, competition and telecommunications were seldom found in the same sentence.

Many of us thought that that could be changed. And at OTP we quickly set our sights on replacing the old paradigm with a new one. Our goal was, in part, pragmatic.

We believed that competition and open entry would encourage more rapid development of new services, with lower costs that were more responsive to consumer needs.

We also had a philosophical goal. We believed that regulation of telecommunications was particularly pernicious, in that governmentally-fostered scarcity foreclosed in the electronic media the freedom and creativity that we have had in the print media, and that it promoted governmental control of electronic content.

By current standards, our agenda was primitive. Our Open Skies policy of open entry in competition in the U.S. domestic satellite services business served two purposes. It was a precursor, or pilot project, for implementing competition among long-distance carriers, and it provided an economical means of distributing television across the country, removing one of the barriers to competing with the big three television networks.

We supported financial syndication rules, prime time access, and cable copyright revisions to encourage competition in the television programming business, and to allow cable to become, in economic practice, a medium of channel abundance, rather than channel scarcity.

We proposed the repeal of the Fairness Doctrine and the deregulation of radio to show that much of the content-based regulation of the FCC was unnecessary and counterproductive.

We supported the reopening of the anti-trust case against AT&T, because the sheer power of the collective Bell System at that time precluded any significant introduction of competition or open entry through regulatory or legislative measures.

We built a case that a breakup of the Bell System was in the public interest, that it was feasible technically and economically, and we persuaded Justice that the monopoly power lay in the local service monopoly rather than in manufacturing.

We opposed the rapid growth of the Corporation for Public Broadcasting, and supported the creation of PBS controlled by the local stations, because we believed that cable and satellite technology in a free-enterprise environment would bring about the channel abundance that would make Federal funding of CPB unnecessary.

Since those prehistoric days we have seen remarkable progress in telecommunications. With the benefit of 20-some years of experience, we can say clearly that competition works: In a free enterprise environment, technology promotes competitive energies, not monopoly power.

Open entry works: No group of companies is uniquely qualified to provide any given service, and we have seen the most progress in this industry in those sectors where we have allowed open entry.

And the First Amendment works: In a competitive open-entry environment, the expansion of channel capacity, computer networks, and customer choices provide an open market in which creativity and free speech can flourish.

Mr. Chairman, as one who has struggled in the past with the issues and the pressures that are now before you and your colleagues, I would like to narrow my remarks to a few key principles.

First, do not try to chart the future of this industry. Try to enable it. The industries we lump under the telecomm label are awash in uncertainty, technical, economic, cultural, and regulatory.

We have learned the hard way, though, that well-intentioned attempts to reduce uncertainty through regulation inevitably create more uncertainty than they remove.

The best thing the government can do, the best thing this Congress can do, is to get rid of the regulatory uncertainty in telecommunications by enabling the industry and users alike to get on with their business.

Second, go for the long run. I know you are being presented with many different positions about many different issues, but look at the remarkable agreement there is on the big picture.

Everyone now accepts that telecommunications should be governed by open entry and competition. Telecommunications cuts across many lines of manufacturing services and applications, and across every element of our society. It should be a big tent, and your regulatory focus should be on the long-run future.

Third, keep it simple. The more complex the legislation, the more often you will have to address new legislation. The more often you intervene in the industry, the more often you will be asked to intervene.

Set a framework based on those enduring principles of competition and open entry, allow a little time for the industry to get used to the idea, and get out of the way.

Fourth, get the courts out of regulation and back into adjudication. Judges are even worse regulators than Senators, Representatives, or commissioners. [Laughter.]

Judicial tests of competitiveness as a precondition of open entry only invite outrageous arguments and add to the uncertainty. It would be far better to set a time certain for open entry and deregulation.

Fifth, let the telecommunications industry be a business. We have a healthy body of contract, corporate, and common law that can more readily and flexibly absorb the complexities of this industry in many cases than could regulatory agencies.

By legislating for the long run with relatively simple rules for competition and open entry, you can provide a framework that will let telecommunications be a business responding to the customer.

Finally, Mr. Chairman, do it now. We have had too long with temporizing solutions, too long with contrived regulatory patches. We are on the verge of unprecedented innovation and creativity in this industry.

The companies in this industry are prepared to invest billions of dollars over the coming decade, and all they want is a little relief from the regulatory uncertainty that confuses the industry.

You and your colleagues are philosophically in accord with that agreement and off to a good start. It has been 60 years since we have had such a consensus on telecommunications policy, and 60 years since we have had a comprehensive communications act. I urge you to give us a new one in this session of Congress.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Whitehead follows:]

Summary of Testimony of Clay T. Whitehead
before the Senate Committee
on Commerce, Science, and Transportation

March 2, 1995

Much has changed since I was Director of the Office of Telecommunications Policy during the Nixon administration. Twenty-five years ago, we had:

- The Bell System.
- The three commercial television networks.
- A fragmented community antenna television (CATV) industry.
- A small industrial two-way radio business.
- A monopoly satellite industry.

The presumption in those days was that complex technology, spectrum limitations, and capital requirements combined to make telecommunications inherently a natural monopoly or, in the case of broadcasting, an oligopoly. But technology was beginning to erode the foundations of this assumption. We set our sights on replacing the old paradigm with a new one, and our agenda was primitive by current standards:

- Open entry and competition for U.S. domestic satellite services and other specialized carriers.

- Changes in broadcasting and cable television rules to allow cable television to grow into a new medium of channel abundance.

- Deregulation of radio broadcasting and repeal of the Fairness Doctrine to show how that FCC regulation of broadcast programming was unnecessary in a competitive environment.

- Building the case that a break-up of the Bell System was feasible and persuading Justice that the monopoly power lay in the local service monopoly rather than in manufacturing.

- Supporting the creation of PBS in anticipation that cable and satellite technology would bring about the channel abundance that would make federal funding of CPB unnecessary.

With the benefit of twenty-some years of experience, we can say clearly: Competition works. Open entry works. And the First Amendment works.

I would like to restrict my prepared remarks to a few key principles:

Go for the long run.
Don't try to <u>chart</u> the future, try to <u>enable</u> it.
Keep it simple.
Let telecommunications be a business.
Get the courts out of regulation and back into adjudication.
Do it now. The 104th Congress has a great opportunity.

The CHAIRMAN. Mr. Henry Geller, Communications Fellow, the Markle Foundation.

STATEMENT OF HENRY GELLER, COMMUNICATIONS FELLOW, THE MARKLE FOUNDATION

Mr. GELLER. Thank you, Mr. Chairman. I would agree with what Tom Whitehead just said, do it now, or whatever the Nike slogan is.

It has been an antiquated law, based on railroad regulation in the last century. You have been trying for 20 years to repair it and have not succeeded, with the exception of the wireless area.

The courts have been much too much involved, and all this has meant that telecommunications cannot make a maximum contribution to efficiencies, and they are needed in this era of global competition.

It cannot make a maximum contribution to the quality of life, education, health care, and so on. I have cited in my statement the Counsel of Economic Advisors' estimate of what it means in jobs, in investment, in growth of the gross domestic product, and it is huge.

Ironically, there is an agreement on the basic principles, and you have heard it again and again this morning, and that is, open entry and facilitating full effective competition.

That means for newcomers, access. First remove the barriers to entry. And for the incumbents it means removing the barriers in the modified final judgment and in the cable/teleco area in the 1984 Act.

As for facilitating competition, for the newcomers it means the access provisions that have been talked about so much, effective interconnection, unbundling, resale, local member portability, dialing parity, and so on.

For the incumbents, it means pricing flexibility to meet the competition, re-balancing prices so you give off sound economic signals, and doing universal service, which remains crucial, in the way that it is competitively neutral. And this letting in, letting out has to be roughly symmetrical.

Now, these principles are to be implemented by the FCC and the States, and I agree with what Ken Gordon told you, I think that while Congress and the FCC may steer, the States have to do the heavy lifting here.

I do think that there needs to be a Federal captain, however. The FCC not only should be able to forebear from regulating when effective competition results, because after all, that's the thrust of all this legislation, but it should also be able to preempt the States and the localities, so where there is effective competition, there is no cartel management, there is no further regulated competition.

There is also a very difficult issue of the time certain that has come up again and again this morning. I share the view that it is a good idea to use such a time certain for both the letting in and the letting out process.

These issues are very contentious, and experience has shown that they can go on for years and years and years in administrative proceedings.

Looking at your bill, you do have a time certain for letting in, 15 days, 135 days, and then the interconnection decision is over in 10 months.

There is 1 year for removing the barriers and probably another year for working it out, and if there is a dispute, governmental intervention and resolution of it within that 2-year period.

Once you have done that, you can do the letting out then in the same way. That is why, while this may not be an optimum way to proceed in theory, in view of the way these things have festered year after year after year, that we have never been able to put them behind us, have never gotten open entry and full contribution by all the competitors, I think it is time to cut the Gordian Knot, and I welcome what you have proposed on that score.

Secretary Irving this morning said the trouble with the time certain is that it may be too soon or, too late in letting them out. After the hearing you will have to determine what the appropriate period is, 18 months, 2 years, 3 years, whatever it is.

But that does not mean they cannot get out sooner. If Nynex or Illinois Bell show that they have met these access conditions, and they have to show it, I agree, in the actual doing of them—for it is one thing to file tariffs that look good in theory, it is another thing to work them out in negotiations—but if they do that, they ought to be able to get out sooner. But in any event, you ought to have some cutoff here, because you have a cutoff also on how long the letting in can go on.

On the last matter, there has been a lot of analogies made to what happens in several areas. I would urge you to look at the information service area.

I really think that there is an apt analogy to that, what we went through in 1987 to 1990. The safeguards here have to be include additional ones, like one plus dialing or resale.

But in the information service area, as Peter Huber said, the RBOCs were let in, the monopoly remained, but with safeguards, and I think the public interest has been served.

I want to mention the spectrum area. You have proposed to give flexibility to the broadcasters, and that is good, but you ought to direct the FCC to go through and give flexibility throughout the spectrum, subject to interference rules of the road.

And finally, I would urge you to extend the auctions, which have been very successfully carried out by the FCC, to everything but to the public safety area. Extend them to broadcast.

The broadcasters are about to move to digital advanced television. That is fine. the broadcaster deserves one-six megahertz authorization free. But whatever the six megahertz that he does not use, it ought to be subject now to auction.

Thank you.

[The prepared statement of Henry Geller follows:]

Summary of Statement of **H. Geller**

Telecom reform legislation is urgently needed in this session of the 104th Congress. If it is not obtained this year, the stultifying stalemate will continue, since legislation is then most unlikely in the second session, an election year. This failure to change an antiquated law will disserve the national interest.

It will mean that telecom will not be enabled to make a maximum contribution to efficiencies that all our industries need in this era of global competition. Telecom will not then make a maximum contribution to the quality of life in the information society --education, health care, and democratic processes.

A consensus has emerged as to the guiding principles of open entry and promoting full, effective competition. Those principles should be applied to both newcomers and incumbents, and the letting in-letting out process should be implemented in a roughly symmetrical fashion.

In light of past experience, there is the danger that the most contentious issues will fester for years in administrative proceedings. To insure that such "gaming the process" does not unduly delay open entry and full effective competition, there should be some cut-off or date certain, with the appropriate time period (e.g., 18 months, two or three years) determined by Congress after hearings. There will be no industry consensus on these contentious issues, and therefore it is up to Congress to cut the Gordian Knot.

Statement of Henry Geller
before the Committee on Commerce,
Science, and Transportation
on Telecom Policy

I am a Communications Fellow with the Markle Foundation and a Senior Fellow at The Annenberg Washington Program of Northwestern University.[1] The letter of invitation requested that I address the need for Congressional action on telecommunications policy reform in the current session of the 104th Congress. I greatly appreciate the opportunity to address this most important issue.

First, telecom policy reform is vitally needed in the national interest. The technology is extraordinaly dynamic, and the private investment markets seek to respond quickly to technological developments with new service applications. The third leg of the stool, government policy, must keep pace with these two driving factors. Unfortunately it has emphatically not done so.

With exception of the recent wireless amendment, the nation is still operating under the 1934 Communications Act, which is based on railroad regulation of the last century. The regulatory agencies, federal and state, struggle under this antiquated regime. Much too much is left to the courts, and the courts are a poor, indeed an inappropriate, place for overarching policy development. That is not their proper role.

For 20 years -- a full generation -- Congress has sought to revise the Act and failed. That failure means that the

[1] The views that I express here are my own and not those of any organization with which I am associated. The views are also disinterested; I am not employed or associated in any way with any of the private parties involved in the telecom debate.

telecommunications cannot make a maximum contribution to efficiencies that all our industries need in this era of global competition. It means that telecom cannot make a maximum contribution to the quality of life of our citizens in the information society that is emerging so strongly -- in education, health care, energy conservation, and in the very democratic processes upon which our nation is based.

Last summer, the Council of Economic Advisers issued a report on the projected contribution to the gross domestic product (GDP) as result of telecom reform. It estimated that with such reform, the GDP would increase about $1 billion over the next decade; that there would be $75 billion in new private sector investment in telecom products and services in that period; that the telecom sector would nearly double in size relative to the economy as a whole, accounting for about 17% of the GDP (as against 9% today); and that in the crucial area of jobs, employment would increase from 3.6 million workers today to more than 5 million in 2003.[2]

As a result of Congressional and Administration efforts in the last Congress, there is general agreement on the basic principles of such reform. First and forement are the bedrock principles of open entry and of promoting full, effective competition. That means for newcomers removing state barriers to entry into local telecommunications -- for incumbents, removing the cable-telco restriction in the 1984 Cable Act and the restrictions in the

[2] See Telecommunications Reports, June 20, 1994, at 24-25.

Modified Final Judgment (MFJ) that prevent the Regional Bell Operating Companies (RBOCs) from entering interexhange service (IX) and manufacturing.

As to facilitating effective competition, that involves for newcomers the interconnection, unbundling, resale, local number portability, dialing parity, etc., conditions in the draft legislation. For the incumbent, it means pricing flexibility to meet the new competition, rebalancing prices so that sound economic signals are given to the competitors, price incentive regulation, and reforming the evolving universal service concept so that it is administered in an equitable and competitively neutral fasion in the new competitive milieu. And this letting in-letting out process is to be achieved in a roughly symmetrical fashion.

These principles are to be implemented by the FCC and by the states, with the FCC steering and the states doing the rowing. Further, the draft bills wisely give the FCC the right to forbear from regulating, if it determines that effective competition has been achieved in some sector. This is of critical importance: the goal over time is to move the telecom sector into the same deregulated state as now exists in the computer (data processing) field, with which it is merging. If effective competition is achieved, further regulation is nothing but cartel management and would be inimical to the national interest. I also suggest that as the Federal captain, the FCC should not only have the power to forbear, when it finds effective competition, but it should also be able to preempt continuing state or local regulation.

There is also a growing view (in which I share) that in light of past experience, the most contentious issues, such as RBOC entrance into the IX field, will fester for years and years in administrative proceedings, just as these issues have festered here on the Hill; and that therefore there should be a cut-off -- a time certain -- when "gaming the process" ends and the nation really has full, open entry -- when all sectors of the telecom industries are allowed to make their full contribution to efficiencies and the quality of life. What that time limit is -- 18 months or two or three years -- is a matter for Congress, after appropriate hearings.

What must be stressed is that there will be no industry consensus that will aid Congress in the resolution of these contentious issues. As the late Senator Magnuson so aptly put it, "all each industry seeks is a fair advantage over its rivals." Each industry wants prompt relief so that it can enter the others' fields, but at the same time wants to avoid the pain of new competition in its own field by tactics that will delay that competition as long as possible. It is therefore up to Congress to make the tough calls and in effect cut the Gordian Knot.

If you fail to do so this year, the odds are very high that it will be most difficult to obtain such breakthrough legislation in 1996, an election year with a shorter session. So the 104th Congress would also pass into history, leaving the same antiquated law on the books. For the reasons I have stated, this would constitute a serious blow to the national interest.

It also makes the U.S. look ridiculous. Other nations like Japan, the U.K., and several in the European Union have moved to reform their national laws in the face of the drastic changes now confronting telecom. The U.S. seeks to be a leader in the Global Information Infrastructre (GII) undertaking -- yet would be seen as unable to revise its own basic law to conform to the GII principles.

This Congress has an historic opportunity to end the stultifying stalement and to enact the telecom reform that is long overdue. I urge you to seize that opportunity.

I have obviously oversimplified and have not covered many of the other important issues in this complex area. I have attached documents that I have submitted to the Congress or to the Department of Justice that flesh out my views in greater detail.[3] With Committee's permission, they could be placed in the record of this proceeding.

Thank you again for the opportunity to address this most important matter.

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[3] The attached January 4, 1995 letter of the Alliance for Public Technology (APT) to Chairman Pressler reflects my views on telecom reform. I am an APT Board member and participated heavily in drafting the telecom reform section.

Alliance for Public Technology

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January 4, 1995

Senator Larry Pressler
United States Senate
Washington, DC 20510

Dear Senator Pressler,

Along with many other interested entities, the Alliance for Public Technology (see enclosed brochure for description) believes that passage of telecommunications reform legislation would greatly serve the public interest. We urge a course that would encourage early enactment of such legislation, which would foster the largest possible investment in the National Information Infrastructure (NII) and ensure all Americans access to advanced telecommunications that support health, education, and other services that promote economic development and enhance the quality of life.

As you know, the largest obstacle to passage of this legislation has been in the area of local telecommunications, where there are today two bottlenecks—the local loop of the local exchange carrier (LEC) and the coaxial drop of the cable television operator. Because of de jure barriers, billions of dollars of private investment in innovative local networks has been held back. As a result of the work of the 103rd Congress, a consensus has been forged on a roughly symmetrical letting in-letting out process. However, the devil is in the details of implementing this consensus. We suggest the following legislative approach:

(i) Specify symmetrical deadlines for the letting in-letting out process: For example, the removal of all state barriers to new entrants within one year of enactment, and the effectuation (by the FCC and the states) of specified conditions facilitating the competition of new entrants (e.g., effective interconnection, unbundling, access to ducts and poles, resale, dialing parity, interim steps for local number portability) within two years. At the end of the same two-year period, or within the two-year period concurrent

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with the removal of barriers and effectuation of the specified conditions, the interexchange (IX) and manufacturing restrictions of the MFJ would be ended, with the RBOCs free to enter these areas, subject to appropriate regulatory safeguards. We use the two-year period as illustrative; hearings could establish the appropriate time period for the symmetrical action. What is critical is that there be this symmetrical deadline, for experience has shown that without it, these issues will fester for years in administrative proceedings. The consensus that has been forged on removal of the MFJ restrictions concerning IX cellular and video distribution or manufacturing, subject to regulatory safeguards, would be implemented upon enactment.

(ii) The LECs today can engage in video dialtone operations (VDT)—a common platform that we strongly support as providing open, non-discriminatory access to all information providers. With the legislation, the LECs should immediately be allowed to engage in local delivery of their own video programming, subject to safeguards, in order to facilitate effective wire competition to the cable television bottleneck. And when cable operators provide a switched, broadband service, they likewise should be required to afford nondiscriminatory access (in place of the present, ineffectual provisions of section 612).

(iii) Regulators should be required to move in an orderly fashion to prepare a fair and open environment for competition by assuring that proper economic signals are given, pricing flexibility is afforded the incumbent to meet competition, incentive regulation is employed, any subsidy scheme is implemented in a competitively neutral fashion, and all telecommunication providers are treated similarly regardless of the technology they presently deliver.

APT strongly endorses a Congressional mandate for universal service goals, and urges that enhanced or additional service requirements should evolve over time to achieve an eventual goal of universal, interactive (two-way), broadband network of networks. See section 1(b)(11) of S. 1822 and enclosed vision statement of APT.

This reflects a sound substantive approach. Process is also important. The legislation should make clear that there is a federal captain, the FCC, but that the, FCC steers through appropriate rulemakings, and the states do the heavy rowing. Experience has shown that the states have served as innovative laboratories for policy, and have the advantage of "grass roots" regulation geared to their particular circumstances. Since the aim over time is to achieve the goal of

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effective competition, clearly regulated competition—really cartel management—should be avoided. The FCC should therefore have the power to forbear from regulation (and to preempt any state or local regulation) when it finds that there is effective competition in some telecommunications sector.

The above deals with regulatory reform. Non-regulatory governmental action is equally important. APT's commitment is to promote connecting all to all in a system of interactive, broadband networks, so that telecommunications makes a maximum contribution to the quality of life. Thus, upgrading the nation's telecommunications infrastructure will contribute to the democratic process by enhancing the Associated Press principle—that the underlying assumption of the First Amendment is that American people receive information from as diverse sources as possible. The contribution to the environmental and energy areas can be most substantial, and telecommunication's innovative efforts in the fields of education and health care are crucially needed. These are, we stress, appropriate governmental responsibilities.

To give one example, it is important to connect our schools and libraries to the NII, so that learners of all ages have the benefit of high-tech training, distance learning, and access to databases. This is a most expensive undertaking and cannot properly be achieved by actions taken solely within the telecommunications sphere. Rather, it must be properly planned and funded in the educational sector, with assistance from telecom. We therefore suggest use of some significant portion of the spectrum auction funds for this linkage to the NII so that the educational and library sectors would then be in a position to plan and evolve such a salutary scheme.

The delivery of health care services to the home is another critical area in which two-way broadband networks are essential. Deployment of these networks will enable health care professionals to be able to treat their homebound.patients with the need to make time-consuming and costly visits to their patients' homes. By the same token, chronically ill patients and persons with disabilities can be spared the need to make office visits—which for many are so difficult that they often forego the visit, with costly long-term consequences to their health and well being.

Further, inter-governmental partnerships with industry should be encouraged by Congress to address problems competitors are likely to encounter in developing and deploying networks to bring the benefits of interactive, multimedia communications to the full spectrum of society. Developing and facilitating applications of the evolving technologies in such areas as education, health care and labor market operations are both socially necessary and critical to achieving almost any promised vision of the Information Age. Yet it is in these community-based applications that the development and aggregation of effective demand may be most difficult to link up with investment decisions of competitors. While the telecom industry should not be expected to assume the full burden of funding community-based applications development, it is in the interest of competitors to work cooperatively with under-funded community agencies and organizations, so as to assess their needs and aggregate demand for applications that can be budgeted or otherwise funded. There is an urgent need, for example, to include in the legislation a Congressionally-mandated FCC-state regulatory partnership with the industry that focuses specifically on market-compatible incentives which are supportive of the industry's responsibility. The primary object of such a partnership should be to encourage competitors even-handedly to develop, as an integral part of their investment strategies for network development and deployment, the community-based interfacing necessary for effective aggregations of demand in socially/community desired areas.

APT urges that 1995 is the critical year for the legislative breakthrough, so much needed in the public interest. We recognize that the legislation is of great import to the contending industries, all of whom seek, in the apt words of the late Senator Magnuson, "a fair advantage over their rivals." We therefore urge that Congress, through the Committee and Subcommittee Chairmen, make clear to all the warring parties that there will be legislation in 1995, with or without consensus agreement. Indeed, such a message, like a hanging, may so focus the minds of the parties that consensus might be achieved.

We hope that the foregoing is helpful to you in the most important task that you have undertaken. The Alliance for Public Technology stands ready to assist in any way that it can.

Sincerely yours,

Susan Hadden
Chair, Policy Committee

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA,

Plaintiff,

v. Civil Action No. 82-0192 (HHG)

WESTERN ELECTRIC CO., INC.
and AMERICAN TELEPHONE AND
TELEGRAPH COMPANY,

Defendants.

To: Department of Justice

COMMENTS OF HENRY GELLER, EVERETT PARKER, AND BCFM,
ON MOTION OF BELL ATLANTIC CORPORATION, BELLSOUTH CORPORATION
NYNEX CORPORATION, AND SOUTHWESTERN BELL CORPORATION
TO VACATE THE DECREE

Henry Geller, Dr. Everett Parker, and Black Citizens for a Fair Media (BCFM),[1] submit comments on the Motion of Bell Atlantic Corporation, BellSouth Corporation, Nynex Corporation, and Southwestern Bell Corporation to vacate the decree. We urge that the Department (DOJ) is pursuing the wrong process in its rather leisurely consideration of that request; that it should instead rely upon the "letting in -- letting out" consensus (described in 1, _infra_) that has been forged this year on the issue and, in a filing submitted before the year's end, request the district court to revise Section II(D) of the Modification of Final Judgment (MFJ or decree), or grant a general waiver, so as to

[1] The commentators are disinterested, having no financial interest of any kind with respect to any of the participants in this proceeding; they have previously participated in MFJ matters.

facilitate the "letting in--letting out" consensus; and that recent legislative experience strongly militates for the soundness of this approach and against sole or too great a reliance on passage of breakthrough legislation. The grounds for this position are briefly stated in the following discussion.

1. <u>There is a clear governmental consensus for an open entry, "letting in-letting out" process.</u>

First, it is most important to recognize that allowing the RBOCs to engage in IX operations markedly serves the public interest, including from the critical standpoint of promoting competition. The reasons why this is so are set out at some length in the attached statement of commentator Henry Geller before the House Subcommittee on Telecommunications, and will not be repeated here. Suffice it to say that there are great benefits to competition from RBOC entry into the IX field and that it is wrong to suppress the competitive contribution of roughly one-half the telecommunications industry in this crucial area; that with equal access, other appropriate safeguards, and the existence of most sophisticated and alert industry participants, the detriments from such entry are slight, indeed, and that in effect we are engaged in repeating the same process as was done in the CPE and the information services sectors (with, it should be stressed, a successful outcome); and that the failure to act promptly on the clear balance in favor of allowing RBOC entry into IX operations will result not only in loss of the above benefits but a festering problem, particularly as to fair competition for the crucial large business customers.

But the issue before the Department and the court no longer stands alone in light of developments this year involving the Administration's National Information Infrastructure (NII) iniative and the Congressional efforts to enact comprehensive telecommunications reform legislation. The issue of "letting out" the RBOCs has become integrally linked to that of "letting in" competition in local telecommunications. Our comments are directed largely to what we believe is the logical and practical consequence of the clear developments this year and hence the clear course that we believe the Department should promptly follow.

A Martian would be amazed by the present proceeding being conducted by the Department. The Martian would note the following:

(i) The Clinton Administration, at the highest levels, strongly believes that the existing stalemate in opening all levels of telecommunications to full and fair competition must be broken as soon as possible, so that telecommunications is enabled to make a maximum contribution to efficiencies and jobs in this era of global competition and to the quality of life in the information society.[2] The Department, of course, has fully joined

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[2] See, e.g., The White House Release, Jan. 11, 1994, "Vice President Proposes National Telecommunications Reform"; Council of Econmic Advisers (CEA) Report, on projected contribution to the gross domestic product and jobs as a result of such reform (estimating that with the adoption of the NII principles, the U.S. gross domestic product would increase about $1 billion over the next decade; there would be $75 billion in new private sector

in this effort, and has therefore supported the "letting in-letting out" scheme reflected in the main bills in the 103rd Congress, H.R. 3626, H.R. 3636, and S. 1822 (i.e., removing state barriers and facilitating competition through effective interconnection, unbundling of functions, resale, access to ducts and poles, local number portability, dialing parity, etc.).

(ii) After the most extensive hearings, a consensus was developed in the 103rd Congress on this issue. The House passed legislation with the "letting in-letting out" scheme by an extraordinary vote (436 to 4 or 5). The Senate Commerce Committee, by an 18-2 vote, adopted essentially the same course. The Senate bill, S.1822, did not come to a vote because of a combination of factors, i.e., the lateness of the session, the opposition of some parties, and the non-negotiable demands of Senator Dole, the minority leader, for a less regulatory approach to telecom reform.

(iii) The FCC, an independent agency, strongly endorsed the open entry, "letting in-letting out" scheme. Most significantly, NARUC also agreed that the states should be required to remove barriers and to facilitate competitive entry.

We fully agree with that approach (see attached statement of Henry Geller before the House Subcommittee). The industry

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investment in telecom products and services in that period; the telecom sector would nearly double in size relative to the economy as a whole, accounting for about 17% of the GDP (as against 9% today), with employment increasing from 3.6 million workers today to more than 5 million in 2003). See Telecommunications Reports, June 20, 1994, at 24-25.

parties were pushed by Congress to join in the approach, but their agreement is important only to the legislative process (see discussion below, pt. 3), not the judicial forum. Generally speaking, none of the industries involved want competition. The four petitioning telcos here want removal of the IX restriction, but ignore the "letting in" process that was forged in Congress and the Administration. The cable industry wants to be allowed to compete in local telecommunications but seeks to put off telco competition to cable for as long as possible. And the same applies to the IX carriers, the newspaper industry, broadcasters, the alarm industry, etc. As the late Senator Magnuson so aptly put it, "all each industry seeks is a fair advantage over its rivals." We submit that what is crucial here is the consensus of the governmental entities. The industries should, of course, have their chance to comment in the judicial process, and those comments should be carefully taken into account, even if motivated by selfish concern. But partisan opposition is to be expected, and thus should not be controlling.

2. The Department is proceeding today most unsoundly by ignoring the above consensus. Our Martian would observe that the four RBOCs ignored the above consensus in their filing, and the Department is taking up their request in a year-long proceeding, also without explicity reference to the consensus. But at the end of the process, unless the Administration and the Department were to conclude that they have been mistaken -- that there is no need to remove barriers to competition and then facilitate such

competition because the RBOCs today face effective competition in their basic endeavors (a most unlikely and indeed an incredible scenario) -- the Department will return to the consensus scheme as necessary and best serving antitrust policy and the national interest.

On the merits (see pt. 3, infra), it is difficult to predict what the antitrust court will do. While the past statements of the court would indicate an aversion to "letting go" in the IX area, the court must give serious attention to the position of the Department, which is, after all, the moving primary party to protect and promote competition. See Western Electric v. United States, 900 F.2d 283, 297 (D.C.Cir. 1990). The district court in the last decade has indicated its belief that the Department was proceeding in a political fashion in the lowest sense of that term. Id. at 298. But it is clear, and the district court can have no doubt, that the Clinton Administration and Clinton Department are proceeding in a political fashion in the highest sense of that term -- that they genuinely believe that their NII proposals, including full support for the "letting in-letting out" consensus, is much needed in the national interest (see n. 2, supra). The district court has shown an admirable tendency to weigh that interest, as demonstrated by its action in permitting transmission information services in order that the United States not fall behind in this crucial area of global competition. See United States v. Western Electric, 673 F. Supp. 525, 564 (D.C.C 1987). We believe that it might well do so again, if the merits are reached.

3. <u>The Department should move along the above lines in 1994, because it is poor policy to base the entire strategy on obtaining legislation in the next Congress.</u> The final observation of the Martian would be that so far as federal action is concerned (i.e., the "letting out" process), the Administration, the Department, and the court are simply waiting for legislation in the next Congress -- and that is why the Department is content to "burn" another year (which the court granted).

In the meantime, the "letting in" process can continue through efforts of the Administration, the FCC, and the States. Thus, Vice President Gore has stated that there will be a "summit" of local, state and federal government officials early next year "aimed at crafting a comprehensive strategy for local phone competition."[3] See also Telecommunications Reports, October 17, 1994, at 7 ("Working Group Expected to Present Funding Proposal to Gore for State Effort on Telecom Issues"). This State effort "... to accelerate a (state-level) move towards telecommunications reform and the promotion of local exchange competition" (<u>ibid.</u>) is commendable and should receive the sound support of the Administration.

The RBOCs will point out, however, that a "letting in" process without any concrete move to "let out" can be disastrous (see attached statement at 4) -- that as the Administration

[3] Multichannel News, October 24, 1994, at 3.

itself recognizes, there must be reasonably symmetrical efforts. Thus, Vice President Gore has "...warned against partially opening up competition -- comparing it to getting across a chasm by leaping in two stages" (see n.2). We would compare it to a country deciding to switch from right hand drive to left hand, and letting the trucks go first. For the "let in" competitors, with the assistance of the interconnection, unbundling, etc., conditions, will focus on the business customers, and it must be remembered that a very small percentage of such customers, most of whom desire one-stop service, generate about 50% of the revenues. If the RBOCs are not allowed to compete effectively for these business customers because they are restricted to the LATA and cannot offer one-stop service, they could end up with a very high percentage of customers (residential) but with what Vice President Gore referred to as a "hollow monopoly" (Communications Daily, Oct. 18, 1994, at 1). So the above sound effort to introduce competition at the local level (which we fully support) should be accompanied by an effective effort to "let out" the RBOCs. There should also be reform to prepare a fair environment for the competition by affording pricing flexibility, moving to price (incentive) regulation, gradually rebalancing pricies to give sound economic signals to the new entrants, and administering the universal subsidy scheme in a competitively neutral fashion.

Certainly Congress should set the guiding "letting in - letting out" policy by amending the archaic 1934 Communications

Act. In that way there will be a national policy rather than having to rely on progress, state by state. And it was certainly most sensible for the district court, the Department, and all other governmental bodies to wait to see if legislation was passed in the 103rd Congress. Indeed, it is sensible for the court to take no action until late in 1995 so that Congress has been given the chance to take up where it left off and pass legislation building on the 1993-94 effort that came so close to fruition. There is, we believe, a good chance of a legislative breakthrough in 1995, just as there was in 1994.[4]

But what we believe to be not sensible -- indeed, to be the poorest policy -- is for the Department and the Administration to place all its eggs in the one basket of legislative reform. For while there is a good chance of legislation in the next Congress, there is, in our opinion, an equally good chance that there will no legislation. The legislation is most complex and seeks to deal comprehensively with the vital and often conflicting interests of powerful industries, with the consequent obvious possibility of stalemate. Take just one possible scenario in the new Congress: Senators Dole and Packwood will clearly have increased weight, and may thus be in position to obtain a "more

[4] Thus, Senator Pressler, the incoming Chairman of the Senate Commerce Committee, has stated that "...he intends to push for immediate passage of the telecommunications bill that stalled in the committee this year, possibly with changes to enhance competition." The Washington Post, November 10, 1994, at A30.

deregulatory" bill.[5] But such a bill might then be strongly opposed by groups such as the IX carriers, the cable industry, the alarm industry, etc. If Von Clausewitz is right that to win an offensive there must be at least three to one superiority, the "defensive" opposition might well be able to block legislation in 1995 and, almost certainly, then in 1996, a national election year.[6] That would mean that these problems continue to fester and that the national interest suffers because of our inability to put our house in order.

In this regard, it should be remembered that the legislative effort began in 1975 and has now consumed roughly a generation of time. AT&T's Chairman stated that the company agreed to divestiture because it was apparent that Congress would never be able to act to set national policy -- that its only chance for relief in the new environment was the antitrust court.[7] It may be again that while Congress this time deserves great praise for its

[5] See, e.g., Telecommunications Reports, November 7, 1994, at 12-15; The New York Times, November 10, 1994, at D7; The Washington Post, November 10, 1994, at B13.

[6] Significantly, an industry group that includes AT&T, MCI, and the National Cable Television Association "plans to announce efforts to persuade states to remove regulatory barriers that prevent competition in local telephone service...partly in recognition that federal legislation to remove those barriers may fail again next year." The Washington Post, Nov. 9, 1994, at B2. This is a move that parallels the sound efforts of the Administration along the same lines. But surely this raises the obvious question as to what the Administration should do to promote the equally necessary "letting out" process in the event that federal legislation to remove those barriers fails in the next Congress.

[7] See Charles Brown, Disconnecting Bell, at 1-7, H.M. Shooshan, Jr., Ed., Pergamon Press, 1984.

effort to work out a consensus, only the antitrust court can deliver the goods. Certainly that option should be kept open, so that there is some protection against a pattern that might turn out to be "waiting for Godot." Failure to keep the option open and timely would, in the words of Samuel Johnson as to second marriages, be the triumph of hope over experience.

It follows, we believe, that the Department this year should submit its own version (rather than that of the RBOCs) as to how the MFJ should be reformed -- namely, that if the Department certifies (subject to public comment and challenge) that a State has removed all barriers to competition and the "letting in" conditions which the Department believes are sound have been met[8], the district court will then permit full IX activities by the RBOC in that State.[9] The Department should request that the district court give notice of this proposal and

[8] As stated, we believe that the conditions in H.R. 3636 are sound, and so also are those added by S.1822. There are problems that must be resolved by the Department initially and the court definitively. For example, while local number portability is necessary, it may be that this process will take a fairly long time, and therefore the RBOCs should be "let out" if reasonable interim procedures are being used and the final solution is well under way. This apparently is the approach of H.R. 3636. The Department clearly should consult with the expert agency, the FCC, in reaching a conclusion on such matters.

[9] This kind of process is already before the Department in the request of Nynex, dated August 25, 1994, for Interexchange Waiver for New York. As indicated in the attached appendix (at), we believe that immediate relief should be afforded in the case of IX activities in connection with cellular or video operations, or in the out-of-region situation.

an opportunity for all interested parties to comment on it;[10] that no final action should be taken upon the proposal until late in the first session of the 104th Congress, at which time the Department and others could advise the court as to the need for consideration on the merits. If Congress has acted, that of course ends the matter. But if it is clear that there is to be no legislative breakthrough, the court will then be in a position to take an action which we believe will represent substantial progress and indeed pave the way for further progress.

We submit that there is no downside to proceeding in this fashion. It does not in any way denigrate the importance of Congressional action. Clearly Congress is to be praised for the consensus it forged and to be urged to adopt national legislation. Such legislation would also eliminate the central role of the antitrust court (and the Department as the court's staff), and place the responsibility where it more appropriately belongs today -- on the FCC to steer and the states to do the heavy rowing. The approach we urge should promote such

[10] It will be particularly important for the FCC and NARUC to submit comments concerning their positions on protecting against improper cross-subsidization through price caps, accounting, and the use of a separate subsidiary. In connection with the latter aspect, see California v. FCC, Case No. 92-70083, 9th Cir., issued October 18, 1994. We believe that a separate subsidiary (SS) should be employed in the case of content information services (where there are no economies of scale or scope as there is no joint equipment, maintenance or marketing); in areas where there are efficiencies, we believe that this is a matter best left to the discretion of the FCC. It may be that the agency should employ the SS approach only if it is indicated by experience (some pattern of RBOC operation that calls for the SS).

Congressional action by putting pressure on Congress -- by telling Congress that however desirable its overall action is, there is a less optimum but still desirable alternative route that can and will be taken. Significantly, there is the precedent of breakthrough legislation in the airline field following the activities of the CAB.

If the court route is taken in late 1995, the burden will shift to the states. Some like New York, Illinois, California, Michigan, and Washington, will, we believe, promptly move to meet the conditions. This, in turn, will place great pressure on states hanging back, because the states are in fierce competition to attract industry. There will be a snow ball effect that will markedly serve the public interest and, as a practical matter, bring to fruition over time the "letting in-letting out" process reflected in the consensus.

If the district court refuses to follow the above route, appellate review could be sought, with its unfortunate delay. There is, we recognize, no assurance of success. But we stress that the Administration and the Department should make every effort to achieve substantial progress in the regulatory reform that it has soundly identified as necessary in the national interest. The worst course is passivity in the face of dire need.

Respectfully submitted,

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November 15, 1994

NATIONAL COMMUNICATIONS INFRASTRUCTURE
(Part 3)

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
TELECOMMUNICATIONS AND FINANCE

OF THE

COMMITTEE ON
ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

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STATEMENT OF HENRY GELLER
BEFORE THE HOUSE SUBCOMMITTEE
ON TELECOMMUNICATIONS AND FINANCE
FEBRUARY 10, 1994

My views on the issues before the Subcommittee are disinterested and my own, not those of any non-profit organization with which I am associated. I shall briefly discuss the general background and the specific issue of the hearing, the provisions in H.R. 3626 relating to Bell Company (BOC) entry into the interexchange (IX) market.

The driving forces here are a very dynamic technology and market, which in turn have led to a convergence of industries and great ferment. Telecommunications policy must keep pace with the two driving forces. Otherwise, the two main goals of governmental policy will not be met: to enable telecommunications to make a maximum contribution (1) to efficiencies because productivity is the key factor in the global competition thaat is now the norm, and (2) to the quality of life in the information society in areas like education, health care, telecommuting, and democratic processes.

To their great credit, the Adminstration and both Houses of Congress are now strongly focussed on revising the 1934 Communications Act. Incredibly that Act looks back to railroad regulation in the 19th Century. Congress and the Administration soundly seek to adopt policies that will manage the transition to the 21st Century.

There also appears to be an agreement within the Federal government (Congress, the Administration, the FCC) on what should be the dominant strategy and goal -- all-out competition.

Competition is the norm in the U.S. because it spurs efficiencies and innovation and drives prices to marginal costs. It has worked brilliantly in the customer premises equipment sector, and has led to rapid modernization in the IX area, with massive investment in fiber optic cable and innovative marketing approaches. In the area of local telecommunications where there is today the greatest focus, competition has already shown its powerful effects in fostering the fiber self-healing rings in the centers of large cities or the accelerated fiber construction response of the local exchange carrier (LEC) to the projected entry of local cable operations such as Bell Atlantic-TCI and Time Warner-U.S. West in the Telesis area. Indeed, a great deal of the heightened broadband activity appears to be supplier driven as large entities "jockey" for position and early advantage.

There is a serious problem at the local level because while several states have been forward looking, many have hung back from adopting the open entry, all-out competition approach. Again there appears to be a strong consensus in Congress, the Administration, and the FCC, on how to deal with that problem. Thus, H.R. 3636 and S. 1822 not only require the removal of state barriers to entry but, even more important, promote such entry through effective interconnection (e.g., co-location), unbundling of functions (e.g., transport, the switch, and the local loop), resale, access to ducts or poles, and local number portability. I cannot stress too much how important it is to provide unbundled access to the local loop. The loop has been the largest bottleneck. Through cable, digital radio and other construction, that bottleneck will surely erode in the future. But for the present, new entrants, while undertaking such construction, can provide full local service by joining their own transport or co-located switch with the LEC's loop. The economies of scale embodied in the loop will thus be available on reasonable terms to the new competitors. I strongly endorse the approach of these bills and regard the implementation of the bill's requirements as the sine qua non for BOC entry into IX.

The issue before the Subcommittee is whether, along with this "letting in" process, the BOCs should be let out of their LATA restraints. It is important to keep in mind that this is an entry issue -- not one of deregulation. The BOCs will clearly be subject to a great deal of regulation on such matters as unbundling, interconnection charges, co-location, and the prices for basic service elements as to which they still retain market power. I believe that for Congress, this issue of BOC entry into IX, either in or out of region, involves the balancing of benefits and detriments to the public interest or stated differently, to competition.

The benefits are obvious. We are today suppressing the competition of over one half of the telecommunications industry in the important IX sector. It serves no useful purpose to try to evaluate how vital or competitive that sector is today. In this country we do not foreclose entry on the ground that we have enough competition. No one can foretell what some new competitor may add as to efficiencies, innovation, marketing, or pricing. Certainly that is true of the entrants here in question, with their resources and great expertise in telecommunications.

Further, the LATA is an artifical boundary that makes no sense in today's dynamic market. It imposes substantial inefficiencies on the BOC operations in the information field (the computer in every LATA), the video field, or in mobile operations. But even were these alleviated, there would still remain the largest inefficiency -- customers, especially business, often want one-stop shopping for services, and the LATA restraint can markedly interfere with the BOC's ability to function in the new market conditions. Ameritech has pointed out that it has lost 75% of its 800-line services in the last four years because of its inability to offer service beyond the LATA in sharp contrast to its competitors who can offer such complete service. These same patterns could be repeated, for example, in the area of intra-LATA toll when, as they should, new entrants obtain 1-plus dialing with pre-subscription.

The issue thus turns on the detriments to competition. In antitrust terms, this calls for analysis whether the BOCs have shown that there is no longer any "substantial possibility" that they might exercise "monopoly power to impede competition in the market [they] seek to enter [IX]" (Section VIII(C) of the MFJ). The Court of Appeals has defined the words "impede competition" to mean the ability to exercise market power by raising prices or restricting output in the relevant market (here IX) (900 F.2d at 291).

If the BOC IX operation is wholly out of region or market, it does not then involve the in-region monopoly and should clearly meet the above test since in such circumstances the BOC could not exercise the above delineated market power.

The more difficult issue is of course an IX proposal that does involve the in-region monopoly operation. There have been very substantial developments since the 1984 divestiture. Equal access has been completed by the BOCs; Open Network Architecture (ONA) has gone forward from its conceptual stage; accounting rules to prevent cross-subsidy have been promulgated; price caps have been adopted, thus substantially reducing any incentive to cross subsidize; and there have recently been FCC decrees expanding interconnection for special access and switched access (i.e., permitting competitors, interexchange carriers (IXCs) and high volume end users to terminate their own facilities in the LEC/BOC central office). <u>Most important, BOC in-region IX operations should be conditioned upon the implementation of the requirements to promote open entry and competition, so that, for example, the bottleneck local loop would be unbundled and available to all upon the same terms and conditions as used by the BOC.</u> Under the Ameritech plan this is accomplished by imputed rates while under the Rochester scheme it involves a separate subsidiary approach. I would leave it to the FCC and the DOJ to resolve the question of efficiencies versus greater protection for competitors, but certainly the FCC should have the authority to impose the separate subsidiary requirement if it found, either initially or over time, that it would be desirable to do so.

Further, while these regulatory developments are of great importance, legislation to govern the transition to the next century must also take into account clear trends. The CAPs or ALTs, with their focus on business, do not stand alone today. BOCs have embarked upon a course of competing with one another in local telecommunications, as shown by the plans of the Bell Atlantic-TCI merger and joint operations of Time-Warner-U.S. West (and see also Cox-Southwestern Bell). A pattern that has been quite successful in the U.K is beginning to emerge here. Similarly the IXCs are stirring, with the announced plans of MCI to enter local telecommunications and the merger of AT&T and McCaw. While AT&T insists that the merger does not envision competition to the local loop, it is clear that at some point fairly early in the next decade, if not sooner, cellular/PCS operations will be competitive with the loop. These efforts to compete directly with the loop will not be greatly significant next year or in the very near term. But I believe that the competition will be here sooner rather than later because of the striking competitive pressures, and therefore legislation, while soundly bottomed on the above regulatory scheme, should also take into account these trends.

In my view, therefore, the public interest would be served by permitting the IX operations of the BOCs, immediately for out of region activities and in-region upon the above described terms. With the implementation of those conditions, I do not believe that the BOCs could raise prices or restrict output in the IX field, and that is the critical test under antitrust law.

It follows that I strongly favor the above regulatory approach and reject the market share scheme advocated by AT&T and other IXCs. Market share is appropriate when considering deregulation, but not here where the issue is entry. Significantly, AT&T is still subject to tariff and price regulation ten years after divestiture and with its market share now reduced to roughly 60%. The nation can ill afford to leave this issue of BOC entry into IX fester for a similar period.

In this connection, I am puzzled by the approach of S.1822 requiring for in-market IX operations a showing that exchange services are available and taken by a significant number of persons from at least one unaffiliated provider who offers such services "predominantly over facilities not owned or controlled" by the BOC. I believe that if a competitor uses its own transport or switch but makes extensive use of the local loop under regulation insuring reasonable and fair terms, that can be effective competition.

The legislation that I advocate would thus allow BOC entry based upon the implementation of the "letting in" requirements, and would afford great flexibility to the FCC as to the "letting out" process and revised terms and conditions. For example, BOCs might be allowed to resell IX services in-market (perhaps with the additional requirement that several IX carriers be used) even though local number portability, while under way, had not been completed, with facilities operation delayed until the completion of the portability or some other important aspect of the regulatory approach. The legislation would not be unduly detailed nor based on specific time periods (e.g., 18 or 55 months) because experience has shown that in this dynamic field it is much better to set out general guidelines and leave implementation to the expert agency based on changing conditions, with oversight by the Congress.

H.R. 3626 does not follow that approach. It soundly calls for both FCC and DOJ actions in this area, but also is very detailed, contains time delay specifications, and in other ways deprives the FCC of considerable flexibility. Nevertheless, I strongly support H.R. 3626. I do so because I recognize that the IX and other MFJ issues have been by far the most contentious ones in this policy area. H.R. 3626 reflects the difficult compromise that is so often used and so necessary to resolve such vexatious matters, involving the clash of industries and participants. It is most important that the nation resolve the MFJ issues and allow the industries to plan and move ahead based on that resolution. Otherwise, we will not have our domestic house in order, and will suffer in the global competitive era. The two committees, Judiciary and Energy and Commerce, have labored hard and most commendably have reached a result that is assuredly a major and vitally needed step forward.

I hope that the foregoing discussion is helpful to the Subcommittee in its consideration of this important matter. I thank the Subcommittee for this opportunity to appear and set forth these views. There is attached a summary of these views.

SUMMARY

We have soundly opted for open entry and all-out competition as the best strategy to achieve the overarching policy goals. There is also a sound consensus that barriers to entry in local telecommunications should be removed and that such competition should be promoted by a strong regulatory scheme (e.g., effective interconnection, unbundling of functions, resale, local number portability). Unbundling the local loop is of particular importance since that is the local bottleneck.

With the implementation of this regime, letting in competition, the BOCs should be let out of the LATA restraint. BOC provision of IX services will spur efficiencies and serve the public interest. Any detriments would be ameliorated by the strong regulatory regime imposed by the FCC and, more important, called for by H.R. 3636 and S. 1822. The competitive trends also militate for such entry.

In this dynamic field, legislation should set forth general guidelines and leave great flexibility in the expert agency to revise process in light of changing circumstances. H.R. 3626 lacks such flexibility and is both complex and detailed. Nevertheless, it reflects the necessary compromise that is needed in this most contentious area and is a major step forward. I therefore strongly support the bill.

The CHAIRMAN. Mr. John W. Mayo, Professor of Economics, Department of Economics, University of Tennessee.

STATEMENT OF JOHN W. MAYO, PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, UNIVERSITY OF TENNESSEE

Dr. MAYO. Good morning, Mr. Chairman, and members of the committee. Thank you for inviting me to be here this morning to discuss the pending telecommunications legislation. My name is John Mayo.

I am a professor of economics at the University of Tennessee and the 1993 to 1995 William B. Stokely Scholar at the University of Tennessee. I provided the committee with a detailed listing of my credentials.

It is my understanding that I have been asked to come here today, because of my experience in studying telecommunications markets, the industrial organization of the industry, regulation, and general micro/macroeconomic composition of the industry.

Of particular relevance for these hearings, I believe, are four articles that I have co-authored with Professor David Kaserman, who is the Torchmark Professor of Economics at Auburn University.

Two of those articles are attached to my prepared remarks, and the other two I will make available to the committee.

Let me begin by saying that with its consideration of the telecommunications legislation here today, and most specifically the development of local exchange telephone competition, this committee, I think, has an exceptional opportunity to serve the American consumer, to promote economic efficiency, and to ensure global leadership for the United States for some decades to come.

I applaud you Mr. Chairman and members of the committee on your willingness to undertake this vital task, and I urge you to move promptly.

Naturally, I will be happy to make myself available to any or all of you as you consider this pending legislation.

As a close observer of telecommunications legislation to date, I have witnessed a great deal of progress so far. It appears to me that there is a consensus developing regarding the need to foster local exchange telephone competition.

My own analysis of the effects of the spread of competition in telecommunications markets over the past decades provides strong support for your efforts to open local exchange markets to competition. I believe that it will both promote economic efficiency and the development of universal service in this country.

Now, to facilitate the additional work required of the committee, I would like to discuss two points that have resulted from my economic research.

First, because of the regulatory policies adopted over the past decade, and the structural changes that have been implemented now some ten or eleven years ago, the long-distance industry today is unequivocally subject to effective competition.

Second, by following a similar model of tearing down barriers to entry, requiring structural conditions, and constraining the ability to use monopoly power, we can foster the development of local exchange competition, while at the same time preserving long-distance competition.

Let me address each of those two points in a little more detail. First, with respect to long-distance competition, our policy effort in the United States to bring about long-distance competition has, I believe, been a spectacular success.

Indeed, the separation of AT&T from the local exchange bottleneck monopoly facilities a little over a decade ago has resulted in an absolute explosion in the number of carriers and of consumer choice.

Today there are well over 400 long-distance carriers nationwide, and typically, residential customers have between 15 and 30 long-distance carriers from which to choose. The result has been that prices paid for long-distance services have dropped precipitously.

Output and usage of long-distance services have expanded dramatically, and consumers have seen scores of new innovative services in the long-distance marketplace.

I realize that not everyone appearing on this panel today appears to share my assessment of the long-distance industry with respect to its extent of competition. I would, however, suggest that my research indicates that the market is effectively competitive.

Indeed, it is my understanding that, for instance, in 1994, consumers in America received an average of 330 contacts from long-distance telephone companies trying to solicit their business, and some 27 million consumers in America chose—one at a time—to switch long-distance carriers.

That willingness to switch long-distance carriers provides a very, very powerful disciplinary effect on long-distance markets today.

The relevance of that observation, I think, is that it is best not to rush to eliminate any and all conditions on regional Bell-operating companies, when it is precisely those structural conditions of separating monopoly from the competitive segments that have served this country so well for the past decade.

Now, that brings me to another issue, and that is the issue of under what conditions is it appropriate for entry into local exchange markets, and the matter of local exchange competition. Let me turn to that.

The draft legislation by the Chairman, Mr. Pressler, and the ranking member, Mr. Hollings, as I understand it, have a great deal in common when it comes to developing local exchange competition.

My understanding is that both proposals act to reduce barriers to entry into the provision of local exchange telephone service.

I wholeheartedly endorse this as a welcome step toward the day when all telecommunications markets will be subject to effective competition and a choice of providers.

With respect to the conditions for BOC reentry into the interLATA market, my sense is that there are two competing approaches.

The first is what has been labeled as the local exchange competition criterion, which simply requires that BOC reentry into the interLATA market be conditional upon the elimination of significant monopoly power over local exchange telephone service.

The second approach is referred to as the date certain approach. Under this approach, the existing line of business restrictions on BOC expansion into interLATA markets would be removed automatically at a predetermined point in time, that is, the date certain.

The two approaches represent very different policy approaches, with substantively different policy economic ramifications. As a result, it is very important that the correct choice be made.

In the paper that I have attached to my testimony, Professor Kaserman and I examine what we believe are six economically relevant characteristics of the local exchange competition criteria for BOC reentry into the InterLATA market.

In short, what we find is, No. 1, that the local competition criteria prevents the BOCs from pursuing anticompetitive practices in the long-distance industry; No. 2, that it provides an objective market-based standard for BOC reentry into interLATA markets; No. 3, and this is a point that has been misunderstood, I think, is that it does not create barriers to entry.

Indeed, the competition-based criteria is no more a barrier to entry than the Sherman Act is a restraint of trade. The fact that over 450 long-distance firms have entered this market successfully I believe provides very strong prima facia evidence that barriers to entry do not exist in that industry.

Fourth, the local exchange competition criteria provides an economic incentive, as Ms. Bingaman suggested earlier, for the BOCs to relinquish their market power over the local exchange marketplace.

Indeed, to the extent that they are constrained or "locked" in a room, I would suggest that the BOCs have the key to their own release.

Fifth, the local exchange competition criteria minimizes the need for regulatory involvement and micro-management.

Sixth, and finally, it has served successfully to promote effective competition in the long-distance market for the past decade.

My assessment of the date certain approach differs somewhat from the local exchange criteria. You might just take a look at the remarks that I have prepared for a detailed assessment.

The CHAIRMAN. We will place the remainder of your statement in the record, and we will have a chance for some questions.

Dr. MAYO. Thank you very much.

[The prepared statement of Dr. Mayo follows:]

Statement of

Dr. John W. Mayo

Professor of Economics and the
1993-95 William B. Stokely Scholar
University of Tennessee
615-974-6081

Before the
United States Senate
Committee on Commerce, Science and Transportation

March 2, 1995

TESTIMONY OF JOHN W. MAYO
PROFESSOR OF ECONOMICS AND
WILLIAM B. STOKELY SCHOLAR AT THE
UNIVERSITY OF TENNESSEE
BEFORE THE UNITED STATES SENATE
COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION
MARCH 2, 1995

Good morning, Mr. Chairman and Members of the Committee. Thank you for inviting me to appear before you this morning to discuss pending telecommunications legislation.

My name is John W. Mayo. I am Professor of Economics and 1993-1995 William B. Stokely Scholar at the University of Tennessee. I have attached to my statement a complete list of my credentials, including the fact that I have served as Chief Economist (Democratic Staff) of the U.S. Senate's Small Business Committee and have published well over 30 articles and monographs and have recently published a comprehensive textbook on Government and Business: The Economics of Antitrust and Regulation. I should add that in my years in the profession I have worked for a number of government agencies and private firms, including the Federal Trade Commission, the Tennessee Valley Authority, the Department of Energy, Oak Ridge National Energy Laboratory and the Attorneys General in both Tennessee and Arkansas. My appearance before the Committee is, however, on my own behalf.

It is my understanding that I have been asked to appear here today because of my experience studying the telecommunications industry: its industrial organization, regulation, and general micro and macro economic composition. Of particular relevance for this hearing are four recent articles I have co-authored with David L. Kaserman, Torchmark Professor of Economics at Auburn University:

- Monopoly Leveraging Theory: Implications for Post-Divestiture Telecommunications Policy;
- Long-Distance Telecommunications: Expectations and Realizations in the Post-Divestiture Period;
- Is the "Dominant Firm" Dominant" An Empirical Analysis of AT&T's Market Power;
- Bell Companies Reentry into the Long-Distance Market: The "Local Competition" Versus "Date Certain" Policy Alternatives

My remarks today stem from these pieces and I hope that you will each find time to read them. Let me begin by saying that with its consideration of telecommunications legislation--and most specifically, the development of local competition--this Committee has an exceptional opportunity to serve the American consumer, to promote economic efficiency, and to ensure our global leadership for decades to come. I applaud you, Mr. Chairman and the Members of the Committee, on you willingness to undertake this vital task and urge you to move promptly. I will be happy to make myself available to help whenever you need it as you consider the pending telecommunications legislation.

As a close observer of telecommunications legislation to date, I have witnessed the great progress made so far. It appears that a consensus is developing regarding the need to foster local telecommunications competition. My own analyses of the effects of the spread of competition in telecommunications markets over the past decade provides strong support for your efforts to open local exchange markets to competition. Indeed, my research indicates that there is every reason to believe that opening local exchange markets to competition will promote both economic efficiency and the development of universal service in this country. To facilitate the additional work required of the Committee, I would like to discuss two key points that have resulted from my economic research:

- First, because of the regulatory policies adopted over the past decade, and the structural changes implemented ten years ago, the long distance market today is unequivocally subject to effective competition;
- Second, by following a similar model of tearing down the barriers to entry, requiring key structural conditions, and constraining the ability to use monopoly power, we can foster the development of local competition-- while preserving long-distance competition.

Let me address each of these points at greater length.

Long-Distance Competition

The policy effort of the United States government to bring about long-distance competition has been a spectacular success. Since the separation of AT&T from the local exchange bottleneck monopoly facilities a little over a decade ago, we have seen an explosion in the number of carriers and consumer choice. Today, there are well over 400 long distance carriers, typically residential customers have between 15 and 30 long distance carriers from which to choose. The result has been that the prices paid for long distance services have dropped precipitously, output and usage of long distance services have grown dramatically and consumers have seen scores of new innovative long distance services come to the marketplace.

I realize that some of the others appearing here today do not share my assessment of the industry and will argue that the long distance market is an oligopoly with AT&T serving as an anticompetitive price leader. My research indicates just the opposite. Indeed, it my understanding that in 1994 consumers between the ages of 18 and 49 received an average of 330 contacts by long distance firms and 27 million demonstrated their willingness to shop around by to switching their long distance carrier. The point is that both my 12 years of studying this industry and my detailed research attached to my testimony very clearly indicate that the long distance market is highly competitive today.

The relevance of this observation is that it is best not to rush to eliminate any and all entry conditions on the Regional Bell Operating Companies when it is precisely the structural separation of monopoly from competitive segments that has served the country so well for the past decade. That brings us then to issue of what condition is appropriate for entry and the matter of local exchange competition.

Local Telecommunications Competition

The draft legislation of the Chairman, Mr. Pressler, and Ranking Member, Mr. Hollings, have a lot in common when it comes to developing local telecommunications competition. My understanding is that both proposals act to reduce regulatory barriers to entry into the provisions of local exchange telephone service. I wholeheartedly endorse this as a welcome step toward the day when all telecommunications markets will be subject to effective competition and choice of providers.

With respect to the conditions for BOC reentry into the interLATA market, my sense is that there are basically two competing approaches. The first approach, which I label the "Local Competition" criterion simply requires that BOC reentry into the interLATA market be conditional upon the elimination of significant monopoly power over the provision of local exchange services. The second approach I refer to as the "Date Certain" condition. Under this proposal, the existing line-of-business restriction on BOC expansion into the interLATA market would be removed automatically at a pre-determined point in time -- the "date certain."

These two proposals represent very different policy approaches with substantially different economic ramifications. As a result, it is extremely important that the correct choice be made. A failure to get this aspect of the legislation right could very well jeopardize the tremendous strides achieved over the past decade in promoting competition in this industry.

In the paper that I have attached to the copy of my oral remarks, Professor David Kaserman and I have analyzed what we believe are six relevant characteristics of the Local Competition criterion for BOC reentry into the interLATA market. Specifically, with respect to the **Local Competition Criterion**, we find that it:

1. **Prevents the BOCs from pursuing anticompetitive practices in the long-distance market.**

   By permitting entry when consumers have a sufficient choice of local telephone providers to render this market effectively competitive, this policy approach completely removes the potential that the BOCs will use their monopoly power over the local exchange to damage competition in long distance.

2. **Provides an objective, market-based standard for BOC reentry.**

   The condition required for the BOCs to reenter the interLATA market is that the threat of anticompetitive behavior on their part is no longer present.

3. **Creates no regulatory barriers to entry.**

   Indeed the market-based criterion is no more a barrier to entry than the Sherman Act is a restraint of trade. The fact that over 450 firms have successfully entered this market under this policy provides prima facie evidence that it is not a barrier to entry.

4. **Provides an economic incentive for the BOCs to relinquish their monopoly power over the local exchange market.**

   The local competition criterion does not prevent the BOCs from reentering the interLATA market. It merely conditions that reentry upon a showing that anticompetitive consequences will not result.

5. **Minimizes the need for regulatory involvement and micromanagement of the market process.**

6. **Has served successfully to promote effective competition in the long-distance market for a decade.**

With respect to the **Date Certain** approach, on these same characteristics we find that it:

1. **Reinstitutes the threat that the BOCs will pursue anticompetitive practices in the long-distance market.**

   The date certain approach allows the BOCs to reenter the interLATA market before their monopoly power over the local exchange has been dissipated. As a result, this policy jeopardizes the current state of effective competition that exists in the interLATA market and, thereby, places consumers at risk.

2. **Permits BOC reentry regardless of market conditions.**

   The date certain proposal relies upon a calendar instead of market conditions to trigger a fundamental change in the economic policy applied to this industry. Such an approach has no foundation in economic theory or common sense. If it were possible to simply legislate an end to all monopoly power on a given date, then we should have done so long ago. There would be no need for any of our antitrust laws or other regulatory systems. We could simply pass a law that declares no monopoly power will exists after a certain date.

3. **Heightens incentives for BOCs to exploit any non-governmental barriers.**

4. **Provides a strong economic incentive for the BOCs to sustain their extant monopoly power over the local exchange market.**

5. **Creates a whole new (intrusive) role for government to become involved in the market process.**

   The date certain proposal envisions that any sort of inter-firm conflicts between the BOCs and the interexchange carriers that might arise as a result of anticompetitive strategies will be smoothly and quickly resolved by the FCC and state commissions acting as arbitrators. This aspect of the proposal is particularly troubling for two reasons. First, it places government regulators directly in the middle of an otherwise free market process, in the hope that opposing parties will somehow be able to negotiate a mutually agreeable exchange. But where the BOC competes with its customers in the long-distance market, such harmonious transactions are extremely unlikely. Second, the very ability of either party to appeal to regulators to arbitrate disputes creates added incentives to make strategic use of the regulator's authority to gain a market advantage. As a result, the FCC and state commissions can expect to be flooded with complaints, both legitimate and illegitimate, as rivals seek to hamstring their market opponents with this new regulatory apparatus. The result will be increased costs, more regulation, higher prices, and reduced competition.

6. **The approach of regulating a monopolist that competes against its downstream rivals was applied unsuccessfully for several decades during the pre-divestiture era.**

We have approximately fifty years of experience with regulatory authorities (the FCC and public utility commissions) trying to control the anticompetitive strategies of a fully integrated phone company. The fact is that effective competition in long distance did not develop until structural separation was imposed. And since that separation occurred, competition has flourished. To presume that the FCC or any other regulatory authority will be able to control anticompetitive behavior through arbitration is to ignore fifty years of experience that teaches us otherwise.

Let me close by again thanking you for the opportunity to share my views with you.

BELL COMPANIES' REENTRY INTO THE LONG-DISTANCE MARKET: THE "LOCAL COMPETITION" VERSUS "DATE CERTAIN" POLICY ALTERNATIVES

by

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One of the principal issues to be addressed by any comprehensive telecommunications legislation is whether and under what circumstances to allow the Bell Operating Companies (BOCs) to enter (or, more accurately, to reenter) the interLATA long-distance market. The 1984 divestiture agreement removed these companies from this market. Indeed, this separation of local exchange companies from the long-distance market was a central feature of the divestiture order. This provision was based on the conviction that effective competition in long distance could develop and survive only if these companies were prohibited from participating in that market. Since then, long-distance competition has flourished, while customers still do not have a meaningful choice of carriers in local markets.[1] Policy makers, then, are considering whether and under what circumstances these firms should be allowed to reenter the interLATA market.

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[1] For a more detailed examination of the evolution of competition in the interLATA long-distance market, see David L. Kaserman and John W. Mayo, "Long-Distance Telecommunications: Expectations and Realizations in the Post-Divestiture Period," in Incentive Regulation for Public Utilities, Michael A. Crew, editor, Kluwer Academic Publishers, Boston, MA, 1994.

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Below, we examine two approaches which have been advanced regarding this important issue. The first, which we label the "Local Competition" criterion, simply requires that BOC reentry into the interLATA market be conditioned upon the elimination of significant monopoly power over the provision of local exchange services. This proposal seeks to resolve the problem of anticompetitive behavior by relying upon a market environment that is intolerant of such behavior. While monopoly power persists, structural separation enforces the necessary discipline. And when that monopoly power ceases to exist, the structural separation requirement disappears with it. In this way, the local competition criterion relies directly upon market conditions to signal the relevant change in regulatory policy.

The second proposal is labeled the "Date Certain" approach. Under this proposal, the existing line-of-business restriction on BOC expansion into the interLATA market would be removed automatically at a pre-determined point in time -- the "date certain." Because it is unlikely that there would be effective local competition by the date certain, the FCC and/or state regulators would be required to step in to govern (or arbitrate) the prices, terms, and conditions under which local networks would be opened and competing carriers would be provided interconnection to the local network.

Proponents of the date certain approach claim that it reduces investor uncertainty regarding the regulatory environment and is more in line with free-market principles. Both of these alleged advantages, however, are illusory. If BOC reentry is not conditioned upon market realities, investor certainty will be purchased at the expense of consumer uncertainty. And if removal of a structural restraint requires regulatory intervention in routine market transactions, government involvement in the market process goes up, not down. Thus, contrary to proponents' claims, the date certain proposal actually entails increased uncertainty and heightened regulation.

These two proposals represent very different policy approaches with substantially different economic ramifications. As a result, it is extremely important that the correct choice be made. A failure to get this aspect of the legislation right could very well jeopardize the tremendous strides achieved over the past decade in promoting competition in this industry. And the success or failure of this legislation in preserving and promoting competition ultimately will determine whether consumers win or lose.

Here, we contrast these policy alternatives to determine which is more likely to lead to a fully competitive (and, therefore, fully deregulated) telecommunications industry. We will discuss each alternative and then close with a summary comparison.

The Local Competition Criterion

In order to weigh the relative merits of the two policy approaches, we must first understand the fundamental characteristics of each. The local competition criterion exhibits at least six features that are worthy of note. Specifically, this policy:

1. **Prevents the BOCs from pursuing anticompetitive practices in the long-distance market.** By permitting entry when consumers have a sufficient choice of local telephone providers to render this market effectively competitive, this policy approach completely removes the potential that the BOCs will use their monopoly power over the local exchange to damage competition in long distance. If the BOCs were to enter long distance before then, there is a significant threat that local ratepayers will be used to subsidize predatory pricing of long-distance service. Where this occurs, consumers in both markets are harmed. Local rates are driven toward monopoly levels while competitors are driven from the long-distance market. By preventing such anticompetitive behavior, the local competition criterion ensures that the tremendous strides made in promoting competition in the interexchange market will not be jeopardized by premature removal of the structural separation.

2. **Provides an objective, market-based standard for BOC reentry.** The condition required for the BOCs to reenter the interLATA market is that the threat of anticompetitive behavior on their part is no longer present. It is important to recall that it was the continued exercise of such behavior over a period of many years in the presence of regulatory oversight under the integrated Bell System that led to the structural separation in the first place. There is every reason to expect such behavior to materialize once again if the structural conditions that fostered that behavior are recreated. The local competition criterion ensures that these conditions will not be restored.

3. **Creates no regulatory barriers to entry.** Contrary to what some parties have claimed, the local competition criterion for BOC reentry does not

constitute a regulatory barrier to entry to the interLATA market under any of the widely-accepted economic definitions of a barrier to entry. For example, Nobel laureate economist George Stigler defined a barrier to entry to be a cost that must be borne by a new entrant that is not borne by the incumbent. Clearly, the requirement that the BOCs face effective competition in the local exchange market before entering the interLATA market does not impose the sort of cost asymmetry required to satisfy this definition. Elimination of monopoly power is not a cost-increasing activity. Similar arguments can be made for alternative definitions of the concept of barriers to entry. Indeed, the market-based criterion is no more a barrier to entry than the Sherman Act is a restraint of trade. The fact that over 450 firms have successfully entered this market under this policy provides prima facie evidence that it is not a barrier to entry.

4. **Provides an economic incentive for the BOCs to relinquish their monopoly power over the local exchange market.** The local competition criterion does not prevent the BOCs from reentering the interLATA market. It merely conditions that reentry upon a showing that anticompetitive consequences will not result. Under this policy, the BOCs themselves hold the key to their own release. In fact, because the door is opened as soon as local telephone customers face effective competition, this policy provides an economic incentive for the BOCs to actually facilitate the growth of competition in this market. Thus, the local competition criterion protects competition in the long-distance market by preventing anticompetitive practices and simultaneously promotes competition in local exchange services by providing an economic incentive for the BOCs to relinquish their monopoly positions. It is very much a pro-competitive policy.

5. **Minimizes the need for regulatory involvement and micromanagement of the market process.** The structural separation of the (monopolized) local exchange market from the (competitive) interLATA market puts in place a market-oriented (as opposed to regulatory) mechanism to ensure the provision of nondiscriminatory access to the local network and to prevent anticompetitive conduct in the long-distance market. That is, it establishes a market environment that simultaneously resolves both of these problems. Because the local exchange company (BOC) does not participate in the downstream long-distance (interLATA) market, it has no incentive to discriminate among the interexchange carriers in providing access to the local network. Nor does it have the ability to leverage its monopoly power from the

local market to long distance. And all of this is accomplished without any direct regulatory involvement in the arms-length transactions that occur between these two groups of firms. Thus, this approach relies on market processes, not regulators, to resolve these problems.

6. Has served successfully to promote effective competition in the long-distance market for a decade. The local competition criterion has been in place now for a decade, and it has served its intended purpose quite well. Competition in the interLATA market has flourished under this policy, and consumers have reaped tremendous benefits in terms of lower prices, improved service, and expanded choice.[2] This success would not have been achieved in the absence of structural separation.

The Date Certain Approach

To facilitate our comparison of the competing policy approaches to BOC reentry, we examine how the date certain approach stacks up with regard to the same six performance characteristics considered above. Doing so, we find that this policy:

1. Reinstitutes the threat that the BOCs will pursue anticompetitive practices in the long-distance market. The date certain approach allows the BOCs to reenter the interLATA market before their monopoly power over the local exchange has been dissipated. As a result, this policy jeopardizes the current state of effective competition that exists in the interLATA market and, thereby, places consumers at risk.

2. Permits BOC reentry regardless of market conditions. The date-certain proposal relies upon a calendar instead of market conditions to trigger a fundamental change in the economic policy applied to this industry. Such an approach has no foundation in economic theory or common sense. If it were possible to simply legislate an end to all monopoly power on a given date, then we should have done so long ago. There would be no need for any of our antitrust laws or other regulatory systems. We could simply pass a law that declares no monopoly power will exist after a certain date.

[2] See Kaserman and Mayo, Supra, Note 1.

3. **Heightens incentives for BOCs to exploit any non-governmental barriers.** By reinstituting the threat of anticompetitive behavior (#1, above) and recreating the market environment that has proven to be conducive to such behavior (#2, above), this policy enhances the incentive for the BOCs to entrench their monopoly power over the local exchange market by any means possible. The effect of this policy is to encourage the BOCs to seek out and exploit whatever barriers they have at their disposal. Thus, by permitting exploitation of non-regulatory barriers to entry, the date certain approach significantly contributes to the prospects for anticompetitive behavior.

4. **Provides a strong economic incentive for the BOCs to sustain their extant monopoly power over the local exchange market.** While the local competition criterion creates an economic incentive for the BOCs to relinquish their monopoly control of the local exchange market, the date certain proposal has precisely the opposite effect. Once the BOCs are told that they will be allowed to reenter the interLATA market on a given date, regardless of the market conditions that exist on that date, they will realize a new strong incentive to protect and even expand the monopoly power they currently possess. Such power will enable them to leverage their monopoly to the interLATA market and, thereby, increase profits, while continuing to exert monopoly control over local markets. Thus, this policy puts in place an incentive mechanism that exacerbates, rather than reduces, the anticompetitive tendencies of these firms.

5. **Creates a whole new (intrusive) role for government to become involved in the market process.** The date certain proposal envisions that any sort of inter-firm conflicts between the BOCs and the interexchange carriers that might arise as a result of anticompetitive strategies will be smoothly and quickly resolved by the FCC and state commissions acting as arbitrators. This aspect of the proposal is particularly troubling for two reasons. First, it places government regulators directly in the middle of an otherwise free market process, in the hope that opposing parties will somehow be able to negotiate a mutually agreeable exchange. But where the BOC competes with its customers in the long-distance market, such harmonious transactions are extremely unlikely. Second, the very ability of either party to appeal to regulators to arbitrate disputes creates added incentives to make strategic use of the regulator's authority to gain a market advantage. As a result, the FCC and state commissions can expect to be flooded with complaints, both legitimate and illegitimate, as rivals seek to hamstring their market opponents with this

new regulatory apparatus. The result will be increased costs, more regulation, higher prices, and reduced competition.

6. __Was applied unsuccessfully for several decades during the pre-divestiture era.__ We have approximately fifty years of experience with regulatory authorities (the FCC and public utility commissions) trying to control the anticompetitive strategies of a fully integrated phone company. From the Communications Act of 1934 to the 1984 divestiture, repeated attempts by competitors to gain a significant foothold in this industry were delayed or thwarted by the incumbent supplier, often with aid of the regulatory agency. Effective competition in long distance did not develop until structural separation was imposed. And since that separation occurred, competition has flourished. To presume that the FCC or any other regulatory authority will be able to control anticompetitive behavior through arbitration is to ignore fifty years of experience that teaches us otherwise.

Summary Comparison

The attached sheet summarizes our comparative analysis of the two competing policy alternatives for deciding when and under what circumstances the BOCs should be allowed to reenter the interLATA market. The first policy, the local competition criterion, resolves the problem of anticompetitive behavior, bases regulatory policy on observable market conditions, raises no regulatory barriers to entry, creates an incentive for the BOCs to relinquish their monopoly control of the local exchange network, and minimizes the degree of government involvement in the market process. Moreover, it has worked very well for over ten years to promote the growth of effective competition in the long-distance market. The date certain approach, on the other hand, reinstitutes the threat of anticompetitive behavior, creates a significant change in regulatory policy with no corresponding change in market conditions, provides a strong economic incentive for the BOCs to sustain their extant monopoly power, and creates a new regulatory apparatus that will be directly and actively involved in what would otherwise be a free market exchange. It is distinctly more government, not less. And the history of this industry strongly suggests that serious anticompetitive consequences will result. Ultimately, consumers will suffer the effects of this reversal in the movement toward competition in this industry.

Finally, there is a very important asymmetry in the risks placed on consumers by these two policy approaches. Specifically, advocates of the date certain approach defend their position by arguing that local exchange competition will become a reality by the date specified for BOC reentry to the long-distance market. If this is, indeed, the case, however, the local competition criterion will also be met by that date, and BOC reentry will be allowed under this policy as well. Thus, if competition emerges at the rate anticipated by proponents of the date certain approach, the two policies yield identical results. If, however, competition fails to develop at this rate, then the date certain approach will allow BOC reentry while significant monopoly power over local exchange services remains in force, thereby exposing both consumers and competition to the risks of anticompetitive behavior. As a consequence, there is nothing to be gained and much to be lost by adopting the date certain policy option.

SUMMARY COMPARISON*

Local Competition Criterion	vs	Date Certain Approach
Eliminates the threat of local exchange monopoly being used to harm competition in long distance.		Reinstitutes the threat that local exchange monopoly will be used to harm competition in long distance.
Provides an objective, market-based standard for BOC reentry.		Permits BOC reentry at a pre-determined date regardless of market conditions.
Creates no regulatory barriers to entry.		Provides heightened incentive for BOCs to exploit any non-regulatory barriers to entry.
Provides an economic incentive for the BOCs to relinquish their monopoly power over the local exchange market.		Provides a strong economic incentive for the BOCs to sustain and expand their extant monopoly power over the local exchange market.
Minimizes the need for regulatory involvement and micromanagement of the market process.		Creates a whole new (intrusive) role for government to become involved in the market process.
Has served successfully to promote effective competition in the long-distance market for a decade.		Was applied unsuccessfully for several decades during the pre-divestiture era.

* This summary comparison is compiled from David L. Kaserman and John W. Mayo, "Bell Companies' Reentry into the Long-Distance Market: The 'Local Competition' versus 'Date Certain' Policy Alternatives."

ABOUT THE AUTHORS

DAVID L. KASERMAN is the Torchmark Professor of Economics at Auburn University. After receiving his Ph.D. at the University of Florida, Dr. Kaserman worked for the Department of Housing and Urban Development, the Federal Trade Commission, and Oak Ridge National Energy Laboratories. Subsequently, he has been on the faculties at the University of Tennessee and Auburn University. Professor Kaserman's research interests span the range of applied microeconomics with particular emphasis in industrial organization, antitrust, and regulation. His research papers have appeared in a number of leading economic journals, including the *American Economic Review*, the *Review of Economics and Statistics*, *Economic Inquiry*, *The Journal of Industrial Economics*, the *International Journal of Industrial Organization*, the *Journal of Regulatory Economics*, the *Review of Industrial Organization*, the *Southern Economic Journal*, the *Yale Journal on Regulation*, and the *Journal of Business*. Professor Kaserman has previously co-authored *The Law and Economics of Vertical Integration and Control* (Academic Press, 1983) and *Antitrust Economics* (Irwin, 1985). Most recently, Dr. Kaserman and Dr. John Mayo have co-authored a comprehensive text on *Government and Business: The Economics of Antitrust and Regulation* (Dryden Press, 1995).

Dr. Kaserman has also served as a consultant in antitrust proceedings, including cases dealing with mergers, price discrimination, price fixing, and monopolization. He has also been an advisor on interstate telecommunications policy and has participated in a number of state-level regulatory proceedings.

JOHN W. MAYO is a Professor of Economics and 1993-1995 William B. Stokely Scholar at the University of Tennessee. Since receiving his Ph.D. at Washington University in St. Louis, Professor Mayo has also served as the Chief Economist, U.S. Senate Small Business Committee (Democratic Staff), and as a visiting faculty member at Virginia Polytechnical University (VPI). Professor Mayo's research interests lie in the areas of industrial organization, regulation and antitrust, and, more generally, applied microeconomics. His research has appeared in numerous economic journals, including, the *RAND Journal of Economics*, the *Yale Journal on Regulation*, the *Review of Economics and Statistics*, the *Journal of Industrial Economics*, the *Journal of Business*, the *Southern Economic Journal* and the *Journal of Regulatory Economics*. Most recently, Dr. Mayo and Dr. David Kaserman have co-authored a comprehensive text on *Government and Business: The Economics of Antitrust and Regulation* (Dryden Press, 1995).

Professor Mayo has also served as an advisor and consultant to both public and private agencies including the Federal Trade Commission, the Tennessee Valley Authority, the Department of Energy, and Oak Ridge National Energy Laboratory. In that capacity, Dr. Mayo has participated in a number of regulatory and antitrust proceedings and has testified before the U.S. Senate, state legislative and regulatory bodies, and courts on a panoply of matters, including monopolization, price fixing, mergers, and regulatory pricing policy in the telecommunications and the electric utility industries.

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LONG-DISTANCE TELECOMMUNICATIONS: EXPECTATIONS AND REALIZATIONS IN THE POST-DIVESTITURE PERIOD

David L. Kaserman
John W. Mayo

Incentive Regulation for Public Utilities, Michael Crew, Editor, (New York, Kluwer Academic Press), forthcoming. 1994

1. Introduction

While the entire history of the telecommunications industry provides a fascinating case study for any student of government-business relationships, the ten years since the divestiture of AT&T undoubtedly offer the richest decade of social experimentation in the 120-year history of the industry. What began as a decade of theoretical argumentation about the merits of alternative public policies has slowly given way to empirical research that promises to resolve (or, at least, inform) various debates that could not be settled on the basis of theory alone.

Specifically, at divestiture, economists and others expressed conflicting expectations concerning the long-run viability of competitive performance in the long-distance telecommunications market. While some were quite optimistic that separation of long-distance from local service would fulfill the promise of effective competition raised by emerging technological and market forces, others were openly skeptical of the ultimate vigor of competitive rivalry in this market. In addition, some authors expressed concern that, regardless of the ultimate intensity of competition in the long-distance market, impending structural changes might adversely affect other politically important aspects of the industry—particularly local residential rates and universal service.

Ten years later, we are now in a position to appraise the validity of these conflicting views. A considerable amount of evidence now exists that can be used to empirically test the various predictions that were made at divestiture. Such evidence consists of: (1) simple, straightforward observations of how important industry characteristics have evolved in the post-divestiture period; and (2) more rigorous econometric studies of how industry performance has been affected by the various regulatory regimes introduced over the past decade.

Given the experience of this rich ten-year period and the research it has spawned, the purpose of this paper is to trace the evolution of the long-distance industry in light of the conflicting expectations that were voiced at divestiture. Such a retrospective is useful for several reasons. First, while a number of excellent works document the evolution of the industry prior to divestiture,[1] similar treatments of the post-divestiture period have not yet emerged. Second, to our knowledge, no survey of the burgeoning and most recent economics literature on long-distance telecommunications exists. It is hoped that this paper can serve as a springboard for further study of the industry. Third, the considerable degree of cross-sectional (and, increasingly, time series) variation in regulatory policies toward the long-distance industry has provided economists considerable information that can be used to improve our understanding of the causes and consequences of alternative regulatory regimes. Finally, by better understanding the evolution of the industry, it is possible to gain a clearer picture of emerging issues and potential topics for further research.

The paper is organized as follows. Section 2 describes the three principal attitudes that emerged regarding the prospects for market performance following the 1984 breakup. Section 3 then surveys the empirical evidence pertaining to the structure, conduct, and performance of the industry that is pertinent to the various predictions, forecasts, and guesses that were proffered. Next, Section 4 surveys the growing body of econometric studies on the effects of alternative regulatory policies. Section 5 draws important policy implications from the evidence presented and points out some promising areas for future research.

2. Expectations

Telecommunications industry jargon—regulatory, technological, and economic—has always made it difficult to identify and analyze the important issues facing this industry. For the uninitiated, a prerequisite to doing work in this area has been completion of what is, in effect, a short course in a foreign language. Moreover, this particular language is dominated by acronyms. SPIF and SLU, TS and NTS, LATAs, POPs, POTS, BOCs, LECs, IXCs, etc. all mean something to the inhabitants of this industry. The key, of course, is to translate these acronyms and the underlying terminology they represent into meaningful economic concepts.

Sifting through this jargon, we find that, prior to divestiture, the telecommunications industry was characterized by the following basic conditions. First, the Bell System was *the* nation's telephone company.[2] This company operated at virtually every stage of the vertical chain involved in the provision of telecommunications services, ranging from R&D, to manufacturing, to provision of customer equipment, to inside wiring, to local service, and finally to long-distance service. In the provision of long-distance services, the Bell System's supplier, AT&T Long Lines,

1 See, e.g., Brock (1981), Faulhaber (1987), and Temin (1987).

2 This is not to say that other telecommunications firms did not exist. Hundreds of independent local exchange companies offered service, as did several budding long-distance providers.

provided roughly 90 percent of all long-distance minutes of use sold in the United States. While MCI had entered the long-distance market in 1968, the "competitive fringe" to AT&T remained both small and impeded in their expansion plans by the Bell System's control over local exchange facilities. These facilities were (and are) needed by competitors to reach customers and, thus, to compete effectively in the long-distance market. Competition in the provision of long-distance services was truly at an embryonic stage in 1984, on the cusp of AT&T's divestiture.

Second, the industry was pervasively regulated at both the state and federal levels. The Federal Communications Commission (FCC) intensively regulated a host of economic decisions normally left to private firms, including pricing, quality of services, and investment. Similarly, state public utility commissions (PUCs) thoroughly regulated intrastate telecommunications operations. The policies and decisions of these myriad regulatory agencies were not generally well-coordinated. As a result, the Bell System was constantly being pulled in different directions in the various jurisdictions within which it operated. The result, of course, was hardly a paragon of regulatory efficiency.

A third key feature of the pre-divestiture telecommunications industry was the pervasive presence of subsidy flows across various dimensions of telecommunications services. Under the complex set of rules known as Separations and Settlements, the pricing of services was driven by fully distributed cost allocations that bore no relationship to economically efficient pricing. Under this system, long-distance service subsidized local service, light users of local service subsidized heavy users of this same service, business customers subsidized residential customers, and urban consumers subsidized rural.[3] The resulting subsidy flows were so complex that, a priori, it was not always possible to say whether a given customer was a net payer or recipient of a telephone subsidy.

In this environment, the Department of Justice filed an antitrust suit against AT&T in 1974. This suit ended in 1982 with a consent decree known as the Modification of Final Judgment (MFJ), which was implemented in January, 1984. The goal of this agreement was to provide the foundation for a "truly competitive telecommunications industry."[4] Toward this end, the MFJ contained three major provisions.

First and foremost, it segmented the industry along product lines, requiring the Bell System to reorganize by divesting the Bell Operating Companies (BOCs) from AT&T. This divestiture was the largest corporate restructuring in American history. Its primary purpose was to divide the industry into potentially competitive and non-competitive segments; although as it turns out, the latter segment contains some portions within which competition appears to be feasible as well.

Second, to accomplish this segmentation, it was also necessary to divide the

3 For a more detailed discussion of the evolution of the subsidy mechanism, see Kaserman, Mayo, and Flynn (1990). Also, see Kahn (1984) and Kaserman and Mayo (1994).

4 AT&T, 552 F. Supp. (1982) at 188.

market geographically. Thus, at the heart of the reorganization plan was the Local Access and Transport Area (LATA) concept. Specifically, the geographic territory served by the BOCs was divided into LATAs, which generally centered "upon a city or other identifiable community of interest." The LATAs' boundaries defined the areas within which the BOCs could provide point-to-point telecommunications service (both local and intraLATA toll). For interLATA calling, long-distance telecommunications companies such as MCI, Sprint and AT&T were to compete with one another. Because intraLATA calling is almost exclusively intrastate, however, the divestiture court deferred to the states on the issue of whether and under what terms to permit competition for toll services within these geographic areas.

Finally, the third major provision contained in the MFJ further restricted the scope of BOC activities across the product dimension. Under the agreement, the BOCs are permitted to engage in any activity they choose except: (1) interLATA long-distance services; (2) information services;[5] and (3) the manufacture of telecommunications products or customer premises equipment. All three of these provisions are clearly designed to prevent the sort of monopoly leveraging strategies which were thought to have plagued the industry prior to divestiture.[6]

Expectations—both dire and enthusiastic—surfaced immediately upon announcement of the divestiture agreement. While many economists and policymakers openly embraced the promise of divestiture and long-distance competition, others (including most consumers) simply expressed confusion or skepticism when asked about the likely consequences of the agreement. Some commentators were so caught up in the excitement of the impending change that they inadvertently violated the first law of a successful career in forecasting— they predicted something to come true within their own lifetimes. These prognosticators can be conveniently categorized into three major groups, which we label the Natural Monopoly Advocates, the Universal Service Advocates, and the Competition Advocates. We briefly describe the predictions made by each of these groups at divestiture.

The Natural Monopoly Advocates. This first group of analysts was firmly convinced that the telecommunications industry was a natural monopoly with significant economies of scale within and substantial economies of scope across local and long-distance services. Consequently, the efficient industry structure was thought to be the fully integrated Bell System or its equivalent under another name. As a result, the pro-competitive open-entry policies of the FCC, carried out over

5 This feature of the MFJ was the subject of further court action. Consequently, the BOCs are now permitted to provide information services.

6 The MFJ provides that these line-of-business restrictions shall be removed upon a showing by a BOC that "there is no substantial possibility that it could use its monopoly power to impede competition in the market that it seeks to enter."

the preceding two decades and culminating in the divestiture order, were believed to be a major public policy mistake that would ultimately lead to disaster.

Two alternative scenarios were developed to describe the impending doom. Under one, a liberated AT&T would return to its old tactics, employing predatory pricing to drive its emerging competitors from the market, thereby re-monopolizing the long-distance industry. Under the other scenario, AT&T would tolerate its fledgling rivals, protecting them under a dominant firm price umbrella. The result would be a tight-knit oligopoly with tacitly collusive price leadership used to sustain rates well above competitive levels.

Obviously, under either of these scenarios, barriers to entry would have to exist to prevent the sort of self-correcting market forces envisioned by contestability advocates. According to the Natural Monopoly Advocates, such barriers (of both the Bain and Stigler varieties) emanated from several sources. First, the capital costs of constructing a nationwide telecommunications network were thought to be prohibitive. Second, legal difficulties of obtaining necessary rights of way would raise entrants' costs above those of the incumbent and delay if not prevent such construction. Third, economies of scale inherent both in network operation and advertising would also yield a significant cost advantage to the incumbent firm. And fourth, brand loyalty along with AT&T's embedded customer base would create product differentiation barriers that would prevent new entrants from successfully capturing customers and expanding output. Together, these entry barriers were believed to be sufficient to sustain the monopoly or oligopoly pricing strategies described above.

The Universal Service Advocates. A second group of analysts that emerged at divestiture were essentially agnostic with regard to whether the long-distance segment of the telecommunications industry was an integral part of a natural monopoly. Accordingly, they were also agnostic about the long-run prospects for effective competition in the interLATA market. Nonetheless, these parties expressed serious reservations about the ultimate wisdom of the divestiture decision and the policy path it represented. These reservations focused not on the long-distance market itself but, rather, on the apprehension that, regardless of the intensity of competition in that market, substantial harm might be caused in other areas of significance to pubic policy.

Specifically, two closely related adverse consequences were predicted. First, to the extent that competition would materialize in the long-distance market, toll prices would be driven to marginal and (with entry) average costs. It was argued that the result of such competitive pricing would be elimination of the long-standing cross-subsidization of local residential rates. This loss of the capacity to cross-subsidize, in turn, would force local rates to increase dramatically, causing intolerable inequities and unacceptable political consequences. Second, as a result of these local rate increases, subscribership levels would fall, thereby jeopardizing the Holy Grail of telecommunications policy, viz., universal service. Thus, regardless of the ultimate vigor or merits of long-distance competition, the road ahead was perceived to be fraught with danger.

The Competition Advocates. The third group was the pro-competitive/deregulation cheerleaders. This group believed that technological change in conjunction with demand growth had eliminated natural monopoly conditions in the long-distance market. Moreover, they also expressed the opinion that this same technological change had removed any significant barriers to entry into the provision of long-distance services. As a result, effective competition would prevail in this market; and, if regulatory restrictions on pricing and the introduction of new services could be removed, consumers would begin to reap the myriad benefits of such competition.

In addition, the Competition Advocates also argued that local rates and universal service would not be jeopardized by the recommended policy for two reasons. First, the cross-subsidization of local rates by toll, if desired, could be maintained through the carrier access charge system that was put in place at divestiture. And second, such cross-subsidization was not necessary in order to promote and sustain universal service anyway. In fact, it was even argued blasphemously that the traditional system of cross-subsidies might actually harm this policy objective. Consequently, this group openly applauded the divestiture agreement and urged policymakers to move rapidly to deregulation.

3. Realizations

A decade after the divestiture, one might think that the economic consequences of this policy action would now be abundantly clear to all observers. In fact, however, they are not. Nonetheless, the passage of time has generated considerable data that are now beginning to permit empirical investigations of issues that were, in the early days following divestiture, debated exclusively on theoretical grounds. Accordingly, we turn now to a series of industry characteristics to examine how these have unfolded. For convenience, we shall organize our discussion around the traditional structure-conduct-performance taxonomy of industrial organization economics.

3.1. Structure

Two fundamental characteristics of industry structure are vital to gauging the evolution of competition in the telecommunications (or any) industry. First, the nature of entry conditions (that is, the height of barriers to entry and expansion) is critical. Second, it is important to understand the configuration of incumbent firms (i.e., market shares) in the market. We deal with each of these in turn.

Prior to the late 1970s, a principal and formidable source of barriers to entry into the interexchange industry existed in the form of regulatory impediments to entry. Specifically, while entry into the long-distance market began with MCI in 1969, it was not until 1977 that the FCC fully embraced the notion of competition for interstate calling.[7] Even with the endorsement of competition by the FCC, state regulatory bodies remained reticent to embrace competition for long-distance service. Consequently, AT&T's competitors were largely limited to competing only for interstate calls. Subsequent to the divestiture, however, both the FCC and the PUCs have virtually eliminated regulatory barriers to entry for prospective long-distance providers, at least in the interLATA market. Entry requirements for interstate and intrastate/interLATA toll providers are now essentially similar to standard business licensing, with virtually every application for entry being approved by the appropriate regulatory body.

As regulatory barriers to entry have fallen, so have economic barriers. A formidable barrier prior to divestiture existed because potential entrants faced the prospect of having access to the local exchange network denied or provided on discriminatory terms. A key characteristic of the MFJ, however, was to remove any incentive for the local exchange monopolist to favor any one long-distance provider over another (because the BOCs no longer participated in the interexchange market). Moreover, the MFJ explicitly required the BOCs to provide exchange access to all interexchange carriers that was equal "in type, quality, and price."[8] As a consequence of this provision of the MFJ, the BOCs were required to upgrade the access arrangements provided to interexchange carriers so that all long-distance carriers could provide service on a 1+ basis. This "equal access" requirement had the effect of reducing economic barriers to entry by making a vital input available to all long-distance providers on equal rates, terms, and conditions.

From a base of virtually no end offices in the United States that offered equal access at divestiture, over 90 percent of the nation's local telephone lines are equipped with equal access today. The result, in terms of the way that interexchange carriers compete for business, has been dramatic. Indeed, the share of the nation's interexchange traffic that is "nonpremium" (not equal access) is now less than 2 percent. An important consequence of the diffusion of equal access has been the confluence of the basic capabilities of long- distance carriers to offer services to long-distance consumers that are very comparable. The result has been that, despite considerable marketing efforts on the part of long-distance companies, the degree of product differentiation, often thought to be an economic barrier to entry, has fallen precipitously.

Another potential barrier to entry, the degree of capital intensity in production, was also sharply reduced as a result of the MFJ. Specifically, with divestiture, the vast majority of AT&T's capital assets were transferred to the Bell operating companies. As a result, the long-distance industry is no longer capital intense relative to other (unregulated) industries. Today, the largest single expense to

7 See Brock (1981) and Faulhaber (1987) for thorough accounts of the evolution of the pre-divestiture industry.

8 See Section II of the Modification of Final Judgment, United States of America v. Western Electric Company, Incorporated, and American Telephone and Telegraph Company, Civil Action 82-0192, August 24, 1982.

long-distance companies is the purchase of carrier access services, which are obtained on a per-minute-of-use basis from local exchange companies. Thus, in contrast to a typical public utility that is very capital intense, the provision of long-distance services is now characterized by relatively high variable costs.

Finally, it is important to note that while the capital intensity of the long-distance industry has fallen, it is still very expensive to construct a nationwide long-distance transmission network. Moreover, in the case of the construction of a fiber optic network, the assets deployed involve considerable sunk costs. Accordingly, it is tempting to conclude that such costs continue to constitute significant barriers to entry into the long-distance marketplace.

Such a conclusion is erroneous, however, for two fundamental reasons. First, the argument establishes the wrong standard by which to judge the height of barriers to entry. That is, entry barriers should be measured by examining the economic characteristics of costs for the *most likely mode of entry*. Thus, the fact that the construction and deployment of a nationwide fiber-optic long-distance network is costly and involves considerable sunk costs is irrelevant, because that is not the least-cost (preferred) mode of entry. That is, profit-maximizing firms will typically seek to enter markets via a least-cost strategy that minimizes their exposure to losses if the new venture fails. In the case of the long-distance industry, this least cost path of entry does not involve de novo construction of a nationwide fiber optic transmission network but, rather, entry as a reseller. Specifically, a new entrant will typically purchase or lease transmission capacity on an existing network rather than construct its own facilities. The firm can then combine that transmission capacity with its own marketing, functions, and features, to capture long-distance customers. At some point, as the customer base expands, it may (or may not) become economical for these new entrants to begin to construct their own transmission networks, depending upon the price and availability of leased facilities. By waiting to construct their own networks these new entrants are able to (1) delay the expenditure on assets that involve considerable sunk costs while still competing for customers, and (2) minimize the risk that those sunk costs will not be recouped by the ex ante development of a base of customers.

The second error contained in arguments involving network costs as a barrier to entry (and virtually all other arguments that continue to claim the existence of high entry barriers into the long-distance market on the basis of a theoretical examination of industry cost conditions) is that they ignore actual marketplace evidence on entry in the post-divestiture period. An examination of the actual patterns of observed entry and expansion provides overwhelming evidence that both regulatory and economic barriers to entry and expansion are low. For example, in figure 1 we see the time path of the number of interexchange competitors. By 1994, we see that roughly 420 long-distance competitors were vying for the patronage of consumers in the United States. Obviously, not all competitors compete in every geographic location. Nevertheless, it is important to note that, once a long-distance carriers has established a point-of-presence (or POP) in a LATA, it can very quickly begin to provide interexchange service to any specific area within that LATA simply by purchasing carrier access from the local exchange carrier to its POP. As a result, even those areas without a significant number of competitors are assured the protection of competitive pricing by virtue of the ease of entry. Beyond the flood of entrants into the interexchange industry, new carriers have demonstrated that they are quite capable of successfully competing for interexchange customers. In figure 2, we see that the growth rates of presubscribed customers for MCI, Sprint, and "Other Carriers" have been very robust. Given the numerous regulatory and economic developments of the past decade and the magnitude of observed entry, one can only conclude that barriers to entry into the long-distance industry are extremely low.[9]

A second feature of industry structure that is often thought to influence conduct and performance is market concentration, which is driven by the number of industry participants and their market shares. As seen above in figure 1, there are a large

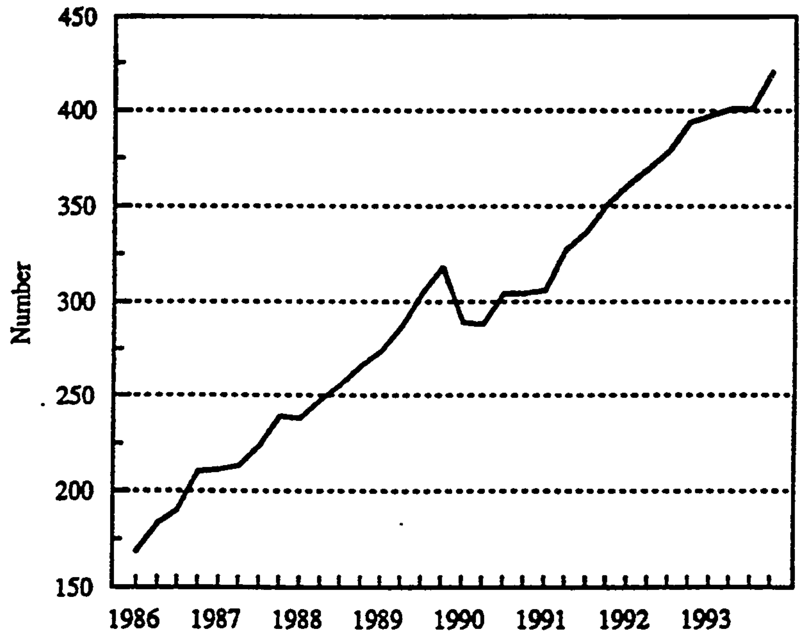

Figure 1. Long-Distance Firms Purchasing Equal Access

Source: *Trends in Telephone Service*, Industry Analysis Division, Federal Communications Commission, May 1994.

9 Observed entry and expansion not only demonstrate an absence of significant barriers to entry but also provide prima facie evidence of an absence of predatory pricing.

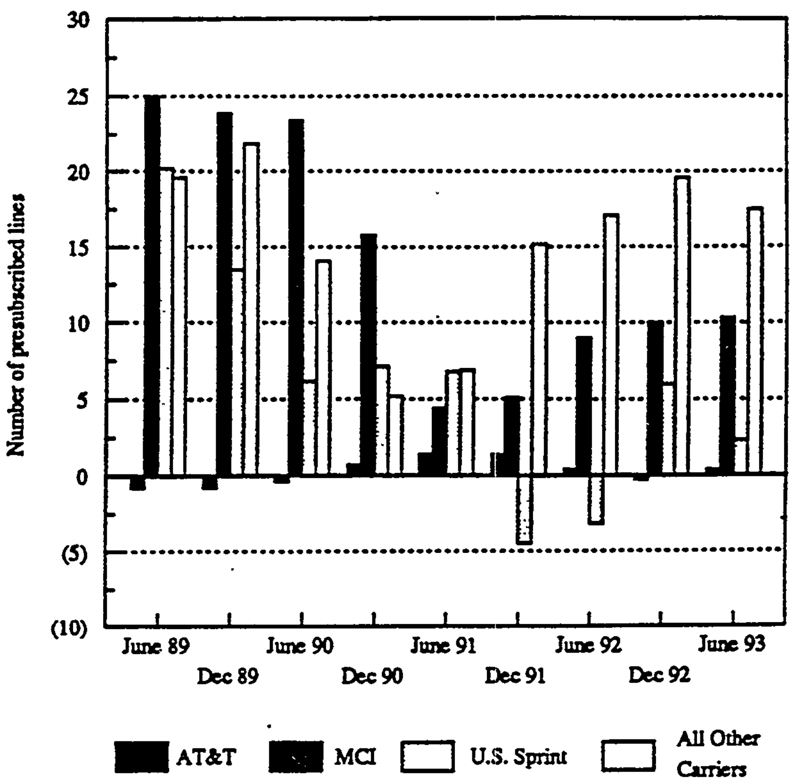

Figure 2. Growth Rate of Presubscribed Customers

Source: Trends in Telephone Service, Industry Analysis Division, Federal Communications Commission, May 1994.

number of competitors in the interexchange marketplace today. Many of these firms, however, do not provide ubiquitous originating service throughout the United States. A survey of the number of long-distance competitors in specific cities, however, is revealing. Table 1 shows the results of a survey of long-distance carriers that were available to residential customers on a 1+ (equal access) basis in September 1993. There, we see that major metropolitan areas typically have between 20 and 30 long-distance firms from which customers may choose. Moreover, table 1 also reveals that even in smaller communities and rural areas, there are typically a number of long-distance competitors from which to select.

Another key characteristic of industry structure is the distribution of market shares—particularly the market share of the largest firm, in this case AT&T. The measurement of market share for the interexchange industry, however, must be

Table 1. Number of Long Distance Carriers in Various Cities and Towns

Major Metropolitan Areas	Population[1,2]	Long Distance Firms[3]
Baltimore	2,382,000	30
Denver	1,623,000	23
New York City	8,547,000	32
San Francisco	1,604,000	25
Milwaukee	1,432,000	22[4]
Salt Lake City	1,072,000	26
Smaller Communities		
Helena, Montana	24,569	14
Moose, Wyoming	100	18
Carthage, Tennessee	2,386	37
Hope, Arkansas	9,643	11

[1]U.S. Bureau of the Census. *Statistical Abstract of the United States: 1991* (111th edition), Washington, D.C., 1991.

[2]U.S. Bureau of the Census. *1990 Census of the Population: General Population Characteristics*,Washington D.C., May 1992.

[3]These are the firms given by the local exchange company business office as offering long distance telephone service on a "1+" basis.

[4]The local exchange company representative indicated that there were 11 "primary" long distance companies chosen by residential subscribers, but that all 22 carriers were available for subscription on a "1+" basis for Milwaukee customers.

approached with caution for at least two reasons. First, the level and time path of market share movements for AT&T reflect not only the normal marketplace rivalries but also the fact that AT&T has been and continues to be highly regulated at both the federal and state levels. Such regulation is likely to distort observed market shares, potentially generating an inference of market power where none exists.[10] Second, while minutes-of-use and revenue-based market share data are more readily available, a more meaningful market share measure is given by the transmission capacities of interexchange firms. Such capacities determine the ability of these firms to discipline any potential attempts by the largest firm to raise prices above competitive levels. Data compiled by the FCC indicate that AT&T's competitors' fiber optic capacity-based market share is in excess of 50 percent.

Equally revealing is the rate of decline in AT&T's market share over time. Regardless of the unit of measurement used, this share has fallen markedly since the divestiture. Figure 3 shows the time path of AT&T's minutes-of-use based market share. This share has fallen from roughly 85 percent in the third quarter of 1984 to approximately 60 percent. This significant decline in the incumbent firm's market share suggests an absence of significant expansion barriers in this industry.

10 See Landes and Posner (1981).

Not only have numerous new firms entered the market, but these firms have succeeded in capturing a substantial amount of business away from the incumbent supplier. This evidence, in turn, demonstrates a willingness of consumers to switch suppliers in response to what have, in fact, been relatively small price differentials. Therefore, brand loyalty also does not appear to present a significant hinderance to competition in this industry.

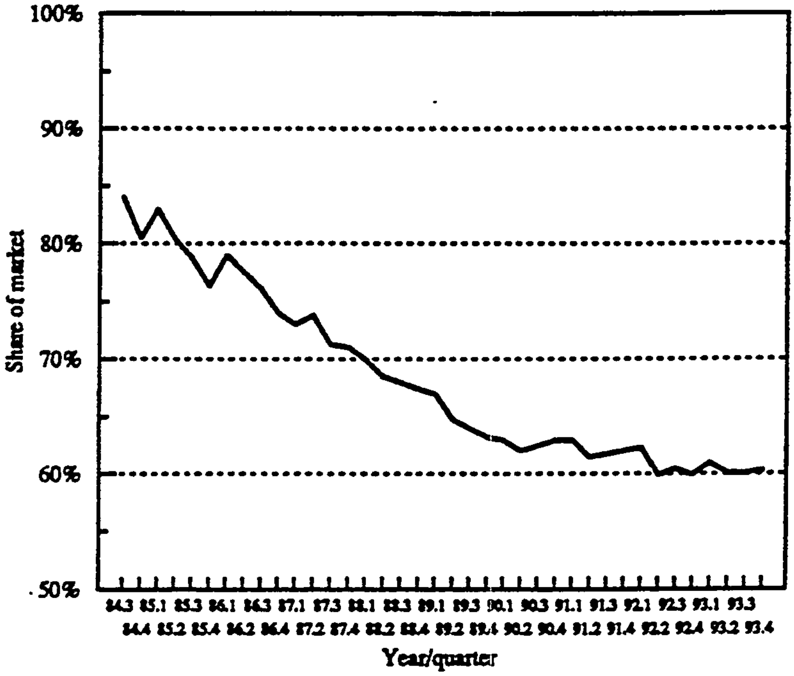

Figure 3. AT&T's Minutes-of-Use-Based Market Share

Source: Trends in Telephone Service, Industry Analysis Division, Federal Communications Commission, May 1994.

Thus, a traditional look at the evolution of market structure in the post-divestiture period reveals an industry with low barriers to entry and expansion and many firms. While the largest firm continues to hold a fairly substantial market share (varying somewhat by which unit of measurement is employed), the ease with which new firms have entered and the success they have had in capturing market share from the incumbent producer strongly suggests that effective competition is both viable and present in this industry.

3.2. Conduct

As we saw in Section 2, industry observers expressed markedly different expectations about how industry conduct would evolve in the post-divestiture period. In light of these divergent expectations, four dimensions of conduct provide noteworthy insights into the evolution of the industry over the past decade: (1) investment; (2) advertising; (3) pricing; and (4) new service offerings. We consider each of these aspects of conduct in turn.

Recall that some observers argued that, despite the divestiture, AT&T's inherent position of strength would result in a dearth of challengers in the long-distance market. That is, given the considerable size advantage of AT&T over its rivals, it was argued that potential entrants would be unwilling to invest the resources necessary to compete successfully with the incumbent firm. This fear has been completely dispelled on two grounds. First, as we saw in figure 1, a multitude of long-distance competitors have entered this market to compete for the patronage of long-distance consumers. Obviously, potential entrants have not been timid about challenging the position of AT&T. Second, not only have new firms entered, but they have also invested significant amounts of resources to develop interexchange networks that are independent of AT&T.[11] Sprint's leadership in developing the nation's first all-fiber transmission network appeared to catalyze the subsequent dissemination of fiber as the standard in the interexchange industry. Together, the deployment of fiber and expansion of electronic switching have vastly expanded the capacity of long-distance firms to carry interexchange traffic. Thus, aggressive investment behavior has emerged as a major source of pro-competitive conduct in the interexchange market.

Prior to the divestiture, many industry analysts anticipated that the long-distance industry would bifurcate, with AT&T providing a high priced, high quality service and its competitors providing lower priced, low quality alternatives. In the wake of the divestiture, however, competitors soon began to utilize equal access connections made available to them by the local exchange companies to provide service that is approximately (if not fully) equal in quality to that provided by AT&T. And, as noted, Sprint led the industry with the deployment of the nation's first all-fiber network. The result was a metamorphosis in the advertising and marketing strategies within the industry that few had anticipated. Specifically, AT&T's competitors soon began to engage in advertising touting the high quality of their services, while AT&T has countered with advertising emphasizing the competitiveness of AT&T's prices. The advertising rivalry of long-distance firms has increased in recent years, as firms scramble to attract consumers to their particular services.[12]

11 Much of the investment in this industry has been in the relatively high sunk-cost technology of fiber optic transmission networks. Such an investment strategy by new entrants suggests that these firms are not leery of predatory tactics on the part of the incumbent producer.

12 Porter (1993) reports that advertising intensity in the long-distance industry, measured by the ratio of advertising expenses to sales, increased from 1.7 percent to 2.7 percent in the

This sort of interfirm rivalry along both the price and quality dimensions is inconsistent with tacit collusive behavior.

Another important dimension of conduct involves the pricing behavior of firms in the marketplace. Given the pre-divestiture concerns, the most prominent fear regarding pricing was that AT&T would be able to utilize large scale economies to price so that no competitors would challenge AT&T or survive if such a challenge was mounted. This concern is (or should be), at this point, completely gone. As noted, a multitude of challengers have, in fact, surfaced. They have demonstrated beyond doubt that the minimum viable scale (the minimal size at which firms achieve costs consistent with the ability to successfully compete in the market) is quite small.

A second generic concern about industry pricing that was voiced at divestiture is the possibility of collusion—either overt or tacit. If interexchange firms were to engage in collusion to restrict output, raise prices, or in any other way refrain from the normal rivalry of the competitive process, then consumer welfare would be damaged. In the decade following the divestiture, however, there have been no known attempts by interexchange companies to collude. This lack of collusion is, indeed, a predictable consequence of the underlying economic structure of the interexchange industry. Specifically, the large number of carriers, the diverse and ample capacity of these carriers, the volatility of demand and cost conditions, the dynamic character of technology, and the ease of entry and expansion all act to deter the likelihood of collusion.

The pattern of firm pricing has evolved considerably over the post-divestiture era. In the early days following divestiture, carriers without equal access were granted a 55 percent discount on their interstate access charges. Moreover, this discount was generally mirrored in intrastate access charges as well. This discount permitted the new entrants to charge considerably lower rates than AT&T for interexchange services. As equal access has expanded, however, these discounts have eroded, costs have converged, and price differences between AT&T and its competitors have narrowed. See figure 4. Two reasons appear to account for this convergence of prices. First, as the percentage of equal access connections has grown, the underlying differences between the services offered by AT&T and its competitors have shrunk. Most importantly, differences in dialing requirements and signal quality have disappeared. The result is that consumers increasingly view the services of all long-distance carriers as roughly comparable if not completely equal. Second, as non-premium access connections came to an end, the discount on access charges levied on AT&T's competitors also came to an end. The result has been a convergence of costs and, predictably, prices. This convergence of prices and the temporal correlation of prices is also consistent with the evolution of competitive pricing in the presence of increasingly similar cost and reduced product

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1986-1992 period.

differentiation.

In addition, expectations that anticompetitive price leadership would arise in this industry have also failed to prove accurate. Indeed, an examination of the full array of service offerings by interexchange companies and their corresponding time paths of price levels reveals that, while observed prices of competing firms have tended to move more or less together over time, there does not seem to be a uniform pattern of single-firm leadership. Instead, it has not been uncommon for AT&T to change some rates without evoking an immediate response by rival firms, and these other firms have similarly made price changes independent of any change in AT&T's rates. Moreover, regardless of which firm has led and which firms have followed, as seen in figure 4, prices have generally tended to move downward since divestiture. Therefore, whether leadership is present or not, observed pricing does not appear to be consistent with the sort of anticompetitive scenario envisioned by the Natural Monopoly Advocates at divestiture. Also, as we explain below, much of the price changing that has occurred in this industry since divestiture has taken place not through alterations in existing tariffs but, rather, through the introduction of new service/pricing options. And, here leadership has been even less prevalent. Thus, the evidence provided by observed pricing behavior is inconsistent with anticompetitive price leadership.

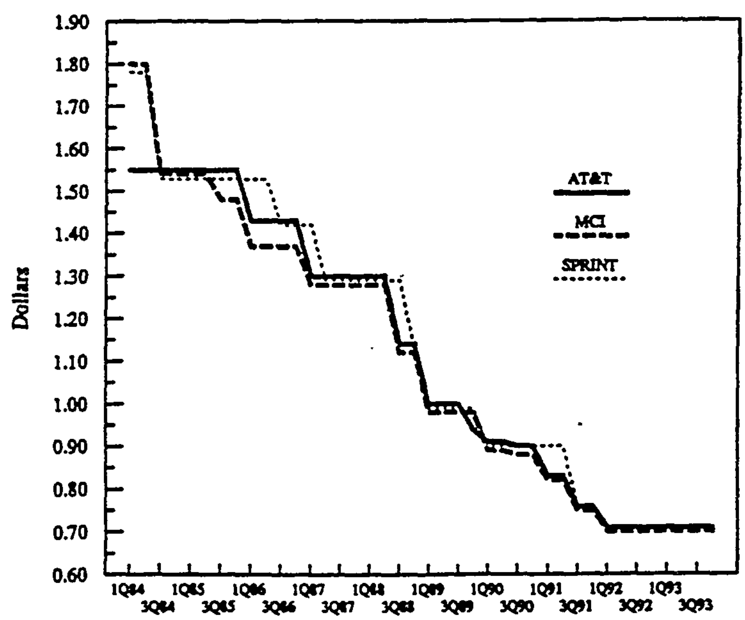

Figure 4. California Intrastate Rate Comparison (5-Minute, 100-Mile Day Call)

Source: Tariff filings, California Public Utility Commission

Finally, the propensity of firms to innovate and introduce new products or services constitutes another important element of industry conduct. In this regard, the interexchange industry has provided a host of positive developments. New services and quality improvements have resulted from significant technological change (e.g., fiber deployment). Such change has led to improvements in the quality of service and creative tailoring of services to customer needs through a proliferation of new service offerings and pricing options (e.g., MCI's Friends and Family). Technological advances have also markedly improved the clarity of calling and reduced blocking rates on long-distance calling over the past decade. Finally active long-distance firms have been rapidly introducing new services into the marketplace. At least two features of this new service introduction stand out. First, the number of new services that have appeared is quite large. Virtually all of these services represent new pricing options that enable customers to lower effective prices below the standard tariff rates. Consequently, the process of new service introduction represents an important vehicle for price competition in this industry; and that competition has been active.[13] Second, the leap-frogging manner in which interexchange companies have introduced new services belies the notion that any one company acts as a consistent leader in the pushing the pace of industry competition.

Overall, then, the traditional indicia of market conduct suggest an industry that is subject to effective competition. Substantial investment programs, aggressive and relatively informative advertising, uncoordinated pricing of an increasingly homogeneous product, and a highly innovative process of new service introductions all point to a healthy and vigorous rivalry between the firms in this market. Thus, the post-divestiture realizations of conduct are consistent with the sort of expectations that one would tend to form on the basis of the structural characteristics described earlier.

3.3. Performance

As noted in Section 2 above, the structural separation of AT&T in 1984 gave rise to a number of concerns about the ultimate performance of the long-distance industry in the post-divestiture period. Of primary importance from a public policy perspective, these questions centered on the price and quality performance of the industry.[14] The past ten years of experience has served to substantially relieve that

13 This tendency for firms to implement price changes through new service offerings (as opposed to tariff changes) also reduces the likelihood that a successful collusive agreement could be forged in this industry.

14 While rate design issues evoked considerable controversy in regulatory circles prior to the AT&T divestiture, (e.g., the debate over TELPAK rates was protracted and intense), the overall level of telephone prices was not a topic that generated a great deal of attention. Between 1935 and 1992, the Consumer Price Index (CPI) rose by an average of 4.2 percent annually. In contrast, the CPI for telephone services rose by a modest 2.1 percent annually over this same period. In light of these price changes, the lack of controversy over telephone

anxiety for most observers. This experience has shown that, for the most part, consumers have benefitted considerably from the divestiture and subsequent developments in the telecommunications industry.[15]

These benefits can be seen graphically in figure 5, which shows a comparison of the CPI for all goods and services and the CPI for all telephone services (including local exchange service). There, we see that, in the period immediately following divestiture, the CPI for all telephone services rose more rapidly than the overall CPI but has subsequently shown nominal prices that are generally flat (decreasing real prices). A more focused look at long-distance prices, shown in figure 6, reveals that both interstate and intrastate toll prices have fallen considerably both in nominal and real terms since the divestiture.

While the aggregate CPI price data provide a view of the overall movement of telephone prices, a more readily digestible assessment of price changes for long-distance service is provided in table 2. There, we see the price changes that occurred

Table 2. Prices For Long Distance Calls

(Selected City-Pairs, AT&T 5-Minute, Daytime)

	January 1984	February 1993	Percentage Change
New York, NY - San Francisco, CA	$2.70	$1.25	-53.7
Washington, DC - Baltimore, MD	$1.60	$1.10	-31.3
Chicago, IL - St. Louis, MO	$2.14	$1.15	-46.3
Dallas, TX - Denver, CO	$2.34	$1.15	-50.9
Boston, MA - Miami, FL	$2.40	$1.20	-50.0
New Orleans, LA - Houston, TX	$2.27	$1.15	-49.3
Charlotte, NC - Columbia, SC	$2.05	$1.15	-43.9

Source: *Trends in Telephone Service*, Industry Analysis Division, Federal Communications Commission, March 1993.

between January 1984 and February 1993 for a sample of specific routes. For a 5-minute daytime call, nominal prices have fallen significantly over the past decade, typically by about 50 percent.

Aggregate price indices provide a good first pass at understanding the benefits realized by consumers in the post-divestiture period. There are, however, several

price levels prior to divestiture is probably best understood in the context of Joskow's (1974) paper which argued that as long as overall rates of a utility's service were constant or falling, the most likely regulatory action is inaction.

15 A notable exception has been the pricing of long-distance operator services by alternative operator service (AOS) providers who contract with hotels, hospitals, and similar facilities to provide long-distance services for individuals at these institutions. On occasion, these firms have been known to charge rates that are several times the levels of the traditional long-distance firms. Their ability to do so, of course, stems from the unique spatial monopoly power held by the hotel, hospital, etc., over access to the long-distance network.

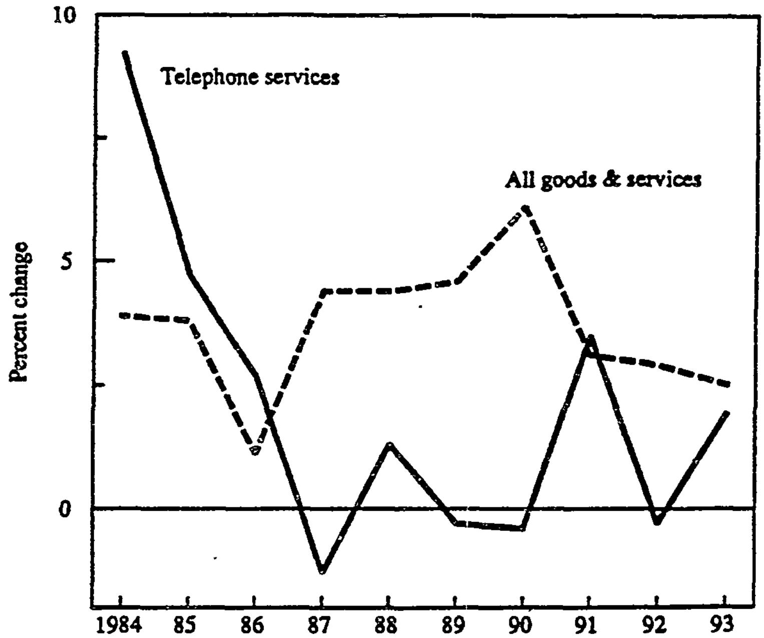

Figure 5. Telephone Price Changes Since Divestiture

Source: Trends in Telephone Service, Industry Analysis Division, Federal Communications Commission, May 1994.

reasons to believe that the CPI-based measures seriously understate these benefits. First, the CPI is a fixed-basket (Laspeyres) index and, consequently, fails to account for changes in the mix of consumption due to relative price changes. The changing price of long-distance service relative to local service together with vastly different demand elasticities for these services have led to dramatic increases in the amount of long-distance calling in the past ten years relative to local usage. The CPI-based measures of telephone prices fail to account for this changing mix of consumption and, therefore, understate the benefits to consumers from their higher consumption of long-distance services at lower prices.

Second, the reported price data are based upon tariff filings (i.e., list prices) and, therefore, fail to account for innovations in pricing that have occurred which better allow consumers to tailor their telephone service to their particular needs. This tailoring of consumer services that is now available through a variety of self-selecting pricing plans means that fixed comparisons like those shown in table 2 are a lower bound on the benefits that long-distance consumers have received.[16] And finally, the data fail to account for the widespread growth of lifeline subscriber plans that reduce considerably the expenditures necessary to connect to the tele-

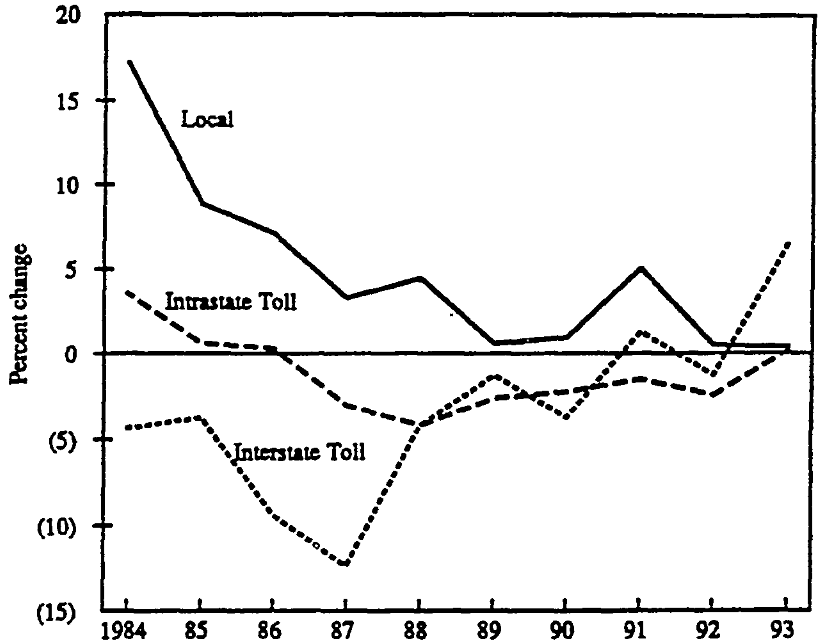

Figure 6. Post-Divestiture Telephone Price Changes

Source: Trends in Telephone Service, Industry Analysis Division, Federal Communications Commission, May 1994.

communications network.[17] Of course, it is not easy to untangle the individual contributions of technology, competition, and regulatory reform in causing the favorable movement in prices.[18] In all likelihood, it is a combination of all three

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16 This observation is similar to those made regarding the pricing developments in airline and railroad service following deregulation of these industries. For instance, it has been pointed out that it makes increasingly less sense to compare the price of a full fare airline ticket for travel between two cities when roughly 90 percent of all passengers fly at discounted fares.

17 Between 1985 and 1992, 35 states implemented lifeline assistance plans for low-income subscribers. While the details of these plans vary from state to state, they typically offer low-income households a reduced monthly payment for ongoing subscription to the telecommunications network. Also, 48 states now offer assistance to low-income consumers for the installation charges associated with initially subscribing to the telecommunications network. See Federal Communications Commission (1993).

18 In a recent study of interstate long-distance prices Taylor and Taylor (1993) argue that long-distance price reductions have been primarily driven by access charge reductions. Their analysis, which is based upon CPI price data for telephone services, is subject to all of the caveats noted above.