FEDERAL TELECOMMUNICATIONS LAW:
A LEGISLATIVE HISTORY OF
THE TELECOMMUNICATIONS ACT OF 1996
PUB. L. NO. 104-104, 110 STAT. 56 (1996)
INCLUDING
THE COMMUNICATIONS DECENCY ACT

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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
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Jamaica, New York
April 1997

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Document No. 175

COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

HEARING

BEFORE THE

SUBCOMMITTEE ON
MONOPOLIES AND COMMERCIAL LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

H.R. 2030

COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

APRIL 29, 1987

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TEXT OF BILL

COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

WEDNESDAY, APRIL 29, 1987

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The subcommittee met, pursuant to call, at 9:40 a.m., in room 2141, Rayburn House Office Building, Hon. Peter W. Rodino, Jr. (chairman of the subcommittee), presiding.

Present: Representatives Rodino, Hughes, Glickman, Staggers, Moorhead, Hyde, and Lungren.

Staff present: M. Elaine Mielke, general counsel; Warren S. Grimes, counsel; Judith Bailey, counsel; Alan Coffey and Charles E. Kern II, associate counsel; and Debra James-Morris, clerical staff.

Mr. RODINO. The subcommittee will come to order.

Mr. STAGGERS. Mr. Chairman?

Mr. RODINO. The gentleman from West Virginia.

Mr. STAGGERS. Mr. Chairman, I ask unanimous consent that the committee permit the meeting this morning to be covered in whole or in part by television broadcast, radio broadcast, and/or still photography pursuant to Rule 5 of the Committee Rules.

Mr. RODINO. Without objection, it is so ordered.

The Subcommittee on Monopolies meets this morning to address issues in the telecommunications industry. The issues are not new ones. This subcommittee and this Nation have had frequent occasion to visit them in the past.

Back in 1913 when telephones were more of a novelty, the Attorney General of the United States obtained a commitment from AT&T to stop buying independent phone companies and to allow such independent companies to participate in the AT&T network. At least since that time, antitrust restraints, along with Federal and State regulation, have been a part of the telecommunications industry.

This subcommittee, too, has a substantial history of involvement with telecommunications issues. In 1958, the subcommittee held 17 days of hearings to review the 1956 settlement of the government's first antitrust case against AT&T. We visited these issues again in 1980 du9of the government's second antitrust
case, and in 1982, after the settlement was announced.

Today, competitive issues have taken on a new urgency. Technology is evolving rapidly to provide new opportunities and new risks. And, as the result of the 1982 settlement, we have a new set of players operating under the significantly modified ground rules. Right now, the District Court under Judge Harold Greene is reviewing proposals to modify that settlement decree. Meanwhile, in the House, we have legislative proposals such as H.R. 2030 that would modify the decree by legislation.

Another issue we have before us is the impact of the breakup of the Bell System on consumers' telephone bills. While many Americans may blame the divestiture for increases in local phone service, there are indications that there are other reasons for these increases.

Congress has a strong interest in understanding the causes and cures of rate increases. In confronting these matters, our goal, I believe, ought to be the same as it always has been—maintaining a modern and efficient telecommunications system that provides a full range of services to all customers at competitive and affordable prices.

At the heart of this issue is the local telephone service that allows customers to connect with all of the key services. Because it has not been economically feasible for more than one company to provide local service, State and Federal policy has long recognized the need to regulate this natural monopoly.

The local bottleneck, as it is often called, gives the local monopolist the ability to discriminate against competing companies that need access to the local network. And this same bottleneck may allow the local provider to generate profits that permit the cross-subsidization of other businesses.

One solution to the bottleneck problem has been to restrict the lines of business that the local provider is permitted to enter. Restraints on lines of business date at least from 1956 when the Justice Department restricted AT&T to traditional telecommunications businesses.

In the 1982 decree, those restrictions were modified and shifted to the seven Regional Bell Operating Companies which split off from AT&T. Recently, there has been a dramatic shift in the Department of Justice's position on these restrictions. The Department, citing technological developments and FCC proposals for improved regulatory safeguards, now urges that most of these restrictions be lifted. Their position is supported by the FCC and the Bell Operating Companies themselves. But many participants in this industry, consumer groups, and a significant number of State regulators do not agree.

These critics urge us to mind the long history of unsuccessful attempts to regulate the local service provider. A long and unsatisfactory history of regulatory safeguards, we must remember, was the major reason why the AT&T trust case was filed and why the biggest divestiture in our history was effected.

I, therefore, welcome the opportunity these hearings will afford us to probe these vital issues in an industry fundamental to the lives and businesses of Americans everywhere.

[A copy of H.R. 2030 follows:]

I

100TH CONGRESS
1ST SESSION

H. R. 2030

To permit the Bell operating companies to provide information services and to manufacture telecommunications equipment, subject to regulation by the Federal Communications Commission.

IN THE HOUSE OF REPRESENTATIVES

APRIL 9, 1987

Mr. TAUKE (for himself, Mr. SWIFT, Mr. LOTT, Mr. SLATTERY, Mr. NIELSON of Utah, and Mr. MATSUI) introduced the following bill, which was referred to the Committee on Energy and Commerce, and concurrently to the Committee on the Judiciary for a period ending not later than thirty calendar days following the date on which the Committee on Energy and Commerce files its report in the House

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A BILL

To permit the Bell operating companies to provide information services and to manufacture telecommunications equipment, subject to regulation by the Federal Communications Commission.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Telecommunications Equipment and Information Services Act of 1987".

SEC. 2. FINDINGS.

The Congress finds that—

(1) the Federal Communications Commission is the appropriate Federal entity for overseeing and regulating the telecommunications industry,

(2) the Bell operating companies currently comprise one-half of the asset base of that industry,

(3) continued economic growth of the domestic telecommunications industry requires that the Bell operating companies be viable businesses in both the short- and long-term,

(4) such continued economic growth is adversely affected by the restrictions that prohibit the Bell operating companies from meeting the demands of the competitive marketplace,

(5) such continued economic growth and the international competitiveness of the United States telecommunications industry are important and vital to—

(A) the long-term research and development projects and programs of the United States telecommunications industry,

(B) the rapid development and introduction into the marketplace of new and innovative telecommunications equipment and services for American residential and business telecommunications users,

(C) the development of efficient, reliable, and state-of-the-art telecommunications networks to serve the needs of American telecommunications consumers, and

(D) the maximizing of employment opportunities for United States workers in the telecommunications industry, and

(6) the provision of universal telephone service at reasonable rates for all Americans is closely linked to the continued economic growth of the domestic telecommunications industry.

SEC. 3. AUTHORITY TO PROVIDE INFORMATION SERVICES AND TO MANUFACTURE TELECOMMUNICATIONS EQUIPMENT.

Notwithstanding any other provision of law, a Bell operating company may engage in the provision of information services or in the manufacture in the United States of telecommunications equipment, or both, subject to the limitations and conditions contained in this Act.

SEC. 4. INFORMATION SERVICE RESTRICTIONS.

(a) PUBLIC INTEREST FINDING.—The authority granted to a Bell operating company under section 3 to engage in the provision of information services shall be available only if the Commission determines that—

(1) there is no substantial possibility that the providing of such services by the Bell operating company could (A) harm competition in the information services industry, or (B) harm customers of telephone service, and

(2) such authority is otherwise consistent with the public interest.

In making the determination under this subsection, the Commission shall consult with the Secretary of Commerce and with the Attorney General.

(b) NONDISCRIMINATORY INTERCONNECTION.—The authority granted to a Bell operating company under section 3 to engage in the provision of information services shall be available only if there are in effect rules prescribed by the Commission which ensure that other information service providers have opportunities for interconnection to the telephone service facilities of the Bell operating company which are comparable to the interconnection provided by the Bell operating company to itself or to any affiliate of such company.

(c) INAPPLICABILITY TO ELECTRONIC PUBLISHING.—The authority granted by section 3 to a Bell operating company to engage in the provision of information services shall not apply to electronic publishing.

SEC. 5. MANUFACTURING RESTRICTIONS.

(a) PUBLIC INTEREST FINDING.—The authority granted to a Bell operating company under section 3 to engage in manufacturing shall be available only if the Commission determines that—

(1) there is no substantial possibility that the manufacturing by the Bell operating company could (A) harm competition among manufacturers in the United States, or (b) harm customers of telephone service, and

(2) such authority is otherwise consistent with the public interest.

In making the determination under this subsection, the Commission shall consult with the Secretary of Commerce and with the Attorney General.

(b) NONDISCRIMINATORY PROCUREMENT.—The authority granted to a Bell operating company under section 3 to engage in manufacturing shall be available only if there are in effect rules prescribed by the Commission which ensure (1) that other manufacturers have opportunities to sell equipment related to telephone service to the Bell operating company, and (2) such opportunities are comparable to the opportunities the Bell operating company provides to itself or to any affiliate of such company.

SEC. 6. SAFEGUARDS AGAINST SUBSIDIES.

(a) PROHIBITION AGAINST CROSS-SUBSIDIES.—

(1) LIMITATION.—Telephone service shall not subsidize, nor be subsidized by, lines of business authorized by this Act. The Commission shall prescribe rules to carry out this subsection.

(2) RULES OF CONSTRUCTION.—Paragraph (1) shall not be construed to prohibit the use of cross subsidies within a Bell operating company if such cross subsidies do not involve telephone service.

(b) RULES FOR COST ASSIGNMENT AND ALLOCATION.—The Commission shall establish rules for assigning and allocating all costs of factors of production which are in any way used in lines of business authorized by this Act. The authority granted to a Bell operating company under section 3 to engage in manufacturing or information services shall be available only if the Commission has determined that the company has provided reasonable assurances that it will comply with the rules prescribed under this section.

(c) SPECIFIC REQUIREMENTS FOR RULES.—The rules shall require that—

(1) to the extent the cost of any factor of production is caused solely by one or more lines of business authorized by this Act, such cost shall not be assigned to, or recovered by charges for, telephone service, and

(2) to the extent that any line of business authorized by this Act uses factors of production that are also

used, jointly or in common, to provide telephone service—

(A) so much of the costs of such factors as are caused by or attributable to a line of business authorized by this Act, shall not be assigned to, or recovered by charges for, telephone service, and

(B) so much of the costs as cannot be directly assigned to lines of business authorized by this Act or to telephone service, shall be allocated, in accordance with the requirements of such rules, in a manner that the Commission determines will provide for a reasonable allocation between—

(i) such lines of business, on an aggregated basis, and

(ii) telephone service.

(d) JOINT AND COMMON COST ASSIGNMENT AND ALLOCATION CRITERIA.—The assignment and allocation criteria established under subsection (c)(2) shall include the assignment or allocation of—

(1) the cost of capacity or special characteristics jointly or commonly required for telephone service and for any line of business authorized by this Act,

(2) investment and associated costs (including depreciation and maintenance) jointly or commonly

needed to provide plant availability to meet demand (including peak demand) for telephone service and for any line of business authorized by this Act, and

(3) the costs of plant and facilities jointly or commonly used for telephone service and for any line of business authorized by this Act.

(e) INSULATION OF RATEPAYERS FROM FAILED VENTURES.—

(1) ASSETS.—The Commission shall ensure that economic risks of line of business authorized by this Act are not borne by telephone service ratepayers and, in the event of a business failure, investment assigned the line of business shall not be reassigned to the telephone service except upon a showing that the customers of telephone service will benefit.

(2) DEBT.—Any Bell operating company affiliate—

(A) which is engaged in a line of business authorized by this Act, and

(B) which is structurally separate from an affiliate engaged in the provision of telephone services,

shall not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the telephone service affiliate.

(f) TRANSFERS OF ASSETS BETWEEN RELATED COMPANIES.—The Commission shall establish rules governing the transfer of assets between a company providing telephone service and related companies. Such rules shall protect the interests of ratepayers of telephone service.

(g) ANNUAL AUDITING REQUIREMENT.—Each Bell operating company that engages in any line of business authorized by this Act shall provide to the Commission each year a report on the results of an audit by an independent auditor conducted for the purpose of determining whether the company has complied with the cost assignment and allocation rules prescribed under this section.

SEC. 7. FEDERAL-STATE JOINT BOARD.

The Commission shall convene a joint board under section 410(c) of the Communications Act of 1934 regarding the establishment and implementation of principles of cost assignment and allocation to be used by the Commission and State commissions in the exercise of their respective authorities.

SEC. 8. DEFINITIONS.

For purposes of this Act—

(1) the term "Bell operating companies" has the same meaning as such term has in the Modification of Final Judgment entered August 24, 1982, in *U.S.* v. *Western Electric*, Civil Action No. 82-0192 (United States District Court, District of Columbia), except

that such term does not include any centralized organization for the provision of engineering, research, and administrative services, the costs of which are shared by such operating companies or their affiliates,

(2) the term "information services" has the same meaning as such term has in such Modification,

(3) the term "electronic publishing" has the same meaning as such term has in such Modification,

(4) the term "telecommunications equipment" has the same meaning as such term has in such Modification, except that such term includes customer premises equipment (as defined in such Modification),

(5) the term "Commission" means the Federal Communications Commission,

(6) the term "factors of production" means any property, plant, equipment, personnel, research, services, investment, or other tangible or intangible resources which is used to produce a product or service, and

(7) the term "telephone service" means telephone exchange service, within the meaning of section 3(r) of the Communications Act of 1934.

SEC. 9. EFFECTIVE DATE.

(a) EFFECTIVE DATE OF BUSINESS AUTHORITY.—Except as provided in subsection (b) and (c), this Act shall be effective on March 1, 1988.

(b) AUTHORITY TO MANUFACTURE.—The authority to manufacture telecommunications equipment under section 3 shall be effective on March 1, 1988, or such later date as the Commission may establish in its determination under section 5(a).

(c) EFFECTIVE DATE OF COMMISSION AUTHORITY.—The authority of the Commission to prescribe regulations and to institute proceedings under this Act is effective upon the date of the enactment of this Act.

Mr. RODINO. Does the gentleman from California have a statement to make?

Mr. MOORHEAD. Mr. Chairman?

Mr. RODINO. The gentleman is recognized.

Mr. MOORHEAD. Thank you.

I am pleased that this subcommittee has returned to the subject of telecommunications. I am certain that we have much to learn and contribute in this area.

The last time this subcommittee visited this subject was in January 1982 when we held two joint hearings with the Commerce Committee's Telecommunications Subcommittee. Of course, as a member of the Telecommuniations Subcommittee of Energy and Commerce, I have since participated in oversight and legislative hearings on many occasions.

On January 8, 1982, after seven years of litigation, a settlement had been concluded between AT&T and the Department of Justice providing for divestiture of the Bell Operating Companies and the entry of AT&T into unregulated, competitive markets.

We felt then, and indeed we knew, that we were on the verge of a brave new world in telecommunications, but no one had total confidence at the time in forecasting what lay ahead.

Now we have entered what one of our witnesses this morning calls an environment of explosive choice in intensified international competitiveness. We will want to explore what in fact has happened, and why, and particularly the state of competition in the telecommunications industry, and how well the consumer has fared.

Issues of cross-subsidy, competitive access, and service quality will be before us, as will many other things.

Mr. Chairman, I join you in extending a warm welcome to our witnesses this morning.

Mr. RODINO. Mr. Hughes, do you have a statement?

Mr. HUGHES. I have no statement, Mr. Chairman, I just look forward to the testimony.

Mr. RODINO. Mr. Staggers?

Mr. STAGGERS. No statement, Mr. Chairman. I look forward to the testimony also.

Mr. RODINO. Thank you very much.

Our first panel of witnesses this morning consists of the Honorable Sharon L. Nelson, Chairman, Washington Utilities and Transportation Commission; Robert W. Crandall, Senior Fellow at the Brookings Institution; Manley R. Irwin, Professor, University of New Hampshire, and Gene Kimmelman, Legislative Director, Consumer Federation of America.

Will you please come to the witness table?

I understand that Ms. Nelson is delayed. We will proceed.

Gentlemen, you will be allowed five minutes to present an opening statement. We will, of course, insert your prepared statements, which you supplied us with, in the record in their entirety.

Mr. Crandall, will you go first?

STATEMENTS OF ROBERT W. CRANDALL, SENIOR FELLOW, THE BROOKINGS INSTITUTION; SHARON L. NELSON, CHAIRMAN, WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION; ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS; MANLEY R. IRWIN, PROFESSOR, WHITTEMORE SCHOOL OF BUSINESS AND ECONOMICS, UNIVERSITY OF NEW HAMPSHIRE, AND GENE KIMMELMAN, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. CRANDALL. Thank you, Mr. Chairman.

I am Robert Crandall, Senior Fellow at The Brookings Institution, an economist who has been involved with the telecommunications industry over a number of years and currently in the middle of a study—without final conclusions, I may add—on the effects of the divestiture of the Operating Companies from AT&T.

My testimony this morning concerns the effects of changes in the industry structure on pricing in the telecommunications industry and, of course, one of the central concerns of this hearing, on the appropriate role of the divested Bell Operating Companies.

The structure of the telephone industry has changed dramatically in the last 10 or 15 years, indeed, far more dramatically than any of us could have imagined when we were looking at it prior to the wave of entry which hit in the 1970's and the 1980's.

The Federal Communications Commission began this process, prodded by the courts, in admitting entry into long distance services, first in private line services and consumer premises equipment. Eventually the FCC could not deny the entry of MCI into switched long distance services. As we all know, the matter finally ended up in the antitrust courts with a settlement in 1982, which divested the Bell Operating Companies from the parent AT&T.

One of the reasons why AT&T was willing to accept that decree rather than go forward and battle all the way through the antitrust courts was the effect of the 1956 decree which it had entered. The 1956 decree had limited AT&T to the regulated telephone industry, and AT&T was apparently willing to sacrifice that to be free to pursue other non-telecommunications. That decree turned out to be a severe constraint, I think, from the standpoint of 1982.

We now see the Bell Operating Companies hemmed in by a similar decree. We have to be concerned that in fact this new decree very quickly outlives its usefulness and becomes an important constraint on competition.

The effect of the divestiture thus far has been very controversial because of the effect on local rates and the overall effect on the price of telephone services measured by the Consumer Price Index of the Bureau of Labor Statistics.

There are two things to be said about the changes in relative rates. One, is that the repricing which has taken place raising the price of local service relative to long distance service was long overdue. In fact, there had been a regulatory process which had suppressed local rates at the expense of long distance rates, cross-subsizing local rates from long distance rates.

The need to reprice telephone services was not as great at a time when AT&T was one large corporation and when there was limited competition. At this point, however, the pressure to reprice services begins to grow because of competition. The bypass threat is not very great just yet; however, on just pure economic efficiency grounds it makes a lot of sense to begin to reprice in terms of what the relevant costs of the services are.

Second, the overall rate of telephone price increase has been affected by the disinflation we have gone through recently, which may be bottoming out now. In any period of inflation, regulators, using rate of return criteria based upon historical costs, tend to suppress rate increases. When that period of inflation abates, when inflation begins to subside, they begin to allow rate increases to rise relative to the overall rate of inflation. Indeed, this happened in the telephone industry, it happened in electrical utilities, and you can see it very clearly in the performance of the stocks of the regulated companies.

During a period of inflation, the equities in the telephone industry and in the electrical utility industry were sharply suppressed relative to their book values. With disinflation and utility commissions allowing rates to rise again, there has been a recovery of these market to book ratios, although not a recovery back to their mid-60's levels.

So we have had two forces driving telephone rates: one is disinflation and the other is a necessity of making prices conform more precisely to cost.

As for the line of business restrictions in the consent decree entered into in 1982, which led to the divestiture in 1984 of the Bell Operating Companies, I tend to agree with the Justice Department findings that in fact it makes sense to begin to release the Bell Operating Companies from these restrictions.

I am mindful of the possibility that there could be cross-subsidies or that through the ownership of the local bottleneck the Bell Operating Companies could engage in practices which would deny competitors access to the network on equal terms. On the other hand, there is the threat to competition by artificially constraining and boxing out the divested Bell Operating Companies from important equipment and service markets as these markets grow and as technology evolves. There is a threat from that both because of a potential reduction of competition and because of the potential for not fully realizing the joint economies of providing all of these services.

The latter threat is somewhat muted by the fact that there is very little evidence in the applied economics literature that there are great economies of scope in telephone services but, nonetheless, the possibility exists and the technology is constantly changing. Most of the applied cost and production function estimates are based upon technology of several years ago.

If there is to be relaxation of these line of business restrictions, then the question arises as to how to police it. It seems to me that the Federal Communications Commission has moved in the right direction by looking more to accounting orders, perhaps accounting approaches, than separate subsidiaries, particularly if there are joint economies in providing the various services.

But the problem of policing, it seems to me, becomes much less severe in a world in which there are many players and many potentially integrated telephone companies as opposed to a world in which there was only one, AT&T, and in which comparisons of transfer prices were very difficult to make.

So it seems to me that the threat of cross-subsidy is less when there are seven, eight, or nine players than when there is one very large player.

Finally, if there is a threat of cross-subsidy it derives only from what Peter Huber in his report to the Justice Department called the "poisonous synergy" between vertical integration and rate of return regulation. One direction to go is to begin to move away from rate of return regulation and indeed to allow more competition at the local level. A combination of increased competition and some other set of regulatory rules other than rate of return constraints would eliminate the possibility of cross-subsidies and make that problem simply irrelevant.

Thank you, Mr. Chairman.

Mr. RODINO. Thank you.

[The statement of Mr. Crandall follows:]

Testimony of

Robert W. Crandall, Senior Fellow, The Brookings Institution*

Before the House Judiciary Committee, April 29, 1987

Mr. Chairman, Members of the Committee, I have been asked to offer testimony on some of the recent changes in the telecommunications industry and their impacts upon consumer welfare. Specifically, I am testifying on a few of the ramifications of the continuing substitution of market competition for government control of the telephone industry that began two decades ago and continues today.

The Transformation of the Telephone Industry

It would be difficult for an economist to appear before you to extoll the virtues of government regulation over competition. In the late 1960s (or perhaps even earlier), competition began to intrude in

* These views do not necessarily represent the views of the Brookings Institution, its staff, or its trustees.

a previously totally regulated telephone industry. Up to that time, virtually all local service, long-distance service, and even customer-premises equipment rentals were offered by regulated companies. But slowly, regulators -- often prompted by the courts -- began to allow competition in the form of private microwave, private line service, the sale of customer-premises equipment, and even switched long-distance service. These incremental decisions increasingly permitted market forces, rather than regulators' wishes, to allocate resources in this industry.

It is important to note that all of the changes in the competitive structure of the telephone industry have occurred without the direct approval of Congress and undoubtedly against the better judgment of many of its members. In short, the testimony that you are likely to hear from economists and will hear from me is at odds with much of the prevailing sentiment on Capitol Hill.

The reasons for this difference of opinion are not difficult to find. For most of the post-World War II period, telephone rates have been set by a political process. "Fairness" has dictated that persons choosing to live far from others in remote areas not be forced to pay the full cost of their communications with the outside world. Loquacious subscribers were not to be charged time-sensitive message units for tying up local circuits at busy hours. Long-distance users, preponderantly business customers, were asked to contribute an increasing share of the fixed costs of local circuits just as the technological barriers to entry into long-distance services eased.

Most of these political decisions made very little economic sense. They resulted in sending all telephone subscribers misleading signals about the true costs of the services they consumed. Obviously, these incorrect signals (rates) led to the overconsumption of underpriced services and underconsumption of overpriced services. They also led to a distortion in investment decisions, particularly in local distribution and customer-premises equipment. And they greatly stunted incentives for efficient operations.

In an unregulated competitive market, these pricing distortions would be overcome by market entry and competition. Indeed, this is precisely what occurred in the long-distance market once MCI persuaded the FCC to allow it to authorize limited entry into a heretofore government-controlled monopoly. The FCC could not control the events that followed, and as we all know, the antitrust courts eventually assumed control over the structure of the industry.

We thus now find ourselves with a vertically fragmented telephone industry in which entry is freely allowed in most markets not controlled by state regulatory authorities. Federal-court restraints exist for the divested Bell regional operating companies, but even these are under attack at present. In short, competition threatens to replace government control of virtually all stages of the delivery of telecommunications service. Twenty-five years ago, this state of affairs would have been unthinkable. Indeed, in Congress it still may be unthinkable.

The Effects of Competition on Rates

Once the FCC let the Genie out of the bottle, it could no longer be quite so cavalier about the distortions that had been created in telephone rates. New carriers would "deaverage" long-distance rates by entering the dense routes and forcing AT&T also to reduce rates on those routes. Because the new carriers were not part of the separations and settlements pool, they began to erode the method by which revenues were transferred from long-distance callers to cover the fixed costs of local loops.

As the FCC deregulated customer-premises equipment, ratepayers could begin to purchase ever more sophisticated equipment that would allow them to economize on local access lines. By purchasing this equipment, they caused a reduction in the regulated telephone companies' total local rate base upon which local subsidies were calculated. The final denouement of this tale was AT&T's write-off of $5.5 billion in 1983.

Despite the vertical fragmentation of AT&T as a result of the government's 1974 antitrust suit, the federal and state authorities continue to exact a substantial amount of subsidy from long-distance sellers to local telephone companies through "access charges." However, the FCC has realized that eventually this attempt to overprice long-distance carrier access will lead these carriers to inefficient choices of alternative methods for access customers and terminating calls. This "bypass" threat has been viewed skeptically by many industry observers and critics on Capitol Hill because it has not yet developed from a trickle into a flood. Nevertheless, it is quite predictable such bypass will develop within the next few years if regulators continue to insist upon using long-distance access charges to cover the fixed (non-traffic-sensitive) costs of local subscriber loops.

The FCC has chosen to begin to rationalize telephone pricing before bypass becomes a reality. By imposing fixed subscriber line charges each month for access to the network, the Commission has been able to force a reduction in long-distance access charges and, therefore, long-distance rates. Not surprisingly, these decisions have led to a rise in local rates and a decline in interstate (interLATA) rates. Indeed, long-distance rates have fallen rapidly since the AT&T divestiture, by 7.6 percent per year in real terms.

There has been a great deal of concern over the recent rise in local rates in part because these rates are most visible and therefore easily attacked politically. The rise in the CPI index for local service since 1981 has been sufficiently large that it has more than offset the official decline in long-distance rates, thereby causing the CPI index for all telephone service to rise by 0.5 percent per year in real terms since 1983. However, this rise is probably a statistical aberration caused by the excessive weight given to local service in the index prior to 1986 (when new weights were assigned) and the change from telephone-company owned customer-premises equipment to subscriber-owned equipment. Moreover, part of the overall rise in rates can simply be ascribed to state regulators' willingness to ease the rate compression that occurred in the inflationary 1970s.

The Importance of Telephone Rates

In some ways, it is perhaps surprising that the level of local telephone rates is such a major political issue. Telephone service accounts for only about 2 percent of consumer spending in the United States, and local service for only about 1 percent. Telephone is certainly not an urgent necessity like food, shelter, or perhaps transportation to one's place of employment. Yet when local service prices rise by a few percentage points, enormous concern is voiced in the political arena. As yet, there is no evidence that these higher rates have had much effect upon telephone subscriber penetration. Nor could one suggest that this rise in a component that accounts for 1 percent of the CPI could be very important even to relatively poor people.

When one compares the impact of our dairy programs on the price of such a necessity as milk; the trebling of U.S. sugar prices because of quotas; the $750 - $2500 rise in the price of automobiles due to quotas on Japanese cars; or the effect of rent control on the supply of housing for the poor, the recent rise in local telephone rates pales in comparison. Yet, Congress has either voted for or acquiesced in most of these other frontal assaults on consumer welfare.

It is also important to keep in mind that interstate telecommunications services are increasingly important in the provision of a variety of other services. Eliminating the regulatory surcharge on the rates charges for these services will inevitably lead to somewhat lower prices for airline travel, flower delivery, legal services, direct marketing of consumer goods, and numerous other goods or services that consumers buy. The increase in efficiency in these markets will be difficult to document and more difficult to defend politically because they reflect "business" use of telecommunications, but it will surely occur. Subsidies that are hidden can have just as important economic effects as those that are transparent.

The Future Role of Competition in the Telephone Industry

AT present, there is a great deal of debate on the best approach to policing competition in long-distance service, equipment manufacturing, and "enhanced" or "information" services. Because the local telephone companies control the "bottleneck" of the local switch and local loops and because services in these local markets are regulated via some form of rate of return regulation in most jurisdictions, the divested Bell operating companies are not permitted to participate in these other markets. But the local monopoly is not necessarily inevitable; it is often fostered and protected by state regulators. Nor is rate of return regulation inevitable. Were states to begin to allow competition in local service and to search for alternatives for rate of return regulation, the case for these artificial restraints on the divested Bell companies would be severely weakened.

The bottleneck argument for keeping the divested Bell operating companies may be persuasive until sufficient competition in local access develops. However, one should not be misled into thinking that this artificial restraint on seven important participants in the U.S. market is costless. The case for such regulations rests upon the uneasy notion that government regulation creates fewer distortions than private attempts to grab for monopoly power. Such a notion should always be examined carefully before it becomes the dogma around which public policy is designed.

Mr. RODINO. Chairman Nelson, I have already given my opening statement, which you didn't have the opportunity to hear it. I think it is important that you know that I have also counseled the panelists to speak for five minutes in their oral presentations. Your written statement, of course, will appear in the record in its entirety. You may proceed.

Ms. NELSON. Thank you, Mr. Chairman. I apologize for being late. We Westerners tend to forget how congested it is and what the traffic levels are back here, so I really do apologize to you and members of the committee.

I am Sharon Nelson. I am representing the National Association of Regulatory Utility Commissioners today as well as my home State Commission, the Washington Utilities and Transportation Commission. We thank you for your invitation to testify before you today.

As the written testimony indicates, NARUC has recommended to Judge Greene that the restrictions on the Bell Operating Companies be lifted, but with certain conditions. I would be pleased to answer any questions about the NARUC position but I will concentrate my oral remarks on the Washington position.

Essentially, the Washington Commission's position is that we believe the facts have not changed enough since the divestiture decree was entered to support the lifting of the restrictions at this time. And we would also like to emphasize that we believe that regulation is not a sufficient preventative to prevent the kind of anti-competitive abuses that prompted the MFJ in the first place.

With respect to the last point—the reliance on regulation, we have pointed out that the Department of Justice's new-found reliance on regulation to prevent anti-competitive abuse is probably misplaced. The Federal Communications Commission regulations which cited in its comments to the Judge are all in embryonic phases of development. It itself admits that the open network architecture on which it relies is a rapidly evolving concept. But it is just that, it is a concept—it is not a set of regulatory rules which is understood by, or even known by, the State and Federal regulatory community.

The joint cost rules that the FCC has issued have just been issued and have many areas for further development within them, by their own stated terms.

We think the Department's about-face on the adequacy of regulation to prevent antitrust abuses such that prompted the bringing of the suit in the first place is rather startling. The Department's new-found reliance on regulation ignores, we think, the unity of competitive policy and regulatory concerns; and that unity essentially focuses on the monopoly ratepayer. It is the regulators' interest that the ratepayer not serve as the source of financing for unregulated ventures of the Bell Operating Company.

We believe that is both improper for the ratepayer and would also undermine the competitive environment we all hope to promote.

It is important to remember that the Bell Operating Companies are both seeking to diversify and to deregulate at the same time at the State level. U.S. West, the parent of the operating company that we regulate, is seeking actively to be deregulated through the State legislatures in all the 14 States in which it operates.

Under the current regime, U.S. West has not had any problem diversifying into related and unrelated lines of business. I have appended to my testimony the latest formal organization chart we have been able to receive from U.S. West. Just the sheer number of subsidiaries should give you some indication of the nature and the size of the problem that State regulators face in trying to police against improper cross-subsidies.

Even though it is already difficult to police against these improper cross-subsidies, a lifting of the restrictions would give the Regional Holding Companies even further incentives to engage in this improper cross-subsidization.

Throughout the DOJ comments, one needs that they are startled by the nature and the quantity of the waivers that have been filed with the court. State regulators are aware of the contentious nature of this industry and the stakeholders who are seeking a place in it. Nevertheless, we don't think that it is time now to take the court and the Department out of this environment and give all of the policy responsibility to State and Federal regulators.

Have factual conditions changed? We in Washington State don't think so. I have cited in our testimony to the reports on competitive nature of our environment in the State of Washington. I think it is typical of what exists across the Nation.

We respectfully submit—and I see that my time is up—that lifting the de jure monopoly, as the Department has recommended, will not have much to do with the natural monopoly—it will remain. The competitive bottleneck remains.

We have in Washington allowed open entry into all areas of that intra LATA market and still we see our Bell Operating Company with over a 94 percent market share.

I will stop there, Mr. Chairman. Thank you.

Mr. RODINO. Thank you.

[The statement of Ms. Nelson follows:]

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HR 2030 AND COMPETITIVE ISSUES IN
THE TELECOMMUNICATIONS INDUSTRY

APRIL 29, 1987

Testimony of Chairman Sharon L. Nelson
Washington Utilities and Transportation Commission
Before the Subcommittee on Monopolies and Commercial Law
Committee on the Judiciary
U.S. House of Representatives
April 29, 1987

Mr. Chairman, members of the committee, thank you for your invitation to testify today. My name is Sharon Nelson. I am Chairman of the Washington Utilities and Transportation Commission (WUTC). Before that, I was staff counsel to a Washington State legislative committee investigating regulatory reform in the telecommunications industry. I also serve as Vice-Chairman of the National Association of Regulatory Utility Commissioners (NARUC) Committee on Communications.

The NARUC is a quasi-governmental, non-profit organization founded in 1889. Within our membership are the governmental agencies of the 50 states, the District of Columbia, Puerto Rico and the Virgin Islands which are engaged in the regulation of utilities and motor carriers. The mission of the NARUC is to serve the consumer interest by seeking to improve the quality and effectiveness of government regulation in America.

Today I will attempt to present the views of NARUC in addition to the views of my colleagues on the Washington Commission. While I will briefly discuss HR 2030, which was recently introduced by Congressman Al Swift of Washington and Congressman Tauke of Iowa, most of the testimony will address the broader topic of this hearing: "Competitive Issues in the Telecommunications Industry." My remarks will focus on the Department of Justice's recently recommended modifications of the AT&T consent decree line of business restrictions. As the Committee is aware, this issue area is highly contentious. The views expressed in this testimony are filtered through my perspective and, thus, I am responsible for any errors or omissions.

THE NARUC RESOLUTION

The National Association of Regulatory Utility Commissioners has been an active participant before the divestiture court since the filing of the original proposed AT&T consent decree[1] in January 1982. Our participation has been guided by one fundamental principle: that the relief ordered by the court should be consistent with the long established national policy of providing universal telephone service to all Americans at affordable rates.

[1] United States v. American Tel. & Tel. Co., 552 F. Supp. 131, (D.D.C. 1982), aff'd. sub nom., Maryland v. United States, 460 U.S. 1001 (1984).

As you know, the decree divested the Bell Operating Companies from their parent, AT&T, on January 1, 1984. The Department's evidence at trial documented a wide range of abuses, including: misuse of the regulatory process,[2] abuse of proprietary network information,[3] manipulation of technical standards and network compatibility standards,[4] and bad faith negotiations regarding interconnection of potential competitors.[5] As the court found, for over 30 years the Bell Companies "shift[ed] from one anticompetitive activity to another, as various alternatives were foreclosed...."[6] In each instance, the misconduct was facilitated by Bell bottleneck control of the local exchange monopoly.

To prevent a recurrence of this anticompetitive conduct, the MFJ prohibited the Bell Operating Companies from offering interLATA long distance and information services, and from manufacturing telecommunications equipment. The decree also required the Bell Operating Companies to obtain permission from the court to engage

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[2] United States v. American Tel. & Tel. Co., 524 F. Supp. 1364, (D.D.C. 1981).

[3] 524 F. Supp. at 1364.

[4] 524 F. Supp. at 1372.

[5] 524 F. Supp. at 1356.

[6] 552 F. Supp. at 167-68.

in activities unrelated to their core telecommunications business. According to the DOJ and the court, these restrictions were the "necessary complement" to divestiture.

As a part of the judgment, the DOJ agreed to report to the court in January 1987 on whether changed competitive conditions reduce or eliminate the need for the line of business restrictions. In its report, DOJ recommended that the Regional Holding Companies be allowed to offer long distance service in certain areas, to provide information services, to manufacture telephone equipment, and to enter other telecommunications businesses. DOJ also recommended lifting restrictions prohibiting Bell Operating Company diversification into non-telecommunications businesses.[7]

The factual basis for the DOJ report was developed by the Department's consultant, Dr. Peter Huber, in a report entitled, The Geodesic Network: 1987 Report on Competition in the Telephone Industry. In relying upon the Huber report, DOJ offers a futuristic vision of a "geodesic" network in which switching, intelligence, and transmission connections are moved from the core of the network out to its edges. In Huber's view, the network is evolving from a few large, central office switches to numerous switching systems under the control of individual

[7] Report and Recommendations of the United States Concerning the Line of Business Restrictions Imposed on the Bell Operating Companies by the Modification of Final Judgment, 4-8 (February 2, 1987).

network users rather than monolithic common carriers. According to Huber, radical changes in technology, in the marketplace, and in regulatory conditions have reduced the risk that entry by the Bell Operating Companies will harm competition in many markets.

Pursuant to an order issued by Judge Greene, the NARUC, along with numerous intervenors in the case, including our Washington Commission and several other state regulatory commissions, filed comments on the DOJ report and recommendations on March 13, 1987. NARUC argued that the court should remove the restrictions if certain conditions intended to protect the public interest and the jurisdiction of state commissions were met. The recommended conditions prescribe that the restricted services be integrated into the switched network of the Bell Operating Companies, in accordance with the following concepts:

1) Each telecommunications service or function will be viewed and evaluated in terms of how it contributes to the enhancement of a "full service" network;

2) The accounting or corporate form for the offering of any new service is a state regulatory decision;

3) The state commissions will have the authority to

enforce conditions deemed essential to assure that the basic network will be protected from erosion of its investment base;

4) The states will have full access to all books, records, facilities and premises of the Bell Operating Companies and all affiliates.[8]

As the NARUC comments make clear, state regulators' primary concern is the effect diversification into high-risk lines of business will have upon telephone rates. Many states have seen Regional Holding Companies and their affiliates aggressively seeking through legislation, litigation, transfer of assets and corporate reorganization to avoid appropriate State regulation of their ventures into more competitive markets.

State regulators fear that revenues derived from monopoly ratepayers may be used to subsidize unfairly the "competitive" activities of the Regional Holding Companies. We believe it is incumbent upon us to prevent such cross-subsidies and the milking of the monopoly "cash cow."

A recent NARUC staff subcommittee report on audits of five

[8] NARUC Communications Committee, "Resolution Supporting Conditions for Removal of Competitive Restrictions on Bell Operating Companies", Adopted February 26, 1987, Reported in NARUC Bulletin No. 10-1987, pages 3-5.

Regional Holding Companies illustrate some of the problems caused by diversification.[9] The Report focused on four problem areas that were common to all the Regional Holding Companies investigated.

First, the Subcommittee found that during the audit process the companies consistently attempted to block access to accounting and cost allocation records. Often, the information that was provided was of low quality. The companies frequently attempted to delay the audits by challenging the regulators' need for information. In some instances, court action was required to obtain needed data.[10]

Second, the Regional Holding Companies, including U.S. West with which the Washington Commission is concerned, were found to have embarked on ambitious and unprofitable investment programs in highly competitive, unregulated ventures. According to Securities and Exchange Commission reports, in 1985 US West had the unhappy distinction of ringing up the largest losses from its competitive subsidiaries -- over $180 million dollars worth that year. The company is predicting that its unregulated operations will turn a profit in 1987, but according to its most recent quarterly financial reports, it is still incurring losses in that

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[9] "Summary Report on the Regional Holding Company Investigations", NARUC, Washington, D.C., September 18, 1986.

[10] Id. at 7.

sector.[11]

Third, the Subcommittee found that a common practice among the Regional Holding Companies was to transfer valuable revenue producing services from the telephone companies to new unregulated subsidiaries. This practice has often resulted in a reduced "contribution" from the transferred service to the operating companies' general revenues. In some cases, the Subcommittee also reported that transferred services have been sold back to the telephone company at inflated prices.[12]

To illustrate the problem of loss of contribution: the operating company regulated by our Commission, Pacific Northwest Bell, transferred its highly profitable Yellow Pages operations to a US West publishing subsidiary, US West Direct, shortly after divestiture in January 1984. Since that time, the division of Yellow Pages profits has been guided by an affiliate agreement between Pacific Northwest Bell and US West Direct. Last year approximately $70 million was contributed by the directory publishing affiliate to the operating company, helping to hold down basic local exchange rates.

Despite this contribution US West Direct still managed to post a

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11 "Three Regional Bells Post Rise in Quarterly Net", Wall Street Journal, April 21, 1987, at 50.

12 Supra. note 9 at 11.

return on equity exceeding 30 percent in 1986. The operating company, however, has recently approached our Commission with a new affiliated publishing agreement that would reduce contribution in 1987 by a third, while actual revenues from publishing are expected to remain constant, and probably grow. The reason cited by the operating company is the intensely competitive nature of the publishing industry. Our staff's view is that the contribution to the monopoly revenue requirement continues to be justified because the monopoly affords US West Direct a dominant market position.

Finally, the NARUC staff auditors were concerned about the telephone companies' gradual shift to a capital structure characterized by large debt issues and the transfer of virtually all net income to the parent Regional Holding Companies, with minimum equity infusions from them to the Bell Operating Companies. Such a structure may ultimately increase the cost of capital, leading to higher telephone rates.[13]

According to the NARUC report, the commitment of the Regional Holding Companies to providing quality residential telephone service has taken a back seat to "their drive to become successful conglomerates."[14] As a result, the report concludes, "telephone subsidiaries currently function as cash cows and

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[13] Id. at 12.

[14] Id. at 2 and 3.

talent pools for the competitive new ventures."[15]

The NARUC Subcommittee recommended that national legislation be passed to grant regulators needed access to the accounting records of the Regional Holding Companies' unregulated subsidiaries. They also urged consideration of a proposal by the Chairman of the Massachusetts Department of Public Utilities, to institute another round of divestiture that would separate the Bell Operating Companies from the Regional Holding Companies.

Absent national legislation, state commissions are beginning to develop their own strategies for tackling the problems brought to light in the Subcommittee's audits. At its recent Winter meeting, the NARUC Communications and Executive Committees adopted a resolution supporting the establishment of Regional Oversight Committees, based on the operating territories of the Regional Holding Companies. The purpose of the Regional Oversight Committees is to ensure the effective monitoring of the Regional Holding Companies' activities, to coordinate the sharing of information, to create a data base, and to support the development of state regulatory policies with respect to diversification and affiliate transactions.[16] The 14 state commissions having jurisdiction over the US West activated a US

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[15] Id. at 11.

[16] NARUC Communications Committee, "Resolution Supporting Creation of Regional Oversight Committees", Adopted February 26, 1987, Reported in NARUC Bulletin No. 10-1987.

West oversight committee at a meeting in Denver last month.

VIEWS OF THE WASHINGTON COMMISSION

The Washington Commission also filed comments on the DOJ report with Judge Greene. Based on our review of the Huber report, the DOJ report and recommendations, and our own knowledge of the telecommunications industry[17], we concluded that DOJ's analysis is overly optimistic and does not accurately depict the current state of the telecommunications industry. In our view, the factual conditions that prompted the establishment of the line of business restrictions still exist. Instead of one AT&T, there now exist seven regional companies. The Bell Operating Companies still retain monopoly bottleneck power in their regions and are the only carriers with the ability to connect end users to any significant extent. There is no indication these facts will change in the near term.

DOJ's new-found faith in the effectiveness of regulation to check the Bell Operating Companies' potential for anticompetitive behavior is startling. Focusing principally on the FCC, the

[17] Ernst and Whinney Telecommunications Group, The Telecommunications Industry in Washington State -- Market Competitiveness, Service Availability, and Cost-of-Service Methodologies, prepared for the Washington Utilities and Transportation Commission (December 1, 1985). Washington Utilities and Transportation Commission, The Annual Report on the Status of the Washington Telecommunications Industry, presented to the Washington State Legislature (January 12, 1987).

Department argues that changes in the regulatory environment suggest that regulation, despite its previous inadequacies, would now be able to police effectively the conduct of the Bell Operating Companies and to prevent them from abusing their monopoly control of local exchange bottleneck facilities. DOJ relies most heavily in this respect on the FCC's Third Computer Inquiry[18] and Joint Cost proceeding.[19]

In Computer III, the FCC abandoned its Computer II[20] rules requiring the Bell Operating Companies to offer enhanced services through separate subsidiaries. Instead, the operating companies will be permitted to offer these services directly, provided that they obtain FCC approval of plans to provide comparably efficient interconnection to competitors. The FCC also requires the companies to obtain approval of an accounting plan based on the Commission's Joint Cost rules and disclose to competitors network planning information.[21] According to Computer III, further

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[18] Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), CC Docket No. 85-229, FCC 86-252 (June 16, 1986).

[19] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, FCC 86-564 (February 6, 1987).

[20] Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), 7 FCC 2d 384, modified on reconsideration, 84 FCC 2d 50 (1980), further modified on reconsideration, 88 FCC 2d 512 (1981), aff'd sub nom., Computer and Communications Indus. Ass'n v. FCC, 693 F. 2d 198 (D.C. Cir. 1982), cert. denied, 461 U.S. 938 (1983), aff'd on second further reconsideration, FCC 84-190 (May 4, 1984).

[21] Computer III Order at paras. 5-6.

relief will be provided in the future after implementation of a concept now known as "Open Network Architecture." This concept is anticipated to result in the modification of the operating companies' facilities in a way that promotes competition.

While DOJ emphasized to the court the potential benefits of the Computer III rules, it recognized that these rules are in their earliest phases of development. The Comparably Efficient Interconnection concept has yet to be put into practice.[22] Each of the Regional Holding Companies' comparable interconnection plans is subject to FCC approval after a period of public comment. Complex plans involving particularly lucrative services will no doubt be subject to considerable opposition and delay. In some cases, Comparably Efficient Interconnection will no doubt present a greater technical challenge than did the "Equal Access" requirement for alternative long distance carriers.

Open Network Architecture plans present similar problems but on an even larger scale. Open architecture plans need not be filed until February 1988, after which the FCC will open them to public comment. The actual form the "open network" will take, much less the effectiveness of this concept in creating a level playing field, is thus wholly unknown.

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[22] The first CEI plan was not filed until March 6, 1987. The plan requests authority for Bell Atlantic to offer a rudimentary Voice Message Storage service in Pennsylvania. Telecommunications Reports, p. 3 (March 9, 1987).

In its Joint Cost Decision, issued less than three month's ago, the FCC adopted standards to apportion costs between carriers' regulated and unregulated activities.[23] DOJ's reliance upon these new rules is no more well-founded than the Department's belief in the effectiveness of the nascent comparable interconnection/open architecture regime.

At this time, no Joint Cost manuals have been filed by the operating companies. Thus, the actual substance of the carriers' cost allocation plans is unknown. A more striking aspect of DOJ's reliance upon the FCC's cost accounting rules, however, is that the decision announcing those rules had not even been released at the time the DOJ report was filed. Thus, the Department was touting the effectiveness of unknown rules.

The Joint Cost order has neither passed through the final stages of FCC review nor been subject to appeal.[24] In fact, NARUC has a Petition for Reconsideration of the Joint Cost Decision arguing that the decision complicates jurisdictional cost separations. NARUC believes that if this matter is not corrected, the

[23] Joint Cost Decision at para. 2.

[24] Petitions for reconsideration of the Joint Cost Order were required to be filed by April 6, 1987. After or in lieu of FCC reconsideration, aggrieved persons may file an appeal with a United States Court of Appeals of appropriate venue within 60 days of the release of the present order (May 5, 1987) or of a petition for reconsideration.

accounting rules should be referred to a Federal-State Joint Board for resolution. In sum, neither the Computer III rules nor the Joint Cost rules are adequate, in their present iterations, to warrant the court's reliance on them to safeguard against anticompetitive practices by the Bell Operating Companies.

It should also be noted that many Bell Operating Companies are actively seeking full deregulation or new legislation similar to that enacted in Nebraska in 1986. Thus, where regulation may previously have been only inadequate, future reliance on regulation to protect ratepayers or competition may be illusory.

With regard to the specific line of business restrictions, the WUTC objects to allowing out-of-region long distance service on the grounds that such service would be impractical and would promote rate deaveraging. We also advocate that the Bell Operating Companies be allowed to provide information services only after the Comparably Efficient Interconnection or Open Network Architecture plans have been approved.[25] In addition, if the court accepts DOJ's recommendation to remove the equipment manufacturing restriction, we believe manufacturing activities should be confined in structurally separated subsidiaries and affiliated manufacturers should be prohibited from supplying equipment to their Bell Operating Company.

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[25] This recommendation was not supported by one Commissioner, indicating that these issues truly are contentious.

Implicit in the DOJ report and the Huber study is the belief that the statutory monopoly should and will end. In fact, the Department asked the Court to encourage this result by making the destruction of the statutory monopoly the essential element of removing the restriction on Bell Operating Companies providing interLATA interexchange service in their own service areas as well as elsewhere. The DOJ and Dr. Huber want the Court to move the industry into a monopoly-free and regulation-free future with no consideration of the social goals of public service regulation. In our view, the states should be free to make their own judgments on whether there is a continuing need for entry restrictions. For example, in the state of Washington, we have proceeded in a deliberate fashion to allow entry into the intraLATA toll market, privately owned pay telephones, shared-tenant telecommunications systems in large buildings, and the resale of "Centrex" enhanced business services.

Dr. Huber noted that his personal vision of the future is that competition requires that open entry be "relaxed symmetrically at the state and federal levels."[26] However, given the nature of our federal system and given the varying philosophies among the states, the sort of symmetrical relaxation contemplated by Dr. Huber is likely to occur only through the pre-emptive authority of the Federal Government. Although the FCC does not now have

[26] Huber Report at 1.33.

total preemptive authority, it is evident that the DOJ is moving in a preemptive direction and seeks the Court's assistance in doing so.[27]

We believe the DOJ is simply missing the point. In analyzing the line of business restrictions, the unity of regulatory and antitrust concerns should be obvious. The opportunity and ince.tive for cross subsidization from the monopoly-based Bell Operating Companies to the unregulated ventures are real. If the Bell Operating Companies are permitted to shift cost responsibility from their non-regulated to their regulated operations, the result will be higher local rates and the ability to engage in unfair competition. And, if the non-regulated businesses do incur losses, ratepayers will find themselves confronted by higher costs of capital or additional improper cross subsidies.

As a state regulator, I am very concerned about diversification efforts by all of the utilities that we supervise. The perils of diversification are not news in the world of business. In the January 14, 1985 issue of Forbes, the magazine compared the performance of 41 highly diversified companies with an all-industry measure. In theory, Forbes said diversified companies ought to beat the all-industry medians. In other words, the

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[27] Louisiana Public Service Com. v. FCC, 476 U.S. ___, 90 L Ed 2d 369, 106 S. Ct. 1890 (1986).

median profitability of the 41 firms surveyed ought to exceed the all industry median. In practice, Forbes said that is not the case. The figure for the all-industry return on equity was 13.4 percent versus 11.8 percent and 10.4 percent for the two groups of diversifiers that Forbes surveyed.

Managers, too, are noting practical problems with diversification. The October 1986 issue of Working Smart examined the high tech company, Perkin Elmer. CEO Horace McDonell noted that his managers lost sharpness of focus and began ignoring losses. He stated:

> We poured money into these minibureaucracies until our administrative costs were equal to -- if not exceeding -- what we were spending on R & D. Finally, I had to ask myself what kind of high-technology company does that?

The stories of the Penn Central, the chemical companies, the food companies and others all have the same ring. Naive faith that Regional Holding Company management will diversify in a manner to maximize benefits to shareholders and ratepayers may be misplaced. Considerable risk is obvious.

In the case of US West, we have no effective way of determining how much capital is being diverted from the operating companies to the deregulated subsidiaries. Washington State has one of the toughest affiliated interest laws in the nation, but our accountants believe they cannot accurately trace the flow of money and resources from monopoly ratepayers to US West's unregulated subsidiaries. For your information, I have appended the most recent organization chart of US West. The sheer number of subsidiaries should provide some indication of the nature of our problem.

The Washington Commission urged the court -- and we urge this committee -- to reject a precipitous restructuring of the telecommunications industry before the full impact of the MFJ and current FCC policies is determinable. While the current market structure is probably not ideal, it is at least now becoming familiar. Customers are adapting. The Bell Operating Companies are thriving. Other industry participants are developing their own competitive strategies in the current regime.

In the interim, if the stockholders who own the Regional Holding Companies wish to invest their capital in new ventures, let them do so in corporations wholly separate from the public service companies which state commissions regulate and which have been supported by the ratepaying public for generations. In my view, the potential economic benefits of greater diversification by the Bell Operating Companies do not now outweigh the anticompetitive and anti-public interest risks which the DOJ and Dr. Huber failed to study adequately.

OTHER CONSIDERATIONS

Apart from the potential threats to competition and ratepayer interests, and the additional burden which adoption of DOJ's recommendations would impose on already limited regulatory resources, the suggested removal of the manufacturing restriction may also have an adverse impact on trade policy. Although I am certainly no expert on trade matters, others have pointed out in comments to Judge Greene that lifting the manufacturing constraint could promote the balkanization of U.S. equipment markets into regional cartels controlled by the respective Regional Holding Companies. Most, if not all, of the regional companies' manufacturing partners are likely to be foreign-based equipment manufacturers. The result will be to reserve large sections of the U.S. equipment market as the exclusive preserve of foreign companies. This would improve neither U.S. competitiveness nor the U.S. trade position.

Moreover, this potential recartelization of the equipment industry would occur at a time when the federal government is aggressively pressing for an opening of foreign equipment markets. Foreign governments are unlikely to be persuaded to loosen the bonds of their own countries' equipment cartels if they see the United States taking steps in the opposite direction.

Further, it is inconsistent with principles of trade policy to take steps that effectively foreclose competition in large segments of the U.S. market. Instruments of trade policy must be flexible in order to have the desired effect. A tariff, for example, can be raised or lowered as trade conditions and policy demand. The same is true for quotas, or any sanction. A green light for self-dealing, on the other hand, flashed by a merger or other joint venture is very difficult to turn off at will.

In summary, the DOJ recommendations on manufacturing may tend to worsen, not resolve, U.S. trade problems because they will reserve domestic market segments for foreign products, send the wrong signal to those foreign governments currently considering steps to liberalize market access, and institute non-tariff barriers to free trade which will be extremely difficult to remove.

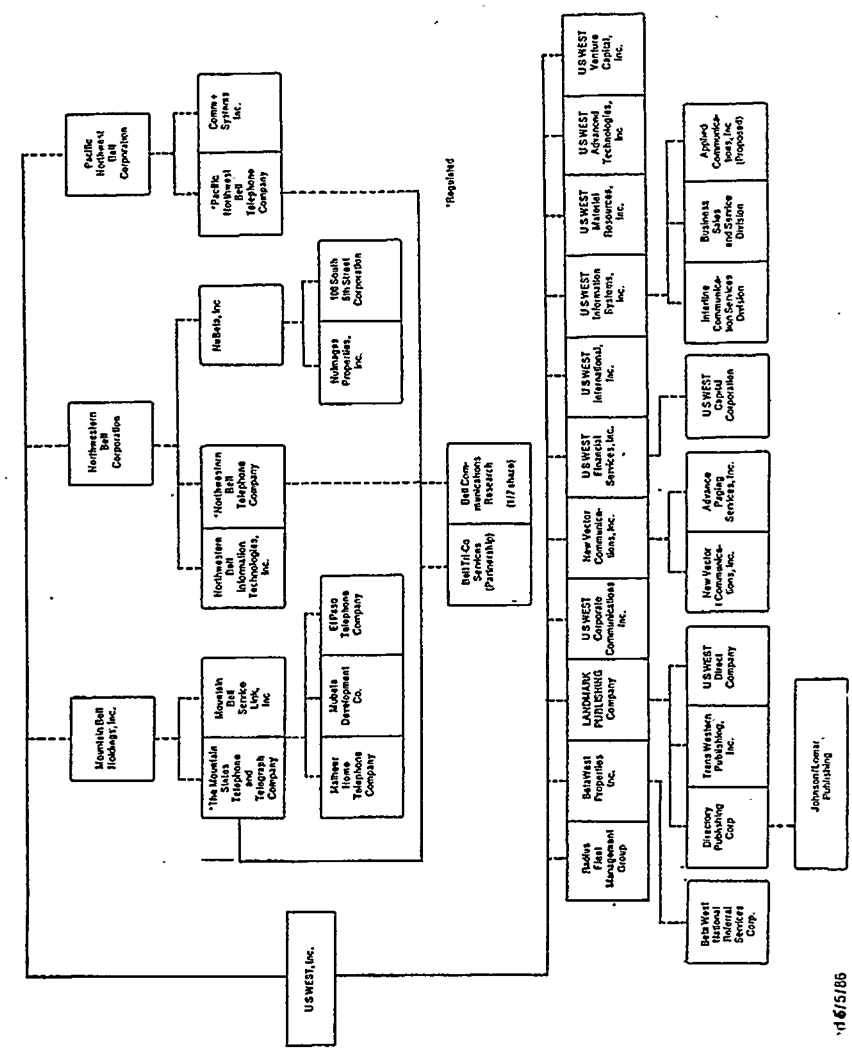
CONGRESSIONAL LEGISLATION

Congressmen Swift and Tauke have recently reintroduced HR 2030. The new draft includes some very positive changes when compared to last year's legislation. The FCC's current Computer III rules will, in all likelihood, meet the information service requirements imposed under Section 4 of the bill and facilitate a hasty elimination of the information services restriction. The "Nondiscriminatory Procurement" language of Section 5 is a welcome addition for the manufacturing area and is similar to our own recommendations to Judge Greene. The cost assignment and allocation directives in Section 6 are also positive additions, and the requirement that a Federal State Joint Board be established to study and implement cost-accounting principles is wise.

SUMMARY

The importance of protecting monopoly customers from abuses of monopoly power, which prompted the line of business restrictions in the first place, remains undiminished. The conditions upon which the court based the original restrictions of the MFJ still exist. The case for elimination of these antitrust protections is simply not persuasive. In my view, the proponents of change have not met their burden of proof. Thus, it is my opinion that the restrictions on the Bell Operating Companies should not be eliminated at this time.

Thank you for your attention. I would be pleased to answer any questions.


US WEST, Inc.
Mountain Bell Holdings, Inc.
Northwestern Bell Corporation
Pacific Northwest Bell Corporation
*The Mountain States Telephone and Telegraph Company
Mountain Bell Service Link, Inc
Malheur Home Telephone Company
Mobeta Development Co.
El Paso Telephone Company
Northwestern Bell Information Technologies, Inc.
*Northwestern Bell Telephone Company
NwBeta, Inc
NwImages Properties, Inc.
100 South 5th Street Corporation
*Pacific Northwest Bell Telephone Company
Commet Systems Inc.
*Regulated
BellTriCo Services (Partnership)
Bell Communications Research (1/7 share)
Radius Fleet Management Group
BetaWest Properties Inc.
LANDMARK PUBLISHING Company
US WEST Corporate Communications Inc.
NewVector Communications, Inc.
US WEST Financial Services, Inc.
US WEST International, Inc.
US WEST Information Systems, Inc.
US WEST Material Resources, Inc.
US WEST Advanced Technologies, Inc
US WEST Venture Capital, Inc.
BetaWest National Deferral Services Corp.
Directory Publishing Corp
Trans Western Publishing, Inc.
US WEST Direct Company
Johnson/Lomas Publishing
New Vector Communications, Inc.
Advance Paging Services, Inc.
US WEST Capital Corporation
Interline Communications Services Division
Business Sales and Service Division
Applied Communications, Inc (Proposed)
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Mr. RODINO. Professor Irwin.

Mr. IRWIN. Thank you. I am Manley R. Irwin. I am an economist. I teach at the Whittemore School of Business and Economics at the University of New Hampshire. I appreciate the invitation to appear before this committee.

My remarks will essentially focus on the integration of the Bell Operating Companies into manufacturing.

Prior to 1984, the Bell Operating Companies were part of the AT&T system. The design of equipment was performed by the laboratories, the manufacturing by Western, the procurement by the Bell Operating Companies. We were told that the integrated system gave us efficiency, productivity, innovation, and that the Operating Companies were free to buy as they so choose.

Since 1984, three things have happened with divestiture.

Number one, we have seen an increase in productivity, lower cost, lower prices of telephone equipment and hardware—in some cases rather dramatic, particularly in customer premise equipment. Digital switching costs have dropped from nearly $1,000 line to $300 per line in three years.

Second, we have seen an increase in the rate of innovation of new products, new services, new facilities, new systems, new features. The rate of innovation has been expedited post 1984.

Finally, we have seen a market that previously was foreclosed—the equipment market—open up and the Operating Companies electing to buy hardware that suits their particular needs and the requirements of their subscribers. We have seen a closed market evolve into an open market.

Today we are told that the Operating Companies are now manufacturer or "vendor dependent", and to overcome that dependence they must integrate into manufacturing, joint ventures, or partnerships. I fear three consequences of that integration.

Number one, I fear that instead of more efficiency, greater productivity, lower cost, reduced prices of equipment, we will see precisely the reverse—especially when a monopoly firm with a rate base integrates into manufacturing.

Number two, I fear that the innovation and the progressivity that we have experienced in the past three years will be interrupted and we will now see a throttling of new innovation and equipment, hardware, supplies, and related apparatus.

Finally, I fear a foreclosure of a market which, after three years, is beginning to open and blossom, despite the fact that that opening has been traumatic. I see a foreclosure of that market to the extent that a carrier will be tempted to buy equipment from its own subsidiary.

The problem with the pre-divestiture era was that regulation failed to prevent monopoly abuses. I am concerned that if the telephone companies diversify into an unregulated manufacturing we will experience less competition and more regulation. And what this industry requires and needs is more competition and less regulation, particularly in the equipment market. In my judgment, competition will benefit the equipment suppliers, it will benefit the Bell Operating Companies, and ultimately it will redound to the benefit of the telephone user, both business and subscriber.

Thank you.

Mr. RODINO. Thank you very much.

[The statement of Mr. Irwin follows:]

Competitive Issues in U. S.

Telecommunications Policy

Testimony:

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University of New Hampshire
Durham, New Hampshire 03824

Subcommittee on Monopolies and Communications
Committee on the Judiciary
U.S. House of Representatives
One Hundredth Congress
April 29, 1987

Testimony

I. Introduction

My name is Manley R. Irwin. I am Professor of Economics at the Whittemore School Business and Economics, University of New Hampshire. For some 25 years I have studied the structure, conduct and performance of the U.S. telecommunications industry. In addition to numerous writings, papers and books I have on two occasions served as an economist with the Federal Communications Commission. I have also been a consultant to the FCC, The President's Task Force on Communication Policy, The Office of Telecommunication Planning, The Executive Office of the President;The National Telecommunication and Information Administration, Department of Commerce; state regulatory commissions, the Combines Investigation Act, Consumer and Corporate Affairs, Government of Canada; and Canada's Ecoomic Council. I have presented lectures in the Far East, North America, and Europe.

This committee is considering legislation that permits the regional Bell operating companies (RBOC's) to diversify into interlata toll service, enhanced/information services and telephone equipment manufacturing. My testimony will concentrate on the latter issue.

I will organize my testimony around the following questions:

1. What is vertical integration?
2. What is telephone carrier integration?
3. Has divestiture promoted competition?
4. Does RBOC integration promote competition?
5. Can state PUCs (public utility commissions) regulate integration effectively?
6. Can the FCC regulate integration effectively?
7. Will RBOC integration reduce regulation?
8. Will RBOC integration reduce local exchange rates
9. Will RBOC integration resolve the telcommunications trade deficit?
10. Will trade reciprocity reduce the telecommunications trade deficit?

1. What is Vertical Integration?

As part of a production sequence, firms supply components and equipment to buyers who combine these inputs into final products. When buyer and seller merge, the acquisition is known as vertical integration.

Integration of buyer and seller abounds in the U.S. economy. Ford owns its own glass plant, GM its battery and electronic affiliate, IBM its semiconductor subsidiary. The rationale for integration is the bottom line. If integration promotes efficiency and profits, firms will combine operations. If integration results in losses the supplier will be spun off. Under competitive conditions, the market serves as a final arbiter of integration economies.

2. What is Telephone Carrier Integration?

A telephone operating company is a licensed firm that provides service and facilities in a geographical area. By definition, a license implies both exclusivity and a policy of no entry. By definition a licensed carrier is a monopoly. Most state commissions regard downtown Manhattan or the Chicago loop as incompatible with more than one local exchange carrier.

Because competition is thought unworkable at the exchange level, regulation becomes a substitute to open market entry. Regulators attempt to simulate the results of competition and adopt what is known as rate base regulation.

Rate base regulation says that a telephone carrier's revenue stream must cover its costs. The revenue stream translates into the price of a call multiplied by the volume of calls generated in an hour, day or week.

The cost stream includes the carrier's expenses plus a return or profit on the firm's investment. Under regulation, a firm is permitted to recover expenditures for labor, repair, taxes, legal fees, etc. on a dollar for dollar basis.

Rate of return is a little more complex. Here a regulated firm is entitled to earn a return on its capital investment. The return is usually calibrated as the cost of capital - equity or debt - or as an opportunity cost. Regulation places a cap or ceiling on the profit a firm can earn on its investment of plant and equipment.

Such profit limitations generate their own dilemma, however. How can a firm be rewarded for conducting its business in an efficient manner? If efficiency results in higher profits, the alert regulator will reduce these profits, and pass them forward as rate reductions to the subscriber. If the firm performs inefficiently and costs rise, the regulator lifts prices in order to equate rate of return with the firm's cost of capital.

Now note the dilemma. Rate of return regulation blunts the carrot and stick of corporate behavior. In fact, regulation introduces a set of economic disincentives. The firm is rewarded by expanding its capital rate base. The reason is simple; the higher the rate base, the higher the absolute flow of profits. In the extreme, a carrier's rate base can be expanded by gold plating - excessive standards of quality, redundancy, and high cost equipment.

When the late Senator Paul Douglas was asked to evaluate the investment rate base of the Chicago Transit operation, he discovered dead horses included as part of the firm's capital generating a profit. In a word, rate base economics is cost plus economics and no one, to my knowledge, has satisfactorily come up with an answer to the quandry - license a monopoly and ask that monopoly to be efficient.

Now permit a regulated monopoly to diversify into telephone manufacturing. The utility tends to purchase from its in-house supplier; the supplier sells to its captive customer. Integration obviously conditions the equipment procurement decision of the carrier. And here vertical integration compounds the issue of corporate efficiency. A cost plus environment now resides not only at the utility level - service, but at the manufacturing level as well. The supplier faces a capitive investment rate base customer. The buyer is under little pressure to search for alternative equipment sources. Buyer and seller are members of the same corporate family. To the extent these costs are passed into the investment rate base and forward to the subscriber, the supplier incurs no penalty for inefficient production.

Moreover, an equipment supplier not only fabricates equipment, it installs apparatus as well. Labor expense, wage rates and installation time becomes part of the telephone company's rate base, upon which the carrier is entitled to earn return. Telephone installation expenses are thus capitalized. Given vertical integration, what incentive resides with carrier to reduce installation costs and expenditures? The reality of rate base economics is that the incentive often runs in the direction of cost plus rather than cost reduction.

3. Has Divestiture Benefitted Competitive Entry?

Since 1984 there have been primary and secondary benefits to vertical divestiture and deregulation. The primary benefits have redounded to operating companies and telecommunication manufacturing. The Bell operating companies now enjoy freedom to purchase products based on price, features and technology. The operating companies possess the alternative to choose products that match their individual requirements and subscriber needs.

Moreover, equipment costs have declined in customer premise equipment, digital central office and transmission systems. Centrex has taken on new life, local loop plant has been upgraded, and the operating companies have saved millions of dollars through competitive buying. All have accelerated the pace of product development and hardware innovation. As one industry observer stated recently:

> "Three years ago advanced voice and data transmission made possible by fiber optics and digital switching seemed a decade away. Now it looks as if the majors will convert by 1988."

The telephone manufacturing market has similarly responded to an open environment. True, the transition of AT&T Network System (formerly Western Electric) has not been without trauma - layoffs, product write downs, old plant closures, cost reductions, service center consolidations, reduced management layers, reorganization, market withdrawal and consolidation.

No one said the transition from a sheltered to a competitive environment would be without trauma. But RBOC choice has obviously created opportunities in not merely customer premise equipment, transmission system, but in central office exchanges. A recent NTIA report catalogues the shifting mix in central office equipment.

Table T-7

Bell Company Equipment Procurement

% percent purchased from AT&T Technologies

1982	1983	1984	1985	1986
92.0	80.	71.8	64.2	57.6

Source: Assessing the Effects of Changing the AT&T Antitrust Consent Decree. NTIA Trade Report, Department of Commerce, Feb. 4, 1987, p. 21.

Beyond that:

- Digital central office prices have declined from 900 per line to 300 per line in the past four years.
- Fiber optic prices have dropped from $6.00 per meter to 30¢ per meter in six years.
- Fiber optic repeater distances are expected to go from 20 units to 1000 miles within a decade.
- Satellite dishes (VSAT's) have dropped in price from 20,000 to 2,000 in five years.
- Satellite costs have declined from 7,000 an hour to 700 an hour in five years.

Market entry in telecommunication equipment has spurred user choice, promoted manufacturing efficiencies, expedited market innovation, stimulated technology adaptation, created feature rich products - all to the benefit of the telephone user.

There are also several secondary benefits of divestiture and deregulation as well - what I term bonding, debonding, space and strategy.

Bonding

Firms sell to customers and buy from suppliers. Divestiture and dregulation have permitted firms to get closer to their customers.

- DuPont employs telecommunications to monitor customer orders, prices, complaints and product repair.
- Banks link their investment to corporate telecommunications, giving direct access to asset balance and portfolio information.
- American Airlines ties its reservation system to travel agents, and is exploring the opportunities of remote financial service and ATM terminals.

Firms also employ telecommunications networks to bond with their suppliers.

- GM is paying its suppliers 4 billion dollars via electronic transfer to eight banks - thus eliminating paper checks.
- Ford is linking its CAD/CAM system with its suppliers and subcontractors.
- Penny's links its buyers to its suppliers via teleconferencing.

Debonding

At the same time, deregulation and divestiture acts to debond or decouple the firm/customer/supplier relationship.

- GMs networks of satellites, digital switches and fiber optics holds the potential of making GM a telecommunication reseller.
- Seven/11's 2000 stores linked by VSAT's not only accelerates POS sales, cost and inventory but permits the firm to diversify into financial services.

Sears telecommunication network not only links computers, finance and insurance operations, Sears excess capacity places it as an entrant into telecommunications services.

Space

Space marks a third effect of divestiture and deregulation. Declining telecommunications equipment costs invite geographic market penetration and generate information transparency.

- USA Today FAX's its newspaper to remote plant locations - and thus becomes a national newspaper.
- Commercial data base services connect personal computers throughout the U.S.
- VSAT's earth terminals permit corporate training and education on site.
- ABC News is exploring its own satellite for remote sensing photos for its evening news program.
- Hotel and airline reservations services are instantaneous and global.

To repeat, telecommunication networks give force to a growing concept of information transparency.

Strategy

Finally, the telecommunication network is evolving into a competitive, strategic response to both market competition and market opportunity. The network permits today's corporation to respond to new user demand, to reduce costs, to expedite product introduction, to develop market niches. As I and a colleague noted recently:

> "...more and more firms are adapting the network as a portfolio of businesses within which a larger portfolio of product and business offerings can take place."

And listen to one banker's assessment of telecommunication as a corporate strategy.

"... the communications facilities multiply the effectiveness of the merchant banking strategy by projecting that capability on a global scale."

Clearly the secondary effects of bonding, debonding, space and strategy confers new options, new opportunities and new challenges to U.S. corporations. In my judgment that opportunity is a gift of comparative advantage to those firms who elect to seize that opportunity - in research, design, manufacturing, finance, retailing, brokerage, insurance, product development, education. Here resides the ultimate benefit of a national policy that rests on enterprise, entrepreneurship and competition.

4. Does RBOC Integration Promote Competition?

The answer can be yes if the RBOC starts a manufacturer operation that adds to the number of players in the equipment market. If, however, the RBOC enters the market through acquisition or a joint venture, the number of players are diminished, not expanded.

But here the possession of exclusive franchise - local exchange service - converts that entry process into the potential for market foreclosure. For surely as a utility buys or acquires ownership and equipment to seller, an external transaction is converted into a transaction within members of the same corporate family. A vertical structure conditions vertical conduct.

The carrier will tend to buy from its own supply affiliate. That means that the outside manufacturer, the independent manufacturer of equipment and apparatus, is denied an opportunity to compete on the basis of price, cost, technology, features, or delivery schedule. Integration becomes market foreclosure; and a licensed monopoly has leveraged market power into manufacturing power.

Is this observation theory or fact? The answer can be found in the past conduct of AT&T, the Bell operating companies and Western Electric. Consider the foreclosure scenarios in existing products.:

Existing Product

- A general supplier seeks investment plans from the Bell operating companies.
- Suppliers are told such plans are proprietary, reserved to Western Electric exclusively.
- An outside supplier seeks corporate specifications on equipment and apparatus.
- The supplier is told such specifications are proprietary or if made available are made late and tardy.
- The supplier approaches AT&T for sales approval to the Bell operating companies. AT&T suggests the supplier visit the operating company.
- The Bell operating companies are unable to evaluate non-Western Electric products to the extent they have no in-house staff or purchasing department.
- If the Bell operating companies do to buy from a non-Western source, Western serves as the buying agency, imposing a mark up on the general trade suppliers price.

Given the structure of the Bell System practices, vertical integration tends to promote in-house procurement and inhibits access to the market by independent or nonintegrated suppliers.

New Products

Consider the scenario in which a firm offers a product not currently designed or manufactured by Western Electric or Bell Laboratory.

- An independent manufacturer offers AT&T a product not manufactured by Western Electric.
- AT&T assigns Bell Laboratory to evaluate the product.
- Bell Laboratory or Western Electric evaluate the product, sometimes taking as long as a year.
- Western Electric or Bell Laboratory then embarks on a crash program to develop a competitive response.
- The Bell operating companies resist buying the available product from the independent supplier, but rather would wait for Western Electric's output.
- In some cases when that output was available, the operating companies would buy the equipment without a hard price quote.
- In the meantime the independent supplier, unable to crack the Bell operating companies, deprived of potential sales, no longer is able to generate revenues for future product development.
- The independent supplier assumes the risk, attempts to be innovative, tries to anticipate new demand but is nevertheless foreclosed by vertical integration.

So yes, vertical integration by an operating company may be viewed as market entry; but integration also carries with it a reverse effect. It is also market foreclosure. That was one of the charges against the Bell System in 1974. Presumably the divestiture of Western Electric, the Bell operating companies, and the mandate that the operating companies buy their equipment on the open, competitive market was sought as a remedy to market foreclosure.

Since divestiture it is clear that the Bell operating companies have exercised their new-found buying freedom. AT&T network systems, the old Western Electric's market share has eroded across a spectrum of equipment from customer premise equipment to transmission equipment to central office equipment. Should the RBOC's now reintegrate?

Judge Green observed in 1982:

> "... a substantial likelihood that should operating companies be permitted to manufacture telecommunications equipment, non-affiliated manufacturers would be disadvantaged in the sale of such equipment and the development of a competitive market would be frustrated."

I believe that observation remains valid today.

5. Can State PUC's and the FCC Redress the Problems of RBOC Integration?

In the past state commissions have tacitly supported carrier ownership of manufacturing subsidiaries. PUC's have seldom tested the economic performance of captive suppliers, deferring instead to telephone companies' assertion that cost, price, features and technology best resides as a prerogative of management.

More critically, state PUC's have been party to the market cartellization of the telecommunications equipment in the U.S. Any anemic performance of U.S. telephone suppliers today must be assigned in some measure to a cloistered, hot house environment protected by state regulation. Certainly any attempt to test the efficiency or innovative performance of the equipment market has been opposed by most state commissions - from customer ownership of equipment to domestic satellite; from specialized carriers to user ownership of earth stations. There is no evidence today that state PUC's welcome or invite competition in telecommunications manufacturing.

6. Can the FCC Deal Effectively with the Issue of Vertical Integration?

We are informed by the Department of Justice and the Department of Commerce that the FCC possesses new tools for regulation. Comparative performance, open network architecture, and joint cost allocation supplement traditional rate of return regulation.

But is the commission's record in the past inspiring? Certainly no one can fault the FCC for at least identifying the efficiency and foreclosure issue of the utility/supplier ownership. The commission's first docket addressed AT&T's and Western Electric's relationship in the 1930's and concluded by essentially doing nothing. Later in 1965 the commission raised the issue of procurement, rate base and economic productivity but terminated the inquiry in 1985.

In the mid-1970's the commission did find that vertical integration blocked entry, denied competitive access and contributed to a less than optimal performance in equipment supply. The FCC recommended that the Bell operating companies be accorded greater autonomy in buying their telecommunication equipment.

But after 17 years of investigation, 100 days of hearings, 1 million pages of discovery and countless millions of dollars spent by intervenors in the FCC docket, the commission's record of integration has been one of essentially omission.

- The FCC did not order competitive bidding.
- The FCC did not disallow Western Electric's prices from AT&T's rate base.
- The FCC did not extend rate of return regulation to Western Electric.
- The FCC did not impose quotas on the buying practices of the Bell operating companies.
- The FCC did not require Western to be spun off from its captive customers.
- The FCC did not require accounting changes of Western Electric's cost and operations.

Regulatory policy is inert if it does not lead to action. Fortunately, antitrust came to the rescue of competition in telecommunication equipment.

7. Will RBOC Integration Reduce Regulation?

In my judgement, integration will do precisely the opposite. Granted the new regulatory tools exist, state PUC's will still face the prospect of internal transactions, internal transfer prices, rate base regulation, to say nothing of potential market foreclosure. Inevitably, regulation at the service end will be drawn into regulation at the equipment end. Even today, the FCC has requested the now independent RBOC's for information on telephone purchases from offshore suppliers. One would have thought that absent integration, the equipment market would be left to negotiation between buyer and seller. But the commission apparently believes "national security" redefines the content of the public interest.

And if the RBOC's acquire equipment affiliates, the issue of efficiency and foreclosure will return to the policy agenda. Integration will be an open invitation to more, not less, state PUC and federal oversight.

8. Will RBOC Integration Reduce Local Exchange Rates?

It is possible manufacturing can support exchange rates so the prices will be below cost. But if state of FCC regulation orders such cross-subsidization what will be the incentive for the supplier to pursue new markets in search of returns commensurate with risk? Will regulation chill innovation, dull venture capital and throttle entrepreneurship in supply markets that are nothing if not competitive? And if regulation is extended to the supply affiliate, will this ceiling on profits not prompt the RBOC's to pull a Bell Canada enterprise? Here is a case when the CRTC, (Canadian Radio Television & Telecommunication Commission) sought to disallow Northern Electric's profits and pass them through to the residential subscribers and Bell Canada. The result was that Bell Canada turned itself inside out and reorganized so as to avoid rate base regulation - effectively blocking the cross-sub pass through. Will not a successful regulation effort by the FCC or the state PUC's prompt the RBOC's to pursue the same course? And will not then the state PUC's argue for more regulatory authority in the name of local exchange rates - all the while pushing for 30 year depreciation life?

9. Will RBOC Integration Resolve the Telecommunication Trade Deficit?

In 1982 the U.S. enjoyed a 200 million dollar trade deficit in telecommunication equipment; in 1986 a 1.6 billion trade deficit. Both the Department of Commerce (DOC) and the Department of Justice (DOJ) have asserted that RBOC integration will alleviate a telecommunications trade deficit.

But can DOC and DOJ tell us what particular U.S. product enjoys a comparative advantage? Can DOC or DOJ tell us which RBOC enjoys a competitive advantage overseas? It is, obviously, very difficult for federal agencies to pick winners or losers in the global marketplace.

And once in manufacturing, should the RBOC's be encouraged to compete overseas by dumping at prices less that cost? And if so, who will subsidize the difference? The telephone rate payers? Or would it be more appropriate to use the Soviet wheat deal as precedent and ask the taxpayer to carry the burden?

But more important, the U.S. trade deficit is a macroeconomic problem that derives from U.S. fiscal and tax policies. The U.S. spends more than it produces. Japan produces more than it spends. Any inquiry into the cause of the trade deficit must address at some point in time the budget and off-budget deficits of the federal government - and the tax disincentives that curtail U.S. savings and investment. To place the burden of alleviating the telecommunications trade deficit on RBOC integration applies a micro-economic fix to a macroeconomic problem.

And if the Department of Commerce, the Department of Justice, the FCC and State PUC's are truly concerned about the U.S. trade deficit; they might do well to ponder the following:

- U.S. commercial research and development as a percentage of gross national product is less than Japan and West Germany.
- U.S. savings rate is 20% of that of Japan.
- U.S. productivity is less than Japan or West Germany.
- U.S. expenditures on investment is 50% that of Japan.
- U.S. capital expenditures per worker is one third of that of Japan.
- The cost of capital in the United States is twice that of Japan.
- The U.S. share of the world's technology has dropped from 70% in the 1970's to a presumed level of 30% in three years.
- The U.S. is the only Western nation with a capital gains tax.

In my judgement, the trade deficit overall is a macroeconomic issue; and in telecommunications equipment, the deficit reflects foreclosure policies of vertical integration and rate base regulation. Bashing the investment and savings incentives of our overseas rivals may be irresistible, but it is hardly a viable long term strategy for the U.S. Better that we heal ourselves.

10. Will Trade Reciprocity Reduce the Telecommunication Trade Deficit?

Both the Department of Commerce and the FCC assert that international access to the RBOC market be conditioned on trade reciprocity; namely, that Europe or Japan opening their equipment market. It is no doubt true that Siemens, for example, is enjoying some success in selling its telecommunications equipment to the regional Bell companies. And it is no doubt true that the Deutche Bundepost - the West German PTT - together with 1/2 million union employees - oppose competition in equipment procurement. The FCC observes that it is only "fair" that if Siemens sells to Michigan Bell, AT&T Technologies be permitted to sell to the Bundepost.

But consider the economic consequences of West German telecommunication protection:

- Only 30% of Germany's population possesses a telephone.
- German telephone rates are 50% higher than the U.S.
- Siemens manufactures more sophisticated PBX's in the U.S. than in West Germany.
- Until recently, personal computer users had to rent Bundepost data modems exclusively.
- There is an acknowledged underground market in facsimile illegally attached to the German public network.
- German banks are locating their telecommunication hubs in London.
- American banks and manufacturers are moving telecommunication hubs out of West Germany (Bank of America, National Semiconductor).

  Nixdorf - a German telecom manufacturer - waited so long for a telephone attachment approval, its equipment became obsolete.
- Nixdorf moved its manufacturing to Massachusetts because of Bundepost procurement and attachment policies.

- The Bundepost/Siemens spent 1 billion dollars on an analog central office exchange only to declare the switch obsolete.

And any observer is entitled to ask why there are some 200 illegal private networks in Italy or why telecom rates in Canada are 30% higher than comparable U.S. rates.

The costs imposed by monopoly PTT's on business and residential subscribers is not trivial in terms of services not available, features not accessible, equipment not sold, jobs not generated. Does not a telecommunications monopoly handicap overseas firms relative to their U.S. competitors? And does not state monopoly, de facto supplier integration, and restrictive telecommunications policy carry repercussions that ripple through entire economic sectors - research, manfacturing, finance, banking, retail, reservation systems, semiconductors, robotics, genetic engineering? Is not this secondary effect the ultimate burden of telecom monopoly in services and manufacturing?

Now why does the FCC seek to alleviate foreign nations of their self inflicted burden? Why does the FCC or the Department of Commerce embrace trade reciprocity? Does the commission now define public interest as helping our competition to achieve new levels of efficiency, productivity and innovation? Is the Department of Commerce advocating a second Marshall plan?

I would respectively suggest that we cease exporting unsolicited economic advice. Let each nation decide which policy best suits their economic interest and well being in the long run. Let each nation choose.

As for the U.S., I would hope a policy of unilateral free trade be adopted as that strategy that best guarantees our standard of living, our economic prosperity, the fulfillment of our unlimited economic potential.

Mr. RODINO. Mr. Kimmelman?

Mr. KIMMELMAN. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee:

On behalf of the Consumer Federation of America, I appreciate the opportunity to testify before you today. I would like to give you a little picture of how consumers see the issue of antitrust, competition, and diversification in the telephone industry.

The whole question here, from our perspective, is the price, the cost of the network equipment that is jointly used for just about everything that is provided through our telecommunications network: local phone service, long distance phone service, data processing. All the issues that have been raised by the Department of Justice and by the legislation before you involve questions of how that network equipment cost will be divided and who will be allowed to provide the various services that connect to it.

This is the ball game in telephone service from the consumer perspective—$30 to $40 billion of network equipment, who pays for it, for what services.

Now I would like to evaluate the current proposals before you—the DOJ proposal, H.R. 2030. In light of what was promised at the time of the breakup of AT&T and what has actually been received by the consumers of this country.

The promise was quite simple. We were entering the information age. We were going to get all kinds of new services. We were going to have vibrant competition that would drive down prices in all markets.

Now what have we received? Unfortunately, looking at the very same facts that Mr. Crandall was talking about, I have to evaluate them somewhat differently from the consumer perspective. We have basically seen a redefinition by regulators of what are the common costs of our telephone network. They have now become local costs. We now see the common costs, the network costs, all being shifted over to the end user: the consumer, the small business, the business customer.

We have seen what are called subscriber line charges, which everyone in this country who is a residential customer is now paying at the rate of $2.00 a month, soon to go up to $3.50 a month. Businesses pay between $4.00 and $6.00 a month.

This is all under the rubric of cost based pricing, as Mr. Crandall described it. From the consumer perspective, this is an inappropriate shift of network cost, that should be recovered from long distance service, into the local monthly bill.

Just looking at the same numbers Mr. Crandall reviewed before about local rate increases, our estimates are that rates are up almost three or four times the inflation rate since the breakup of AT&T—not because of the breakup, but because of changes in regulatory decisions.

Now, we have seen some long distance rate reductions in the interstate portion of the market, anywhere between 20 and 40 percent, depending on what time of day you call. It is interesting to note that the time of day when consumers do most of their calling has received the smaller portion of the rate reductions. And instate long distance charges have not been falling—they are actually up three or four percent since the divestiture.

So it should come as no surprise to you that consumers' bills on average are up, according to the Bureau of Labor Statistics, almost twice the level of inflation since divestiture.

Now, how bad is this? It could have been worse. If you look in the context of the current market conditions, I would argue that it should have been much better, and it should continue to be getting better for the consumer.

Mr. Crandall talked about a regulatory lag period where we are just catching up with inflation. Our belief is that this is not a catching up period, this is an anomaly in the historical trend of telephone pricing, it is a break with the 50 year tradition of reduced real cost for phone service. It should come as no surprise that the earnings of the Bell Companies who are charging these exceptional rates are way beyond what anyone else in the market is earning today.

We believe that beyond this regulatory lag described earlier, the Bell Companies are earning $3 billion too much from ratepayers on an annual basis in this country.

We have an inflation rate that is the lowest in 20 years. We have interest rates that have dropped and yet we have not seen the price of local phone service drop; on the contrary, it is up out of line with these market conditions.

We have a tax reform law that is reducing the liability, and thereby the cost to phone companies and yet consumers are not seeing those benefits.

Local rates should be falling as long distance rates fall, and with appropriate regulation we would see that. Yet, the phone companies have an incentive to shift as much cost as possible to the monopoly portion of the business, and that is what we are seeing. That is why consumers are fearful about the DOJ recommendations and H.R. 2030, since they do not provide assurances that we will be able to prevent this shifting of cost inappropriately into local charges.

All the FCC decisions that these proposals rely on would continue to shift network costs into local rates. So from the consumer perspective, if policymakers really want to see the Bell Companies diversify, which we believe may be dangerous at this point in time, you must explicitly prevent the cost shift that is going on.

In other words, so far consumers are really getting the short end of the stick since the breakup of AT&T. Local rate hikes outpace any savings in long distance. It is time to see this process turned around.

We think you need to put consumers first in any measures that you evaluate. Please do not restructure the telephone system again until consumers get some upfront protection.

If local and long distance rates should be falling, as we believe they should, you need to put protections in the measures before you to make sure that happens.

In other words, Mr. Chairman, to conclude, we believe the risks of change in the telephone industry at this point in time ought to be placed on the industry itself and not on the backs of consumers where they have been in the recent past.

Thank you.

[The statement of Mr. Kimmelman follows:]

Consumer Federation of America

Statement

of

Gene Kimmelman

Legislative Director

Consumer Federation of America

Before the

Monopolies and Commercial Law Subcommittee

of the

House Committee on the Judiciary

on

H.R. 2030 and Competitive Issues

in Telecommunications

April 29, 1987

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INTRODUCTION

As local telephone rates keep climbing, consumers wonder what happened to the promises of the information age. Efforts to integrate new, exotic services into the local telephone network appear to carry a hefty price tag: the risk of continued local rate increases and reduced competition.

The Consumer Federation of America (CFA) believes that ratepayers' pocketbooks must be protected and the benefits of competition made available to all consumers before the Bell Operating Companies (BOCs) are released from the restrictions they voluntarily agreed to as part of the Bell system breakup. Consumers have already been asked to bear more than their fair share of post-divestiture risks. Any further telecommunications policy changes must, first and foremost, promote attainment of affordable phone service for all Americans.

I. BACKGROUND

As telecommunications technology changes and public reliance on the telephone increases, consumers face new challenges to their desire to preserve affordable phone service. After almost twenty years of watching the federal and state governments struggle to protect affordable service while increasing competition, consumers remain unconvinced that policymakers know how to open the door to the information age without shutting the door on cheap, high quality basic phone service.

A. Technology and Regulation

Policymakers have fought an uphill battle, using everything from rate-of-return regulation to divestiture, in an effort to keep the price of monopoly services -- like local residential service -- down while opening the equipment, long distance and computer markets to full, fair competition. Unfortunately, the tools of public policy have not developed at the same pace as technology.

Technology has eroded many of the conceptual distinctions essential to effective regulation. For example, regulatory policies based on a clear distinction between communications and computer technologies became ineffective as telephone companies began using computerized equipment. Similarly, technical changes in equipment and service have outpaced accounting definitions and categories, making it impossible for the Federal Communications Commission (FCC) to establish a uniform accounting system that properly allocates costs.

B. Market Segmentation/Competition

These regulatory difficulties have been exacerbated by the uneven development of competition in niche markets surrounding the local network monopoly. Since the network of lines and switches connects both monopoly (e.g., local residential service) and competitive (e.g., long distance and data processing) services, regulators must divide network costs among these services. As competition develops for a particular product, like telephones, or service need, like big-business data communications, regulators must restructure prices. Yet without effective accounting tools or a head-start on technology, it is difficult, if not impossible, for regulators to divide the $30-40 billion of today's shared network costs without impeding competition or driving up basic service prices.

C. Dangers of Lifting Bell Operating Company Restrictions

Because a misallocation of network costs can mean the difference between affordable local phone service and doubling or tripling local rates, CFA is fearful, under current regulatory conditions, of letting the companies that control the local network -- the BOCs -- enter competitive markets. Until policymakers develop the regulatory tools necessary to catch up with technology, and properly allocate the cost of jointly used equipment and resources, consumers have more to lose than gain from local phone company diversification into competitive markets.

II. REPRICING TELEPHONE SERVICE

Although the telephone industry is no longer a monolith, one common theme runs through all industry pricing strategy. Both long distance and local phone companies are rushing to enter as many lucrative, competitive markets as possible, reduce prices in these markets as much as possible, and dump the bulk of their costs on the local ratepayer who must pay or give up service altogether. Consumers face an avalanche of threats to reasonably priced phone service, ranging from local rate requests to increased depreciation charges. In addition, the industry has united around a revolutionary FCC pricing proposal that would transform $6.5 billion of network costs from long distance to local charges. [1] By raising charges for local service, where consumers have no alternative service providers, the telephone industry gains added cash to increase profits or lower charges for services the industry wishes to promote.

III. THE END OF AN ERA OF NETWORK EXPANSION

Rather than require new services connected to the local telephone network to pick a fair share of network costs, federal and state requlators are shifting costs from long distance and other competitive services into monopoly, local service. Little by little, FCC decisions and state rate cases indicate that federal and state regulators have accepted industry repricing proposals. By shifting costs into local rates, regulators are threatening the affordability of basic telephone service.

A. Access Charges

Instead of preserving the goal of universal phone service, the FCC has adjusted its regulatory policies to coincide with telephone industry efforts to shift network costs from all services into local rates. After the breakup of American Telephone and Telegraph (AT&T), the FCC decided to transform billions of dollars in long distance cocts into local charges. [2] All residential customers, regardless of whether they make any long distance calls, currently pay a $2/month "subscriber line charge" for equipment costs formerly charged to interstate long distance users. By 1989, this charge will rise to $3.50/month. In addition, the FCC recently shifted over $800 million of equipment costs previously included in long distance rates into the local rate base. [3]

B. Local Rates

Despite market conditions that point clearly in the direction of lower telephone rates -- both local and long distance, the average consumers phone bill has risen about 20 percent since the breakup of AT&T. [4] Even though our nation is experiencing the lowest inflation rate in over 20 years, consumers have faced a 40 percent increase in local phone charges since divestiture, driving local rates from an average of $10.55/month in 1983 to about $15.40/month at the beginning of 1987. [5]

C. Long Distance Rate Reductions

The benefits of post-divestiture long distance rate reductions have not been equitably distributed among telephone users. Of all the interstate long distance rate reductions since divestiture -- approximately 40 percent for daytime calling, 35 percent evening and 23 percent night/weekend -- a significant portion reflect anhistorical pattern of increased long distance usage, population growth (i.e., more households need phones), family income growth, and the FCC's reduction in the RHCs' and AT&T's rate of return. CFA estimates that the subscriber line charge (SLC) is responsible for bringing down daytime rates by a little over 30 percent, evening rates by slightly less than 30 percent, and night/weekend rates by less than 20 percent. Since almost all residential long distance calling occurs during the evening, night and weekend periods, business customers are getting a bigger break than consumers from the FCC's differential rate reductions.

Even if the SLC-induced savings were passed along in an even-handed fashion, as we believe they should be, most consumers end up paying more for SLC than they save in long distance calling. Based on the survey data gathered from a large sample of telephone bills in Michigan, more than half of American houselonds are currently saving no more than $1.50/month in long distance charges in exchange for paying $2/month more for the subscriber line charge. [6] When SLC rises to $3.50/month, as proposed by the FCC, a majority of American households will see their annual phone bill rise by at least $13-$16. While it is clear that some users benefit by paying larger local phone bills in return for long distance rate reductions -- and the benefits for the largest-volume, big business users may amount to millions of dollars annually -- most consumers end up with larger phone bills. If the states impose their own subscriber line charge, as at least six already have, [7] local residential charges will grow even higher. As interstate rates drop significantly below in-state long distance charges, long distances carriers have an incentive to route all calls as interstate calls to offer lower prices. Therefore, if the federal SLC rises, state regulators will face increased pressure to shift costs from intrastate long distance charges into local rates. To prevent this "double-whammy" local rate hike, it is necessary to freeze the SLC at its current level.

D. Bell Company Earnings

While the profit rates of all other utilities and the nations' most competitive firms fell significantly as post-divestiture inflation and the cost of money have declined, the Regional Holding Companies' (RHC) earnings have soared. By earning a 2.5-3.5 percentage point greater return on equity than all other utilities and the Business Week Top 1000 (see Table 1), and through excessive depreciation expenses and shifts in capital structure, the RHCs have been charging ratepayers about $3 billion per year too much for the last two years. [8] Had the RHCs' been allowed to earn a rate of return no greater than the nation's other largest corporations, telephone rates would have increased no more than the 9 percent general inflation rate since the Bell breakup. [9]

TABLE 1:

RETURN ON EQUITY AND DIVIDEND YIELD:
RHCS COMPARED TO ALL LARGE CORPORATIONS AND OTHER UTILITIES

	RETURN ON EQUITY (IN PERCENT)			DIVIDEND YIELD (PERCENT OF MKT PRICE)		
	1984	1985	1986	1984	1985	1986
AMERITECH	14.1	14.5	15.0	7.3	5.5	5.4
BELL STL.	13.1	13.8	14.2	7.7	5.5	5.4
BELL SOU.	13.4	14.2	14.4	7.4	5.4	5.2
NYNEX	12.9	13.3	13.9	7.6	5.5	5.4
PACTEL	12.8	12.8	14.1	7.1	6.4	5.7
SW BELL	12.9	13.6	13.4	7.2	6.6	6.0
US WEST	13.3	13.3	12.7	7.6	5.9	5.4
RHC AVG.	13.2	13.7	14.0	N/A	N/A	N/A
NON-RHC UTILITIES	9.8	9.7	11.3	7.6	N/A	N/A
TOP 1000* CORPS.	13.2	11.4	10.4	3.2	2.8	2.9

SOURCES: Business Week, "Scoreboard Special, 1985," "The Top 1000, 1986," "Corporate Scoreboard, March 16, 1987." RHC averages are weighted averages. Yields is defined as annual dividends as a percent of market price.

* 1986 12 month average is for the top 900 corporations.

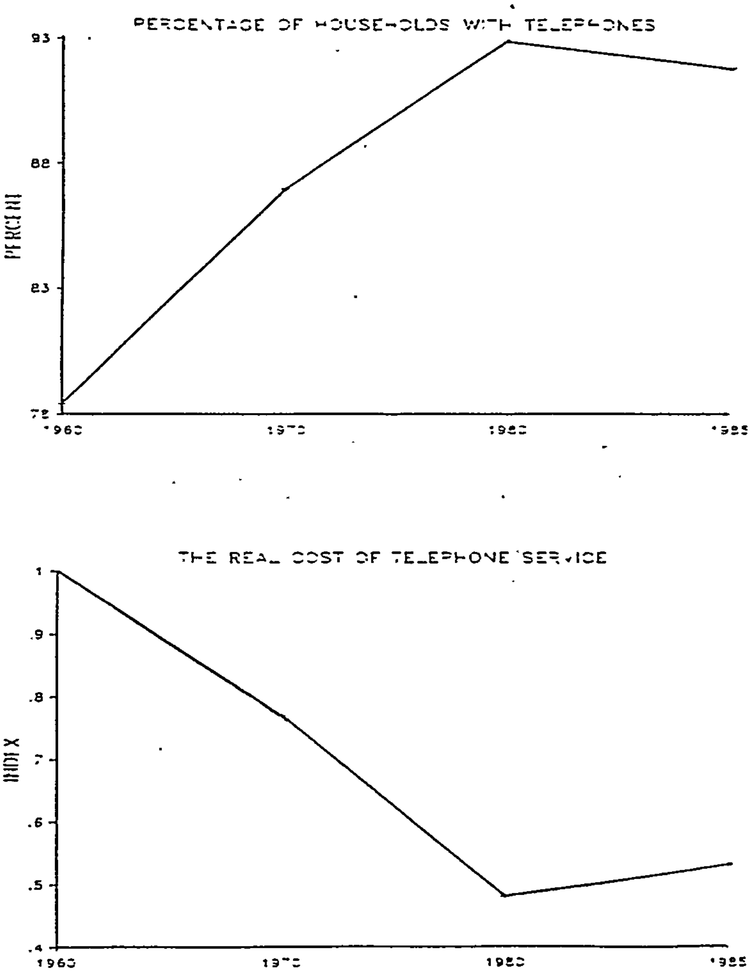
E. Inadequate Regulatory Response

Recognizing this unjustified discrepancy between regulated phone companies' earnings and the rest of the market, the Federal Communications Commission (FCC) reduced AT&T's and the RHCs' interstate rate of return last fall. [10] By dropping AT&T's rate of return from 12.75 to 12.2 percent and the RHCs' from 12.75 to 12.0 percent, the FCC provided consumers welcome relief: long distance rate reductions that are not tied to local rate increases. Unfortunately, the Commission stopped short of reducing profit rates as much as current market conditions warrant, and most states have done nothing at all to reduce intrastate rates of return.

F. A Break With Historical Trends

Recent telephone rate increases run against the grain of the telephone industry's historical trend toward cost reductions resulting from technical innovation. Between 1940 and 1980, the real cost of phone service (factoring out inflation) declined significantly as technological development and network expansion brought a telephone to about 93 percent of American households. [11] Yet since 1980, even with significant long distance rate reductions, overall telephone rates have risen much faster than inflation. [12] Most significantly, the price of phone service is rising much faster than the price of its key component parts (e.g., labor, computers). [13] Although all indications show that telecommunications has been, and should continue to be, a declining cost industry, telephone rates in the 1980s' defy this logic. As a result of this reversal in the historical decline of real telephone costs, progress toward our nation's 50 year goal of universally affordable phone service has been stalled (see Figure 1).

FIGURE I



Source: Bureau of the Census, <u>1960, 1970 and 1980 Census of Population and Housing</u>; <u>Current Population Surveys, March 1983 - July 1985</u>.

Bureau of Labor Statistics, Consumer Price Index

G. Phone Company Cost Savings Resulting From Federal Tax Reform

In addition to the local and long distance rate reductions consumers should receive as phone company profits are brought in line with market conditions, ratepayers should benefit from federal tax reform. Since the maximum corporate tax rate is falling from 46 to 34 percent as a result of last years' tax reform legislation, consumers' should reap significant savings from the decline in telephone company expenses. In 1987, RHC tax liability will decline by about $450 million, and then drop by about $900 million in 1988. [14] Since consumers are being charged through their current telephone rates for greater RHC tax expenses than the companies will ever have to pay, CFA believes local rates should be reduced to reflect the new tax law. Yet unless state regulators or the federal government affirmatively act to require a pass-through of corporate tax savings, the RHCs will receive a $900 million annual windfall.

H. Time For Rate Reductions

With appropriate regulatory intervention, both local and long distance rates ought to be falling simultaneously. If regulated local and long distance companies were allowed to earn no more than everyone else in the marketplace, and required to pass through tax savings, intrastate charges could be reduced by almost $4 billion and the FCC's more than $600 million in interstate rate of return reductions could be significantly augmented. [15] Today's marketplace provides the perfect opportunity to convince the American people that the Bell system breakup can bring the benefits of increasing competition without undermining affordable local phone service. If regulators would ensure that ratepayers receive their fair share of the benefits from reduced taxes and a low-inflation economy, consumers may forget their skepticism of the Bell system breakup. Unfortunately, regulators have allowed the RHCs to defy the realities of the marketplace and earn excessive profits, and would face additional pressure to raise local rates if the MFJ restrictions were lifted.

IV. PROBLEMS WITH H.R. 2030 AND THE DEPARTMENT OF JUSTICE RECOMMENDATIONS TO JUDGE GREENE

H.R. 2030, the "Telecommunications Equipment and Information Services Act of 1987," sponsored by Representatives Al Swift (D-WA) and Tom Tauke (R-IA), and the Department of Justice (DOJ) recommendations to the federal courts would provide consumers inadequate protection against continued local rate increases. Since the bill and DOJ's proposal would allow the BOCs to enter the information services and manufacturing markets under today's cost-shifting/repricing regulatory regime, consumers would have no assurance that network costs will be fairly allocated.

By relying on current FCC regulatory policies to protect ratepayers and competition, H.R. 2030 and DOJ's recommendations could jeopardize the affordability of basic phone services and the potential consumer benefits of competition. These proposals expect the FCC's newly adopted Computer III [16] and Joint Costs rules [17] to do what the Commission has never been able to accomplish in the past: prevent cross-subsidization through accounting procedures.

A. Reliance on the Joint Costs Rules: Hidden Local Rate Hikes?

Although the Joint Costs decision appears to be based on the principles of the attributable cost method proposed by the Department of Justice in its comments in that proceeding, [18] it may conceal a renewed effort to shift network common costs into local monthly charges. Despite the fact that many of the nonregulated services contemplated by the FCC and covered by the Joint Costs Order will use the same non-traffic sensitive loops, switches, other central office equipment and network transmission facilities used to provide basic service, the FCC believes that between 80 and 90 percent of all costs can be allocated on a cost-causative basis, either directly, through analysis of the origins of the costs themselves, or indirectly, through some logical linkage of cost causation to a directly assigned cost. [19] Cost causation, when applied to new, competitive services and their investment costs and operating expenses, may prove a helpful approach to a difficult regulatory task. However, the logic of the Commission's Access Charges Order and related decisions, [20] dictates that the end-user (i.e., the ratepayer) is the cost-causer for a substantial portion of already existing network costs, those considered non-traffic sensitive ("NTS"). If this philosophy is applied in the separation of regulated from nonregulated costs, and the FCC's consistent adherence to this pricing theory along with its astonishingly low estimate of common costs supports this assumption, then all NTS costs will be placed into the separations process as regulated costs directly assigned to the end-user. Since DOJ its consultant, and Mr. Huber inappropriately believe that local phone rates are currently subsidized, they show inadequate concern that lifting the line-of-business restrictions would enable the BOCs to subsidize competitive ventures with revenue from monopoly services. By supporting the FCC's Access Charges Order theory of shifting all NTS costs onto end-users' monthly phone bills, the DOJ by definition would reduce the pool of interstate-access common costs to be allocated through the regulatory process by billions of dollars. Once one assumes that these common costs are eliminated from what Mr. Huber describes as the "inescapably arbitrary" process of allocating joint costs among separate activities, [21] it comes as less of a surprise that the DOJ has developed greater faith in the ability of regulators to prevent cross subsidization. After all, as Mr. Huber points out, the more common costs, like loop costs, are redefined as direct costs caused by the end user, the less likelihood that regulatory misallocation of common cost will substantially impair competition: "First, full implemen- tation of the FCC's $6.00 SLC would cut revenues from ICs to LECs in half. The less there is to dissect, the less it matters exactly what size pieces finally emerge."

On the other hand, if CFA has misunderstood the FCC, DOJ and Mr. Huber's categorization of loop and other common NTS costs under the Computer III, Joint Costs, and Access Charges proceedings, lifting the line-of-business resrictions would open the door to widespread price discrimination by overwhelming the regulatory process with a large pool of common costs. If the Justice Department's definition of joint costs, "cost incurred even if only the regulated service were provided," DOJ Report at 145 n.289, is intended to include loop, switching and other central office NTS costs, as CFA believes it should, it is difficult to understand why the Department expects the FCC's new regulatory rules to prevent the cross-subsidies that no other regulatory approach could manage in the past. As Mr. Huber points out:

> The regulatory history of separating costs between local and interexchange businesses is one of rampant and often deliberate cross-subsidy, blessed if not actually required by various regulatory bodies. Cost separation is torture of a thousand cuts... Each slicing operation involves a measure of discretion. The discretionary judgments at each tier of the dismemberment multiply... If there is a 20 percent discretion as to just where each cost cut will be made, there is a 250 percent discretion as to the size of each small piece that finally emerges.[22]

B. Accounting Problems

No accounting system has yet been devised that can adequately detect a misallocation of the costs of jointly used equipment and resources. Although the FCC has not developed a set of accounting procedures to handle this problem, and has historically been criticized for failure to develop adequate accounting standards,[23] the Commission presumes that an accounting-fix is just around the corner.

Given the pricing incentives of companies that provide both monopoly and competitive services, CFA believes ratepayers would be endangered if the BOCs are allowed to enter competitive markets under the FCC's accounting rules. New technologies have transformed a unified, monopoly telecommunications market into a segemented mixture of monopoly and competitive submarkets. The partial competition of a segmented telecommunications market distributes benefits to large volume, long distance/computer customers (i.e., big businesses), and loads costs on everyone else (i.e. residential and small business customers). Telephone companies that serve both competitive and monopolistic markets have an incentive to maximize profits by shifting costs from the most to the least competitive services. To prevent such cost shifting, the FCC proposes a cost allocation accounting approach based on a network structure of the future, that does not yet exist: "Comparably Efficient Interconnection (CEI) and Open Network Architecture (ONA)." Yet until CEI and ONA are developed and tested, CFA believes it is inappropriate to assume the FCC can handle a task that the General Accounting Office says has never been handled in the past. [24]

C. Intangible Subsidies

Even if the FCC could devise the best imaginable accounting system, some subsidies that utility companies can supply to competitive ventures are so intangible as to defy quantification. These intangible subsidies come in a variety of forms. For example, the name reputation of the companies which comprised the former Bell system is a valuable asset for a competitive service, as is the attractiveness to potential customers of one-stop shopping for information services at the same company which supplies basic, dial-tone service. Unfortunately, accountants cannot objectively assess the value of these shared resources.

Many other activities that a diversified BOC may engage in would involve similar cost allocation difficulties that accounting systems cannot overcome. For example, it is impossible to allocate costs where: experienced utility personnel staff new competitive services; the cost of capital for competitive ventures declined because of the financial stability of the local phone company; competitive services benefit from access to customer information from the BOC's substantial sales base; or ratepayers bear increased costs because overall corporate investment is riskier when competitive services are added to the network. CFA believes these intangible subsidies can only be dealt with through non-accounting methods.

D. Joint and Common Cost Allocation

H.R. 2030 and the DOJ recommendations fail to address the major pocketbook issue facing consumers in the post-divestiture era: who will pay for the astronomical cost of network equipment and resources used jointly to provide many services? Unless legislation like H.R. 2030 overrides the FCC's cost-shifting access charge price theory, consumers will end up paying for anywhere from $6 - 12 billion in network costs through local rate increases (i.e., interstate and intrastate access charges), regardless of how much money the BOCs make from new services.

There is no "correct" way to allocate the cost of jointly used equipment and resources. While one approach may provide maximum economic efficiency and another maximum social fairness, many cost allocation methodologies can meet the Communications Act's combined goals of affordable phone service and fair competitive conditions. As pointed out in recent appellate court review of FCC policies:

> The very problem at issue here -- allocation of common costs -- arises precisely because there is no purely economic method of allocation... elements of fairness and other noneconomic values inevitably enter the analysis of the choice to be made.[25]

Industry cost allocation proposals, which in the access charge decision were accepted by the FCC, would lead to significant local rate increases. Whenever costs do not vary with usage, as is the case for most joint and common network costs, most Bell companies have recommended exempting new competitive services from sharing these costs. As Bell Atlantic stated in its Computer III filing, "any reasonable firm... does not allocate any portion of its joint and common costs which do not in fact vary as a direct result of offering the new service."[26] Southwestern Bell, U.S. West and Ameritech expressed similar views in their comments.[27] So, most of the Bell companies seek to benefit reatepayers by adding new services to the telephone network that will not pick up any of the $6.5 billion worth of non-usage sensitive network costs under FCC jurisdiction, or the $5 billion worth of similar costs under state jurisdiction.[28] Unless Congress requires the FCC to reverse its pricing policies -- and policy reversal not mandated by H.R. 2030 or recommended by DOJ, the Commission's Computer III transmission tariff procedures are unlikely to distribute any fixed network costs among information services.

CONCLUSION

CFA believes that ratepayer concerns must be addressed before Congress or the Department of Justice tamper with the terms and conditions of the Bell. system breakup. Ratepayers' pocketbooks must be protected and the benefits of competition made available to all consumers before the Bell Operating Companies are allowed to enter competitive markets. Until policymakers develop regulatory tools that properly allocate the cost of jointly used equipment and resources, consumers have more to lose than gain from local phone company diversification.

FOOTNOTES

1. MTS and WATS Market Structure, CC Docket No. 78-72, Phase I, Third Report and Order, 48 Fed. Reg. 10319 (March 11, 1983).

2. In the Matter of MTS Market Structure, CC Docket No. 78-72, Phase IV, Adopted December 19, 1984, Released January 4, 1985.

3. FCC Report No. DC-890, reporting action in CC Dockets 78-72 and 80-286, Mimeo No. 2837 (April 16, 1987); Recommended Decision and Order, CC Dockets No. 78-72 and 80-286, MTS/WATS Market Structure, FCC 87J-1 (Federal-State Joint Board, March 31, 1987) ("Joint Board decision").

4. Mark N. Cooper and Gene Kimmelman, Divestiture Plus Three: Still Crazy After All These Years (Consumer Federation of America, December 1986), page 1.

5. Id. page 2.

6. Mark N. Cooper, Low Income Households in the Post Divestiture Era: A Study of Telephone Subscribership and Use in Michigan, Executive Summary (Michigan Citizens Lobby, October 1986) page .

7. Telephone Competition and Deregulation: A Survey of the States (National Telecommunications and Information Administration, U.S. Dept. of Commerce, October 1986), page 17.

8. Mark N. Cooper, Local Rate Increases In the Post-Divestiture Era: Excessive Returns to Telephone Company Capital, (Consumer Federation of America, September 1986), p. 2 and p. 10.

9. Id., page 36.

10. Authorized Rates of Return for Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800 Phase II, Memorandum Opinion and Order on Reconsideration, adopted August 7, 1986, released August 25, 1986.

11. Local Rate Increases, op. cit., page 2, 6.

12. Divestiture Plus Three, op. cit., pages 1-2.

13. Local Rate Increases, op. cit., page 8.

14. Statement of Gene Kimmelman Before the House Telecommunications and Finance Subcommittee, April 2, 1987, Appendix A.

15. Conversation with Bert Halprin, Chief, Common Carrier Bureau, FCC, March 3, 1987.

16. Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), CC Docket No. 85-229, FCC 86-252 (released June 16, 1986.

17. Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, FCC 86-564 (released February 6, 1987). As DOJ acknowledges on p. 32 n.69 of its report, this document was not yet released at the time the report was prepared. CFA, et al. will not belabor the obvious quesitons raised by reliance on a press release.

18. Id., paragraph 151.

19. Id., paragraph 162 and n.280.

20. Third Report and Order, MTS/WATS Market Structure, 93 F.C.C.2d 241 (1983); First Reconsideration Order, 97 F.C.C.2d 682 (1983); Second Reconsideration Order, 97 F.C.C.2d 834 (1984); Recommended Decision, CC Docket No. 78-72 and 80-286, 49 Fed. Reg. 48,325 (1984); Subscriber Line Charge Order, 50 Fed. Reg. 939 (1984).

21. P. Huber, The Geodesic Network, 6.39 (January 1987) [hereinafter "Huber Report"].

22. Id., pp. 3.53-.54.

23. Legislative and Regulatory Actions Needed to Deal With a Changing Domestic Telecommunications Industry, United States General Accounting Office, CED-81-136, September 24, 1981.

24. Id.

25. MCI Telecommunications Corp. v. FCC, 675 F.2d 408, 415-16 (D.C. Cir. 1982).

26. Comments of Bell Atlantic Companies in Notice of Proposed Rulemaking, Amendment of Section 64.702..., op. cit., p.10.

27. Comments of Southwestern Bell Corp. in Notice, op. cit., pp. 49-53, Comments of U.S. West, Inc. --. 106-7, Comments of Ameritech, pp. 35-41. But See Comments of Pacific Telesis Group, Attachment A -.3 for a more reasonable cost allocation methodology.

28. Report of the Committee on Energy and Commerce on H.R. 4102, 98th Congress, First Session, Report No. 98-479 pp. 19-24.

Mr. RODINO. Let me ask you, Mr. Kimmelman, do you think a sufficient amount of time has elapsed to make a determination on whether it would be worthwhile or helpful to the decree?

Are you talking about time, or are you talking about having made a judgment already and just suggesting that maybe we need more time?

Mr. KIMMELMAN. I think time is a major portion of it because historically what we find in evaluating what has gone on is that technology has outstripped regulatory abilities to keep up with these changes. We find that if there is a regulatory lag at all, that it really is in following the appropriate pricing practices of new technologies.

So I think with the changes that have occurred in the marketplace, it would be appropriate to give regulators the opportunity to catch up and to be able to provide the kind of price protections that we believe consumers need if you are going to experiment with a new industry structure.

Mr. RODINO. Let me ask each of you, and be as brief as possible in answering this question. Was the divestiture a good thing for the industry and the American public?

Ms. NELSON. I think the jury is still out.

Mr. RODINO. You think the jury is still out? You feel that you need more time to make the determination—more facts, more investigation, more information?

Ms. NELSON. We are definitely an industry in transition. As has been said, technology is evolving very rapidly. I think regulators are trying to keep up as best they can with the evolving industry structure.

In our State, we are giving the industry pricing flexibility where we see competitive markets, we are attempting to give them as much freedom as we can where competition actually exists.

I think, though, that a new restructuring at this point in history would be premature. We should see how the market shakes out with competition in the interexchange business and see how that impacts the local exchange and the monopoly ratepayer, and see if technology actually will provide competition in that local exchange market, which is the crucial one for State regulators.

Mr. RODINO. Are you able to say now whether the divestiture has been the cause of the increases in the local phone rates?

Ms. NELSON. I don't think that divestiture itself has been. This process is, again, evolutionary. The FCC had determined that some markets would be allowed to be free. There has been cost shifting going on because of various Federal policies that are having an impact on the separations and cost allocations between the Federal and State jurisdictions. So we are seeing that cost shift now come to fruition. How far it will go, again, is yet another open question.

Mr. RODINO. Professor Irwin?

Mr. IRWIN. Thank you.

I see two effects of divestiture and deregulation. In the narrow sphere of telecommunications, our U.S. rates are 30 percent less than Canada and 50 percent less than Germany. I don't know how they stand in Japan, but the U.S. has experienced, at least in terms of toll calls, lower long distance expenditures, both for residential and for consumer users.

I have also alluded in my testimony to the effect of competition on the equipment market, on production and hardware. Competition is no longer confined to telecommunications but is beginning to penetrate in the banking industry, the finance industry, the manufacturing industry, robotics, computer aid, design, and so on.

It is that second effect that I think is a windfall to the U.S. and its future environment. Our industry, I believe, is now enjoying a comparative advantage vis-a-vis our overseas rivals and competitors, because we are harnassing telecommunications and information as a competitive strategy which ranges from retailing, to K Mart, to General Motors paying its bills by electronic mail to aid banks, to the banking industry. Competition penetrates the entire U.S. economy and I believe is causing an economic renaissance that will ultimately benefit our international trade posture.

So, yes, I am quite positive, not merely on divestiture, but I am quite affirmative in terms of the benefits of deregulating markets. and letting the entrepreneurial genius and the creative actions of American industry finally reach its full potential.

Mr. RODINO. Is it good for both industry and the consumer?

Mr. IRWIN. I believe it is because industry is a consumer as well as a supplier of products and services.

Dr. Crandall will obviously comment on the realignment between exchange rates and toll rates. My own view is the reason local exchange rates are high is because of capital intensive plant, because of long depreciation life, because of the absence of entry and the absence of technological change, and the incentive system that is associated with rate base regulation in which the name of the game is load the investment rate base and pass it forward to the consumer.

Mr. RODINO. So you would answer no to the question, is divestiture the cause for the increase in local phone rates?

Mr. IRWIN. I would say essentially no. I am an academic and we always hedge. I would say essentially no, but that the realignment would have taken place irrespective of divestiture. Although divestiture to that extent, Mr. Rodino, did perhaps expedite the process.

Mr. RODINO. You haven't answered the question, though.

Mr. IRWIN. Try it again.

Do I think divestiture realigned local and toll rates?

Mr. RODINO. Yes.

Mr. IRWIN. Yes and no.

Yes to the extent that it may have expedited the process. But no, in the long term, I believe that realignment would have taken place anyway, given the nature of the technology change and market competition.

Mr. RODINO. Okay. You try it, Mr. Kimmelman.

Mr. KIMMELMAN. I am going to say the exact opposite. I don't think the realignment of rates needed to occur, not because of divestiture or because of anything else in the industry. I think that with divestiture or without, we could have substantially lower basic telephone rates today. So it is not because of divestiture that the rates have gone up.

I think that what has happened is a very good idea: trying to infuse competition in the telecommunications industry, has been misapplied in a number of ways. It is not causing any kind of catastrophy, but it is denying benefits to consumers, which we believe they should be able to receive in a system that is partially competitive and partially a monopoly for the foreseeable future.

So it is really inappropriate regulatory practices which we think are the culprit in causing these shift in rates, not divestiture in and of itself.

Mr. RODINO. The fact of the matter is, though, you meet a lot of consumers, a lot of telephone users, and they tell you that their rates have increased.

Mr. KIMMELMAN. I think they are probably fairly accurate. Our own surveys of consumers indicate that they——

Mr. RODINO. I can tell you that mine has.

Mr. KIMMELMAN. Most consumers have a pretty good idea of what they are paying, and they know they are paying quite a bit more than they were a few years ago.

Now, there are many explanations for why that has occurred. We believe many of them do not justify the rate increases. But I don't think any of them have to do directly with the divestiture itself.

Mr. RODINO. Professor Crandall?

Mr. CRANDALL. The problem with this discussion is the notion that somehow if a cost is loaded onto business, consumers don't pay for it. I am concerned about the fact that our domestic price of sugar is three times the world price, even though I know that lots of businesses buy sugar and I don't buy very much. I buy my kids soft drinks and so forth, into which the price of sugar is included. So I don't think you can make that artificial distinction.

The important thing is that what we were doing was cross-subsidizing from long distance services, which are preponderantly paid for by business, to local service. That is now coming to an end because of competition in long distance service.

The answer to your question is, yes, divestiture will put further pressure on this because one of the major players in long distance is obviously AT&T, which now has the incentive to look to bypass its former Operating Companies—an incentive it would not have had in the absence of divestiture.

The question of whether divestiture was the cause of the rise in local rates is answered in part by an FCC study released in the last two weeks.

On April 10th, the Common Carrier Bureau of the FCC published a very lengthy analysis of the Bureau of Labor Statistics price indices on telephone service. They demonstrate that local service started rising in the early 1980s before the divestiture. It was because of changes in ratemaking procedures at the States, and this was, as I suggested earlier——

Mr. RODINO. Those increases did not become apparent, though, until after the divestiture .

Mr. CRANDALL. There may be a long consumer lag, maybe people only responded to their telephone bills after a two-year lag. But in fact, the BLS has captured this earlier rise rather accurately.

The second thing to notice is that it is very difficult to construct a continuous price index on a service which is changing rapidly. We now own our own handsets for the most part. We do not lease them from the telephone company. All of these changes—changes in how we pay for the inside wiring in our own homes or businesses—have made it very difficult for BLS to construct a continuous price index.

A big part of the increase occurred just at divestiture because of these regulatory changes by the FCC.

Since the divestiture, February 1984, the study by the FCC shows that the average rate of price increase in telephone service has been almost exactly equal to the average rate of increase to the CPI, which I think is still a temporary anomaly. I think telephone rates will resume their pattern of increasing much more slowly than the CPI.

Mr. RODINO. I will ask this for all of you to comment. Do you agree with the Department of Justice's argument, recently made in its filing with the court, that the Bell Operating Companies' control over the local bottleneck is diminishing because of technological innovations?

Another part to that question: Do we now have the technological expertise to provide consumers with an affordable alternative to the copper wire pairs and buried cables that comprise the local networks?

Ms. NELSON. I will take a crack at that.

Mr. Chairman, I think it is important that we try to analyze these questions with a view to exactly which markets we are talking about. You just mentioned the local exchange market. I think that no one would say that there is effective competition in the market for local exchange access or local exchange services presently defined.

Take the BOC's within their LATA's—that term of art that was coined as a result of the divestiture—within their intraLATA toll area. In our State we are finding they have a 94 percent market share there. There is no equal access requirement, there is no presubscription requirement.

So the question of bottleneck in intraLATA toll is trickier than it is in local exchange. Or I could say definitively to you, yes, the bottleneck theory still applies in local exchange.

So to try to answer the question quite succinctly, I would say that the technologies that we are seeing evolve that would serve as an alternative to the universal service, that the residential, small business ratepayers have come to think of telephone service now is way over anybody's planning horizon. To be sure, the shared tenant service providers are moving into large buildings in our metropolitan areas; to be sure, cellular telephone service is coming down in price, but still is not accessible or affordable to a middle-class consumer; to be sure, there are all sorts of dazzling new technologies that we are beginning to see some applications for—but they are not in any position to be produced to a mass market at this point.

Mr. RODINO. Professor Irwin?

Mr. IRWIN. Despite cellular radio, and PBX's and shared tenant services, and fiber optics, and microdishes, today the local exchange is still regarded by State Public Utility Commissions as a natural monopoly. And that situation does not invite market entry in manufacturing or in long distance.

It seems to me the real question is why is the local exchange regarded as a natural monopoly?

I think the answer is not so much technological, although that still may be a driving force, but rather, regulatory. State Commissions have fought for 20 years any diversity in terms of user choice, in terms of access, in terms of new competition at the local level, to say nothing of the toll level.

I would say that today's bottleneck problem is as much a state regulatory issue as it is a technological one.

Mr. RODINO. Mr. Kimmelman?

Mr. KIMMELMAN. Once again, I would totally disagree with Professor Irwin. I do not think it is an issue of the decision-makers. I think it is an issue of the technology in the marketplace. Even the report that the Department of Justice relied upon found that all residential users relied for all their service on the local phone company and the bottleneck, and that almost all business users do as well. I believe the figure was that 97 percent of minutes of use go through the switched telephone network controlled by the Bell Companies.

So for virtually all users of telecommunications service, there is a bottleneck, there is a monopoly at the local level. There are some alternatives. They are mainly high cost, or they are certainly not available for mass marketing to the general public because people will not purchase them. They are much more expensive than basic telephone service is today. They are for niche markets, and I think for the foreseeable future that is likely to be the case.

I would add, it is not just the State regulators. This Congress dealt with what is considered to be one of the best alternatives to telecommunications at the local level, and that would be cable, a number of years ago in the cable act. The Congress did not decide to open the door to competition as it looked at market conditions. So if it was policymakers, it wasn't just State regulators who were viewing that marketplace, it was the Congress as well.

Mr. RODINO. Yes.

Mr. CRANDALL. I think what Mr. Kimmelman says is correct about the current bypass percentage, although there may even be less actual bypass of the local network than he suggests because some of it takes the form of leased private lines rather than switched services.

The Huber report to the Justice Department documents the rather aggressive protection of the local monopolists by about 18 State Public Utility Commissions. I think the State Public Utility Commissions are the problem and will be the problem in the future.

As to how technology will evolve, I don't know that any of us can see that very well. I don't think there are any licensed electrical engineers on the panel here. It is hard to predict how this technology will evolve. As of yet, the alternatives for the small user of telecommunications service to the local network, local telephone company, are indeed very, very few.

Ms. NELSON. Mr. Chairman, could I?

Mr. RODINO. Yes.

Ms. NELSON. I just find the notion that State regulators cause barriers to entry somewhat objectionable. It may very well be that

18 States have State regulators that are actively protecting some part of the franchise notion of relatively limited entry. But that may very well be because there are State statutes which they are duty-bound to apply which require the protection of the franchise and may not allow entry such as we do in Washington.

I would like to emphasize that in Washington State there never has been a regulatory barrier to entry. We had, until 1985, a scheme which said that any initial tariff had to be accepted by the Commission. The Commission could not deny a new entrant into the marketplace their tariff.

Despite that, we now have requirements to review the financial competency of new firms so that we can prevent the absolute fraudulent people from reselling, and so on. We now have STS buildings in Seattle and Spokane. We allow the resale of Centrex services. We have new firms entering that market. We have whole communities that are served by STS private telecommunications systems that we don't regulate at all. We don't regulate cellular at all. And still we don't see any firms entering those markets.

We have rural areas that are crying out for just the common garden variety—MCI and Sprint—for their intraLATA service, and they don't get served. They don't enter those markets. So there are other things besides legal or regulatory barriers preventing competition from entering those markets.

Thank you.

Mr. RODINO. Let me ask you to help me understand something. As I said in the past, the Justice Department has consistently taken the position that divestiture and structural separation were the only effective means to deal with the ability of the local monopoly to discriminate or cross-subsidize. In 1980, the then Assistant Attorney General Sanford Litvak told this subcommittee, and I quote:

> We see basic structural relief as the answer. A separate subsidiary, in our minds, while a step in the right direction, doesn't, and can't, by definition, deal with the problem. So, short of divestiture, I really have no solution.

Then again in 1982, the then Assistant Attorney General William Baxter explained the divestiture decree to this subcommittee as follows:

> The most straightforward and effective way to eliminate AT&T's incentives and abilities to exclude competition from potentially competitive telecommunications markets, is to require the divestiture of its regulated local exchange monopolies from those portions of AT&T that engage in competitive and potentially competitive activities.

Now the Justice Department appears to be shifting its position dramatically to the point where they are urging that the local exchange companies be permitted to engage in competitive businesses subject to State and Federal regulation.

How do you explain this change of position?

Mr. CRANDALL. I would be happy to explain it.

Given the distorted structure of telephone rates, particularly between long distance and local service (which in fact, interestingly, for reasons I cannot yet figure out, accelerated at just the time that competitive entry became a practical possibility), AT&T found itself in a situation of being attacked on its highly distorted, high price-to-cost ratio market, namely, the long distance market. It is not surprising that they behaved the way they did, although they should have consulted antitrust counsel before they did so.

Now if we indeed allow markets to determine these prices more rationally so that there is no artificial incentive of this sort, I see little reason to expect that aggressive a response.

Secondly, in the other area, namely, consumer premises equipment, where I think the leadership of AT&T against the better wishes of others within the corporation, pursued an extremely aggressive strategy, including bringing a piece of legislation up here to you to grant them perpetual monopoly in CPE, AT&T found that despite all of its attempts—including legislation and anti-competitive behavior—it could not maintain their share of that consumer premises equipment. In fact, they lost market share very rapidly prior to divestiture.

Many of the changes in the CPE market that Professor Irwin talks about had started long before the divestiture. AT&T had lost its grip on things like the PBX's. In fact, it has come back a bit in PBX's since it lost the burden of the local exchange network.

Mr. RODINO. Would any of you like to try?

Mr. KIMMELMAN. All I can say is that from our perspective the marketplace has not changed that dramatically, and certainly the regulatory environment has not changed very much at all in terms of the tools that regulators possess at this point in time compared to five, six, seven years ago.

So all that we can figure out is that the politics of the Department of Justice have changed. As a matter of fact, I would go further and say that their original optimism about a restructuring of the industry and competition in long distance may have been too strong. Because I think what we have seen in the last few years is continued dominance by AT&T in the long distance market with a very large market share, an appearance of economies of scale in long distance that may actually indicate that competition was only available on a marketplace basis for niche markets, not for the general public. There are many people in this country who still did not receive alternative long distance services.

So I would say that it appears to be a political change in judgment, and that if anything, they ought to be more skeptical of changing the rules of the game again now, given the fact that they were not that accurate in predicting what would happen three years ago.

Ms. NELSON. Mr. Chairman, our written statement, as well as our comments to the Department of Justice, attempt not to speculate on the motives of the Department for its switch. But just notice, as you did, that it is quite an about face in the faith they have now in regulation.

As our comments try to make clear, we don't have the same faith that they do. We would like to. But we see that the FCC's system of regulation is evolving. There are new ideas in regulation emerging all the time. But none of them is, in the opinion of the Washington Commission, at this point determinable enough, tried enough, true enough, to give us faith that it will be a good preventive medicine.

Now I should say that some of my colleagues in other States believe that they can exercise appropriate regulatory control. California is a clear example of that, where the California Commission has faith that it can impose separate subsidiary requirements on Pacific Telesis and the like, and govern the evolution in the market.

However, those of us who regulate the operating companies of US West have much less confidence in our ability to police against those improper cross-subsidies and prevent anti-competitive abuse such as the sort that prompted the bringing of the suit in the first place.

Mr. RODINO. Professor Irwin?

Mr. IRWIN. I don't understand why the Department of Justice, which employed the antitrust laws to supersede regulation, has now deferred to regulation. I don't understand that at all. Perhaps it is simply an institutional loss of memory.

Mr. RODINO. Thank you very much.

Mr. Glickman?

Mr. GLICKMAN. Thank you very much.

Obviously, this is an extremely complicated subject. As I look at the subject on the one side, the side favors the Justice Department's position and/or the position perhaps of Mr. Tauke in his bill, is the fact that society has moved along with more entrants in the game of developing new technology, and that the current scenario restricts seven very large companies from producing new technology, which means there are fewer people doing it and it restrains competition generally. I think that is persuasive.

On the other side of the coin, what concerns me, is an FCC which has shown a great reluctance to do an effective job in protecting consumers, and the assumption by the Justice Department if we open all of this up the bottlenecks will disappear and go away.

Underlying all of this, I think there is merit in both positions. And I think underlying all of this is my great concern in the parallels between what has happened in the telephone industry and to some extent what has happened in the airline industry.

In the airline industry, what we have seen is the public in underserved areas has suffered. But more significantly, the safety of the flying public may have suffered in the process.

I think that the FAA is a more effective protector of the public interest than the FCC. It is very difficult for government to be too effective of a protector in a society like ours, and I am glad that we have a society like ours.

I guess what concerns me more than anything else is devising a system that provides that kind of public protection. In the case of telephones it is really not safety, unless you get electrocuted by a poorly manufactured telephone, as it is adequacy of service. We recognize in America, that universal communications service is something that is part and parcel of our democratic system.

I wonder if I have adequately developed the underlying issues as they relate to us, to the Energy and Commerce Committee, and to the Congress, as we deal with this issue of how we expand the authority of the operating companies.

Have any of you any comments on that?

Ms. NELSON. I should probably defer to Mr. Crandall on the airline analogy, since he had a lot to write about all of that. But I would say yes, I think you have outlined the dilemma, the policy dilemma, quite well.

I would say in response to your comment about technological innovation, the notion that there are seven entrepreneurs waiting to get into those markets, I think there is some merit to that.

However, there is a tone in the Department of Justice's comments to the judge which struck me, that technological innovation is somehow parallel to the invisible hand of the marketplace—it is something that is not influenced by us mere mortals, that we should somehow just get out of the way and let innovation take its course, take its head. But it struck me that that also represented something of a memory lapse on the Department's part.

Monopolists have their own incentives for impeding innovation, and I think that cartel participants would have those incentives as well. So I think we have to again think about the markets, specifically the manufacturing market. Maybe there should be different rules there than there would be in the other markets that we are talking about—the information services markets.

I think you have stated the dilemma well.

Mr. GLICKMAN. Yes?

Mr. CRANDALL. I don't disagree with you. I think it is extremely healthy to have a skepticism about the ability of regulators to police cross-subsidies. I mean, for 15 to 20 years the Federal Communications Commission was unable to come to a conclusion that any rate filed before it was indeed lawful because it couldn't sort out all of the different costs of the AT&T system.

So I think it is very difficult in a highly complex market like this, with lots of joint and common costs, to try to be sure there aren't cross-subsidies. Indeed, regulators not only have a difficult time policing cross-subsidies—they even induce cross-subsidies of their own, as I mentioned earlier.

On the other hand, you should be equally skeptical to have hordes of people coming up before you telling you that, as the Antitrust Subcommittee of the Judiciary Committee, that you should be eager to accept their position that it is necessary to fence out seven large rivals from their markets. So I think you face a trade-off.

If you make the judgment that it is too soon to allow these seven large companies back into these markets, I think you might want to reconsider your position a year from now, two years from now, three years from now. It seems to me eventually you want to let them back in. And even though you may risk some cross-subsidies through the regulatory process, that those evils are less than the evils of artificially constraining competition.

Mr. GLICKMAN. I think that my time is about up, but I think I generally agree with you, Mr. Crandall. And I think that at some point we are going to have to open the restrictions and let these people into the game. But what I don't want to see happen in this country, and it is beginning to happen right now, is that if you operate in the business sector of our society, if you are relying primarily on the long distance operations, and if you can afford fancy electronic equipment, you benefit. But a lot of my constituents don't fit into that category and they can't even find people to come and fix their telephones any more when there is a problem.

So I don't want to see the same parallels worsen that have happened in health care, and that happened in other forms of our society where we have basically deregulated. So as we open the competitive fences and gates and let people come in, you have got to have an effective government regulatory body, or else you have got the survival of the fittest out there, and you have got a very chaotic condition for a lot of folks who cannot participate in the benefits of this process, because there are some folks that can't participate in that.

I am not sure we disagree. I just think that that is our job to make sure that a regulatory body is effective and strong.

Thank you, Mr. Chairman.

Mr. RODINO. Mr. Staggers?

Mr. STAGGERS. Thank you, Mr. Chairman.

One concern I have, and it pretty much follows up on what my colleague, Mr. Glickman, was saying, I am concerned about rural America—and I know Ms. Nelson touched on that a little bit. But what would be the effect on rural America? And if in fact we do allow the entrants into the market, what about universal service? Isn't it likely that we will see universal service, the concept, be attacked also?

Ms. NELSON. I think that, again, is the other horn of the dilemma, as stated by Mr. Glickman. We do see at this point a dazzling array of products and services available to primarily the large business user. As one goes down the socio-economic hierarchy, that array is just not there. And constituents in our rural areas have, as I said, no alternative long distance carrier at this point. Most of them are served by independent companies who are under no compunction, no judicial or regulatory mandate, to provide alternative service. And, as I said, we are seeing that the interLATA or even intraLATA resellers are not entering those markets.

In our State, some of the larger towns, the fifth and sixth largest towns in the States, are beginning to have resale alternatives. But, again, the truly rural places do not have any alternate carrier except—well, of course, the predominant one, AT&T.

The CPE, again, the markets are different—they would have more choice there. But in terms of the services part of the equation, we don't see much choice. And that is a true dilemma, I think, for policymakers.

Mr. IRWIN. I live in a rural area and I frankly don't feel deprived. I remember the day when the New York Times came in two days late, the Wall Street Journal came in three days late, when the Sunday New York Times came in on Wednesday. Now I get newspapers each morning. I would ascribe and assign that to satellites, to facsimile, to remote printing, to information technology. So I feel I am a beneficiary of deregulation and the diversity created in an environment of change.

Mr. KIMMELMAN. If I could just add something. The rural issue and universal service are part of the broad issue of distribution of benefits. I don't disagree with what Mr. Crandall said before that there are some benefits. But our concern from the consumer perspective is what is the distribution of benefits?

And if you look at what has happened so far and you look at where people are clamoring to get into markets, you find there are a lot of markets people do not want to enter. And you find there are a lot of people they don't really want to provide services to because it is not that profitable. So whether regulators are continuing to regulate, or changing their posture, you can see where we are going just on the developments in the marketplace.

Our concern is there are a lot of people who are not even getting much benefit from shifting costs from long distance to local because they don't do much long distance calling, and many of them are rural telephone subscribers. If you expand that to computer services, information services and other sophisticated equipment, I would say the disparity grows even larger.

One thing I wanted to add to Mr. Glickman's scenario before, if there is anything that is very dynamic it is the political process itself that surrounds the whole telecommunications industry. I found it ironic to note the Department of Justice relying on regulatory developments and regulatory processes, and the Bell Companies filing in agreement with them at the very same time that those Bell Companies in many States of this country were seeking State deregulation, at least of rate of return of many services and often across the board.

So on the one hand, there is a proposition that we have adequate regulation to deal with cross-subsidies and to deal with all the network equipment costs, at the same time, the very people who are claiming that may be seeking a very different regulatory environment at a different level of government. And I say that is cause for concern.

I would agree that it is a little early to change the rules of the game. I think consumers are still very confused about what happened. But I would urge that in any analysis of what changes need to take place that you look very carefully at what the regulatory environment is around the country.

Mr. CRANDALL. Mr. Staggers, I don't think there is any particular cause to be concerned about the impacts of easing the line of business restrictions on rural consumers. I think the major impacts upon rural consumers have come from the repricing of telephone services and the partial elimination of the subsidy from long distance to local service, so that those rural consumers who, as Mr. Kimmelman suggested, do not consume large amounts of long distance service have probably suffered a real increase in their telephone rates.

You can't put the genie back in the bottle, so the only way to attempt to maintain the subsidy, to the construction and operation of rural telephone systems would be to do it overtly, do it directly rather than through excess charges on dense routes on long distance service.

Mr. STAGGERS. If we don't do it directly, what would happen with two of them, a small local company, a county company, that provide services now, wouldn't there be the likelihood of a creaming of service? And what happens with equipment once technology passes that county by? I doubt if they could maintain.

Mr. CRANDALL. I think the systems have been designed in light of the fact that they are obtaining substantial subsidies from the separations and settlements pool. They would simply have to be redesigned to reflect the lower density population and to use different sorts of technologies. There's no reason why they should use the same technology in a rural location as used in a highly dense urban location. They may have to rely more on radio transmission and less on wire transmission, and so forth.

It seems to me that we have given them the wrong incentives over the years. What the immediate effects would be, I simply don't know, not having enough of the perspective of the small telephone company operator. Perhaps Ms. Nelson could comment.

Ms. NELSON. I think that is one of the unknowns. I suspect we may see some activity as the market shakes out. We may see some mergers, we may see some acquisitions. I just don't know what will be the fate of the smaller company.

I would like just to mention—not to answer your question directly—but I think there are people looking at telecommunications in all kinds of ways. In our State, the legislature has just mandated that the Commission and the Department of Community Development inventory telecommunications services available in some of our less densely populated counties with a view to targeting economic development activities in some of those counties.

In our State, like many other States, the resource, based counties, the old timbering and agricultural counties, are very, very depressed. They have high unemployment rates up into the 30 percent range, and the notion is to try to target some development of the telecommunications infrastructure in those counties to attract and recruit new business to the region.

I think that is just one of the long-term issues that we as policymakers should be examining. I really can't give you much of a better answer than that. Sorry.

Mr. STAGGERS. Do I have more time?

Mr. RODINO. Yes, go ahead.

Mr. STAGGERS. Thank you, Mr. Chairman.

With the question of competition in the local services, I know that Mr. Crandall has mentioned that if not now then later, what are your feelings? Is there sufficient competition now, or is this something we should be doing?

Mr. CRANDALL. In what service and in what areas are we talking about?

Mr. STAGGERS. Generally.

Mr. CRANDALL. If you are talking about competition in the local access and distribution function of local exchange companies, there is relatively little competition now for most customers except the very largest of customers.

How rapidly that will change, I was unwilling to try to guess. Technology is changing, but how rapidly that will spread to smaller and smaller customers is unclear. It seems unlikely that any time in the foreseeable future there will be intensive competition to reach the small business or small residential subscriber, and particularly the one out in the rural areas to which you refer.

Mr. STAGGERS. Thank you, Mr. Chairman.

Mr. RODINO. Mr. Lungren?

Mr. LUNGREN. No questions, Mr. Chairman.

Mr. RODINO. I want to thank you very much for your appearance here this morning.

Mr. RODINO. Our next panel consists of Robert A. Levetown, Executive Vice President and General Counsel, Bell Atlantic; George J. Vasilakos, President and Chief Executive Officer, ALC Communications Corporation; John D. Zeglis, Senior Vice President and General Counsel, T&T Company.

Gentlemen, you are under the same caveat as the others. You will present your oral testimony in five minutes, and the prepared testimony you have presented will be inserted in the record in its entirety.

You proceed first, Mr. Levetown.

STATEMENTS OF ROBERT A. LEVETOWN, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, BELL ATLANTIC; GEORGE J. VASILAKOS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ALC COMMUNICATIONS CORP; AND JOHN D. ZEGLIS, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN TELEPHONE AND TELEGRAPH CO.

Mr. LEVETOWN. Thank you, Chairman Rodino.

My name is Robert A. Levetown. I am Executive Vice President and General Counsel of Bell Atlantic.

Bell Atlantic provides telephone service in New Jersey, West Virginia, Virginia, Maryland, Washington, D.C., Pennsylvania, and Delaware.

I very much appreciate the invitation to appear here today to express Bell Atlantic's views.

Now, Mr. Glickman said that unlike airline deregulation, there is no safety issue in connection with the telecommunications industry. That is true, but in fact, the divestiture did represent a near miss. It was a near miss in the sense that the divestiture gave us a structure that was appropriate to full competition. And yet, at the same time, the decree included restrictions which precluded it.

The reason for this was something that Representative Moorhead referred to. Nobody knew what lay ahead at the time of divestiture. Nobody knew what the effect would be on telephone service. So Judge Greene allowed the decree to be adopted, which included these line of business restrictions. But at the very same time, he insisted that the decree also contain a mechanism to remove the restrictions when it seemed appropriate to do so.

In the three years that have now transpired since the decree has been entered, it has been very clear that telephone service has not fallen apart and that, if anything, service is better than ever.

Chairman Rodino, in your remarks you indicated that there was this concept of the natural monopoly, and this is true. That is the concept that AT&T used to argue about the interexchange network. They said that long distance service was a natural monopoly and that no true competition was ever possible in the long distance field. They argued that position for over 10 years.

Now, of course today, AT&T says that there is competition, or at least the potential for competition in the interexchange business, and we agree with that. That is why we would like to participate. However, it is also true that there is no true price competition as matters now stand.

The rate reductions that AT&T has claimed, a 30 percent reduction, is really a rate shift—a shift from the toll usage category to the flat rate subscriber line category. That is why customers seem to think that their local bills are rising. This is not true price competition. These rate reductions in the toll market were caused by the lowering of telephone company access charges rather than competition between the interexchange carriers.

Now, is there a natural monopoly in the local exchange?

Again, I don't think that is true. I don't think it is true because there are businesses who are devoting millions of dollars these days to building alternate networks to the telephone companies. There is such an alternate network that has been constructed in Washington, D.C. It begins in Rockville, it goes through the heart of downtown, and it goes out to Tysons Corner. This is a fiber optic network that can carry the traffic within the metropolitan area and can deliver it to interexchange carriers, if that is what the customers want. Similar networks are being built in Philadelphia, in Chicago, and other major cities around the country.

Chairman Nelson indicated that the regulators, at least the Washington Commission, believe that more time is necessary to see whether divestiture and competition are compatible with universal service and the other regulatory goals that all of us share.

However, the Washington Commission is somewhat alone in this. The National Association of Regulatory Commissioners has filed with Judge Greene on several occasions now and entered a resolution which Chairman Nelson dissented from, asking that the restrictions be lifted at the present time.

I would also point out that the West Virginia Commission and the New Jersey Commission have both indicated that they believe that the time is now to lift the restrictions—not some years from now.

I would like to address the issue of the local rate increases because I know that is near the heart of the concern of the committee. There has been a lot of explanation of why local rates have gone up. But in Bell Atlantic overall, we don't think the local rates have gone up in a disproportionate way since divestiture. In fact, our figures show that if you looked at the average rate, the average flat rate, resident rate, in the Bell Atlantic territories, and you looked at the progress of that rate during the three years prior to divestiture ending January 1, 1984, and then during the three years that came thereafter, you would find that the local rate increase since divestiture has been less than the local rate increase prior to divestiture.

Now, if you looked at only the part of this that was a truly local rate increase following divestiture, it would be very, very small—on average, only 80 cents around the Bell Atlantic region.

On the other hand, if you also threw in these Federal subscriber line charges, the shifted rates that have been shifted from the toll to the local service category, it would still be less—it would still be less than the predivestiture local rate increases. So under those circumstances, I think that if there is any correlation between divestiture and local rate increases, you would have to say that since divestiture, local rate increases have slowed down and I don't think that is so contrary to intuition. The fact is, since divestiture the industry has become much more competitive, and everybody in the industry now realizes that the only way to succeed is to cut costs, not raise rates.

Thank you, Mr. Chairman.

[The statement of Mr. Levetown follows:]

STATEMENT OF ROBERT A. LEVETOWN

EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL OF BELL ATLANTIC

before the

SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW

of the

COMMITTEE ON THE JUDICIARY

of the

U.S. HOUSE OF REPRESENTATIVES

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STATEMENT OF ROBERT A. LEVETOWN

My name is Robert A. Levetown. I am the Executive Vice President and General Counsel of Bell Atlantic, a company that owns the Bell telephone companies operating in New Jersey, Delaware, Pennsylvania, West Virginia, Virginia, Maryland and Washington, D.C.

I am familiar with the litigation that resulted in the AT&T consent decree and I represent Bell Atlantic before the decree court in the continuing proceedings related to the decree.

On April 27, Bell Atlantic filed a Memorandum with Judge Greene, asking to lift most of the line of business restrictions that the decree imposes upon Bell Atlantic and the other former Bell System telephone companies. A copy of that Memorandum is attached to this statement.

Bell Atlantic's basic position is that competition in telecommunications, and in the economy generally, should be encouraged rather than forbidden. Competition in telecommunications has been shown to be effective in driving down costs and prices; it has also been effective in stimulating innovation and permitting customers a range of choices.

1. Universal Service and Competition

For many years, the issue in telecommunications was whether or not competition could be introduced into the industry without compromising important policy goals that have been established by Congress and the regulatory authorities. The most important of these goals was the Congressional purpose stated in the Communications Act of 1934 to make available "so far as possible, to all the people of the United States," efficient telephone service at reasonable charges. This objective is frequently referred to as the goal of universal service.

Any doubts about the compatibility of competition and universal service have now been laid to rest. There is now more competition in the telephone industry than ever before; there are now more households (and generally a greater percentage of households) with telephone service than ever before as well.

Bell Atlantic has taken steps to be sure that basic telephone service remains affordable. It has in place in every one of its jurisdiction a wide range of optional telephone services that can be tailored to meet the calling needs and economic circumstances of almost every consumer. The most economical of these services costs as little as $5.00 per month. Moreover, in cooperation with state and local officials, Bell Atlantic has instituted a number of lifeline plans which are even less expensive. Other Bell telephone companies have similar rate plans dedicated to keeping customers on their networks.

2. The AT&T Consent Decree And Its Provisions Governing Competition

In 1982, AT&T and the Department of Justice entered an agreement to settle the Department's antitrust suit that was then being tried before Judge Greene in the United States District Court for the District of Columbia. Under the terms of the agreement, AT&T's local telephone companies were to be divested; all telephone equipment on customers' premises owned by the telephone companies was to be transferred to AT&T; the Yellow Pages advertising business was also to be transferred to AT&T; and further, the telephone companies were to be forever foreclosed from entering any competitive business.

The telephone companies were specifically prohibited from manufacturing or selling any type of telephone equipment. They were also barred from providing most interexchange (long distance) services or any of a broad class of high-tech services known as "information services".

Judge Greene held a proceeding to obtain comments from interested parties on the terms of the proposed settlement. Very few commentators objected to the proposed divestiture. A number of intervenors, including the FCC, expressed grave reservations about the restrictions on the Bell telephone companies. Judge Greene also noted that these restrictions were anticompetitive. AT&T took no responsibility for the restrictions: its officers told the Court and Congress that the restrictions were "not our idea."

Judge Greene insisted that the decree contain a provision that would allow the Court to waive any of the restrictions that prohibited the telephone companies from entering other businesses. He also ruled that the restrictions on the telephone companies would be revisited after three years and, if necessary, every three years thereafter. AT&T and the Department accepted the agreement as amended and the decree was entered by the Court.*/

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*/ Judge Greene also required that the agreement be amended to permit the telephone companies to sell telephone equipment and to allow them to retain their Yellow Pages business.

The decree as entered, was principally designed to facilitate competition between the long distance carriers. However, it permitted competition between all vendors, including the Bell telephone companies, in the sale of telephones and other customer premises equipment. It also permitted the telephone companies to compete in the furnishing of certain other communications services, such as mobile (e.g., car telephone) services. Competition in Yellow Pages advertising was permitted as well. And, on a case by case basis, the Court could authorize the telephone companies to engage in other business activities where their participation would not impair competition.

On the other hand, the telephone companies remained barred from furnishing many long distance services, from manufacturing any type of telecommunications equipment, and from providing information services.

3. The First Three Years: Progress In Competition Under The Decree

Three years of experience has taught the following lesson: in those telecommunications activities in which the Bell telephone companies could participate, they have competed vigorously with themselves and with others and consumers have benefitted from sharply lower prices and a wider range of options; in those activities in which the telephone companies are barred from competing, the public benefits potentially available from the Bell System divestiture have not been fully realized.

The most spectacular illustration of the value of competition in telephony, and particularly competition in which the telephone companies are free to participate, has been provided by the experience in the telephone customer premise equipment market. The price of all customer premise equipment has been drastically reduced over this three-year period and the range of customer choice is at an all-time high. No monopoly profits are being earned by anyone in this business but the consuming public has reaped enormous benefits.

Similar improvement in price and quality has been noticeable in the provision of mobile telephone services. Again, in this activity, some Bell telephone companies are competing against other Bell companies as well as against independent vendors.

Yellow Pages advertising has also become an intensely competitive business. NYNEX and Southwestern

Bell are publishing competing directories in major population centers in Bell Atlantic's territories. R.H. Donnelley is publishing competing directories throughout Bell Atlantic's Pennsylvania and Delaware territories. In many cases, these directories offer lower advertising rates and, in some instances, they claim new features.

By contrast, the telecommunications activities from which the Bell telephone companies have remained barred from participating have developed in ways that are disappointing.

(a) Interstate Long Distance Competition

AT&T contends that there is vigorous competition in the interstate long distance market and that rates have decreased 30% since divestiture. In fact, most of this decline in these toll rates has been the result of FCC directions to the telephone companies to bill to customers certain costs that were formerly billed to long distance carriers and had been passed on by them in toll charges. Bell Atlantic supported this FCC action. However, the point is that what has occurred here is a rate shift, not a rate reduction; and certainly it is not a rate reduction caused by competition among long distance carriers.

The questionable state of competition among these carriers is best exemplified by MCI's recent request to the FCC that the FCC deregulate AT&T. MCI obviously does not foresee vigorous price competition with AT&T. Rather, it apparently anticipates that if AT&T could maintain or increase its prices, free of regulatory oversight, MCI would be able to operate under AT&T's price umbrella.

This, however, is a prescription for monopoly profits, not true competition. Both MCI and AT&T, as well as the other smaller long distance carriers, are dead set against Bell telephone company participation in the interstate long distance market. Undoubtedly they feel that such participation would result in the same price competition that has characterized the telephone equipment market.

(b) Information Services Competition

Results have also been disappointing in the market for information services. No mass market for information services has developed in this country. In France, Japan and other industrialized nations where the telephone companies participate in the provision of information services, the mass market is growing rapidly and independent information service providers appear to be satisfied with the role of their telephone companies.

Here, in contrast, legal restrictions have barred the telephone companies from enhancing their networks to make such services available to the general public. Consequently, many such services are only available to large businesses or other institutions who can afford to buy their own telephone switching equipment for installation on their premises; such equipment, unlike the telephone company's public network, can incorporate information service features without legal restrictions.

Groups representing consumers and information service providers have recently made formal filings with Judge Greene asking that he remove the information services restriction in whole or part. The consumer groups are concerned that the continued prohibition will result in the indefinite delay in the availability of such services to the public at large; that this, in turn, will contribute to the evolution of a two-class society consisting of information service sophisticates, on the one hand, and high-tech illiterates on the other. Groups representing independent information service providers also point out that telephone company participation in these activities is essential to facilitate the economical and wide-spread availability of their services.

(c) Manufacturing Competition

Presently, the Bell telephone companies have been granted waivers that authorize them to manufacture and sell telecommunications equipment abroad. Bell Atlantic and the other telephone companies want authority to manufacture and sell in this country as well.

Some manufacturers do not oppose this relief. Others, and particularly AT&T, are strongly opposed to it. AT&T believes that, if the Bell telephone companies are free to manufacture telecommunications equipment, they will buy less of that equipment from AT&T.

The fact is that the telephone companies have a reason to rely less on AT&T as a supplier regardless of whether or not they are authorized to manufacture. The reason is that AT&T is not only a supplier; it is also a formidable competitor, particularly for large business customers. AT&T provides these customers with complete communications systems that substitute for most of the services that are or can be provided to them by the telephone companies. AT&T also sells all business users equipment that is competitive with telephone company services. To the extent the telephone companies continue to place heavy reliance on AT&T providing them with their equipment, they are dealing with a competitor who has the incentive to make available equipment to customers, for whom they all compete, on terms which disadvantage the telephone companies.

Despite these concerns, Bell Atlantic still buys a large portion of its new central office switching equipment from AT&T. Their equipment is quite good. With the industry being as competitive as it is, no telephone company can afford to buy inferior or overpriced equipment, regardless of its source.*/

4. The Standard Arguments Against The Telephone Companies Competing For The Provision of Additional Services

There are basically four standard arguments made by those who would restrict the provision of products or services by the telephone companies. These arguments are (a) the telephone companies will use their exchange revenues (and will obtain exchange rate increases, if necessary) to cross-subsidize their other businesses, thereby putting their non-telephone competitors at an unfair disadvantage; (b) that the telephone companies, by buying from their

*/ Nearly all of the Bell telephone companies are still largely dependent on AT&T for upgrades or additions to their existing central office switching equipment, much of which had been originally manufactured by AT&T.

own affiliates, would foreclose certain markets to competition; (c) that the telephone companies have "bottleneck" control over their local exchanges through which long distance traffic must pass, and they could use this control to disadvantage the services of long distance competitors; and (d) if permitted to engage in other businesses, the telephone companies might neglect telephone service.

(a) The Cross-Subsidy Issue

Cross-subsidy theories depend on the existence of cost-plus regulation. The notion is that costs of unregulated ventures will be shifted to regulated activities and assigned to the basic service category which is relatively free of competition. Thereafter, so the argument goes, regulators will unwittingly permit such improperly shifted costs to cause basic rates to rise.

If the telephone companies had any intent to cross-subsidize in this fashion, logically they should want to retain the present system of cost-plus regulation. In fact, however, they do not.

Bell Atlantic and many other telephone companies are in favor of regulatory reform plans that would give the telephone companies an opportunity to benefit from any improvements in their own efficiency. In return for this opportunity, the telephone companies are willing to freeze basic telephone rates for extended periods. This is not the strategy of companies who intend to cross-subsidize.

Even under the present system of regulation, the FCC has pointed out that basic exchange services are an unlikely source of subsidy. Historically, by regulatory design, basic rates have been subsidized by other services. Many of these other services are now subject to competition. Consequently, neither basic rates nor other telephone rates are available to finance losing ventures.

No business, moreover, has a rational incentive to engage in cross subsidy unless there is a realistic expectation that, by subsidizing a product or service, competing suppliers can be driven from the market. The antitrust courts have rejected theories of antitrust cross subsidy that are not based upon such proof. There is no realistic possibility that AT&T can be driven out of telecommunications manufacturing or the long distance market; nor is it credible that the telephone companies will be able to monopolize other lines of business in which they have little or no prior experience.

Under the foregoing circumstances, there is no incentive for a telephone company to cross-subsidize even if it were to be assumed, contrary to fact, that neither the federal nor state regulators would detect such improper cost shifting. Nor would the incentive exist even if it were further assumed -- also contrary to fact -- that basic rate increases based on such improperly shifted costs would promptly and automatically be granted. The telephone companies have no incentive to take on regulatory, political and legal risks simply to shift profits from one pocket to another. That's all they would be doing if, at the end of the process, they could not realistically expect to oust competitors from the subsidized market.

Moreover, the premise that local rate increases are automatic is not now and has never been true. And, the more competitive telephony has become, the less rates have risen. Everybody in the industry today realizes that successful providers of telecommunications services will have to cut costs not increase rates. Bell Atlantic has requested no general rate increases and received none since January 1, 1986. None are planned for this year either.

A fuller discussion of the cross-subsidy issue and the various fallacies inherent in the cross-subsidy arguments presented by the opponents of telephone company competition appears at pp. 15 to 21 of Bell Atlantic's attached Memorandum.

(b) <u>The Foreclosure Issue</u>

The foreclosure argument is generally relied upon by those manufacturers, such as AT&T, who claim that the telephone companies, if permitted to manufacture telephone equipment themselves, would only buy from themselves, thereby foreclosing the market to better or cheaper goods that are produced by others.

The premise of this argument is entirely absent to the extent equipment of the type sold to telephone <u>customers</u> is at issue. It is those customers, not the telephone companies, who will decide whether the equipment meets the price and feature standards of the marketplace. Unless a telephone company can produce better or cheaper customer premise telephone gear, there's no reason to produce it at all.

The argument is made, however, that market foreclosure remains a problem with respect to central office switching equipment which is purchased primarily by telephone companies rather than by the general public. The contention is that telephone companies would have the ability to purchase inferior equipment from affiliates and would do so simply because they were affiliates.

For reasons previously referred to, that is very unlikely. Bell Atlantic needs the best and most efficient equipment to remain a preferred communications supplier in an increasingly competitive industry. It is for this reason Bell Atlantic still buys AT&T equipment despite its misgivings about the long-term reliability of AT&T as a supplier in light of its incentives as a competitor.

In addition, it is a very costly undertaking to develop and build a central office switch. Even if Bell Atlantic bought all of its central office switches from an affiliated manufacturer, it could not support the product alone. Sales would have to be made to non-affiliated telephone companies if the manufacturing project is to be viable. If the switch could not meet the standards of the marketplace, such sales would not take place.

(c) The Bottleneck Issue

The premise of this argument is that long distance carriers can only obtain access to their customers by passing their traffic through local exchange "gateways" controlled by the telephone companies. It is argued that, at these "gateways", there arises a potential for discrimination which would become actual discrimination if the telephone companies were authorized to compete for long distance services.

Allegations based on this theory were at the heart of the government's antitrust suit against AT&T. The decree, therefore, specifically prohibits the telephone companies from engaging in such discrimination; it also requires that the telephone companies provide "equal access" connections to all long distance carriers.*/ The decree itself, therefore, provides an answer to "bottleneck" fears.

*/ The decree required the telephone companies to convert their networks to provide "equal access" services, i.e., arrangements to permit customers of all long distance companies to make long distance calls by dialing "1" plus ten digits and to provide the long distance companies with various technical capabilities formerly available only to AT&T.

All of the regional companies met the decree deadline for converting one-third of their lines to equal access. Bell Atlantic presently has converted 84% of its lines and expects eventually to have all lines converted.

The premise of the bottleneck theory, moreover, does not apply to many large customers. Such customers have sufficient volumes of long distance traffic to make it economically feasible for them to by-pass telephone company facilities and set up direct communications links to their long distance carriers. These customers generate a very large share of total long distance traffic. With respect to these customers, the telephone companies cannot be said to have bottleneck control.

Nor can it be argued that the telephone companies have bottleneck control over long distance traffic originating in areas where they do not provide local telephone service. In those areas, they have no control over the local exchange facilities.

It is Bell Atlantic's position that the telephone companies should be permitted to participate in long distance competition for those services and in those areas where the bottleneck argument is not a significant issue. A much larger volume of long distance traffic would then be subject to true price competition.

(d) The Neglect Issue

It is untrue that the Bell telephone companies are not interested in the provision of local telephone service. Every year since divestiture, Bell Atlantic has invested approximately $2 billion to improve its local networks; the other telephone companies have invested comparable amounts. In Bell Atlantic, the quality of service is very high as measured not only by technical indicators but also by extensive and on-going customer satisfaction surveys.

It is ridiculous to assume that the telephone companies are interested in abandoning or phasing out their stake in their successful, multi-billion dollar exchange businesses. On the contrary, they want to be able to use this considerable investment to provide any service or capability for which there is a market. It is also in the nation's interest that these assets be made to be as productive as possible. The decree restrictions, however, stand in the way.

Absent these restrictions, Bell Atlantic would be dedicating more funds, not less, to the telephone network. It would be enhancing its network to provide valuable information services which presently are unavailable to the public and it would be making the incremental investment necessary to provide a price-competitive long distance alternative.

5. The Possible Impact On Competition Of The Current Triennial Review

The decree Court is presently engaged in the first triennial review of the line of business restrictions. Approximately 120 intervenors are participating in this proceeding, nearly all of whom filed initial comments on March 13. There will be additional opportunities for written comments to be filed on April 27, May 12 and May 22. The Court has reserved decision as to whether or not it will require oral argument.

The proceedings focus in part on a study prepared by the Department of Justice by an independent consultant, Dr. Peter Huber. This study, which was conducted over nearly a year, culminated in a printed report approximately 600 pages in length that was issued in January, 1987. The report gathers and analyzes extensive data on the state of competition in telecommunications. Broadly, it concludes that technology has made and will continue to make telecommunications more competitive.

The Huber Report was submitted to the Court by the Department along with the Department's own Report and Recommendation. The Department concluded that all of the line of business restrictions should be lifted with the exception of the interexchange restriction.

With respect to that restriction, the Department concluded that it should be partially removed to permit the telephone companies to provide long distance services outside of their territories. Inside of the territories, however, the restrictions would remain until the removal of all state barriers to entry which, to varying degrees in various states, now protect the telephone companies from local exchange competition.

Bell Atlantic thought this proposition was fair in concept. The principal refinement it has offered to the Court is the proposal that if any individual long distance service -- such as private line service -- should be freed of state barriers to competition, then the competition with respect to that service should begin immediately and it should not be necessary for all barriers to competition for all services to be first removed.

AT&T, however, was very displeased with the Department's proposal. It argued that whether or not legal barriers to exchange service competition were removed, the exchange network is a "natural monopoly" and no actual competition is possible.

This is precisely the argument AT&T used to make about long distance. It filed hundreds of pages of testimony, affidavits and legal pleadings in support of the theory that, as a matter of telephone engineering, no true competition for long distance traffic was possible. Neither the FCC nor Judge Greene ever accepted this argument. And now AT&T disavows it as well. AT&T contends, in fact, that there is sufficient long distance competition to permit AT&T to be fully deregulated.

Competition is not impossible either for long distance service or local service. It it were, Bell Atlantic would not want to provide long distance service; nor would competitors for the local exchange business be building competing facilities in many cities across the country. One such competitor is constructing a fiber optic network within the Washington Metropolitan Area that will be able to compete with Bell Atlantic's C&P Telephone Companies. That network begins in Rockville, goes through the heart of the downtown Washington business district, and continues on to Tysons Corner.

In the proceedings before Judge Greene, there are many participants who favor giving the telephone companies greater freedom from the decree restrictions. Even if Judge Greene were to agree, however, there are still regulatory requirements that would have to be satisfied. Bell Atlantic, for example, would not be able to provide information services without meeting the stringent requirements of the FCC designed to assure other information service providers comparable access to Bell Atlantic's network. The FCC has also stated that it would have to approve any entry into the interstate long distance business.

6. The Potential Impact On Competition of H.R. 2030

H.R. 2030 makes a positive contribution to the policy debate concerning competition in telecommunications in that it proposes the lifting of the manufacturing and information services restrictions in the decree. However, the bill also requires the FCC to begin a process of inquiry, effective March, 1988, that the FCC has already been engaged in for several years and which is now largely complete.

The various departments of government that the FCC is directed by the bill to consult regarding information services have expressed their views to the FCC in formal pleadings; the principles for comparable access to the telephone network have been thought through and prescribed by the FCC; and all the required findings proposed by the bill have been made by the FCC after extensive consideration of the views of all interested parties.

In short, H.R. 2030 has a good purpose but it needs updating before it could serve as a useful spur to competition. Bell Atlantic would be opposed to starting the clock over to require the FCC, beginning in 1988, to consider once again the very same issues it has already resolved.

CONCLUSION

The Department has recommended that the line of business restrictions in the AT&T consent decree be removed in major part. It has done so after three years of post-divestiture experience. During that period, it has become apparent that the competition authorized at divestiture has benefitted the public and has not resulted in the deterioration of telephone service or the impairment of universal service.

The Department's recommendations, together with the views, pro and con, of approximately 120 parties, are now before the Court. Given the volume of pleadings, a ruling from the Court probably cannot be expected before the Fall.

Bell Atlantic supports the Department's Recommendation. It also supports Congressional interest in the telecommunications industry. Our telecommunications capabilities are a unique national asset. The full utilization of that asset is an important public policy concern.

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA, Plaintiff, v. WESTERN ELECTRIC COMPANY, INC., and AMERICAN TELEPHONE AND TELEGRAPH COMPANY, Defendants.	Civil Action No. 82-0192

MEMORANDUM OF BELL ATLANTIC IN SUPPORT OF
MOTION TO REMOVE PORTIONS OF THE
LINE OF BUSINESS RESTRICTIONS CONTAINED
IN THE AT&T CONSENT DECREE

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April 27, 1987

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UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

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MEMORANDUM OF BELL ATLANTIC IN SUPPORT OF
MOTION TO REMOVE PORTIONS OF THE
LINE OF BUSINESS RESTRICTIONS CONTAINED
IN THE AT&T CONSENT DECREE

In 1982, the Court courageously approved an historic antitrust settlement, thereby setting the stage for an enormous increase in competition in telecommunications.

The decree that was originally presented to the Court -- a document privately bargained between the Department of Justice and AT&T -- would have made that competition impossible. The proposed decree made no express provision for the Bell telephone companies to engage in any competitive business.

Furthermore, the agreement specifically prohibited the to-be divested Bell telephone companies from competing in AT&T's

major remaining lines of business: the manufacture of telecommunications equipment and the provision of most long distance services.

Publicly, AT&T took no responsibility for this aspect of the decree. Rather, it maintained that these restrictions were "not our idea." AT&T's officials repeated that statement to Congress, to the Court, to the FCC and to AT&T's shareholders. Obviously, these anticompetitive restrictions, according to AT&T, were not the inducement for it to agree to divestiture. Consequently, there is no "deal" between AT&T and the Department that the lifting of the restrictions would breach.

To its credit, this Court refused to adopt this agreement in the form it was originally presented which would have severely and permanently foreclosed competition in telecommunications. As the Court has pointed out many times, the stimulation of competition, rather than its foreclosure, was the advantage to be gained from divestiture. Consequently, the Court required that the decree be amended to permit the Bell telephone companies to engage in competitive sales of telephone equipment and Yellow Pages advertising. The Court also required that the decree include a provision for waivers which would allow the Bell telephone companies to enter any line of business in which their entry would not harm competition.

To date, more than one hundred such waivers have been granted. However, most have granted authority to engage in various nontelecommunications lines of business. Very few of the waivers have granted authority to engage in long distance services or information services in this country and, when granted, such relief has been very limited.

Here, then, is a paradox: the Court has accused the telephone companies of wanting to become conglomerates; however, it is the decree restrictions which are forcing the telephone companies to invest in projects other than investments to improve and extend their telephone networks. The telephone companies are interested in the telephone business: Bell Atlantic has invested an additional $2 billion every year since divestiture to improve telephone service. It is willing to make the additional investments necessary to provide sophisticated information services to its customers or to offer them competitive long distance services.

In areas related to telecommunications in which the decree has authorized the Bell telephone companies to participate, the resulting competition has resulted in great bargains to the American publics. The price of equipment, such as telephone sets and switchboards, has been slashed and innovative features have been rapidly made available. The same is true in the competition for mobile services.

Divestiture was a step into the unknown. Nobody could be sure how the event would affect the quality or price of telephone service. Under those circumstances, the Court was understandably reluctant to authorize additional changes in the status quo of the industry.

As the Court foresaw, however, experience after three years has provided a basis for a second look at the decree and an opportunity for further scrutiny of the line of business restrictions. The Court insisted upon this because, from the very beginning, the Court realized these restrictions were anticompetitive.

It is now clear that such restrictions are an unjustifiable obstacle to the introduction of further competition into telecommunications and should, in whole or major part, be removed.

Summary of Bell Atlantic's Position

The relief requested by Bell Atlantic in its accompanying motion[1/] is consistent with the principles of the

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1/ Bell Atlantic asks that the restrictions in section II(D)(1) of the decree be removed to permit it to provide interLATA private network services and vendor coordination services, including interLATA consulting, to private network customers; also, that Bell Atlantic be given authority to provide 800/WATS services. In every case, however, Bell Atlantic's relief would be implemented in each of its LATAs or portion thereof only if and when comparable state barriers to entry for competitors were removed.

Bell Atlantic also requests immediate authority to provide interLATA mobile services within its region and all categories of interLATA service outside of its region.

Bell Atlantic further asks that the restrictions of sections II(D)(1) and (2) of the decree be removed to permit it to provide information services, to manufacture customer premise equipment (CPE), and to manufacture and provide telecommunications equipment.

Finally, Bell Atlantic asks that the section II(D)(3) "catchall" restriction be removed and that the existing waiver orders addressed to Bell Atlantic be vacated in order to eliminate the burdensome and inconsistent conditions those orders now contain.

Department's Report and Recommendation and is supported by the documentation and conclusions in the Huber Report[2/] that was commissioned by the Department and submitted to the Court on February 2, 1987. The relief requested also meets the section VIII(C) standard in that it does not pose any substantial risk of harm to competition in the markets Bell Atlantic seeks to enter.

The interexchange relief sought by Bell Atlantic poses no substantial risk of harm to competition because it has been carefully crafted to avoid any "bottleneck" concerns. Outside its region, Bell Atlantic has no control of the exchange network, much less bottleneck control. Inside its region, Bell Atlantic proposes to provide, first, a limited class of interLATA services to a relative handful of large customers who have ready competitive alternatives to Bell Atlantic's access services; and second, a limited class of services to business customers wherein competitors will have the equivalent of 100% equal access and will be at no dialing disadvantage to Bell Atlantic's services.

The information service relief sought by Bell Atlantic poses no substantial risk of harm to competition as shown by the fact that information service providers have hired lawyers and affirmatively petitioned this Court to remove or at least modify

2/ Dr. Peter W. Huber, The Geodesic Network, 1987 Report On Competition in the Telephone Industry (January, 1987).

the information service restrictions.3/ Consumer groups,4/ the FCC and state commissions,5/ and other carriers6/ have also cast their votes for relief, as has the Department of Commerce.7/ A common theme among these commentors is that the general public in this country, unlike the publics of other nations, is being deprived of useful, sophisticated services; in this country, these services have only been made available to the economically privileged. The restrictions, consequently, are contributing to the fears of policy-makers that the telecommunications

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3/ Comments of Integrated Communication Systems, Inc. at 2-3; Comments of the Videotex Industry Association at 1-3; Comments of the Motion Picture Association of America, Inc. at 13-15; Comments of the Computer & Communications Industry Association at 18-21; Comments of United Press International at 3-6.

4/ Joint Comments of National Consumers League, Black Citizens for a Fair Media and the Council of Churches of New York City, the National Association of State Universities and Land Grant Colleges, Native American Public Broadcasting Consortium and the National Indian Youth Council, Office of Communications of the Church Federation of Greater Chicago, Consumer Interest Research Institute, Public Interest Computer Association and National Association for Better Broadcasting at 11-37.

5/ FCC Comments at 7-9; Michigan Public Service Commission Comments at 4-5; Minnesota Public Utilities Commission Comments at 2; Virginia State Corporation Commission Comments at 1-2; West Virginia Public Service Commission Comments at 8.

6/ United States Telephone Association Comments at 8; Rural Telephone Coalition Comments at 6-8.

7/ United States Department of Commerce, National Telecommunications and Information Administration, NTIA Trade Report: Assessing the Effects of Changing the AT&T Antitrust Consent Decree (Feb. 4, 1987).

revolution will produce two user classes -- the haves and the have nots -- information service sophisticates, on the one hand, and high-tech illiterates on the other.

First amendment considerations also militate in favor of information service relief. The FCC has now created an elaborate set of regulatory mechanisms -- concurred in if not inspired by the Department -- for the very purpose of assuring telephone network access to all information providers. The FCC program goes even beyond the "information access" required by the Decree itself. Under these circumstances, there is a heavy and undischargeable burden on those who would continue to deny Bell Atlantic's first amendment right to publish. The theory that an electronic gag rule of this type is necessary to facilitate electronic publishing by others is a premise that is not only legally unsound, but it is also a theory which has been proven to be factually incorrect by experience abroad.

The manufacturing relief sought by Bell Atlantic poses no substantial risk of harm to competition, as demonstrated by the pleadings of various manufacturers who support the lifting of the restriction.8/ There is no possibility that Bell

8/ A number of manufacturers support the complete removal of the manufacturing restriction. See Comments of Ericcson North American at 4-7; Comments of Stantel at 1-2; Comments of Novell at 7-16; Comments of Verilink at 5-6. Other manufacturers ask that the restriction be lifted in part so that the BOCs could manufacture customer premises and similar equipment. See Comments of the Computer and Communications Industry Association at 21-23.

Atlantic could foreclose the market for CPE. Most CPE must be sold to the general public in a wide-open competition where foreign suppliers play a substantial and increasing role.9/ The same rationale supports Bell Atlantic's request to manufacture various CPE-like devices which may be used either on a customer's premises or in Bell Atlantic's central offices. This equipment is similar if not identical to equipment produced for a wide variety of other purposes and thus presents no realistic opportunity for any significant market foreclosure.10/

Even central office equipment itself cannot successfully be built and sold on a market foreclosure strategy -- the costs of development and production are so high that the only successful switch manufacturers are producers whose markets exceed those of any single regional company.11/ Any such central office equipment that may be manufactured by a regional company would, therefore, have to meet the test of successful sales to third parties - a test similar to that prescribed by this Court for waivered sales of software by a regional company to its own operating companies.12/

9/ NTIA Trade Report at 36-44.

10/ Huber Report at 14.17; Table CO.11a.

11/ Huber Report at 14.13 - 14.15.

12/ E.g., Order ¶ G (Aug. 14, 1985) (Bell Atlantic waiver).

There is no realistic possibility that the regionals, if permitted to manufacture, could manipulate network standards to benefit their manufacturing operations. Neither AT&T nor GTE has achieved that result; there is no reason to believe that the regionals could accomplish it. Nor would this be a rational objective: manufacturing efficiencies are captured through large production runs; to maximize production, the equipment must be marketable anywhere; high levels of profits cannot be produced by custom manufacturing to idiosyncratic specifications for regional "boutiques."

The removal of the "catchall" restriction sought by Bell Atlantic poses no substantial threat to competition as shown by the fact that, since divestiture, over 100 waivers have been granted by the Court for nontelecommunications lines of businesses; none, in fact, has been denied by the Court. The restriction was originally based on the "quarantine" theory, i.e., the notion that because the BOCs had "monopoly power" over exchange service, they should be barred from any other line of business. The Court never accepted this theory. The Department abandoned it when it recommended the first line of business waiver in 1984.

None of the relief now requested by Bell Atlantic, and none of Bell Atlantic's existing waivers, should be subject to the elaborate and inconsistent conditions that have been engrafted upon them through the current waiver process.13/ Provision of network services, such as interLATA services and information services, should not be subject to any conditions at all, and especially not to separate subsidiary requirements which would kill them in their cradle.

If, contrary to the Department's Report and Recommendation, the Court concludes that manufacturing and nontelecommunications activities must be housed in corporate entities other than the telephone companies, a consistent set of generic conditions should be prescribed to cover all such activities. Such conditions should apply as well to existing waivered activities.

In particular, however, the current 10% net revenue cap condition should be removed. The 10% restriction was not originally proposed by the Department, any party or intervenor. Consequently, its merits were never ventilated through the pleading process. The impact of this cap on the

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13/ As explained more fully in Bell Atlantic's March 13 pleading, the current waiver process, which has no time limits and essentially affords no appeal from the Department's inaction, is a process in which the Department holds all the cards. As arbiter of the waiver process, the Department seeks to accommodate the objectors. Consequently, depending on who the objectors are to any particular waiver, and depending on how fanciful their notions of competitive harm may be, the BOC seeking the waiver is coerced to accept additional conditions in order to obtain the Department's approval. The net result of this process is a set of waiver conditions that are unnecessary to protect competition but were necessary to placate particular competitors. These conditions are in some cases inconsistent from waiver to waiver and frequently devoid of economic logic.

various regions is uneven, depending upon the nature of their nontelephone activities.14/ Furthermore, the economic consequences of the restriction are counterproductive to the purposes of the Court even assuming those purposes, which appear to be regulatory in nature, were appropriate matters of concern under the terms of the Decree.15/

I. THE BASIC ARGUMENTS OF AT&T AND OTHER OPPONENTS OF INCREASED COMPETITION HAVE BEEN DISPROVEN BY EVENTS.

Twenty years ago, telephony was almost a total monopoly of AT&T. Over the years, as competition was introduced in incremental stages, AT&T always opposed it and always predicted dire results for the future of telephone service if competition were allowed.

It is not unexpected, therefore, that AT&T would continue to oppose additional competition in the two areas in which it retains market dominance: interexchange service and telecommunications manufacturing. This time, the dire threat to the future of telephony allegedly revolves around Bellcore.

14/ Bell Atlantic Comments Concerning the Report and Recommendations of the Department of Justice at 30-33 (March 13, 1987) (hereafter "Bell Atlantic Comments").

15/ Id.

A. Competition Poses No Threat to the Functioning of Bellcore or to the Quality of Local Telephone Service.

AT&T claims that the "standard setting and equipment testing functions of Bellcore that the Court deemed so essential" would be substantially weakened if the BOCs were allowed to manufacture, in turn leading to "balkanized" regional network standards, and "threaten[ing] the Decree's goal of maintaining the quality and uniformity of the national telecommunications network."16/

Bellcore, however, does not set network standards. Instead, standards are now set domestically by an open industry forum, established in 1984 under FCC auspices, called T1. This group is open to all interested industry groups, including exchange carriers, interexchange carriers, manufacturers, and customers, and no BOC or group of BOCs can control it. Standard setting requires a two-thirds vote, and all the BOCs and Bellcore together constitute only 8 percent of T1.

Furthermore, even if Bellcore could torpedo the standard-setting process, manufacturing relief for the BOCs would not lead to any network "balkanization." Any BOC-manufactured equipment would have to be able to interact with the large embedded base of customer premises equipment manufactured by others, and equipment, manufactured by others

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16/ AT&T Comments at 106-07.

such as AT&T, already in the BOCs' networks. The requirement for network compatibility strongly militates against the production of any equipment with unique standards.

There is also no reason to believe AT&T's claims that Bellcore's equipment testing efforts would become biased in favor of BOC-affiliated manufacturers. Bell Atlantic, for example, is not going to tolerate Bellcore overlooking faults in equipment made by NYNEX -- faults that will cost Bell Atlantic money or make its services less competitive. NYNEX, logically, would have the same attitude about equipment manufactured by Bell Atlantic. Precisely because Bellcore has multiple, independent owners, the Bellcore behavior predicted by AT&T is highly unlikely.17/

B. Competition Poses No Threat to the Consuming Public.

It is also not surprising that other long distance carriers and some (but not all) of the telecommunications manufacturers, would take a position against competition similar to AT&T's. The fact is that the only consistent winner from increased competition is the consuming public. And the public

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17/ The United States Telecommunications Suppliers Association observes that, when Bellcore evaluates equipment, it receives proprietary information from the manufacturer. If the BOCs are permitted to manufacture, USTSA claims, they would have access to this proprietary information. USTSA Comments at 24. These concerns should not stand in the way of manufacturing relief. Instead, procedures for limiting information flow within Bellcore could be employed so that the potential harm which USTSA describes does not occur.

has won - and won big - from the competition already authorized by the Court.

The most spectacular public benefits were produced by CPE competition. Despite stubborn resistance from the original parties to the decree and from many intervenors, the Court resolutely insisted that the decree be modified to permit the BOCs to enter the CPE market.

In the three years that have now transpired, the alleged BOC abuses have not materialized but the public has reaped enormous dividends from the Court-ordered competition: CPE prices have been slashed and customer choice of features and options has greatly increased.[18/] CPE suppliers, including the BOCs, have not made a great deal of money in this competition but that was because monopoly profits could no longer be earned.

C. Competition Poses No Threat of Collusion Among the BOCs.

There has been no "collusion" among the BOCs in CPE sales - just as their has been no collusion in Yellow Pages advertising competition, another activity sanctioned by the Court over the objection of the original parties to the Decree. Today, for example, two regional companies, NYNEX and Southwestern Bell, are competing head to head with Bell Atlantic

18/ Huber Report at 17.1; National Telecommunications and Information Administration, U.S. Department of Commerce, NTIA Special Publication 85-17, NTIA Competition Benefits Report at 11 (1985).

in major population centers in Bell Atlantic's territory. A similar pattern of vigorous inter-BOC competition is apparent in other activities, such as paging and mobile services.

The BOCs are all highly independent and competitive organizations. They are rivalrous siblings, each of whom intends to outperform the others. Not only will they not cooperate in the marketplace whenever they have the opportunity to compete, but they can rarely even bring themselves to cooperate on joint pleadings to be filed with this Court - despite this Court's repeated requests that such joint pleadings be filed.

Given the history of inter-BOC competition since divestiture, it is nothing short of outrageous that unfounded speculation about possible collusion among the BOCs is still offered by some intervenors as a reason to deny the BOCs the opportunity to compete. Such speculation deserves no weight whatsoever in this Court's deliberations.

D. Competition Should Not Be Thwarted By Fallacious Notions of Cross-Subsidy.

Nearly every one of the 100 or more section VIII(C) waivers that has been granted by the Court has been opposed by some competitor who has alleged that BOC competition would create an unmanageable problem of unfair cross-subsidy. These claims were made with special vehemence when the Court was considering the advisability of allowing the BOCs to enter the

CPE business.[19] Had the Court been impressed by such rhetoric, the public would never have received the extensive benefits of that competition.

The claims of potential cross-subsidy, moreover, are based on propositions that are obviously and demonstrably incorrect. These propositions are as follows: (1) that telephone companies, unlike other business enterprises, have an incentive to lose money on a continuing basis on particular products and services even where there is no realistic opportunity to drive well-entrenched competitors out of the market; (2) that costs improperly shifted to telephone operations cannot be detected by federal or state regulators, or by independent auditors, and that local rate increases will automatically be permitted on the basis of such improperly shifted costs; and (3) that it is somehow unfair to permit the customers of the BOCs, unlike the customers of other large businesses with dominant positions in particular markets, to

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19/ In opposing BOC provision of CPE, the Department noted that "the FCC struggled for more than 20 years unsuccessfully to solve the problem of allocating common costs between competitive and non-competitive services. This very same problem would confront regulators if the BOCs were permitted to engage in competitive lines of business." Response of the United States to Public Comments on Proposed Modification of Final Judgment, at 57-58 (May 20, 1982). Likewise, NATA urged the Court not to permit the BOCs to market CPE in order "to interdict the abusive practices and cross-subsidies that occur and eliminate the incentives that fuel them." Comments of the North American Telephone Association in Support of Immediate Approval of Proposed Modification and Settlement at 20 (Apr. 20, 1982).

benefit from the savings attributable to their suppliers' size and scale.

1. The Fallacious Belief in the Attractiveness of Perpetual Losses.

The BOCs are in the business to make money, not to lose it. In this regard, they are like any other profit-seeking organization.

This Circuit and the Supreme Court have repeatedly rejected antitrust theories based upon the supposed incentives of businesses to pour money into a perpetual black hole of losses.[20/] Unless the BOCs could substantially and permanently lessen competition in a particular field, there is no rational basis for a policy of cross subsidy even if it were to be assumed that improperly shifted costs could be recouped by increases in basic telephone rates.

There is no motive for management to shift profits from one pocket to the other and to shoulder thereby significant regulatory risks and antitrust liabilities unless, at the end of the process, there is a realistic expectation of being able to dominate the cross-subsidized market. In none of the activities that are at the heart of the present controversy - and

20/ Cargill, Inc. v. Monfort of Colorado, Inc., 107 S. Ct. 484, 494 n.15 (1986); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 106 S. Ct. 1348, 1357-62 (1986); Southern Pacific Communications Co. v. AT&T, 740 F.2d 980, 1003 n.26, 1006-07 (D.C. Cir. 1984).

especially not for interexchange services or telecommunications manufacturing - is such an expectation realistic. It is even less realistic with respect to information services and nontelecommunications activities in which the BOCs have little or no prior experience.

2. The Fallacious Belief in the Availability of Automatic Rate Increases.

Telephone rate increases, and particularly increases in rates for basic exchange services, are not and have never been automatically granted in the telephone industry.21/ Long delays, sometimes exceeding a year, attend the rate case process and any increases in the rates for basic service are highly controversial and politically explosive. Therefore, even assuming that competitive costs - despite the best efforts of auditors and regulators, including the elaborate rules now promulgated by the FCC - could be shifted improperly to basic telephone services, it would be a gross miscalculation for telephone company management to assume that the rates for such services would promptly or automatically increase.

The actual experience since 1985, when the BOCs began entering competitive lines of business pursuant to the authorization of the Court, is that telephone rate increases,

21/ The difficulty of obtaining such rate increases was described to this Court in the testimony of AT&T witness Richard R. Hough at 24-43 (DT-124).

and especially basic rate increases, have sharply declined. This is a reflection of the fact that all phases of telephony have become more competitive and telephone companies have realized that they must cut costs, not raise rates. Bell Atlantic has no general rate increases planned for this year, and received none since the beginning of 1986.

Furthermore, many of the BOCs, including Bell Atlantic, are in favor of regulatory reform plans that would largely eliminate cost-plus regulation. A multi-year moratorium on basic rates is generally a feature of such plans. These are not programs that companies intent on cross-subsidization through basic rate increases would support.

3. The Fallacious Belief That Economies of Scale and Scope Constitute Cross-Subsidy.

Like most other businesses, telephone companies derive efficiencies from economies of scope and scale. If sharing of facilities, personnel and corporate infrastructure were to be condemned as cross-subsidy, the public would be deprived of the primary benefits that large companies can offer them as consumers.

The antitrust laws do not condemn efficiencies of scope and scale or handicap competitors because they have such efficiencies. It is well settled that "a large firm does not violate [the antitrust laws] simply by reaping the competitive rewards attributable to its efficient size, nor does an integrated business offend the Sherman Act whenever one of its departments benefits from association with a division possessing a monopoly in its own market."22/ These efficiencies recognized by the Berkey court -- "more efficient production, greater ability to develop complementary products, reduced transaction costs, and so forth"23/ -- are precisely the economies which the opponents would deny to Bell Atlantic and to the consumers that Bell Atlantic serves.

The comments of TelCor America Corporation are illustrative. It claims that, in providing information services, the BOCs would have an unfair advantage because they could bill for information services using their existing billing systems, and the incremental costs incurred in the process would be minimal. Other information service providers, it claims, would not have this advantage.24/

This, however, is no proof of anticompetitive conduct. It is simply an example of the ways in which BOCs could provide

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22/ Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 276 (2d Cir. 1979), cert. denied, 444 U.S. 1093 (1980). Nor do the antitrust laws require a different test of cross subsidy when the company in question is a regulated utility in part of its business. Northeastern Tel. Co. v. American Tel. & Tel. Co., 651 F.2d 76, 90 (2d Cir. 1981), cert. denied, 455 U.S. 943 (1982); American Tel. & Tel. Co. v. FCC, 602 F.2d 401, 410 n.49 (D.C. Cir. 1979).

23/ Berkey at 276.

24/ Comments of TelCor America at 16.

service more efficiently.25/ Their information service competitors have similar advantages. For example, nobody contends that it would be unfair if publishers use the same news gathering staffs for both print and electronic publications; nor does anyone claim that IBM should not use the same account executives to sell information services, computers, Rolm PBXs and MCI communications services.

Competitors have no incentive to permit the telephone companies to offer goods and services to the public that are priced on either incremental costs or shared costs. The public's gain is their loss. However, this Court has considered and rejected the notion that sharing of personnel and facilities for multiple services provided by the BOCs automatically constitutes cross-subsidy.26/

The possibility of such sharing does not, therefore, present a basis for denying any of the relief requested by Bell Atlantic -- including relief from the patchwork of idiosyncratic conditions in Bell Atlantic's existing waivers.

25/ If, for example, solely to avoid allegations of cross-subsidy, the telephone companies were required to build two networks - one for business services and another for residence service - telephone service for all classes of users would become much more expensive.

26/ The Department of Justice, right after divestiture, argued that no personnel or facilities should be shared between waivered activities and exchange operations. The Court rejected this proposal. United States v. Western Elec. Co., 592 F. Supp. 846, 872 & n.110 (D.D.C. 1984), appeal dismissed, 777 F.2d 23 (D.C. Cir. 1985).

E. Competition Should Not Be Thwarted by Fanciful Theories of Possible Network Discrimination.

Opponents of BOC entry into the CPE business prophesized that the BOCs would resurrect all the evils of discriminatory access the decree was designed to stop. Commentors warned that the BOCs had the incentive and ability to discriminate and that regulators would be incapable of preventing abuses in an evolving technological environment. Worse, even if monitoring of the technical aspects of interconnection were possible, the BOCs could still discriminate in "more subtle" ways, such as the untimely provision of maintenance, testing and restoration of facilities.27/ During the three years in which the BOCs have participated in the CPE business, these abuses have failed to materialize.

Similar theories of network discrimination have been rejected by the Court in granting waivers since the decree was entered. For example, in opposing Bell Atlantic's computer maintenance waiver requests, TRW asserted that the BOCs could disadvantage other providers of computer maintenance services by manipulating the quality of exchange diagnostic services, by lack of installation responsiveness and by withholding technical

27/ Response of the United States to Public Comments on Proposed Modification of Final Judgment at 58 (May 20, 1982).

information to favor their own computer affiliates.28/ However, no competitor has complained of any actual interference or discrimination in telephone service since Bell Atlantic entered the computer maintenance market.

The March 13 pleadings filed with the Court contain these same sorts of implausible discrimination theories. For example, AT&T suggests that BOCs would discriminate in the provision of private line services to interexchange competitors.29/ These, however, are "plain vanilla" facilities which involve none of the sophisticated signalling and processing capabilities used in the completion of an ordinary

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28/ United States v. American Tel. & Tel. Co., 604 F. Supp. 256, 265 (D.D.C. 1984); Comments By TRW, Inc. In Opposition To Proposed Waiver of Section II(D) Of The MFJ To Permit Bell Atlantic To Enter The Computer Sales and Service Business at 7-12 (Oct. 24, 1984).

The Court has also granted other waivers in spite of competitors' predictions of future discrimination. E.g. foreign manufacturing (Order (June 26, 1986)) approved over NATA's claim that if a BOC manufactured CPE overseas, its customers would try to import that equipment in violation of the terms of the waiver order to get more favorable interconnection with the BOC (Partial Opposition of the North American Telecommunications Association to the United States' Motion for a Waiver Regarding Ameritech Foreign Business Ventures at 6 (June 11, 1986); advertising waiver (Order Apr. 13, 1987) approved over claims that the BOC would have incentive and opportunity to discriminate against competing advertising agencies if BOC facilities could be used to deliver advertising copy (Letter from Michael Yourshaw, attorney for ANPA, to Kevin R. Sullivan, Department of Justice, dated Oct. 21, 1985, at 3).

29/ AT&T Comments at 54-55.

long distance call.30/ The simplicity of these private line services alone substantially reduces the risk of discrimination.

Any degradation in the quality of a BOC private line provided to an interexchange carrier, moreover, would have to be so obvious that the interexchange carrier's ultimate customer would notice the difference. Otherwise, the discrimination would serve no purpose. At the same time, the discrimination would have to be so subtle that the interexchange carrier -- for example, AT&T or MCI -- would not notice and complain. Obviously, no "degradation strategy" could meet both objectives.31/

In addition, if a BOC provided inferior private line service, the interexchange carrier could simply bypass the BOC. The Huber Report documents the extensive bypass alternatives to BOC private lines.32/

Finally, some electronic database providers claim that, if the information services restriction were lifted, they would

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30/ Huber Report at 3.39.

31/ AT&T also suggests that BOCs could delay private line installation or provide poor maintenance to their interexchange competitors; AT&T even implies that such BOC behavior led to the private line provisioning problem in early 1984. AT&T's Comments at 55. However, the Department found that this problem was caused by "the complexity of the ordering process" and the "lack of familiarity" of both AT&T and the BOCs with the new procedures that had to be supplemented, for the first time, after divestiture. Letter from Jeffrey Blumenfeld, Department of Justice, to Richard C. Schramm, Bell Atlantic, dated June 18, 1984, at 1.

32/ Huber Report at 2.13-2.18.

be vulnerable to BOC manipulation of "dial-up access" services. This dial-up service, however, is simply an ordinary local exchange call made by a database customer to a specialized carrier -- generally a Value Added Network ("VAN") -- which in turn connects the customer to the database. As the Huber Report notes, there is no opportunity for selective manipulation here:

> [T]he link here is precisely the same as the one LECs provide to users of voice services, and the data traffic is in fact an indistinguishable trickle in a river [of] traffic.[33/]

II. EXPERIENCE UNDER THE DECREE HAS CAUSED THE DEPARTMENT TO CHANGE ITS POSITION ON THE NECESSITY FOR THE LINE OF BUSINESS RESTRICTIONS; SELF INTEREST HAS CAUSED AT&T TO CHANGE ITS POSITION TOO.

AT&T faults the Department for changing its views about the line of business restrictions and for arguing different positions now than it argued when the Decree was originally presented. The Department now has the benefit of three years of hindsight and experience under the Decree. It is not improper for the Department to base its views on the record of events since divestiture rather than on the stale trial record of events in the 60's and 70's which occurred under a entirely different industry structure.

AT&T, moreover, has also changed its position on key issues. The difference is that AT&T's change of position is

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33/ Huber Report at 5.14.

based on its desire to assure its dominance in the long-distance and telecommunications equipment manufacturing markets, the only line of business restrictions that AT&T insists the "public interest" still requires. Further, while AT&T has changed its position and argued different propositions to this Court then and now, it is presently also arguing inconsistent propositions to this Court and to the regulatory authorities.

A. AT&T's Past Positions Before This Court Conflict With Its Present Position About the Alleged Monopoly Characteristics of Telephone Networks.

1. AT&T Used To Claim Long Distance Service Is a Natural Monopoly; Now It Contends It's Fully Competitive.

AT&T presented to this Court, and before that to the FCC, literally hundreds of pages of testimony, proffers of proof and pleadings dedicated to the proposition that the long distance network is a natural monopoly.[34] AT&T contended that because of the scope, scale and ubiquity of its network, it was an immutable rule of telephone engineering that no true competition could ever exist for interexchange traffic.[35] Neither this Court nor the FCC ever accepted that argument.

34/ See, e.g., the testimony of James N. Rosse (DT-119); Richard R. Hough (DT-124); Otto Eckstein (DT-250); Robert Olley (DT-130); Ronald A. Skoog (DT-117); and L.R. Christensen (DT-128); Economic Implications and Interrelationships Arising From Policies and Practices Relating to Customer Interconnection, Jurisdictional Separations and Rate Structures, 61 F.C.C. 2d 766, 785-86 (1976).

35/ Testimony of James N. Rosse at 75 (DT-119).

AT&T now disavows it as well. In fact, AT&T contends that interexchange competition is alive and well - so vigorous, indeed, that AT&T argues that it should be completely deregulated by the FCC.36/

2. AT&T Does Not Apply the Same Economic Criteria To Exchange Service That It Routinely Uses to Demonstrate the Competitiveness of Long Distance Service.

AT&T has not retired the "natural monopoly" argument; it has simply reassigned it to the BOCs. It now argues that the Court should accept the very same argument, based on the same telephone engineering principles, applied to exchange service.37/ Thus AT&T contends that, whether or not state barriers to entry are removed in the intraLATA markets, these markets will inevitably remain natural monopolies.38/

Yet, as the Huber Report documents, where exchange competition has been permitted by law, it has flourished. There are private switches now in place that substitute for 30 million lines that would otherwise be switched by telephone central offices.39/ The capacity of private microwave systems has grown

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36/ See, e.g., Comments of AT&T, In the Matter of Decreased Regulation of Certain Basic Telecommunications Services, FCC Common Carrier Docket No. 86-421 (March 6, 1987).

37/ AT&T Comments at 45-52.

38/ AT&T Comments at 52-57.

39/ Huber Report at 2.6.

from 270,000 voice grade circuits in 1982 to 3,400,000 in 1986, an increase of more than 1100 percent, and the growth of private fiber optic systems is even more dramatic.40/ In fact, one of those systems is operating today under the streets of Washington, D.C. These systems can be substituted for telephone company access lines, tie lines and other exchange services.

While it is true that the BOCs still retain the preponderant share of exchange revenues, AT&T has repeatedly told this Court and the regulatory authorities that static market share cannot be used to judge the competitiveness of a market.41/ Instead, AT&T has pointed to other factors, such as the growth in the number of competitors, and the growth in the capacity of the competitors' networks, as more accurate indicators of the state of competition. These same measures, when applied to the local exchange market, prove that no natural monopoly exists.

3. AT&T Argues to This Court That ByPass Is Not Practical; It Has Told the Regulatory Authorities That ByPass Is a Clear and Present Danger; And It Has Told Its Customers That ByPass Systems Are a Great Bargain.

In the present case, it is in AT&T's interest to argue that the potential for bypass of the exchange network is

40/ Huber Report, Table L.15.

41/ *E.g.*, AT&T Memorandum in Support of Defendants' Motion for Involuntary Dismissal Under Rule 41(b) at 25-31 (July 10, 1981); Testimony of Robert D. Willig, AT&T, before the Pennsylvania Public Utility Commission, Generic Access Charge Investigation, Docket No. P-830452, February 24, 1984.

minimal. This preserves the bottleneck myth and protects AT&T's dominant position in the interexchange market.

In regulatory contexts, it is in AT&T's interest to be more candid about the potential for bypass. Such frank talk convinces regulators that they must reduce the access charges that telephone companies bill to AT&T.42/

AT&T has solved this dilemma by arguing one set of claims about bypass to the Court and a completely inconsistent set of arguments to the state and federal commissions. For example, AT&T assured the Public Service Commission in West Virginia that "bypass is readily available today" and that "bypass alternatives exist that are already cheaper than special

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42/ AT&T implies that competition has caused its toll rates to decline 30% since divestiture. It fails to point out to the Court that most of this rate decrease was directly attributable to reductions in access charges billed to AT&T by the telephone companies. The costs involved, at commission direction, were billed instead to ratepayers in the form of flat-rate recurring charges. This change in rate structure was necessary to prevent bypass and AT&T repeatedly made that point to the FCC. See, e.g., Comments of AT&T, In the Matter of MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, FCC Common Carrier Docket Nos. 78-72 and 80-286 (August 26, 1986) at 4-5, 16-19.

access charges for very large customers."43/ In Texas, AT&T said:

> The overwhelming weight of the evidence confirms that facility bypass technology _today_ is in an advanced stage of development, is relatively inexpensive when compared to the cost-reduction opportunities and is readily available to medium and high volume toll users.44/

In a number of states, AT&T has also presented detailed engineering testimony explaining that bypass technologies were often cheaper than local exchange carrier services.45/

43/ Testimony of Mary E. Murphy, AT&T, before the Public Service Commission of West Virginia, General Rate Case, Docket No. 84-747-T-42T (June 3, 1985) at 7, 8.

MCI also claims in its pleadings to this Court that bypass is not practical even for high volume customers. MCI Comments at 18. This representation, however, like AT&T's claim, is inconsistent with MCI's representations to the regulators. In Texas, for example, MCI said that "the growing competition in the provision of facilities between interexchange carriers and their customers will no longer permit the subsidy from access service to local exchange service." MCI Brief, Rate Design, Application of Southwestern Bell Telephone for Authority to Increase Rates, Public Utility Commission of Texas, Docket No. 6200 (December 9, 1985) at 23.

44/ AT&T Brief, Rate Design, Application of Southwestern Bell Telephone Company for Authority to Increase Rates, Public Utility Commission of Texas, Docket No. 6200 (December 9, 1985) at 14 (emphasis in original).

45/ _E.g._, Testimony and Exhibit B of John D. Schell, AT&T, before the Public Service Commission of West Virginia, General Rate Case, Docket No. 84-747-T-42T, June 3, 1985; AT&T Brief, Access Charge Phase, Generic Access Charge Investigation, Pennsylvania Case No. 83-0452, November 19, 1984 at pp. 42-43; Testimony of Robert D. Willig, New Jersey BPU Docket 8312-1126, January 20, 1984; AT&T Reply Comments, Virginia SCC Case PUC 850035, Investigation of Competition for IntraLATA, Interexchange Telephone Service, November 18, 1985.

AT&T is also willing to take advantage of bypass vulnerability when it comes to dealing with its customers. AT&T is actively marketing a short-haul microwave radio designed to bypass BOC services, "a compact, economical transmission system . . . that sends and receives information across the street or across town."46/ AT&T tells its customers that this system is so economical that it "can pay for itself in less than a year in most cases."47/

AT&T has also restructured its service offerings--particularly those services which are used by private network customers--to give its high volume customers an incentive to bypass the BOCs.48/ Furthermore, AT&T has announced to its high volume customers that it would assist them to build their own facilities to interconnect with AT&T's private lines.49/

In short, while AT&T is telling this Court no one could conceivably compete with the BOCs, AT&T and many others are doing just that. AT&T's repeated demonstrations to the

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46/ AT&T Network Distribution System DR 23 (undated AT&T promotional material).

47/ *Id.* at 4.

48/ These restructured tariff offerings include AT&T's private line tariffs as well as its Software Defined Network ("SDN") and Megacom and Megacom-800 offerings. Huber Report at 3.41, Table IX.18.

49/ Huber Report at 3.41 n.141.

regulators that bypass is a real competitive threat cannot be harmonized with its contrary claims to this Court that bypass is virtually impossible.

B. The Lifting of Restrictions Will Not Deprive AT&T of Any Benefit That Induced It To Concur in the Decree.

AT&T took no responsibility for the line of business restrictions when the proposed Decree was originally made public. It told this Court, the FCC, Congress, the press and its shareholders that the line of business restrictions were not its idea.[50/] Not having bargained for the restrictions, AT&T is in no position to contend that it has been denied any benefit to which it is entitled should the restrictions be lifted.

AT&T's public interest arguments against lifting the restrictions are both misplaced and transparent: misplaced because the applicable standard is not some vague and generalized "public interest" but the procompetitive standard of section VIII(C); transparent because the facts do not bear out its public interest claim that the decree minimizes litigation. The maintenance of the interexchange and manufacturing restrictions -- the only restrictions AT&T supports -- would not

50/ See 552 F. Supp. at 186 n.227; Transcript, June 29, 1982 at 25211; Brief of the FCC as Amicus On Question No. 1 (June 14, 1982) at 8-9, quoting from the FCC's March 24, 1982 hearing on the proposed decree.

minimize litigation and uncertainty in the industry; on the contrary, these restrictions are a source of these very evils.

The scope of the decree's interexchange restriction has been before this Court on a number of occasions. For example, the Court considered the meaning of this restriction in connection with Ameritech's motion concerning shared tenant services,[51/] AT&T's complaint about PNB's service to the State of Oregon[52/] and the Department's motion to compel Southwestern Bell to discontinue a business relationship with an interLATA reseller.[53/] It is now before the Court on AT&T's motion concerning BOC operator services[54/] and MCI's motion concerning database access for 800 service.[55/]

The manufacturing restriction has also been the source of controversy. As early as April 1985, AT&T complained to the Department that three different regional companies were engaged in manufacturing in violation of the decree.[56/] Another

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51/ United States v. Western Elec. Co., 627 F. Supp. 1090, 1099-103 (D.D.C.), appeal dismissed, 797 F.2d 1082 (D.C. Cir. 1986).

52/ Memorandum Order (June 28, 1985).

53/ Memorandum order (April 11, 1985).

54/ AT&T's Motion for Declaratory Ruling on Operator Call Handling (Aug. 20, 1986).

55/ Motion To Cease Deployment of Interexchange and Information Service Capabilities in BOC 800 Service Database (March 12, 1987).

56/ Letter from Jim G. Kilpatric, AT&T, to Kevin R. Sullivan, Department of Justice, dated April 29, 1985.

manufacturer, American Telecorp[57/] and the North American Telecommunications Association[58/] have complained to the Department about other supposed BOC manufacturing activities. In none of these cases did the Department find any violation of the decree. In addition, AT&T used the uncertainty about the scope of the manufacturing restriction to delay turning over to Bellcore, for more than two years, certain software to which Bellcore was entitled at divestiture.[59/]

AT&T is even trying to inject one of these disputes over the scope of the manufacturing restriction into this proceeding. In its comments, AT&T claims that the decree prohibits a BOC from participating in designing the telecommunications equipment it needs for its own use.[60/] AT&T had previously made this claim to the Department in connection with its consideration of an Ameritech waiver request.[61/] In

57/ Letter from Thomas J. Casey, attorney for American Telecorp, to Michael F. Altschul, Department of Justice, dated August 19, 1985.

58/ Letter from Albert H. Kramer, attorney for NATA, to Kevin R. Sullivan, Department of Justice, dated January 14, 1986.

59/ *See* letter from Kevin R. Sullivan, Department of Justice, to Jim G. Kilpatric, AT&T, dated October 25, 1985.

60/ AT&T's Comments at 82.

61/ Letter from Francine J. Berry, AT&T, to Nancy C. Garrison, Department of Justice, dated October 30, 1986.

response to this claim, Bell Atlantic[62] and others demonstrated that the language of the Decree did not support AT&T's argument and that the Court expected the BOCs to be involved in developing design specifications for the equipment they purchased.[63]

In any event, the precise definitions of what a BOC may and may not do consistent with the decree's interexchange and manufacturing restrictions are complex matters. This has contributed to the proliferation of litigation concerning the meaning of the decree's terms, resulting in the parties' spending a reported $75 million on decree-related disputes since divestiture.[64]

III. THE SPECIFIC RELIEF REQUESTED BY BELL ATLANTIC MEETS THE VIII(C) STANDARD.

Bell Atlantic obviously wants the same freedom to operate under the decree as may be granted to any of the other subject companies. Some BOCs, particularly with respect to the

62/ Letter from John M. Goodman, Bell Atlantic, to Nancy C. Garrison, Department of Justice, dated December 11, 1986.

63/ "[T]he operating companies will, of necessity, have to negotiate with independent equipment manufacturers over a variety of contractual terms (e.g., specification and design terms, volume contracts, trademark licenses) in order to obtain a distinctive line of products for resale." United States v. Western Elec. Co., 569 F. Supp. 1057, 1089 n.133 (D.D.C.), aff'd mem., 464 U.S. 1013 (1983).

64/ Wall Street Journal, dated April 8, 1987, at 6.

interLATA restriction, may request broader relief than others. Consequently, Bell Atlantic's motion and proposed order requests equivalent relief should such relief be granted to any other regional company or BOC that goes beyond the interLATA authority specifically requested herein.

A. The Limited InterLATA Relief Requested by Bell Atlantic Is Conditioned on Reciprocal Competitive Entry by Others Within Bell Atlantic's Region and Avoids Any Bottleneck or Network Discrimination Concerns.

Bell Atlantic is not asking to provide general toll services within its region. It is asking for those rights outside its region where there can be no conceivable claim that it controls the local exchange network.

1. Private Network Services and Packet Services.

Within its region, Bell Atlantic requests authority to provide a small group of large customers with a limited set of services for which these customers have many competitive alternatives. These services are private network services and consist of private line circuits associated with dedicated switches.65/ The Court has already made clear that the BOCs are

65/ Huber Report at 3.45:

> A private network consists of transmission facilities, nodal switches, and other customer premises equipment configured for the exclusive use of a single, geographically dispersed organization.

entitled to offer the switching associated with private networks, provided the customer directs the routing of traffic to any circuits that cross LATA boundaries.66/ Additional waiver relief is necessary to permit Bell Atlantic to provide the interLATA circuits.

Permitting the BOCs to provide these services would promote competition. This market is highly concentrated, and AT&T is by far the largest provider of these services.67/ Moreover, there is evidence that AT&T is attempting to manipulate this market, forcing customers to migrate to new AT&T network services with private line characteristics.68/ The BOCs are the most logical competitive counterweight to AT&T in this market, just as they were in the CPE market in 1982.69/

Nor do the BOCs have bottleneck control over these networks, even though the BOCs do supply some services -- such

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66/ This was the Court's holding when it rejected AT&T's complaint that PNB's service to the State of Oregon violated the decree. Memorandum Order at 3-4 (June 28, 1985). In spite of this fact, AT&T is challenging a similar switching service provided by another US West company. Letter from Francine J. Berry, AT&T, to Nancy C. Garrison, Department of Justice, dated March 5, 1987. The Bell companies have responded, demonstrating that the service in question is permitted by the decree and this Court's prior orders. Letter from Saul Fisher, NYNEX, to Nancy C. Garrison, Department of Justice, dated March 25, 1987.

67/ See "AT&T Rides Out Private Line - Private Network Storm," Communications Week (April 13, 1987).

68/ Id.

69/ 552 F. Supp at 192.

as local private lines -- for these networks. There are ready bypass alternatives for local private lines. For example, the fiber optic bypass system now operational in Washington, D.C. actively promotes its ability to replace BOC private lines connecting customer locations or connecting a customer's PBX to an interexchange carrier's point of presence.70/ A growing number of microwave vendors are pursuing the same market.71/ To the extent these competitive private networks choose to use local BOC private lines, they will be ordering "plain vanilla" facilities, any degradation of which can be readily detectable.

Bell Atlantic also seeks authorization to provide interLATA private lines to the packet switch networks of itself and others. These networks are simply a specialized type of private network used by one type of high volume customer -- database providers -- to provide their own customers with access to their service.

As with other private networks, AT&T now provides the overwhelming share of interLATA links for these packet networks.72/ Allowing the BOCs into this business would also further competition.

70/ Bell Atlantic Comments at 12; Huber Report at 2.13 - 2.15.

71/ Bell Atlantic Comments at 12-13; Huber Report at 2.16.

72/ Huber Report at 5.11.

2. <u>InterLATA Consulting</u>.

Some large customers, including multilocation banks, state governments and large industrial enterprises, want their telecommunications vendors to be able to recommend complete telecommunications systems. To meet this customer requirement, Bell Atlantic requests authority to provide consulting services on all aspects of interLATA service, but only to those large customers needing private network services. These customers represent no more than one percent of the total customer body.73/

The right requested does <u>not</u> include resale of service; it does include the right to serve as an ordering agent, assisting eligible customers in assembling the package of interLATA and intraLATA services which best meet their needs. Except for private line services and such other specialized business services that Bell Atlantic may be authorized to provide within its region, the consulting service that Bell Atlantic would provide is similar to the vendor coordination service that the Court has previously encouraged the BOCs to make available to their customers.74/

The Department has concluded that the GTE telephone companies, <u>even without a waiver</u>, have the right to recommend

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73/ Huber Report at 3.44.

74/ <u>United States v. Western Elec. Co.</u>, 627 F. Supp. 1090, 1102 n.51; 592 F. Supp. at 863.

interLATA services to all of their customers. The GTE situation should logically present a harder issue: the GTE telephone companies have an affiliated, general toll carrier operating out of their exchanges that they might be tempted to favor. Under the limited relief requested by Bell Atlantic, there would be no comparable incentive to discriminate.

3. 800/WATS Services.

Bell Atlantic also requests authority to provide interLATA WATS and 800 services. For these services, interexchange carriers already have the equivalent of 100% equal access. Moreover, Bell Atlantic would have no dialing advantage for these services.

For 800 service, Bell Atlantic already provides ubiquitous NXX access service, and the Court has found that this arrangement meets the BOCs' equal access obligation.75/ For WATS, equal access is also ubiquitously available.76/

Bell Atlantic would not have any dialing advantage over its interexchange competitors because all 800 calls and WATS calls are completed by dialing the same way. There is no

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75/ United States v. American Tel. & Tel. Co., 604 F. Supp. 316, 322-24 (D.D.C. 1985).

76/ See Bell Atlantic Tariff F.C.C. No. 1, Transmittal No. 135 (January 20, 1987) which provides WATS access for OCCs even in areas where equal access is not available for general toll services.

"10XXX" dialing for either service. In addition, Bell Atlantic would use the same 800 access arrangements -- initially NXX and later database access -- to complete its 800 calls that it can make available to the interexchange carriers.77/

4. InterLATA Mobile Services.

Bell Atlantic should also be permitted to provide interLATA mobile services, including cellular and conventional mobile services.78/ Such authorization poses no risk of competitive harm.

LATA boundaries have a very different significance for mobile services than for ordinary long distance services. For long distance, the LATA line is a boundary designed to prevent the BOCs from providing interexchange service in competition with the interexchange carriers.

There is no comparable decree purpose to prevent the BOCs from competing with other mobile service providers, and a

77/ MCI and Sprint complain that they cannot freely compete to provide WATS and 800 services because of state regulatory restrictions. MCI Comments at 20-24; Sprint Comments at 15-16. Bell Atlantic's interLATA proposal, however, addresses these concerns. Under that proposal, Bell Atlantic would be permitted to provide a customer with interLATA WATS and 800 service only if interexchange carriers could provide intraLATA WATS and 800 service to that same customer. Bell Atlantic Comments at 16.

78/ Conventional mobile services include paging, conventional mobile telephone service, marine radio, and air-ground mobile services. Huber Report at 4.1-4.2.