"Unregulation" as Regulatory Reform in Telecommunications

By The Honorable PATRICIA M. WORTHY

Acknowledging that a free market ideology dominates much policy making in federal regulatory agencies at the present time, the author of this article — the chairman of an agency that is the equivalent of a state utility commission — is critical of a number of current policy determinations which are driven by a desire to effectuate a free market in telecommunications. The article gives reasons for a conviction that real possibilities exist for monopolistic abuses in many areas of telecommunications without continued regulatory oversight employing policies that are effective as well as properly motivated.

To some extent, recent trends toward what I have called "unregulation" in the guise of regulatory reform stem from a political environment that totally rejects the idea of any role for government intrusion in economic affairs. At last, after living in Washington, D. C., for more than 20 years, I have had the opportunity to observe a state of total devastation and chaos brought about, not by my colleagues — members of the legal profession — but instead by a group of pedantic economists.

In recent times, several interrelated concepts within mainstream economics have grown in strength and merged into a stated reality. First, the conditions of economies of scale that had been identified as justifying social intervention were interpreted more narrowly and consequently were seen as more open to disintegration through the availability of substitute products and services and a myriad of technological changes.

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Concurrently, the agreed-upon definition of competition has been radically altered. A new theory of competition, that of "contestable markets," has been developed and employed to demonstrate that monopoly is, as a former colleague of mine, Edythe Miller, cleverly puts it, "apparently only competition in drag."[1] Moreover, an "economic theory of regulation" has evolved that questions the public interest implications of regulation by depicting us regulators as pawns of the industry and regulation as an effort conducted in pursuit of a private, as opposed to a public, interest. The conservatives find the "contestable markets" approach attractive in that it fosters their goal of "getting government off the back of big business" and the depiction of regulators as pawns excites the political liberals who are always motivated by a hint of corruption in high places. Together, they have almost swept the political board clean of rate of return regulation as we have known it.

The overall effects of these regulatory changes have been in large measure quite debilitating: Consumers are confused, rates for local services have risen dramatically and will continue to rise, the Bell operating companies (BOCs) face greater financial risk due to their accelerating diversification, and approximately seven million Americans remain without telephone service. Nevertheless, the zeal of those advocating reduced public oversight of essential and monopoly services remains unfettered.

In spite of the long history of regulatory accomplishments, the pendulum is now clearly swinging away from regulation to a laissez-faire capitalism in which essentially monopoly firms are free to pursue their objectives

without the discomfort of government intrusion and oversight.

There are many examples today of the impact associated with the federal government's infatuation with the "free market" concept. This article will describe and assess three specific examples from the telecommunications industry which clearly evidence that infatuation and have the effect of continually disrupting an industry already in the throes of transition: (1) the Federal Communications Commission's efforts to relax the longstanding prohibition against ownership of cable television facilities by telephone companies outside rural areas; (2) the continuing oversight of the AT&T modified final judgment by Judge Harold Greene of the United States District Court for the District of Columbia; and (3) the FCC's continuing efforts to put in place a price cap regime.

Telephone and Cable Cross-ownership

In 1987, the FCC instituted an inquiry to review the telephone company and cable television cross-ownership restrictions established by its rules, and later codified in the Cable Communications Policy Act of 1984. In general, those restrictions prohibit telephone companies from providing video programming services within their telephone service areas if located in nonrural areas. The FCC initially established these restrictions to prevent telephone companies from impeding the early development of an independent cable industry. This objective had a twofold purpose: First, it was intended to prevent cross-subsidization of nonregulated telephone company cable television activities with resources committed to the regulated sector. The effect of such cross-subsidization would have been that telephone ratepayers would, through artificially higher rates, pay some of the costs of providing cable television service. Second, the prohibition was imposed to prevent telephone companies from using their monopoly position in the basic exchange service market as leverage to dominate the cable services marketplace as well. For example, it was feared that telephone companies (telcos) could use their ownership of utility poles and underground conduit to compel other cable companies to pay exorbitant access fees, thereby affording the telcos a substantial competitive advantage.

In its *Cable Inquiry,*[2] however, the FCC has tentatively found that the cable industry has had an opportunity to outgrow the likelihood of abuses found at the inception of the cross-ownership prohibition. The FCC now believes that the market landscape could support telephone company entry into the provision of cable channel services, even outside of rural areas, and is now considering submitting to Congress legislative recommendations that would do away with the restriction. In large part, the FCC's tentative recommendation places great hope and reliance on its version of "nonstructural" regulatory safeguards, such as those formulated in the third computer inquiry, as the primary protection against abuses. For a variety of reasons, the FCC's course of action is ill-advised.

First, the FCC's reliance on its *Computer III* nonstructural safeguards is wholly inadequate and grossly premature. The nonstructural safeguards applied to BOC provision of unregulated enhanced communications service include: (1) providing competitors with "equal access" to transmission and other facilities, ultimately through technical reconfiguration of the network called open network architecture; (2) segregating regulated from unregulated costs, revenues, and property using the accounting manuals required by Part 64 of the FCC's rules regarding cost allocations; (3) disclosing new technical developments and configurations in a timely fashion to allow competitors to plan new service offerings within similar time constraints to those of the BOCs; and (4) adopting procedures governing the disclosure to competitors of customer proprietary network information known to the BOC regulated network services subsidiaries.

The FCC's *Computer III* framework has not been tested over time, nor has it even been upheld as lawful by the courts. I am also concerned about the effectiveness of nonstructural safeguards, given the tremendous level of human resources necessary to oversee them — particularly with respect to cost accounting, which must form the foundation for relaxed cross-ownership regulations. For example, increasing the audit responsibilities of state commissions to include transaction-by-transaction analysis of BOC enterprises could require additional resources and facilities at greatly increased regulatory cost. Public utility accounting is remarkably complex and extremely intricate in its detail. It is impossible for even the most vigilant regulator to track every transaction and balance every account. Even the FCC, mindful of its own limited resources, has had to delegate this responsibility to the big accounting firms.

The consequence of ineffective nonstructural safeguards is a far greater risk of cross-subsidization of nonregulated cable services using revenues from regulated activities. The artificial increase in telephone rates caused by this subsidy could be enough to drive many subscribers off the network. Universal telephone service is a goal in the District of Columbia and not a term of art bandied about by those attempting to stave off blame and public scrutiny.

If the FCC is successful in relaxing the cross-ownership prohibition, the traditional role of state public utility commissions in regulating intrastate telecommunications must be preserved. At a minimum, this requires that each state must have the discretion to decide what regulatory framework would best prevent anticompetitive conduct by telephone companies in their respective ju-

risdictions. It is my personal belief that cable cross-ownership by the BOCs should be allowed, if at all, only through arm's-length subsidiaries. While there is some debate that this would diminish benefits of economies of scale, I reject this argument if the alternative results in captive ratepayers bearing the burden associated with cross-subsidies.

The most effective and simplistic mechanism to prevent cross-subsidy is a retention of the existing prohibition. As one cable operator put it in testimony to Congress before passage of the 1984 Cable Act:

> It would be impossible to totally stop the utility from cross subsidizing the cable TV operations from their telco customer revenues. This is true because cable TV uses the same hardware — strand, anchors, pedestals, bolts, clamps — the same type of construction personnel and techniques, same type of service, vehicles, and the same conduit, poles and trenches. . . . Only cable and electronic devices differ between these operations, and this represents less than 20 percent of the investment required to build a cable system.[3]

The FCC's cable cross-ownership inquiry has also focused attention on whether further preemption of state regulatory authority is necessary in order to promote use of cable systems for provision of channel and data services currently provided, primarily, by regulated telephone companies. This proposal flies in the face of long-standing precedent and common sense. The Communications Act of 1934 and the Supreme Court of the United States recognize that states have a special interest in regulating local telecommunications service.

The intent of Congress was, clearly, to allow for the cross-ownership of cable systems by telephone companies in rural areas only, with the intention being to bring cable service to sparsely populated regions that independent cable providers would find unprofitable. There was also explicit congressional recognition that AT&T and its then affiliates must be barred from cross-ownership in populous areas, with the added requirement that all unregulated services offered by telephone company subsidiaries must be carried out through a separate subsidiary.[4] I see no changed circumstances that would suggest that a basis exists for changing this federal policy.

The Modified Final Judgment

Most readers are, by now, well versed in the highly publicized outcome of the first triennial review of the AT&T consent decree regarding the line of business restrictions imposed on the Bell operating companies at their divestiture from AT&T.

The conditions which warranted the imposition of restrictions still clearly exist, I believe. Nevertheless, in light of the record of the first triennial review, Judge Greene, in September 1987, deemed circumstances to be sufficiently changed to justify elimination of the restrictions concerning nontelecommunications lines of business and information transmission services. With respect to nontelecommunications lines of business, Judge Greene based his decision on: (1) the general agreement among commenters that the companies could not use local exchange facilities to inhibit competition in nontelecommunications ventures; (2) his belief in the limited opportunities available to BOCs for cross-subsidization; and (3) the tremendous resources necessary for the court to provide continuing oversight.

It is my opinion that the court exercised flawed reasoning and I attribute the court's action in great part to the continued emphasis at the federal level that regulatory restraints must be lessened.

Perhaps the most far-reaching of Judge Greene's changes to the modified final judgment information services order allowing the BOCs to provide information gateways through which consumers could access a multitude of video and audiotex services. While Judge Greene no doubt believes that his decision will create a new competitive industry, many state regulatory commissioners are concerned about his inexplicable about-face in only three years. Are these not the same notorious monopolists at the controls which led to the initial Bell breakup?

In order to understand state regulators' concerns with Judge Greene's oversight of the AT&T divestiture, and the information services order in particular, one must understand that the role of a federal judge enforcing the antitrust laws is distinct from, and on some issues, in conflict with, the role of state utility commissioners overseeing the local operations of telephone companies. In his order relaxing restrictions on BOC provision of information services Judge Greene is explicit in this regard. He explains that the "fundamental principle of jurisprudence is that the antitrust laws protect competition, not competitors."[5] At the same time, he notes that any benefits reaped by ratepayers and consumers are only tangential in nature. While consumers benefit from fair competition, their interests are of only indirect concern. The court explained that "[the antitrust] laws seek to foster competition by increasing the number of providers in the marketplace and thereby allowing the consumers, through demand for services, to select the winning firm."[6]

That is not to say that Judge Greene's decisions fail to consider the plight of our citizens, for in his September 10, 1987, order he stated, most emphatically, that "The protection of consumers is a foremost objective of the antitrust laws."[7] Nevertheless, he tempered that position by stating that the "court's decisions on the core restrictions do not turn on the factors of protection of ratepayers from price gouging or that of universal

service."[8] Judge Greene further noted that "Universal service has been explicitly declared by the Congress to be a paramount national objective, and the courts may be expected to avoid taking actions, if that can legitimately be done, that are inconsistent with this objective."[9] Unlike the role described by Judge Greene for his court, the primary role of state regulators is to ensure universal service, through affordable, reasonable, and nondiscriminatory rates. To achieve these goals, state regulators must have the tools necessary to protect against discrimination and cross-subsidization by the BOCs and their operating companies.

The executive committee of the National Association of Regulatory Utility Commissioners has adopted a resolution[10] which lists four conditions for NARUC support of lifting any of the original line-of-business restrictions on the BOCs. In evaluating Judge Greene's information services decision, we should look to see if those conditions, though not necessarily within Judge Greene's power to satisfy, have, in some way, been met. While industry can claim that Judge Greene has shared our concern in the first of these conditions, that "Each service or function should be viewed and evaluated in terms of how it contributes to the enhancement of a 'full service' network," I find regulatory protection addressing our other concerns sorely lacking.

For instance, as I have noted, the organizational format utilized in offering any new intrastate service is, first and foremost, a state regulatory decision. States must be free, as stated in the second condition, to treat these services as 'above the line' or 'below the line' items, and to require accounting separation procedures or separate subsidiary requirements to protect fully the interests of captive ratepayers of the regulated company or regional holding company. However, when the FCC backed away from the structural separations requirement in its *Computer III* decision, it also preempted state regulators from using that method to protect ratepayers. The NARUC and the states have appealed the *Computer III* decision.[11] A decision will likely be forthcoming in midyear.

Nor have NARUC's third and fourth conditions been met. The third condition states that "In the event that an affiliate of the regional holding company is utilized, the state commission must have the authority to enforce conditions deemed by it to be essential to assure that the switched network would be enhanced or protected from possible erosion of its cost-effective investment base."

The fourth condition holds that "The state regulatory commissions shall have full access to all books, records, facilities, and premises of the BOCs and all affiliated companies." The District Court's order fails to impose either of these requirements on the BOCs or condition BOC information services on adoption by states of rules providing for these protections. By allowing the BOCs' greater market presence while rejecting the opportunity to impose additional regulatory protection, Judge Greene's information services decision only exacerbates an already difficult problem caused by the FCC's *Computer III* decision.

The greatest threat to captive ratepayers from BOC provision of competitive service is the incentive for the companies to use ratepayers' dollars to subsidize their competitive activities. Efforts undertaken by the states in 1984, 1985, and 1986 to audit the BOCs were complicated and at times hindered by problems in gaining full access to all corporate books and records of the BOCs and their unregulated affiliates. The states lack assurances from the court, Congress, or the FCC that future efforts will not face the same barriers.

Price Caps in Lieu of Cost-of-service Regulation

The clearest evidence of the trend toward misguided regulatory reform which I described at the beginning of this article is the FCC's proposal to employ price caps to set rates for AT&T's interstate service and the Bell operating companies' provision of interstate exchange access service. On May 23, 1988, that commission released its *Further Notice* of proposed rule making in CC Docket No. 87-313. The *Further Notice* was far more detailed and represented, in my opinion, a significant effort by the FCC to address the concerns raised in light of its August 21, 1987, original notice. As commenters, including the District of Columbia Public Service Commission, pointed out, however, the FCC's price cap proposal still contained certain flaws and weaknesses which needed to be addressed prior to a decision as to whether a price caps regime served the public interest.

State regulators have made known their positions concerning price caps. Led by NARUC, our concerns regarding price caps have been made clear to the FCC and to Congress. Of paramount concern to me, however, is the question of whether price caps will preserve the high level of quality which we, as network users, enjoy today. Service quality is not a jurisdictional issue. Therefore, prior to any implementation of price cap, state and federal regulators should work together to develop and put in place a system for effectively addressing and monitoring service quality issues. A good starting point would be the model service quality rules adopted by NARUC in 1987.

But why, you may ask, would price caps undermine levels of service quality? The concern is simply that the price cap proposal, if implemented, may create incentives to forsake network investment, and therefore quality, in order to increase profits. The Bell system service quality crisis in the late 1960s resulted from AT&T's efforts to increase net earnings. The company refused to increase capital outlays at a time when demand growth in several areas exceeded switching capacity. The resulting capacity shortages caused serious declines in service quality, with service interruptions in major East Coast

cities during 1967-68. By 1969, service throughout the urban regions of the eastern part of the country was beset by delays in dial tone, repairs, and installation of new equipment.[12]

While I have not touched on all concerns raised by commenters on the FCC's further notice, on balance, and in light of the limited risks associated with the price cap proposal to carriers which elect that alternative, and the lack of clear-cut guaranties that consumers will be better off under price caps, I conclude that the FCC's current price cap proposal is not in the public interest.

Proper Regulatory Objectives

It may surprise my readers to know that I am not opposed to regulatory change, provided it is not mindless "unregulation"; that is, change for change's sake. Regulatory reform for its own sake is not progress: it is merely the replacement of one form of regulation for another. Before I will subscribe to a particular regulatory approach in this area, it must be proven that the change will improve the overall state of telecommunications, that it will increase efficiencies, yield technological innovations, and create sustained price reductions, and that benefits will appreciably exceed risks.

I also believe that regulatory change should proceed slowly, cautiously, on a service-by-service basis, and only after a convincing showing that it is in the best interest of customers and company alike.

Endnotes

[1]Edythe S. Miller, "Market Structure and Pricing Issues in Local Service Telecommunications Markets" (1988), p. 2.

[2]*Telephone Company/Cable Television Cross-Ownership Restrictions (Notice of Inquiry)* 2 FCC RCD 5092 (1987).

[3]Statement of Jack Blanchard, president, Mogollon Cable TV Company, *Cable Television Regulation Hearings:* Hearings Before the Senate Committee on Commerce, Science, and Transportation, Parts 1 and 2, 97th Cong., 2d Sess. at 5.

[4]H.R. 6121, 96th Cong., 2nd Sess. I FC II (1979).

[5]*United States v. AT&T*, No. 82-0192, Slip Op. at 60, n. 88 (D. C. March 7, 1988).

[6]*Id.*

[7]*United States v. AT&T*, 673 F.Supp. 525, 585.

[8]*Id.* at n. 267.

[9]673 F.Supp at 585.

[10]Resolution Supporting Conditions for Removal of Competitive Restriction on Bell Operating Companies, Adopted February 26, 1987, NARUC Bulletin No. 10-1987, pp. 7-8. The relevant section is as follows:

RESOLVED, That any function or service to be authorized that is now proscribed by the MFJ should be integrated into the switched network of the BOC or otherwise structured to relate to the regulated operations in accordance with the following concepts:

(a) Each service or function should be viewed and evaluated in terms of how it contributes to the enhancement of a "full service" network for the purpose of determining how the function of service should be integrated in, or structured to, relate to the network;

(b) The accounting or corporate form for the offering of any new service is a State regulatory decision and may include treatment 'above the line,' or 'below the line' through accounting separation or separate subsidiaries of the regulated company or regional holding company;

(c) In the event that an affiliate of the regional holding company is utilized, the State commission must have the authority to enforce conditions deemed by it to be essential to assure that the switched network would be enhanced or protected from possible erosion of its cost effective investment base; and

(d) The State regulatory commissions shall have full access to all books, records, facilities, and premises of the BOCs and all affiliated companies; . . .

[11]In light of *Louisiana Pub. Service Commission v. Federal Communications Commission*, 476 U.S. 355, 74 PUR4th 1 (1986), a number of states and the District of Columbia have appealed the *Computer III* orders to the extent that they preempt the state regulation of BOC provision of enhanced services. In part, the appeal rests on the conclusion that the case upholding the FCC's *Computer II* decision, heavily relied upon by the FCC in its *Computer III* preemptions, may have been flawed, and that *Louisiana* compels a different result. In that pivotal case, the U. S. Supreme Court clarified and reiterated that Congress created a dual scheme of federal-state regulation in this country, and that the FCC may not ignore this mandate in order to expand its power.

[12]A Carron and P. MacAvoy, *The Decline of Service in the Regulated Industries*, p. 37.

Utility Officer Honored by National Academy

Harold N. Scherer, Jr., senior vice president for electrical engineering of the American Electric Power Service Corporation, has been elected a member of the National Academy of Engineering. Scherer is the only representative currently employed by an electric utility among the 90 American engineers elected to membership in the Academy and the seven foreign engineers selected as associates of the Academy. In announcing his election in mid-February, the Academy cited Scherer's contributions to the development, design, and effective utilization of extra-high-voltage and ultra-high-voltage electric power transmission systems. Scherer began his career with the AEP Service Corporation in 1963 as a senior engineer. He became chief electrical engineer in 1969 and was elected to his present position in 1982. The National Academy of Engineering of Washington, D. C., is a private organization established in 1964 that shares responsibility with the National Academy of Sciences to advise the federal government on questions of science and technology. It also recognizes distinguished engineers, sponsors engineering programs, and encourages education and research.