The FCC and the Aftermath of Divestiture

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It is almost impossible to consider divestiture in terms of an isolated event, somehow separate from events that have transpired in federal and state regulatory arenas.

For those of us in telecommunications, it seems that the more things change, the more things change. The changes that have taken place in the provision of telephone services and equipment as a result of the divestiture have been monumental. AT&T, the monolithic operator in the telecommunications industry, is now just another player in the market with competitors such as Siemens, and a host of others, including the equipment subsidiaries of the seven regional BOC holding companies, getting the business that used to go to AT&T.

Along with more competition, the overall CPE market also appears to be growing. Between 1983 and 1984, for example, retail sales of telephone units are also growing. Between 1984 and 1985, for example, retail sales are expected to have climbed to over 31 million units. CPE deregulation is truly one of the major success stories of the divestiture era.

CPE reforms at the FCC pre-date the divestiture. The Commission has long encouraged the development of a competitive CPE industry. But there was not much activity on this front until 1980, when the Commission issued Computer II. Among other things, Computer II...
required AT&T to deregulate all of its CPE then offered under tariff, and to offer new and deregulated CPE on a competitive basis through a separate subsidiary.

The divestiture court took the FCC’s decision as a given, authorizing AT&T to retain its CPE business. Then it became the FCC’s turn to decide the specifics of how to transfer the estimated $10 billion of CPE subject to public utility regulation, to AT&T’s separate subsidiary without choking competition in the emerging CPE marketplace. And, we had to ensure that AT&T ratepayers were not treated unfairly, all before the January 1, 1984 divestiture. AT&T submitted its proposal, comments were taken from interested parties, and in December 1983, the Commission issued its decision. CPE would be transferred to AT&T’s separate subsidiary at its net book value, and would remain subject to a “price predictability” program for two years so that AT&T did not overcharge or undercharge for CPE.

Another major FCC policy initiative was a step-by-step introduction of competition into the long-distance market. A necessary predicate for this was pricing reform for interstate services. These interrelated reforms are often thought of as separate policies, but they really represent one integral attempt to restructure the way service is provided. Competition, if it is to be successful, depends upon allowing competitors to establish prices in relation to costs.

The Commission has focused on two areas to bring interstate cost-based pricing: access charges for originating and terminating interstate communications, and pricing of AT&T’s long-distance services. In both these areas, pricing has historically been inaccurate due to the existence of cross subsidies between various parts of pre-divestiture AT&T.

FCC pricing reforms were underway when the divestiture was announced. If there was any doubt that price reform was needed, divestiture laid all doubts to rest. With the Bell Operating Companies established as independent, local gatekeepers for long-distance traffic carried by any interstate carrier, the BOC’s needed to be able to recover their costs of providing origination and termination services, plus a reasonable rate of return.

Here again, the FCC originally took its cue from the divestiture. For example, as a result of the divestiture court’s decision to require BOC’s to provide equal access to all long-distance carriers, we had to construct a mechanism so that discounted rates paid by AT&T’s competitors would be phased out as equal access was phased in. The result we ultimately adopted, an end-office-by-end-office approach to discount phase-out, has worked well to place carriers on an equal competitive footing.

With the BOC’s separate from AT&T, the interstate access services they performed had to be offered at compensatory rates. In addition to massive changes in rate structure, we also had to face, in the area of special access, changes in rate levels reflecting the loss of revenue support occasioned by the divestiture. At the same time, we had to make sense out of the practice of loading the interstate portion of non-traffic sensitive (NTS) cost of telephone service (that is, the interstate portion of local loop costs) on AT&T’s long-distance rates. A more economically rational way to recover these fixed costs was through a monthly charge on the subscriber. By implementing the subscriber line charge, AT&T’s rates could drop to a level reflecting costs of providing long-distance service. Finally, we sought ways to build mechanisms that would encourage entry and foster competition into the transition to cost-based rates for all carriers.

The results of the FCC’s efforts are most encouraging. A rapidly growing number of firms provide interstate telephone service. We do not know precisely how many. We do not know because, as part of our effort to reduce unneeded regulation, we have exempted smaller “non-dominant” firms from our regulatory process. They no longer need our permission to enter the market, construct facilities, offer new services, change prices, or otherwise operate their businesses.

Not only are there more firms in the business, but some of them are growing at an incredible pace. MCI and Sprint have grown with phenomenal speed. The number of customers serviced by Sprint increased 40 percent in 1984. MCI, which now serves 407 of the Fortune 500 Companies, increased its customer base by 95 percent in the last nine months of 1984 alone.

We now find a remarkable variety among long-distance firms. Some specialize in serving business customers, while some specialize in serving residential customers. Others utilize their own long-distance transmission facilities, and some concentrate on reselling services purchased from others.

Some firms are now emerging with solely the goal of serving as wholesalers—marketing their services not to ultimate subscribers but to other carriers. Some are serving customers nationwide, while some are concentrating their efforts in regional markets.

Furthermore, the overall market for interexchange telecommunications services is growing. Industry sources estimate that interstate revenues increased 121 percent between 1978 and 1984. This growth comes at a time when rates for interstate services are dropping. AT&T’s rates have already dropped nearly 12 percent as a result of the introduction of subscriber line charges, and the flow through of these charges to consumer rates. Lower prices result in greater demand, which will, in turn, lead to increased revenue for the interstate service providers as a group. In sum, the competitive market for interstate service is not only growing, but growing in a way that will permit vibrant competition in years to come.

Of course, federal regulation only accounts for part of the telecommunications picture. We share an important regulatory partnership with state regulators, who are also working to keep rates down. Although state rate cases are not an area over which the FCC has jurisdiction, we have observed a decided drop-off in the proposed state rate increases since the divestiture. During 1984, state regulatory commissions granted $3.5 billion in rate increases. (This amounts to about half of what had been requested).

In 1985, amounts requested and granted leveled off considerably. For example, in 1984 local companies requested $7.3 billion in revenue. In the first nine months of 1985, revenue requests total only $2.6 billion; state regulators have allowed approximately $827 mil-
ion. Requests for revenue increases, which began dropping in the third quarter of 1984, have remained at a relatively stable level since that time and most recently have declined.

Another change at the local exchange level is introduction of high-cost assistance through revenues generated from carrier common line charges paid by interexchange carriers. Created by the FCC, this assistance is known as the Universal Service Fund. It allows exchange carriers that have higher than average local loop costs to allocate more of their costs to the interstate jurisdiction.

For purposes of qualifying for assistance, the FCC has divided local exchange carriers into two groups—those study areas with less than 50,000 working loops (excluding WATS, wideband, and private line loops) and those with more than 50,000 working loops.

For smaller study areas, companies whose relevant cost per loop is between 115 and 150 percent of the national average receive an interstate allocation of 50 percent above the basic 25 percent allocation. Those whose relevant NTS loop costs exceed 150 percent of the national average receive an additional 75 percent interstate allocation. For larger study areas, companies whose relevant cost per loop is between 115 and 150 percent of the national average receive an additional interstate allocation of 25 percent. Those whose relevant costs exceed 150 percent of the national average receive an additional 75 percent allocation.

This mechanism lets high-cost companies take more out of the carrier common line pool than they contribute, but that is made up for in the nationwide averaging process embodied by the pool. Thus, the Universal Service Fund provides a way for local carriers to hold down their rates when their NTS costs are higher than the national average.

While numerous changes have occurred in the industry over the past two years, the Commission has not yet completed its post-divestiture regulatory reform. We have made a good start on reforming interstate pricing. We have access charges and a transitional mechanism to account for the change from less-than-equal access, which the long-distance competitors to AT&T still receive in many areas of the country, to equal access. We have not, however, completed the task of revamping rate of return methodology for AT&T and for interstate services provided by local exchange carriers.

The new environment calls for a reassessment of our old notions about the risks involved in the industry and how to factor these risks into the rate of return. We have begun a two-step proceeding to deal with these issues, including methodologies and procedures for developing interstate rates of return for over 1400 exchange companies. We asked for comment on a plan to prescribe a single, uniform rate of return for interstate access, rather than to prescribe rates individually or by groups of carriers.

We also proposed three different methodologies for producing the proper rate of return. First, the FCC would take a weighted average of overall returns granted by state commissions, as a presumptively correct overall return for interstate access. Second, it would look at returns of other companies (not limited to telephone companies) that exhibit risk indicia comparable to that of interstate access to establish an overall return or range of returns. Third, it would look to the average of required returns for each of the regional BOC's computed individually. We look forward to reviewing comments that we expect to receive on this issue.

The growth of competition in the CPE and long-distance services markets is also causing us to change the way we treat the dominant provider of these services—AT&T—in comparison to its non-dominant competitors. Changing technology, too, is forcing us to reevaluate how we regulate dominant providers so that the network can evolve and, at the same time, accommodate competition for enhanced services. In Computer II, the Commission required AT&T to structurally separate its basic communications services from those that would be offered competitively, such as CPE and enhanced services. Competitive services would be offered outside of regulation.

When AT&T divested its operating companies, the FCC decided to continue to apply the structural separation approach to the Bell Operating Companies, although in modified form. In September 1985, after evaluating the extent of competition in the CPE and long-distance markets, the FCC eliminated structural separation rules that apply to AT&T, thereby enabling AT&T to jointly provide CPE and long-distance services. The FCC found that significant changes had occurred in the telecommunications industry since structural separation was adopted, including divestiture, and the twin development of competition in CPE and in long distance.

In removing separation requirements, however, the Commission instituted nonstructural safeguards to limit AT&T's ability to use its regulated operations unfairly to benefit its unregulated CPE activities. These included requirements such as network disclosure rules, no discrimination in favor of CPE customers, protection of customer proprietary information, and annual audits conducted by an independent firm. They should provide adequate protection for CPE competition and rate payers, without unduly burdening AT&T's ability to compete vigorously in both the long-distance services and CPE markets. We intend to monitor AT&T's performance under these safeguards and will take appropriate action should these prove either insufficient to protect competition and rate payers or overly intrusive or unnecessary.

The Commission also expects to reexamine structural separation in regards to the BOC's. If rate payers can be insulated from risks of competitive undertakings through regulatory techniques less intrusive than structural separation, it is to ratepayers' and consumers' benefit to dismantle this requirement. Regulatory restrictions such as structural separation are ultimately paid for by ratepayers, so we must remain vigilant about reforming our regulatory policies where costs of regulation outweigh benefits.

Finally, we are reevaluating structural separation as it applies to enhanced services. In August 1985, the Commission in Computer Inquiry III proposed to alter the rigid criteria used to determine whether or not a service can be offered outside of regulation. Rather than classifying a service as basic (subject to regulation) or
enhanced (offered competitively through a structurally separated subsidiary), we proposed to look at the type of entity offering the service (dominant or non-dominant), the service market (competitive or non-competitive), and the relationship of the new service to a carrier's basic communications services.

The decisional principles set forth in the proposal have been developed from principles we have learned through the process of reviewing numerous requests for waivers from Computer II rules. For example, if a dominant carrier offers a non-communications service such as real estate, our sole concern would be possible cross subsidization from the company's regulated services. A service which is ancillary to communications, such as CPE, might be subject to some controls short of structural separation, depending upon whether it was offered by a dominant carrier, whether it can be offered competitively, and whether the competitive offering depends on the carrier's dominance (such as control over bottleneck facilities). Traditional communications services would continue to be subject to regulation if offered by a dominant carrier. We look forward to the industry's thoughts on these issues.

Reforms proposed in the Computer III rulemaking demonstrate both how far we have come since the divestiture two years ago and how far we have yet to go. If there is one constant in this business, it is that there will always be pressure for change. Technology forced changes in the way CPE and long-distance services were provided. The divestiture resulted, in part, from pressures to keep activities which appear to be monopolistic separate from those which could be offered on a competitive basis. Reforms to accommodate these policy goals fueled competition further, resulting in elimination of structural separation for AT&T. Today, technological changes once again force us to rethink the way we regulate enhanced services.

The FCC is well-equipped to replace outmoded methods of regulation with more flexible, pro-competitive mechanisms. One by one we are addressing these, until a new regulatory framework, designed for today's competitive activities, is completed. I hope that the industry can continue to build upon the competitive cornerstones of divestiture and present FCC policies. This way, wherever possible, efficient marketplace regulation can replace agency oversight.

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