

# COMPETITION IN THE TELEPHONE INDUSTRY: WHAT WILL CONGRESS PERMIT?

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## INTRODUCTION

The Communications Act of 1934 (47 U.S.C. 201), which established the Federal Communications Commission and brought all common carriers of telecommunications under governmental regulation, may be completely revamped by Congress in the near future.<sup>1</sup> Rep. Lionel Van Deerlin, chairman of the House Subcommittee on Telecommunications, has organized a staff to study the 43-year-old statute, in response to an acrimonious battle between the telephone industry, led by the American Telephone and Telegraph Company, Inc., and businesses offering new types of communications equipment and services. The dispute concerns the degree of competition that should be permitted in the communications industry.

Nine years ago, the FCC authorized limited competition against the telephone industry's services in two specialized markets: terminal equipment and specialized common carriers. The Commission claimed that it had been inundated with complaints from customers that the established communications companies could not or would not provide them with new communications services and equipment made possible due to advances in electronic and computer technology.<sup>2</sup>

The telephone industry argued that the FCC had overstepped its statutory jurisdiction and was formulating policy rather than regulating. Following lengthy litigation in which the courts sustained the Commission's actions, the telephone industry turned to Congress for relief. In March, 1976,<sup>3</sup> and again in January, 1977,<sup>4</sup> the industry had a bill introduced which would drastically curtail competition in the lucrative new markets.

## THE NEW TELECOMMUNICATIONS MARKETS: SPECIALIZED COMMON CARRIERS AND TERMINAL EQUIPMENT

When the Communications Act was passed in 1934, telecommunications consisted primarily of two markets: voice telephone service provided by AT&T

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1. *Business Week*, January 10, 1977, at 25-26.
2. *Hearings on H.R. 12323 Before the Subcomm. on Telecommunications of the House Committee on Interstate and Foreign Commerce*, 94th Cong. 2d Sess. 5 (1976) [hereinafter cited as *Hearings*].
3. H.R. 12323, 94th Cong., 2d Sess. (1976); S. 3192, 94th Cong., 2d Sess. (1976).
4. H.R. 8, 95th Cong., 1st Sess. (1977).

and the independent telephone companies, and telegraph service, provided by Western Union. This structure continued undisturbed until the 1960's when technological advances made it possible for computers and other sophisticated equipment to be interconnected with the telephone network.<sup>5</sup> When the old rotary dial phone was replaced by the push-button telephone, it was found that the distinctive tone patterns of the push-button equipment could be used to code and decode instructions to computers.<sup>6</sup>

This simple invention may change the lifestyle of every American. Ordinary customers may soon be able to utilize their telephones to do their shopping and banking electronically. The push button tones can instruct the computer to transfer money from one account to another or to pay monthly bills. The customer need only dial the access code to the computer and enter his user number. A mini-computer attached to the customer's own home telephone can be set so that a telephone call could turn utilities on or off. Or the computer terminal could automatically switch an incoming call to another telephone where the customer may then be located.<sup>7</sup>

The business world can make the most immediate use of these new techniques in data transmission. Already, for example, police departments "call" their computer in a distant city with a license plate number and receive information about that number in a matter of seconds. A new type of company, the specialized common carrier, wants to offer to businesses data transmission of non-voice communications, utilizing microwaves or laser beams that operate at a much higher frequency than telephone wires. In the past decade, the FCC authorized these companies to interconnect with the telephone network permitting customers to use ordinary telephones to key into the services offered by the specialized common carriers. While some data transmission, such as teletype, has existed in the past, it was a cumbersome and expensive process. Interconnection with the national telephone network permits the specialized common carrier to offer to a customer transmission of his data to any other customer who also owns a telephone. Businessmen eagerly await the day when computers in different parts of the country can "talk" to each other and produce information at lightning speeds.

These specialized, or private line, offerings will not compete directly with the basic voice telephone service of the telephone industry. Rather, the specialized common carriers claim that the new technology will expand the total communications market by providing large industrial and governmental customers with high speed transmission of data utilizing microwaves or satellites.

A related but separate new market ripe for competition is the "terminal equipment" market. Terminal equipment is any piece of equipment directly interconnected at the customer's end with the telephone network. Terminal equipment includes the plain black telephone, the private branch exchange (PBX), answering machines, facsimile devices and the multiple buttoned key telephone. Prior to FCC decisions permitting competition in this area, the customer's right to use privately manufactured (i.e., not produced by the Bell Sys-

5. *Hearings, supra* note 2, at 3-4.

6. *Science Digest*, November, 1976, at 48.

7. *Science Digest*, November, 1976, at 46-47.

tem) equipment was severely limited. At present, however, there is a range of equipment available to consumers. These options will be drastically curtailed if Congress approves the industry-sponsored "Bell bill" discussed below.

### THE CONSUMER COMMUNICATIONS REFORM ACT

In March, 1976, Rep. Teno Roncalio and Sen. Vance Hartke introduced a bill on behalf of the telephone industry, entitled the Consumer Communications Reform Act of 1976.<sup>8</sup> This act would, if enacted, make the following significant changes:

- 1) Divest the FCC of its jurisdiction over these new markets and vest control completely in the regulatory commissions of the individual states;
- 2) Require specialized common carriers to prove that their services will not result in a duplication of the present telephone industry's offerings or result in any harm to the technical integrity of the telephone network;
- 3) Permit the established telephone companies to acquire any other common carrier without regard to the proscriptions of the anti-trust laws;
- 4) Stipulate to the FCC what constitutes "just and reasonable" pricing on the part of the telephone industry.

In September, 1976, the House Subcommittee on Telecommunications held hearings on this bill. AT&T testified<sup>9</sup> that the increasing competition will cause higher telephone rates for the basic services as a result of wasteful duplication of services and the "cream-skimming" of profits by competitors from the specialized markets. The Bell system claims it uses the profits from these markets to subsidize basic telephone service. AT&T has issued public statements that the basic telephone rate may rise as much as 70% if competition is permitted in these areas.<sup>10</sup> The telephone industry also asserts that this new competition will pose a threat to the technical integrity of the telephone network and cause a disruption of the efficient and integrated telephone system which now services 95% of all American homes.

The opponents of the bill include consumer advocate Ralph Nader, AT&T competitor Microwave Communications, Inc. (MCI) (whose survival depends on the defeat or amendment of the bill), the FCC, and the New York State Public Commission (which disputes the allegation that competition will cause the basic rate to rise). The opponents claim that the telephone industry is trying to protect itself against healthy competition, obtain legislative approval of its "predatory" pricing tactics, limit the telecommunications options open to consumers, and raise the basic service rate.

The 94th Congress took no further action on this bill after the hearings were completed. Consequently, the bill expired when Congress adjourned. However, on January 4, 1977, substantially the same bill (HR 8) was introduced into the 95th Congress by Representative Roncalio. In February, 1977, a House resolution was passed to study the entire area of telecommunications.<sup>11</sup>

8. H.R. 12323, 94th Cong., 2d Sess. (1976); S. 3192, 94th Cong., 2d Sess. (1976).

9. *Hearings, supra* note 2, at 2, 26 (testimony of AT&T Chairman deButts).

10. *Business Week*, November 18, 1976, at 116.

11. H.R. Res. 136, 95th Cong., 1st Sess. (1977).

Since the entire statutory basis for telecommunication regulation is now being reviewed by Congress, this note will summarize the background of the subject before reviewing the evidence presented to the House Subcommittee in September. The note will discuss how the traditional theory of the public utility as a natural monopoly has been applied to the telephone industry, the specific FCC actions taken since the 1960's which created the new competition in communications, the appellate courts' reviews of the FCC actions, and the specific issues discussed before the subcommittee in September, 1976.

### NATURAL MONOPOLY AND THE TELEPHONE SYSTEM

Like public utilities, the telephone system in the United States has been granted the status of a "natural monopoly."<sup>12</sup> The classic definition of a natural monopoly is given by Professors Kaysen and Turner: "In the economic sense, a natural monopoly is a monopoly resulting from economies of scale such that one firm of efficient size can produce all or more than the market can take at a remunerative price, and can continually expand its capacity at less cost than that of a new firm entering the business."<sup>13</sup>

The textbook example of a natural monopoly market is a small town which can only feasibly support one daily newspaper.<sup>14</sup> The newspaper which has the "monopoly" in this market should be exempt from antitrust laws, because it is felt that the economic reality of this limited market dictates that only one firm can efficiently supply the consumers and still maintain a rate profitable enough for its economic survival.

In 1975, AT&T submitted to the FCC a rather dreary academic thesis, "Natural Monopoly and the Bell System," which traced economic theory from the Nineteenth Century to the present to prove that the Bell system fits the "neoclassical economic model of a natural monopoly."<sup>15</sup> However, care must be taken to distinguish the use of the term "natural monopoly" in the economic sense from the way that it is employed in the legal sense. The very term "natural monopoly" may be a loaded one, conjuring visions of some victorious Darwinian entity which has justifiably triumphed over its inefficient rivals.

Although the courts have consistently justified the structure of public utilities as "natural monopolies,"<sup>16</sup> it would be more precise to say that they are statutory monopolies. Another example of a statutory monopoly is a patent. A patent confers a monopoly power upon its owner for a limited time. The government has decided to depart from a general policy favoring competition in order to promote new inventions and reward the inventor. Likewise, the government has made a policy decision that the services performed by public utilities are so

12. The power of the government to regulate common carriers or "businesses affected with the public interest" was first prescribed by the Supreme Court in *Munn v. Illinois*, 94 U.S. 113 (1877). This power included the setting of minimum rates. *Id.*, *Jackson v. Metropolitan Edison*, 419 U.S. 345 (1974); *Fcc v. RCA*, 346 U.S. 86 (1953).

13. C. Kaysen & D. Turner, *Twenty-Five Years of Antitrust Policy* 191 (1954); *Northern Natural Gas Co. v. Federal Power Comm.*, 399 F. 2d 953, 965 (1968).

14. M. Handler, *Trade Regulation, Cases and Materials* 819 (1975).

15. F.C.C. Docket No. 2003, Bell Exhibit No. 27 (I. Horowitz, *Natural Monopoly and the Bell System*).

16. *Gulf States Utilities Co. v. FPC*, 411 U.S. 747 (1973); *Jackson v. Metropolitan Edison*, 419 U.S. 345 (1974).

vital that they are best performed by one firm, supervised by a government regulatory agency. The offerings of the utilities are considered to be "quasi-public." Regulation by the government agency takes the place of competition in securing reasonable rates for consumers.<sup>17</sup>

The practical problems which would result from competition were felt to outweigh any benefits of competition in this area. As one writer has pointed out:

The telephone is best treated as a monopoly because of the necessity of unified service. . . If there are two telephone systems in a community, the subscribers of one system will be unable to converse with the subscriber of the other, and as a result the usefulness of the telephone system will be greatly curtailed.<sup>18</sup>

In return for protection from competitive rigors, utilities are required by their regulatory agencies to perform a quasi-public function. One student of public utilities describes this function in the following terms:

A public utility is under an extraordinary duty to render reasonably adequate service to all who apply. . . A public utility is required to serve up to the limit of its capacity, where capacity is more and more being defined, not as mere physical capacity but as the limit of profitableness. . . Finally, a public utility must observe more than ordinary care in the rendition of service. . .<sup>19</sup>

In addition to the need to insure full and adequate public service, public utilities are granted natural monopoly status because it is thought that "competition is ruinous, that is, fails to establish a normal level of rates sufficiently remunerative to attract the additional investments of capital that recurrently become necessary."<sup>20</sup>

The economic theory behind this statement is that, since the expenses of utilities are generally fixed, the more customers served by the company, the lower its costs per customer. Under a regulated system the lower costs may be passed on to customers while allowing for sufficient capital to be retained by the company to insure reliable equipment and service. Under a competitive system, it is assumed that rates will be cut so low that poor service will result. For example, if expenses are fixed, a telephone company in a competitive system could maximize profits by providing service to new urban customers where the company had already made the capital investment to string telephone wire. However, a competitive system would discourage companies from making the capital investment to serve a small number of rural users.<sup>21</sup> Under a regulated system, all consumers are

17. A Farris & R. Sampson, *Public Utilities, Regulation, Management and Ownership* 157-58 (1973).

18. E. Jones & T. Bigham, *Principles of Public Utilities* 89 (1931) [hereinafter cited as Jones & Bigham].

19. M. Glaseser, *Public Utilities in American Capitalism* 218 (1957) [hereinafter cited as Glaseser].

20. Jones & Bigham, *supra* note 18, at 70.

21. Jones & Bigham, *supra* note 18, at 72.

assured of being served.

Four years after its establishment in 1937, the FCC itself conducted a study of possible competition in the telephone industry and concluded: "Attempts at this late date to develop a strong, independent telephone system would be futile. . . [P]rotection of that interest (that of the rate-paying public) must be accomplished through effective regulation of the telephone industry."<sup>22</sup>

Given this tradition of government protected monopoly in the utility field, what prompted the FCC to permit competition in the communications markets? The original impetus in favor of some limited competition came from the courts rather than the Commission.

In 1953, the Supreme Court held, in *Federal Communications Commission v. RCA Comm., Inc.*,<sup>23</sup> that the FCC had no authority under the 1934 Act to sanction new radio-telegraph carriers (such as RCA). The Court specifically held that the "national policy in favor of competition" upon which the Commission had predicated its decision, was not in itself enough to override the basic statutory scheme of natural monopoly.<sup>24</sup>

However, the Court presented an important exception to its holding: "Of course, the fact that there is substantial regulation does not preclude the regulatory agency from drawing on competition for complementary or auxiliary support."<sup>25</sup> The Court went on to delineate those conditions under which the Commission would be authorized to grant competition in complementary areas. It required the Commission to find that competition was "reasonably feasible"<sup>26</sup> and "would serve some beneficial purpose, such as maintaining good service or improving it."<sup>27</sup> These two requirements later became known as the "RCA test" under which the Commission measured the present competitive offerings in the specialized communications markets.

However, the "RCA test" was merely dicta and the Commission did not at that time appreciate the latitude the high Court had given to the Commission. It was an appellate court that first interjected limited competition into the communications market.

### FCC DECISIONS: TERMINAL EQUIPMENT MARKET

In the mid-1950's, Hush-a-Phone Corporation developed a cup-like device which, when attached to the telephone receiver, assured the speaker greater privacy and better reception by funneling his voice through the cup and into the receiver. Pursuant to section 203(a) of the Communications Act, the telephone companies filed tariffs with the FCC forbidding the attachment of this device. The FCC found that although the Hush-a-Phone was not "physically harmful", it "impaired telephone service" within the broad meaning of the 1934 Act.<sup>28</sup> On appeal, the U.S. Court of Appeals for the District of Columbia Circuit disagreed, stating that there were "no findings to support this conclusion of sys-

22. Glaser, *supra* note 19, at 110.

23. 346 U.S. 86 (1953).

24. 346 U.S. 86, 92 (1953).

25. 346 U.S. 86, 93 (1953).

26. 346 U.S. 86, 96 (1953).

27. 346 U.S. 86, 97 (1953).

28. *Hush-a-Phone Corp. v. United States*, 238 F. 2d 266, 268 (D.C. Cir. 1956).

tematic or public injury."<sup>29</sup> The court held the FCC action to be "unwarranted interference with the telephone subscriber's right to reasonably use his telephone in ways which are privately beneficial without being publicly detrimental."<sup>30</sup>

The FCC relied upon *Hush-a-Phone* in 1968 when it approved the interconnection of the "carterphone" into the telephone network.<sup>31</sup> The carterphone is a device which connects the telephone network with mobile radio units. The FCC found that "the principle of *Hush-a-Phone* is directly applicable here, there being no material distinction between a foreign attachment such as the hush-a-phone and an interconnect device such as the carterphone."<sup>32</sup> Within this decision the FCC made the significant statement that a tariff preventing any interconnect device merely because it was not supplied by AT&T was "discriminatory" and "unlawful."<sup>33</sup>

Prior to the *Carterphone* decision, virtually all terminal equipment, including PBXs, answering devices and key telephones, were provided only by the Bell system. The *Carterphone* decision enabled an industry providing special terminal equipment to blossom almost overnight. The products ranged from sophisticated computerized equipment to faddish antique telephones. More than 400 companies have entered the market since 1968.<sup>34</sup>

However, at that time, the FCC did permit the telephone companies to require customers to utilize AT&T-supplied protective connecting devices between their terminal equipment and the network.<sup>35</sup> AT&T dispensed with this requirement for certain types of "safe" equipment such as answering devices which met company prescribed standards.<sup>36</sup>

In 1975, the last vestige of AT&T control over the private terminal equipment market was removed when the FCC ruled that equipment certified by the Commission as having its own protective circuitry could be interconnected directly into the telephone network without a connecting device. In making this decision the FCC adopted the resolution of a joint board of federal and state utility regulators.<sup>37</sup> The decision was prompted, in addition, by findings that 1) the Bell system did not use these connect devices for its own equipment; 2) Bell had allowed major customers, such as the U.S. military, to interconnect directly into the network without the use of protective devices; 3) the devices which customers were required to lease from Bell were often purchased by the telephone company from independent manufacturers. Thus, if a customer needed a protective interconnect device, the Commission reasoned, there was no reason why he could not purchase it himself directly from the manufacturer.<sup>38</sup> The Commission suspected that Bell wished to retain the income from the leasing of the protective devices as much as it wanted to protect the telephone network when it argued for the retention of control over this area.

29. 238 F. 2d 266, 268 (D.C. Cir. 1956).

30. 238 F. 2d 266, 269 (D.C. Cir. 1956).

31. *Caterphone*, 13 F.C.C. 2d 420 (1968), *recon. denied*, 14 F.C.C. 2d 571 (1968).

32. 13 F.C.C. 2d 420, 423-24 (1968).

33. 13 F.C.C. 2d 420, 424 (1968).

34. *The New York Times Magazine*, November 28, 1976, at 116.

35. *Hearings*, *supra* note 2, at 6-7.

36. *Hearings*, *supra* note 2, at 7.

37. *Hearings*, *supra* note 2, at 7.

38. *Hearings*, *supra* note 2, at 7.

As a result of these decisions, a customer may now purchase any piece of privately manufactured terminal equipment on the market and interconnect it directly into the telephone network so long as the FCC certifies the equipment as being safe. The FCC claims that the new competition in this area has spurred innovations in equipment by both the new companies and the established carriers.

### FCC DECISIONS - SPECIALIZED COMMON CARRIERS

Throughout the period when competition in terminal equipment was expanding, the specialized common carriers recurrently petitioned the Commission for authorization to provide specialized data transmission services tailored to the needs of particular clients, such as the computer industry, government and educational institutions. The staff of the FCC undertook a study of this market and, in 1971, reported to the Commission as follows:

Data communications, which has been in an embryonic state of development, will probably exhibit very substantial growth over the next decade. In proposing a policy favoring the entry of new specialized common carriers, we look towards a degree of competition oriented towards the development of new communications services and markets and the application of improvements in technology to changing and diverse demands.<sup>39</sup>

The staff further concluded:

There is a substantial public need for the proposed services which is not being met by the established carriers . . . [There is] dissatisfaction on the part of the computer industry and by many data users who have been trying to adapt their requirements to existing services.<sup>40</sup>

The Commission first authorized competition in this area<sup>41</sup> in 1969 when it permitted Microwave Communications, Inc. (MCI) to provide high speed data transmission utilizing microwaves between Chicago and St. Louis. The Commission justified this action under the *RCA* test that competition was reasonably feasible and could be expected to provide some public benefit. The public benefit was the expansion of communications systems available to users to include microwaves, which can transmit data at a much faster speed than conventional telephone wire. (Telephone wire must convert to lower frequencies when channeled through the central office.)

After surveying the staff analysis of 1971, the Commission greatly expanded this authorization in the *Specialized Common Carrier*<sup>42</sup> decision. This decision granted the requests of MCI and Datran (Data Transmission Corporation) to construct additional microwave facilities. In 1973, the Commission authorized the use of domestic satellites as another method of high speed data

39. *Specialized Common Carrier*, 29 F.C.C. 2d 870, 881 (1971), *aff'd*, 513 F. 2d 1142 (9th Cir. 1975).

40. 29 F.C.C. 2d 870, 882 (1971).

41. MCI, 18 F.C.C. 2d 953 (1969), *recon. denied*, 21 F.C.C. 2d 190 (1970).

42. 29 F.C.C. 2d 870 (1971).



transmission.<sup>43</sup>

In permitting these new carriers to enter the communications markets, the Commission made it clear that its intent was to expand the total communications system, rather than to siphon business from the existing common carriers. The Commission further noted that the percentage of AT&T's business vulnerable to this new competition was a miniscule two to four percent.<sup>44</sup> But the Commission also declared in these decisions that it would sanction no protective regulatory umbrella to bolster the economic viability of these new entrants. If competition was to exist in the telecommunications field it would be real competition, governed by the free play of market forces. AT&T countered that the Commission has not permitted the established companies to flex their full economic muscle in these markets.

### COURT DECISIONS

After seeing competition expand with each successive FCC decision, the telephone industry turned to the appellate courts for relief. In 1974, the Commission required the Bell system to allow MCI to interconnect into its local exchange facilities. Bell argued that with this decision, the FCC had overstepped its legislative authorization to regulate interstate communications. In *Bell Telephone Company of Pennsylvania v. FCC*,<sup>45</sup> the Third Circuit sustained the FCC policy of permitting competition in these areas as meeting the *RCA* test: "We regard the listing of factors independent of competition and the identification of benefits (reasonably expected) as proof that the FCC viewed competition as a means rather than a goal in and of itself."<sup>46</sup>

In 1975, the Ninth Circuit<sup>47</sup> directly confronted the scope of the FCC's authority. This case was brought by the Washington State Utilities Commission and the National Association of Regulatory Utility Commissioners (NARUC), which sought clarification of the jurisdiction over telecommunications services originally interconnected into local exchanges. NARUC put forth the argument, among others, that under the 1934 Act "new entrants (specialized common carriers) would only be authorized when existing carriers could not provide adequate services."<sup>48</sup> The court replied that:

NARUC interprets the statute too narrowly . . . the broad (statutory) standard is to be interpreted in light of the Commission's sweeping mandate to regulate interstate and foreign commerce so as to make available . . . a rapid, efficient, nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges.<sup>49</sup>

43. *Domestic Satellite*, 42 F.C.C. 2d 654 (1973).

44. 29 F.C.C. 2d 870, 882 (1971).

45. 503 F. 2d 1250 (3d Cir. 1974).

46. 503 F. 2d 1250, 1272 (1974).

47. *Washington Utilities and Transportation Comm. v. FCC*, 513 F. 2d 1142 (9th Cir. 1975).

48. 513 F. 2d 1142, 1157 (9th Cir. 1975).

49. 513 F. 2d 1142, 1157 (9th Cir. 1975).

In 1976, NARUC and others claimed before the Fourth Circuit that the FCC had again exceeded the authority given to it by the Communication Act, this time regarding the authorization of customer-provided terminal equipment.<sup>50</sup> The petitioners forcefully argued that section 2(b) (1) of the act specifically forbade the Commission from intervention in the terminal equipment area when it stated that this Act "shall not be construed to apply to or give the Commission jurisdiction with respect to . . . facilities, or regulation for or in connection with intrastate communication service . . . of any carrier."<sup>51</sup> The court, however, found that 1) "terminal equipment that is connected with the subscriber's station and line does in fact connect with the national telephone network,"<sup>52</sup> and that 2) the legislative history of the Communications Act showed that section 2(b)(1) was directed at the narrow circumstance where a single telephone exchange serviced an area that included more than one state, such as where the local exchange was close to the state border.<sup>53</sup>

On the issue of legislative intent, the court further noted:

Congress cannot have been unaware that for some 30 years the FCC has viewed and treated section 2(b) (1) of the Act as imposing no bar to its exercise of jurisdiction over facilities used in connection with both intrastate and interstate telephone communications. Significantly, it was as recently as 1971 that Congress amended the Act by adding the present section 410(c) with its discretionary Joint Federal-State Board procedure . . . We think it likely that Congress would have taken quite different action to restrict the Commission's jurisdiction and assure state primacy if, in its view, the Commission has long and repeatedly been exercising its jurisdiction and impinging upon an area which Congress had intended for exclusive state control.<sup>54</sup>

Thus, three circuits have sustained the FCC's primary jurisdiction over the regulation of terminal equipment and specialized common carrier markets. On December 14, 1976, the Supreme Court refused to review the Fourth Circuit's decision.<sup>55</sup> Since the courts refuse to interpret the 1934 Act as vesting primary jurisdiction in the states, the telephone industry made state primacy a major provision of its Consumer Communications Reform Act.

The Bell system still maintains that the FCC "has presumed not merely to regulate but to legislate"<sup>56</sup> and the Consumer Communications Reform Act thus "reaffirms" Congressional intent that jurisdiction over terminal and station equipment shall rest with the states. However, the very existence of this proposed legislation indicates that the telephone industry has abandoned its attempt to persuade the courts of its interpretation of the Communications Act. It is now for Congress to decide, through this or other legislation, what degree of competition

50. *North Carolina Util. Comm. v. FCC*, 537 F. 2d 787 (4th Cir. 1976), *cert. denied*, 97 S. Ct. 651 (1976).

51. 537 F. 2d 787, 791 (4th Cir. 1976).

52. 537 F. 2d 787, 791 (4th Cir. 1976).

53. 537 R. 2d 787, 795 (4th Cir. 1976).

54. 537 R. 2d 787, 795 (4th Cir. 1976).

55. 97 S. Ct. 651 (1976).

56. *Hearings, supra* note 2, at 3 (testimony of AT&T Chairman deButts).

should be permitted in the telecommunications industry in the future, and how it should be regulated.

### THE BELL BILL

In September, 1976, the Subcommittee on Telecommunications of the House Interstate and Foreign Commerce Committee held hearings on the telephone industry sponsored bill. AT&T and the telephone industry presented certain arguments on their behalf, including: that the FCC has granted protective umbrellas for new entrants into the market; that AT&T must obtain the FCC's approval before marketing new products and thus suffers from a regulatory lag that its competitors may not have to shoulder; and that the telephone industry has a duty to provide universal service while competitors may concentrate on selected lucrative markets without incurring the expenses of universal servicing. AT&T says that these factors will prevent true competition from taking place. Whatever the validity of these arguments, the proposed legislation, H.R. 12323, will not adequately regulate the new trends in telecommunications in the best interest of the public.

Rather, the ironically-titled Consumer Communications Reform Act would probably do a great disservice to the consumer by chilling competition and closing the options available to consumers in new telecommunications markets. The bill would also take the unprecedented action of stripping the FCC of its jurisdiction over these markets and dictate to the Commission what constitutes fair and reasonable prices for telephone services. Furthermore, the bill would exempt telephone industry mergers from the antitrust laws.

### THE EFFECT OF THE BELL BILL ON NEW MARKETS

New and existing specialized common carriers will be greatly hindered by section 8(b) of this bill. It forbids the FCC from authorizing "any construction, acquisition, or operation of any communication line or facility . . . to any specialized carrier . . ." unless the carrier can prove 1) that this action will not result in increased charges for telephone exchange services; 2) that the services offered will not duplicate any service already offered by existing carriers; and 3) that the offerings will not significantly impair the technical integrity of the nationwide telephone network. Particularly through the non-duplication requirement, this places an almost impossible burden on the specialized common carriers. The FCC testified that "the proposed standards for authorizing any specialized carrier applications are so unreasonable as to potentially eliminate existing and preclude prospective carriers so that consumers would no longer enjoy any benefits from such specialized networks."<sup>57</sup>

Foreseeing the probable demise of the existing specialized carriers, sections 4 and 5 authorize the FCC to approve the acquisition of one common carrier by an existing carrier. Section 4 goes further and exempts these acquisitions from the antitrust laws: ". . . any Act or Acts of Congress making the pro-

57. *Hearings, supra* note 2, at 2.

posed acquisitions unlawful shall not apply."

Competition from terminal equipment manufacturers is not attacked directly in this bill. Even AT&T seems resigned to some competition from this burgeoning industry. "We make no claim that the supply of terminal equipment is by itself a natural monopoly." AT&T Chairman John D. deButts stated to the subcommittee.<sup>58</sup> However, Mr. deButts followed this admission with a reiteration of the company's consistent argument that terminal equipment not supplied and serviced by the telephone industry may constitute an impairment to the technical integrity of the telephone network to which it is attached.

Section 2(b) of the bill warns ominously that "technical integrity . . . (with) its co-ordinated planning, installation, improvement, management, operation and maintenance are indispensable elements in the interstate telecommunications network . . ." While this section does not forbid non-Bell terminal equipment, it seems to be laying a foundation of legislative intent opposing privately manufactured equipment which AT&T could use in future litigation against its competitors.

Section 2(d) could cause further problems for the new terminal equipment manufacturers. This section divests the FCC of its jurisdiction over terminal equipment and vests it in the several states. Should this happen, the private terminal equipment manufacturers will, at best, face a confusing patchwork quilt of regulations varying from state to state. At worst, the state utility commission may deny any interconnection of non-Bell equipment.

The Nader group, Public Citizen, strongly opposes this provision. Its spokesman testified that the true impetus behind the measure is the greater political influence that AT&T can exert upon state regulatory commissions than upon the FCC. Public Citizen further contended that the state commissions, which are responsible for "electric utilities, water companies, transportation systems, pipelines, natural gas utilities and occasionally, interstate air carriers," in addition to the local telephone companies, are inadequately staffed to handle the new terminal equipment market. To illustrate that effect, Public Citizen submitted a table contrasting the meager number of state public utility employees in comparison to the size of the businesses which they must regulate.<sup>59</sup>

### THE EFFECT OF THE BELL BILL ON TELEPHONE RATES

One of AT&T's most dramatic and well-publicized arguments is that the profits made by the company from their long distance, specialized business offerings and terminal equipment are utilized to hold down rates on the basic telephone service. AT&T has issued statements claiming that basic rates could rise as much as 70% if the new entrants are allowed to skim the profits from the telephone industry.<sup>60</sup> This claim is disputed by the FCC and by the New York State Public Service Commission.

In 1972, the New York State Public Service Commission ordered New York Telephone to unbundle its rates. "Unbundling" means a separate listing

58. *Hearings, supra* note 2, at 16 (testimony of AT&T Chairman deButts).

59. *Hearings, supra* note 2, at 10-11.

60. *The New York Times Magazine*, November 28, 1976, at 117.

of costs and revenues attributable to each piece of equipment and type of service. Unsatisfied with the data reported by the company, the Commission undertook a three-year study of the company's records. The Commission declared that "this comparison represented the first attempt in the country to check comprehensively the validity of a telephone company's individual cost estimates."<sup>61</sup> The results of this study were distinctly at odds with the telephone company's allegations that terminal equipment revenues help to subsidize basic service. To the contrary, the staff's study showed that "terminal equipment revenues fell some \$329 million short of meeting 1974-5 costs!"<sup>62</sup> From this data the conclusion must be drawn that, contrary to the company's assertions, basic service revenues must be subsidizing the special terminal equipment offerings normally used by big business customers, with the average consumer footing the bill.

New York Telephone disputed the results of the study, saying it was based on incorrect methodology. "[The Company] . . . does not acknowledge, in any manner, the validity as either a ratemaking tool or cost analysis tool, of the type of study performed by the [Commissions's] staff," the company stated in a memorandum.<sup>63</sup>

The main point of contention between New York Telephone and the Public Service Commission (as it is between AT&T and the FCC) is whether terminal equipment costs should be evaluated on the basis of incremental costs or fully distributed costs. The telephone companies' method of incremental costing lists as costs only the expenses incurred in providing the specific piece of terminal equipment; the utility commissions feel that true costs must also reflect a percentage of overhead and investment expenditures. Specifically, New York's P.S.C. staff wants the telephone company to include overhead and the expense of the company's own terminal equipment as costs. The staff remarked: "It is hard to imagine . . . that the company does not incur any ongoing expenses to manage this billion dollar terminal equipment business in the midst of stiff competition."<sup>64</sup>

Other studies by state utility commissions in Vermont and Massachusetts tend to confirm the finding that terminal equipment is actually priced below cost and thus can hardly be subsidizing the basic telephone service. In fact, just the opposite situation appears to be the case.

How does the Consumer Communication Reform Act address the subject of ratemaking? Section 3 of the bill decrees that "no compensatory charges for or in connection with such communications services may be found to be unjust or unreasonable on the grounds that it is [sic] is too low." "Compensatory" is defined in the bill as a charge that "equals or exceeds the incremental cost of providing the communication service." This provision would definitely resolve the dispute about ratemaking in favor of the telephone companies' method of cost accounting. This provision is bolstered by section 2(e) of the Act which admon-

61. New York State Public Service Commission, *Staff Report* 61 (1975) [hereinafter cited as *Staff Report*].

62. New York State Public Service Commission, Press Release, September 13, 1976 at 1.

63. New York Telephone Co. (May 28, 1976) (unpublished memorandum in connection with the 1975 cost-embedded terminal equipment study).

64. *Staff Report*, *supra* note 61, at 29-30.

ishes that "the Federal Communications Commission shall take no action inconsistent with the findings and declarations of this Act."

The effect of this section would be to allow the telephone companies to employ their "monopoly profits," or "economies of scale," as the telephone companies would have it, to hold down the price on selected segments of their telephone offerings, including terminal equipment offerings. AT&T claims that the beneficiary of such a system will be the ordinary consumer who will receive lower rates on basic service. Competitors, and some of the utility commissions, on the other hand, assert that this will give Bell the opportunity to employ predatorily low prices for its terminal equipment offerings in order to drive competitors out of the market. For example, New York State's Public Service Commission staff found that customers who provided their own privately-purchased PBX system were required to pay the same monthly charge to Bell as customers who received Bell-provided PBX equipment and servicing. Obviously, this practice discourages customers from patronizing private PBX manufacturers. The staff termed this "clearly an anti-competitive practice."<sup>65</sup>

Furthermore, Microwave Communications, Inc., alleged in its testimony that Datran, the innovative manufacturer of the switched digital service for computer communications, has been driven to bankruptcy by AT&T's "predatory" practices.<sup>66</sup>

Regardless of whether big business or the average consumer is benefited by the use of subsidies from one type of telecommunication service to another, the FCC and Public Citizen point out that economic subsidies of one societal group over another is a governmental and not a corporate function. In fact, the FCC claims that the motivation behind its recent decision has been as much to prevent discrimination between different classes of users, in accordance with the FCC's statutory mandate, as it has been to promote competition.<sup>67</sup>

## CONCLUSION

The public interest would best be served by allowing competition to continue in the new telecommunications markets of terminal equipment and specialized common carriers. Furthermore, if competition is permitted, it must be genuine.

Congress should not sanction the telephone industry's use of incremental pricing to undercut the industry's new competitors. The Federal Communications Commission should be allowed to continue as the regulator of the telephone industry. Finally, the FCC's hands should not be tied by congressional stipulations which would prevent the Commission from regulating both pricing and mergers in the telephone industry. For these reasons the "Bell Bill," H.R. 8, should not be approved.

However, Congress and the FCC must take care to balance the regulation of the industry so that the telephone industry's obligation to provide quasi-public service does not act as a bar to its own viable competition. Congress was

65. *Staff Report, supra* note 61, at 26.

66. *Hearings, supra* note 2, at 15.

67. *Hearings, supra* note 2, at 3 (testimony of FCC Chairman Wiley).

wise when it chose to study the entire field of telecommunications instead of merely accepting or rejecting the telephone industry-sponsored bill. That industry is now entering a unique phase in its history—one in which both regulated and non-regulated businesses will be competing in the same markets. Congress and the FCC must be alert to potential inequities that could result from new regulation of the competition.

In his testimony before the subcommittee, AT&T Chairman John D. deButts alluded to AT&T's real fear. He noted that IBM, ITT and RCA are all poised and eager to enter the specialized markets.<sup>68</sup> A consumer-conscious Congress should keep this warning in mind. After all, consumers would hardly be benefited if Bell's monopoly in specialized markets were handed over to another giant conglomerate.

68. *Hearings, supra* note 2, at 15 (testimony of AT&T Chairman deButts).