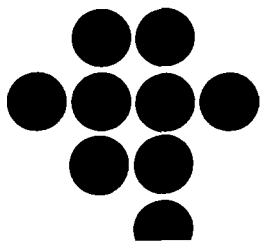


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DIVESTITURE:
FIVE YEARS AND COUNTING

May 4, 1989

Seminar Notes

**MASSACHUSETTS INSTITUTE OF TECHNOLOGY
COMMUNICATIONS FORUM**

**DIVESTITURE:
FIVE YEARS AND COUNTING**

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Seminar Notes

**Michael D. Baudhuin
AT&T**

**Eli M. Noam
New York State Public Service Commission**

**Professor Jerry Hausman
Economics Department, MIT**

**Professor Peter Temin, Moderator
Economics Department, MIT**

**Gail Kosloff
Rapporteur
MIT**

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

COMMUNICATIONS FORUM

This session of the Communications Forum focused on the effects of the AT&T divestiture over the past five years and what the future may hold. The speakers examined the rationale for the breaking-up of AT&T, its effect on the telecommunications industry (equipment and services), and its impact on current and future regulation of telecommunications services and related businesses.

The first speaker, Michael Baudhuin, Corporate Vice-President of AT&T, referred to Peter Temin's book (The Fall of the Bell System) in summarizing the events surrounding the break-up of AT&T. He agrees with Temin that in many respects "it is still too early" to evaluate the effects of divestiture and whether it worked. Baudhuin did observe that AT&T employees did not "fare so well." He believes that in the long run people will look at divestiture as having been an enormous gamble.

Baudhuin reminded the audience that the Sherman Act will be a century-old next year. He believes this act commemorates the tension that has existed over the years between the U.S. government and AT&T. Baudhuin went on to review the many Consent agreements AT&T had with the U.S. government starting with one in 1913. The rationale for these agreements has been to protect certain competitive markets from the monopoly powers of the Bell system.

Mr. Baudhuin noted that after World War II AT&T grew considerably and in 1949 again attracted the attention of the Justice Department. The result of this was the Consent Decree of 1956 which stipulated that AT&T could not provide any services beyond telecommunications services and products. According to Baudhuin, the next major government suit was brought against AT&T in 1974, again to protect competitive markets from the power of monopolies. One of the primary objectives of the suit was the separation of Western Electric from AT&T.

During the 1970s, Baudhuin noted that AT&T "went through turmoil" regarding regulation at the Federal and State levels. According to Baudhuin, AT&T, during this period, argued for the "integrated network of services from end-to-end." In contrast, Baudhuin observed that regulators were "crying for competition in hopes of bringing down prices and increasing the pace of technological innovation."

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

COMMUNICATIONS FORUM

Baudhuin also reviewed the effects of AT&T's break-up from a consumer perspective: He believes most of the impact has been positive. He acknowledged that long distance telephone rates have dropped approximately 40% in the last five years. He believes that as a result of AT&T's break-up there has been a "rash" of new innovative services introduced for residential and business customers. According to Baudhuin, local telephone rates have also grown as AT&T originally projected--8% annually adjusted for inflation and did not triple as some had forecasted.

Baudhuin believes another benefit of divestiture is that telephone subscribers today know more about telecommunications service and equipment choices than ever before. He also noted the post-divestiture explosion of new telecommunications equipment, both consumer and network equipment. Baudhuin explained that both AT&T's and the industry's R&D expenditures have increased over the past five years, and has driven this growth in new telecommunications equipment offerings.

Baudhuin went on to discuss the direct impact, including the negative effects, of divestiture on AT&T. Baudhuin acknowledged that some at AT&T might argue that divestiture brought inefficiencies into the networks. Also, AT&T was forced by the divestiture agreement to give up \$1 billion in assets in exchange for being able to compete more competitively with other long distance companies (e.g., it was authorized to move away from rate of return regulation). AT&T thought it could be more competitive especially selling equipment abroad, but found itself bogged down with anti-dumping suits in the early post-divestiture years. AT&T was also not happy that the U.S. opened its market to outside competition at a time when AT&T was at a weak point and many foreign markets were still closed. He noted that the U.S. is still in a positive trade position when it comes to items like large scale switching equipment, but this is not the case with consumer goods (e.g., foreign firms have tripled shipments of facsimile products to the U.S. since divestiture). According to Baudhuin, AT&T is looking to become more competitive on a global scale.

Baudhuin explained that there are still regulatory issues being debated since the break-up of AT&T. The injunctions that apply to AT&T and the ex-Bell Operating Companies are administered by a Federal District Court and Judge Harold Greene.

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

COMMUNICATIONS FORUM

The second speaker, Eli Noam, is the Commissioner of the New York State Public Service Commission, and a professor on leave from Columbia University. Commissioner Noam also defered to Peter Temin's analysis of how and why divestiture happened. Noam structured his presentation in the form of a "reality check" to illustrate that the past five years after divestiture have not been as bad as many had anticipated.

Noam noted that one of the major fears people had of divestiture was that it would negatively impact the concept of "universal service" in the United States. However, according to ICC data, telephone penetration in the post-divestiture era actually increased from 91.5% in 1983 to 92.8% in 1988, and this trend touched all income classes. He noted that on a local level regulators have acted to keep local rates down. New York State, for example, instituted a lifeline plan which provides dial tone for \$1 per month.

Noam explained that many people had feared that the price of telephone service in the United States would double and triple. Noam agreed with Michael Baudhuin of AT&T that this did not occur; instead rates increased by approximately 8% annually. Commissioner Noam explained that New York Telephone's average customer telephone bill only increased by 80 cents between 1983 and 1986.

Commissioner Noam also noted that people feared that telephone service quality would decline as a result of AT&T's break-up. He alluded to New York Telephone data which revealed that New York Telephone's service quality and customer perception, after an initial decline, was back at pre-divestiture levels mostly due to Commission pressure. Noam also explained that many had also projected that consumers would be very confused by divestiture; in time, however, people got used to the new system. Ninety percent of the population is currently aware of the fact they can choose their long distance telephone service company and 80% of the population knows who to call regarding service problems and equipment.

Commissioner Noam went on to discuss the impact of divestiture on labor productivity. He cited data from the Communications Workers of America showing that labor productivity in the telephone industry increased by 40%. Noam also noted New York

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COMMUNICATIONS FORUM

Telephone statistics which revealed that the number of its employees has been declining. He explained that although this could also be a sign of increased productivity other divestiture pressures could be involved. Noam also pointed to data regarding the decrease in access line costs, e.g., from \$53/line down to \$44/line for New York Telephone, to support this increased productivity thesis.

Noam also addressed the projection that divestiture was to have had a negative impact on Bell Labs and telecommunication's R&D. He cited data which revealed that, on the contrary, R&D employment rose for AT&T and the regional ex-Bell Operating Companies. However, Noam showed data that in 1986 there were many other companies in the electronics sector, e.g., GTE, IBM and so forth, were more research intensive than the newly independent ex-Bell Companies.

Noam also observed that many feared that AT&T's market position would revert back to a monopoly. But actually, competition has become increasingly vigorous and last year MCI was actually more profitable (though for reasons of AT&T accounting). AT&T's marketshare is decreasing at approximately 2% per year. On the equipment side, Noam explained that many post-divestiture observers had expected the ex-Bell Operating Companies (BOCs) to "cling" to AT&T for their equipment needs, primarily for reasons of tradition. However, the BOCs started sourcing equipment from several outside companies, and equipment prices declined. Noam presented data that revealed AT&T's marketshare for central office switches was 70% in 1983 and dropped to 46% in 1986, with Northern Telecom capturing a significant portion of the market. Partly as a result of competition, thousands of employees in the manufacturing area of the company lost their jobs. However, Noam alluded to data from the Communications Workers of America that said employment in the telecommunications manufacturing sector actually rose again in the past two years, and Labor Department data showing the sector as a whole growing.

According to Noam, the international trade is probably the number one problem of the post-divestiture era. He noted that in 1982, telecommunications equipment showed a \$817 million trade surplus, but ran a deficit of \$2.5 billion in 1986. Noam explained that a majority of terminal equipment now being registered with the FCC are made by foreign companies. Commissioner Noam sees that the

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COMMUNICATIONS FORUM

trade problem has not resulted from protected markets abroad and open markets in the United States, but was due to technical and price competitiveness of equipment. He believes the timing of imports of foreign telecommunications products into the U.S. is not primarily caused by divestiture.

Instead, equipment trade has to be seen within context. Noam explained that as the basic communications networks in other industrialized countries become completed (e.g., Germany, France and so forth) leading telecommunications equipment companies become more export-oriented.

In closing, Commissioner Noam cited several issues that he believes need to be addressed in this post-divestiture period. He is concerned with protecting the concepts of interconnection and access, as well as maintaining a standard of balance and diversity. He presented related models and raised several policy issues for the future, including the nature of "common carriage" in an environment of broadband networks.

The final speaker, Professor Jerry Hausman of MIT's Economics Department, structured his presentation to focus on divestiture's impact on the future of the telecommunications industry. He has recently released a book on this topic--Future Competition In Telecommunications--coedited by Stephen P. Bradley.

Prof. Hausman acknowledged that the divestiture of AT&T was a "good thing" and agrees with most of Eli Noam's analysis. Hausman believes divestiture showed "the importance of technology and how important it is for regulators to keep up with technology." In his opinion, the break-up of AT&T was an example of the massive failure of regulation. In this vein, Hausman recommends changing current regulation to ease some of the problems of the past.

Hausman went on to discuss the two main charges that had been levied on AT&T leading up to divestiture. Both involved accusations of cross-subsidy. The first charge argued that AT&T had been buying over 90% of its equipment from Western Electric (WE) at high prices and would not buy from WE's competitors. According to Hausman, the second charge was that long distance service revenues were being subsidized by local service revenues. In his opinion, the cross-subsidy actually went in the other direction. According to Hausman these cross-subsidy charges are no longer valid with the doing away of "rate of return" regulation.

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COMMUNICATIONS FORUM

Looking to the future, Prof. Hausman reviewed the current restrictions imposed on AT&T and the ex-Bell Operating Companies per the Modified Final Judgement (MFJ): (1.) AT&T is still restricted to the long distance service market, while the Operating Companies cannot compete in the interLATA long distance market; (2.) both AT&T (until 1991) and the Operating Companies are banned from electronic publishing; (3.) the Operating Companies cannot participate in manufacturing.

Hausman noted that in 1987 and early 1988 Judge Greene released some of the restrictions on the Operating Companies related to information services. In the manufacturing area, Prof. Hausman believes AT&T has a problem since AT&TComm will become a big competitor of the Operating Companies. He observed that Northern Telecom is currently losing market share to AT&T in the central office switch area, since AT&T has been making a comeback since the mid-1980s. Hausman went on to argue for Judge Greene to allow BOCs into manufacturing and for state regulators to impose price caps on telecommunications services as a way to remove the incentive for the BOCs to cross-subsidize their manufacturing (and any other) activities.

In reviewing the post-divestiture period, Hausman agrees with the others that "no disaster has happened." Moreover, he sees divestiture as a tremendous tool for productivity gains. Hausman cited data from New York Telephone and Pacific Bell that revealed significant productivity increases (6.5%/year) over the past five years. He attributes most of these productivity increases to improvements in technology and to more well-managed companies.

Hausman's prescription for the future includes getting rid of rate of return regulation and replacing it with a system of price caps. He views price caps as more of an incentive system for the telephone companies. Hausman believes the current regulatory system is bad for the U.S. economy. He believes that since the large customers have benefited from post-divestiture competition, more than small business and residential customers, state regulators should take account of this development. Hausman specifically suggests that regulators deregulate AT&T rates for big businesses.

Hausman is glad to be seeing the long distance service market is becoming more competitive, especially with MCI's renewed emphasis

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COMMUNICATIONS FORUM

on the residential sector and U.S. Sprint's solid marketing direction. He believes that we should expect to see a lot of price competition since there is tremendous excess transmission capacity in the industry (especially with the push to install fiber).

In addressing the trade issue, Hausman does not believe that the U.S. trade deficit in telecommunications equipment is that closely tied with the Modified Final Judgement (MFJ). He recommends instituting a system of price caps to allow the BOCs to become involved in equipment manufacturing. Hausman is also concerned that the current MFJ restriction on information services will have a negative impact on the growth of these services in the United States. He believes that the newspapers (represented by ANPA) already have too much power and are actually retarding the information services business in the United States. Hausman is not certain of the solution should be to this problem, but suggests the resolution of the cable cross-ownership issue as a starting point.

In closing, Hausman pointed to some of AT&T's post-divestiture weaknesses in making recommendations for the future. He believes AT&T needs to focus on developing its future direction. Hausman hopes that as competition increases between AT&T and companies like U.S. Sprint and MCI that any battles are settled in the marketplace and do not end up in the regulatory arena. Similarly, he feels that future competition between AT&T and the BOCs should take place in marketplace competition, not through attempts at regulatory interference to competition.