COMMUNICATIONS
FORUM

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Seminar Notes

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Mark Cooper
Consumer Federation of America

Louise McCarren
Vermont Public Service Board

John Scanlon
New England Telephone

WHAT HATH DIVESTITURE WROUGHT?

Mark Cooper - Consumer Federation of America

Cooper posed the question "what had gone wrong with divestiture?". Divestiture he said, is something consumer groups like his had supported. He asserted however, that the problem was not with divestiture but with its misapplication.

The regional Bell Operating Companies (BOC) have acted in the best interest of their shareholders reaping windfall profits. However, these profits have come at the expense of rate payers. All in all the regional BOCs, he said, have recreated the same source of market power that divestiture was supposed to eliminate. These BOCs have local monopolies, and seek to link that monopoly to more competitive markets. Also they have a level of profit higher than 'phone companies have ever earned in the past. He also observed that this is linked to the much reduced regulatory oversight, which they are seeking to reduce even further.

Cooper stated that telecommunications because of its natural monopoly and crucial infrastructural nature provided a basis for regulation. He claimed that telecommunications regulation for over half a century had been remarkably successful. However, he stated that the degree of success in telecommunications regulation suddenly began declining in the early 1980s. The driving force he said behind this dramatic reversal was and is the erroneous belief that competition is a powerful force in the telecommunications industry. He asserted that while this may become true in the future it is not so today.

He then discussed a number of ways in which competition has been misinterpreted and misapplied to telecommunications.

First, the one area of true competition, customer premise (CPE) and central office equipment (COE), have economic charateristics that have no similarity of relationship he said, to the production of telecommunications. The area of CPE and COE production, unlike the production of telecommunications, can and should be vigorously competitive. He said that while consumers were done a disservice by the extension of monopoly in CPE, and by the abuse of monopoly power in COE, they were also done a disservice by the misapplication of the lessons of this market to the broader telecommunications industry.

The second misapplication of competition, according to Cooper, has been in long distance. Initially the competing companies were largely free riders, and as a result very profitable. Unfortunately the profitability of free riders was taken as proof of the workability of competition - that other companies could come in and compete with the dominant firm on a equal footing. However, with the closing of the regulatory niche, the high earnings of the competitors evaporated. As a result, the dominant supplier remains dominant, with about an 80% market share. Cooper asserted that with the overshooting of the necessary response to the long distance monopoly the alternative being suggested is to allow regional BOCs to compete for the long distance market, which may eventually give rise to the same abuses suffered in the past.

The third area of competition, he said, is the local level which actually has almost no competition and only some vague threats of future competition. Though competition for the local 'phone company in the form of bypass of the network has been a central concern, the empirical evidence of actual bypass was always sparse. Operating statistics he said, show a continued growth in basic local services (both the number of access lines and the number of intraLATA toll messages).

Cooper noted that the threat of bypass, though not very real in the marketplace, was very real in the regulatory and political arenas, where the BOCs argued on this basis for rate increases. Though the public utility commissions resisted the arguments to a degree, some rate increases were awarded. He stated that by every measure of financial performance, the regional operating companies are earning excessive returns.

Looking to the future, Cooper believed that unjustified rate increases, unfounded rate restructuring, and unnecessary diversification, can be resisted without affecting the technological development of the system. He asserted that before deregulating or reducing regulatory oversight, there must be real competitive forces in place - not the hope or threat of competition developing at some future date. If those forces are not actually in place, captives (those with inelastic demand) will be exploited. He suggested that the alternative path, of course, is to hold the line against excessive price discrimination. Bypassers should be allowed to build their alternative systems.

In closing, Cooper stressed that there will be cost shifting and perhaps rising real costs over time as the nature of the network changes from simple voice grade communications to more complex uses. There will be more and more demand-based or market-based pricing necessary, as alternative technologies become viable. He warned however that complete capitulation to telephone company demand in the name of the feeble competition that now exists is completely uncalled for and certainly not a logical extension of divestiture. If anything, these proposals he said, "fly in the face of divestiture."

Louise McCarren - Vermont Public Service Board

McCarren began by noting her strong disagreement with Cooper's comments on the issue of divestment. She also pointed out that the topic to be discussed had an inherently negative tone. At the outset of her discussion she identified three things brought about by divestiture:

- Changed price structure (small customers pay a lot more while large customers pay less)
- Changed role of state regulation
- Chaos created and out of it phenomenal opportunities.

While divestiture brought about the above changes, she asserted, it has not fundamentally changed relationships and the underlying issues. Corporate structure, and diversification issues remain the same, but are focussed more closely at the regional BOC level.

Discussing further the changes brought about by divestiture McCarren expanded on the three areas referred to earlier. In the area of price structure she stated that every deregulated industry had the phenomenon that small customers pay more than large ones. In the telecommunication industry divestiture forced the reallocation of NTS costs from large to small users more quickly than it would have normally happened. As for the role of State Regulators, it has changed from preventing monopoly rent extraction to enforcing antitrust constraints. She noted that competitors had replaced consumers in the role of plaintiff and are an increasingly dominant influence in the 'hearing room.'

As for creating chaos and out of it phenomenal opportunities, she said, divestiture has fundamentally changed the State Regulator's objectives and goals - to establish a ubiquitous, publicly accessible, reasonably priced network that is capable of and does deploy new technology and services to all economic and geographic segments of society.

McCarren then commented on the attitude and response of New England regulators (NER) who she said have been very involved and vocal on the issues of protection (of captive customer), quality service, and the development/deployment of new technology. She stated that the NERs are not opposed to consolidation, reasonable diversification and price and rate of return regulation. The NER's view on corporate structure is very clear - i.e. it should not raise the cost to customer to more than it otherwise would be. On the issue of diversification and new services, the regulatory view is different from that of a business decision. The issue here is that of risk apportionment and cost allocation between consumer and shareholder. The regulators restrict the amount of capital that can be utilized for new ventures and also require that the new venture should be functionally related to their main business (she voiced her personal disagreement to the latter requirement). With regard to restriction on lines of business preventing competitors their use, she said that this was clearly related to corporate structure and diversification, and as such it behooves the regulator to look at the benefit to the consumer as a result of a new company being allowed in.

John Scanlon - New England Telephone Company

Scanlon began by reviewing some of the general perceptions which existed in 1983 just prior to divestiture. People felt AT&T would lose a substantial share of its toll market as a result of the equal access process. However, the toll losses they thought would be replaced by gains in the computer business. There was also the expectation that the equal access process would be followed by deregulation of the interLATA toll markets. As for the OCCs (MCI, SPRINT, etc.) it was felt that they had been granted a marketing bonanza (the right to compete for a $40 billion business where each customer would be forced to choose). Many predicted that the OCCs would gain 35%-40% of the market. The picture for BOCs was somewhat different.

There was a fear that basic rates would soon have to double or triple. Bypass and the loss of CPE it was expected would cause difficulty for the BOCs. Along with which BOCs would probaoly be restricted with regard to new business opportunities.

However, the actual situation has turned out to be quite different to what was predicted/expected. While AT&T has not made any significant inroads into the computer business, it has also lost relatively little market share (15%-20% rather than 35%-40%). On the other hand, the bright future anticipated by the OCCs has been dimmed by their inability to capitalize on their marketing opportunity and also their inability to raise capital. However the BOCs have had three years of good earnings as a result of cost cutting, improved service, improved regulatory ahd economic climate, and moderate overall basic rate increases. This has been achieved despite the largest construction programs in NET's history.

The reasons Scanlon gave for things turning out so differently in practice compared with predivestiture expectations is that regulators and companies played vital roles in the management of situations. Two significant decisions were the decision to implement end user access charges (resulting in a decrease in usage rates), and the trend of the court and regulators to broaden the scope of BOC's business. Scanlon asserted that technology will not allow a protection of the intraLATA marketplace from what some people view as the negative effect of competition. He said that instead of trying to protect against the inevitable, creative solutions should be found to address the problems caused by these changes.

Scanlon drew attention to two problems associated with the introduction of intraLATA compettition. First, is the regulatory concern that monopoly rents might be sought by suppliers in an effort to cross subsidize and protect market share in the more competitive areas of the business. The second, is the issue of equal access in the intraLATA market which is just beginning to be explored. Some of the concerns arising from the above issues are listed in exhibit A.

Discussing possible solutions to these issues, Scanlon referred to the monopoly rents issue, where several solutions have been proposed. These could fit a continuum ranging from the conservative approach of using separate subsidiaries to total deregulation (exhibit B). Some schemes that fit the mid range of the continuum are being examined he said, in the New England area. Their intention in the contract venture being tried in Vermont, is to increase the BOC'c ability to meet the needs of the marketplace in a timely manner while protecting the monopoly rate payer from becoming the guarantor of the revenue requirement. While recognizing the regulator's justifiable concern that the monopoly rate payer should not become the guarantor of the revenue requirement, he also cautioned that if this becomes the overriding or only concern, it will ultimately work to the demise of the monopoly rate payer. He added that what may be inherently fair and equitable in a social context may become irrelevent once policies are changed and market forces are allowed to work.

Finally, looking to the future he made the following predictions:

- IntraLATA competition will come sooner than anticipated. Therefore, the mix of monopoly and competitive services require a new regulatory model.
- Must protect universal service through direct rather than general subsidy.
- Company's agenda should be market based pricing.
- Solution to monopoly rents issue - either ceilings on basic rates, or an accounting scheme for assigning direct costs.

In closing, he expressed confidence that the state and federal parties involved will successfully work out these issues and not relegate the BOCs to becoming the railroads of the 1990s. The local networks, he said, are simply too efficient and valuable to be abandoned.

Speakers' Comments and Responses to Questions

Cooper commenting on the second presentation said that he didn't disagree with the speaker. His point, he said, was that real competition as originally envisaged has not yet come and in that light the treatment of BOCs should necessarily be different. The ROR for instance of these regional operating companies is higher than AT&T's ever was in the past. He cited this as evidence of the BOC's local monopoly power and lack of regulatory control. McCarren added that monopoly rents should not be abandoned and the price of monopoly service should be fixed, allowing it to rise by predetermined amounts.

A question was raised about the financing of new technology and resulting services. Of particular concern was the issue of who will pay for digital capability in the local loop and similarly the optical fiber capability in the local loop. McCarren said that it was difficult to decide as to whether different cost assignments could be made. However a cost /benefit analysis she suggested would be useful in determining the form of funding. She disagreed with Cooper's suggestion that such facilities were not needed for the POTS (plain old telephone service).

Responding to a query about competition in the local loop, Scanlon stated that there were a number of people interested in the intraLATA business in Massachusetts. Competition for intraLATA services began on 1st Dec, 1986, in Massachusetts. McCarren added that instead of trying to predict the type of possible competition, regulators should open the doors to it.

EXHIBIT A

INTRALATA COMPETITION
MAJOR REGULATORY ISSUES

- MONOPOLY RENTS/CROSS SUBSIDY
  - UNIVERSAL SERVICE
  - RECOVERY OF JOINT AND COMMON COSTS
  - RECOVERY OF THE COST OF NEW TECHNOLOGY
  - DEPRECIATION RESERVE DEFICIENCY

- INTRALATA EQUAL ACCESS
  - ANOTHER ROUND OF BALLOTING
  - BOC EXCLUSION FROM INTERLATA MARKET
  - INTRALATA ACCESS CHARGES
  - PROVISION OF ENHANCED SERVICES
  - ONA & CET

EXHIBIT B

NEW REGULATORY SCHEMES

MOST CONSERVATIVE — MOST LIBERAL

- SEPARATE SUBSIDIARIES
  - FULLY DISTRIBUTED COSTS
    - FULLY DISTRIBUTED COSTS AND MARGINAL COSTS
      - STAND ALONE COSTS AND MARGINAL COSTS
        - MARGINAL COSTS/RAMSEY PRICING
          - DEREGULATION/PART X
            - CONTRACT
              - DEREGULATION