STATEMENT OF HENRY GELLER
ASSISTANT SECRETARY FOR COMMUNICATIONS AND INFORMATION
U.S. DEPARTMENT OF COMMERCE
ON S. 611 and S. 622

NTIA believes that Congress, should explicitly state in the legislation the results it wishes to obtain rather than leave the fundamental policy decisions to the discretion of an independent regulatory agency. The following four principles should guide Congress:

(1) Congress should reaffirm our traditional national commitment to competition among private firms in a free market environment by extending this system to the interexchange telecommunications industry.

(2) Jurisdictional responsibilities for telecommunications regulation should be divided between state and Federal authorities in a manner consistent with the structure of the telecommunications service market: intraexchange telecommunications should be subject to Federal regulation.

(3) A suitable transition to a free market environment must be specified, with an initial deregulation of firms without dominant market power and a further phasing out of the residual regulation over a fixed period of time.

(4) The universal availability of basic local exchange telephone service or its equivalent and basic interexchange message telephone service at affordable rates should be assured.

NTIA agrees with the underlying concepts expressed in S. 611 and S. 622 -- that common carrier rate regulation need not be applied to all carriers serving the Interexchange market. Regulation is intended to protect the public and should only be authorized in circumstances where the marketplace will not function adequately.

In applying the above principles to S. 611 and S. 622 the following concerns arise:

(1) The Commission has great discretion in both the scope and duration of regulation to be applied to competitive or potentially competitive services without clear standards or guidelines which would lead to eventual deregulation.

(2) Under the fully separated carrier approach of S. 611, it appears that the separated carriers or entities of Category II carriers will continue to be subject to extensive Commission regulation and that benefits derived from economies of scope, scale, or integration may be lost as a result of the rigid application of the separated carrier approach.

(3) The definition of "interexchange telecommunications" to include the origination and termination of telecommunications within exchange areas will result in regulatory responsibility for the local telephone

exchange being divided between state and Federal authorities, with many of the economic and institutional problems of the existing jurisdictional separations process.

NTIA strongly supports provisions which provide for adjusting the level of transitional regulation to remove marketplace deficiencies, anticompetitive behavior or other practices which frustrate the purposes of this legislation; i.e., competition and deregulation.

STATEMENT OF
HENRY GELLER, ASSISTANT SECRETARY
FOR COMMUNICATIONS AND INFORMATION
U.S. DEPARTMENT OF COMMERCE

ON

S. 611 AND S. 622
BEFORE THE
COMMUNICATIONS SUBCOMMITTEE
U.S. SENATE

April 24, 1979

# DOMESTIC COMMON CARRIER TESTIMONY

Mr. Chairman:

I welcome this opportunity to testify on one of the most important communications policy issues that will be addressed by this Subcommittee during the 96th Congress. I refer, of course, to the question of how the Communications Act of 1934 should be amended to reflect the fundamental changes that are occurring today and having occurred in the domestic common carrier industry over the past decade. I believe that there is a substantial consensus that the '34 Act must be amended to adjust to new realities and that the hard question before us today is how comprehensive this change must be. The issues here are extremely complex, and the Executive Branch has not completed its study of the Bill or coordinated with all interested agencies in order to reach final conclusions. Therefore, NTIA's conclusions presented today represent our views as an expert agency, rather than a final Administration position.

At the outset of my testimony, Mr. Chairman, I wish to commend you and Senator Goldwater and Senator Schmidt for the energy, foresight and understanding which you have brought to this issue. Your two bills, S. 611 and S. 622, are thoughtful, well conceived legislative proposals. In both cases you have devoted considerable attention to the domestic common carrier issue and have recognized that it is here, above all, that changes to the '34 Act are most necessary. Your proposals reflect the fact that the revolutionary advances we have experienced in telecommunications and data processing technology will continue to result in new entry by firms providing sophisticated and diverse services, in a proliferation of specialized terminal equipment for both the office and the home and, hopefully, in a more competitive and balanced industry structure. These developments are in the national interest, for our economic future lies in the full realization of our resources in the information sector. We must maintain, and hopefully enhance, our

position as the world leader in telecommunications and information technology. To do so requires a vital, dynamic industry that can achieve optimal efficiency and innovation in a competitive marketplace. The touchstone of our comments is the recommendation that the Federal government regulate the communications industry only where competition is not possible or adequate to achieve these ends. Specifically, we support regulation only to the extent necessary to protect the customers of firms that have the ability to exercise dominant market power in the interexchange telecommunications market.

Economic regulation of industry by government in this nation has been traditionally viewed as a substitute for competition. Where market forces have failed to function regulation has been considered clearly preferable to government ownership. Regulation has been intended to provide consumers with the benefits that they could expect from an effectively competitive marketplace. Among the factors generally considered in determining whether to impose regulation are the industry's importance to the economy, its size, and the nature of the market conditions. Industries with natural monopoly characteristics, for example, have generally been considered appropriate for regulatory controls because they could not be expected to support competition.

Competition, under optimal conditions, is expected to allocate resources so that they will make the maximum contribution to total output, cause prices to be set at marginal costs, bring to consumers the goods and services they want at prices they are willing to pay, and result in revenues set at a level equal to the cost of production plus a reasonable profit. To duplicate this complex, interactive process by regulation requires continuing, detailed intervention by a government agency in the conduct of the business involved. The regulator generally controls entry into and exit from the market, and prices, terms and conditions related to the service provided. For such regulation to be effective a well drafted governing statute is required, in addition to an adequately staffed and supported agency, and an industry in which changes occur relatively slowly and infrequently.

The decision to apply regulation to a market or industry is one that must be based on a variety of considerations: economic, legal, social and political. It is recognized that perfect regulation, like ideal competition, is rarely achievable. The decision may often be based on "least worst" criteria. The costs of regulation, both the direct costs to the government and the indirect costs to the economy, must be balanced against the benefits which can be expected to flow to the public. These costs are difficult to ascertain. We know, however, that there is a danger that a regulated industry will evolve into a "cost plus" environment that discourages efficiency, innovation, and risk taking. This nation's traditional policy toward regulation has been to apply it sparingly. Thus, we have often refrained from applying regulation to firms operating in imperfect markets where the difficulties and costs of undertaking regulation did not appear justified by the potential benefits. Furthermore, we have significantly deregulated industries, e.g., the airlines, when conditions seemed appropriate for such action.

During the 96th Congress, as the question of telecommunications regulation is reconsidered, two fundamental concepts should be kept in mind. First, regulation should be continued only if the telecommunications marketplace cannot function satisfactorily in a competitive mode. In view of the competitive gains made in long distance telecommunications services and the competitive activity in non-voice telecommunications services, we are convinced that in large measure the industry can today and in the future function in that mode. An explicit mandate to evolve from the transitional regulation to a fully competitive market should be specified in the legislation. Second, Federal regulation should be applied only to the extent necessary to assure that consumers do not suffer economic harm at the hands of firms that have dominant market power in the interexchange telecommunications market. The scope of regulation, if necessary, must not be so broad as to stifle competition by providing firms the opportunity to use the regulatory process as a means of gaining advantage against one another. It is this latter danger which is perhaps the most destructive aspect of regulation to the industry involved and to the economy generally. In addition, limits on the scope of regulation will tend to minimize the natural bureaucratic tendency to expand

regulation beyond its useful limits. From these broad concepts certain basic principles can be derived which should form the foundation of the new legislation.

## Basic Principles

NTIA believes that Congress, insofar as possible, should explicitly state in the legislation the results it wishes to obtain rather than leave the fundamental policy decisions to the discretion of an independent regulatory agency. The following four principles should guide Congress as it contemplates amending the 1934 Communications Act:

(1) Congress should reaffirm our traditional national commitment to competition among private firms in a free market environment by extending this system to the interexchange telecommunications industry.

(2) Jurisdictional responsibilities for telecommunications regulation should be divided between state and Federal authorities in a manner consistent with the structure of the telecommunications service market: intraexchange telecommunications should be subject to state regulation and interexchange telecommunications should be subject to Federal regulation.

(3) A suitable transition to a free market environment must be specified, with an initial deregulation of firms without dominant market power and a further phasing out of the residual regulation over a fixed period of time.

(4) The universal availability of basic local exchange telephone service or its equivalent and basic interexchange message telephone service at affordable rates should be assured.

In the balance of my testimony, Mr. Chairman, I shall expand upon these principles and then discuss them in relation to the bills. While I shall not comment on each section of the common carrier titles of the bills, I will present NTIA's

views on specific language with regard to certain key sections. Our aim is to be helpful on both an overall basis and, if the Congress decides to proceed in a more incremental fashion, on particular aspects.

## Introduction

The need for specificity in the legislation lies in the fact that we are at a major turning point in domestic common carrier matters. Decisions must be made which will affect the future of this industry for perhaps decades to come. NTIA believes that it makes a great difference whether the common carrier industry becomes truly competitive or exists indefinitely in the state of regulated competi tion. While we recognize the clear need for a transition period in which regulation is continued, we believe that it is vital that this period be truly transitional. In addition, the legislation should obligate the Commission to direct its regulatory efforts to implementing a plan of phased deregulation over the transitional period. We would urge Congress to place a sunset provision in the legislation which would terminate the regulation after a fixed period of time--say, ten years. We are not forecasting that ten years is the time period needed to establish reasonably competitive conditions, but rather that it is an appropriate period for Congressional reexamination of this important matter. If the domestic telecom munications market is not reasonably competitive within ten years, Congress should reexamine the area to determine whether to extend the regulation and if so, how long and with new directions (including whether more drastic structural remedies need to be applied to lessen dominance and control).

Similarly, the degree of transitional regulation to be applied to firms that presently can exercise dominant market power in the interexchange telecom munications market is a fundamental policy decision and should be determined by Congress. For example, should competitive and non-competitive services that are offered by dominant carriers be regulated differently? Are there circumstances in which competitive services do not need to be regulated at all? To what extent may

accounting systems be relied upon to avoid cross subsidization? Are separate subsidiaries needed for competitive services and how separate should they be? These decisions require the application of political philosophy as much as the exercise of regulatory expertise. While Congress may ultimately conclude that it cannot fully resolve all fundamental policy issues in this legislation, we urge that it seek to do so. The public, the industry, and the Commission will all benefit from the stability that this will produce. One of the problems with the public interest standard in the 1934 Act is that often the industry has been surprised by how the courts have interpreted it. Such uncertainty is inherent in government regulation and is, indeed, an aspect of it that causes firms to behave cautiously where boldness and innovation would better serve the public.

While uncertainties will never be eliminated, Congress can go far in minimizing them. NTIA has some specific recommendations in this area that I will discuss in the course of my testimony.

## I. Competition and Deregulation

NTIA believes that maximum reliance should be placed on actual and potential competition, and marketplace forces in general, to provide efficiency, innovation, and low rates and to determine the variety, quality, and cost of telecommunications services.[1] Consistent with the principle of putting maximum reliance on competition, the use of regulation would be restricted to (1) accomplis

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1. In this context, telecommunications service is defined as the transmission, of sounds, symbols, images, or information of any nature by wire, radio, optical fibers, or other electromagnetic system which may perform circuit or message switching, network control and routing, and intra-network signal processing functions related thereto. Not included is the sale or lease of terminal devices located on the premises of the end user, or the acquisition, processing, or marketing of information or program material. (See page 16, *infra.*)

the feasibility of competition. NTIA urges that government involvement in the telecommunications marketplace should be limited to assuring the achievement of social goals in those instances when they would not otherwise be produced by the natural forces of the marketplace and to assuring the existence of competitive conditions in general (e.g., through enforcement of the Antitrust Laws).
hing social goals when marketplace forces are insufficient to produce the desired result, and (2) to assuring full and fair competitive conditions. These concepts simply reflect this Nation's fundamental policy of fostering a competitive, free enterprise business environment in which the quantity, quality, and prices of the goods and services produced and consumed are determined by marketplace forces. Since this principle is one of fundamental national policy, we need not expand upon it here. Rather, the issue is whether all or parts of the domestic telecommunications industry exhibit special characteristics that affect

Turning first to the intraexchange market, it is apparent that while there are local distribution systems serving other purposes (e.g., cable television systems), there is no widely available, close substitute for the basic telephone local exchange service. That is, it is the only system available for providing fully interconnected, two-way electronic communications within a community. Although competitive substitutes for this basic local exchange service may eventually appear through increased penetration and technical developments in cable television, through further developments in advanced mobile/portable radio systems, or through the use of advanced radio techniques in general, their technical and economic feasibility is still uncertain. Moreover, improvements in the telephone distribution system itself (e.g., the expansion of broadband capabilities) may result in the continuation of a monopoly in local distribution. The local distribution is currently a <u>de facto</u> monopoly of the local telephone companies and it is possible that it will remain so in the foreseeable future. Because of the existing monopoly, and in recognition of the <u>possible</u> "natural monopoly" characteristics of the local exchange market, we recommend continued regulation of local exchange services as long as the monopoly exists. This, however, is a matter for individual states to

decide. The regulation should include authority over rates and quality of service, the power to grant franchises and establish franchise areas, and to define local exchange boundaries. To forestall possible abuses of the monopoly power, we recommend that the right of interexchange service providers to use and interconnect with the local exchange service be guaranteed in the legislation. Another check on the abuse of the local exchange monopoly is the ability and right of interexchange carriers to use alternative facilities for the local distribution of interexchange telecommunications.

In the interexchange or long-haul transmission market, the situation appears quite different. There are numerous technologies for long-haul transmission, each with significantly different cost and technical attributes. These rapidly changing technologies are widely available to different firms and they can easily be combined with other equipment to provide specialized telecommunication and teleprocessing services. Not only is there demand for basic interexchange telephone and telegraph service alone, but also for electronic funds transfer services, for electronic message services, for teleconferencing services, for sophisticated data communications networks, for information services, and for a host of services associated with the "electronic office" of the future. Some of these services will be most economical to provide on a common system while some can be more economically provided on a specialized or dedicated system. Some may be able to take advantage of existing local exchange networks to reach their customers while others may need specialized local distribution networks. To reiterate once again, there are dynamic changes in both the demand and supply side of the interexchange market. In such a dynamic market, we believe our traditional reliance on competition would best serve the interests of the nation.

The arguments against full and open competition in the interexchange market have centered on social goals with respect to local telephone services and interexchange (toll) telephone rates. It is argued that the existing procedures for distributing some revenues from interstate interexchange toll service accomplish dual social objectives:

(1) Universal service (through contributions to the costs of the local telephone network);

(2) Reasonable interstate toll rates (through averaging between high cost and low cost routes).

It is further argued that competition will reduce the contributions to, and hence raise the price of, basic local exchange telephone service and will lead to rate deaveraging on interexchange routes. It is then concluded that to maintain these subsidies from interexchange to local and from low cost to high cost routes, competition in the interexchange market must be banned entirely or confined to services that are not close substitutes for interexchange telephone service. We believe that such restrictions would be both unnecessary and unwise.

First, they are unnecessary because, as we describe later, these social goals can be achieved through adjustments in pricing methods and, where necessary, through explicit subsidies. Such solutions are preferable to restricting competition in such a dynamic and important market. Second, segmentation of the interexchange market between telephone and other services in order to achieve these social goals is difficult to accomplish and even harder to maintain. If the competitive market is defined too narrowly, the benefits of competition are largely lost and the competitors would be at a severe disadvantage relative to the monopoly interexchange telephone service supplier because some or even all truly innovative services may be uneconomical to supply on a stand-alone basis. That is, denying competitors the ability to compete in certain markets may affect their ability to compete in others as well. If, on the other hand, the competitive market is defined too broadly, i.e., it includes close substitutes for interexchange telephone service, it may well be impossible to distinguish it from the monopoly market. Even it if were possible to distinguish it on a technical or legal basis, the boundary may be impossible to enforce. In such a situation, segmentation would be of little value. Moreover, the technological forces are such that many of these distinctions are becoming increasingly blurred. Hence, legislatively mandated market segmentation in order to achieve social goals would be unwise and fraught with problems.

A final argument in favor of retaining some regulation of the interexchange market concerns the residual market power of the established carriers and, in particular, the American Telephone and Telegraph Company. It is feared that, absent regulation, this market power could lead to excessive prices and predatory conduct during the transition to a more competitive interexchange market. We believe there is some merit to this concern and, therefore, we address it separately and at length in Section 3.

## 2. Jurisdiction

Given the increasingly national and even international character of the telecommunications industry, it is imperative that Federal preeminence over state regulatory authority be formalized in all matters which have interstate as well as intrastate implications. The division of jurisdiction between Federal and state regulators of the telephone industry has always been uneasy and this uneasiness has been exacerbated in recent years by changes in policy at the Federal level. These changes -- aimed at increasing competition in the terminal equipment and interexchange communications markets -- have, with some notable exceptions, been opposed by state regulatory authorities. In the judicial appeals that have resulted from their opposition and the opposition of others, the courts have affirmed the national character of the issues and that Federal preeminence must prevail. Because of this industry's increasingly national and international character and because of the basic changes in national communications policy that are being proposed, it is necessary to provide statutory reaffirmation of the principle of Federal preeminence in areas where important national interests are involved. Otherwise, conflicting policies and regulations will continue to develop in the two jurisdictions, with the result that Federal policy will be delayed or frustrated entirely.

It should be emphasized that our arguments concerning Federal preeminence are <u>not</u> that regulators at the Federal level possess greater wisdom or that the

record of state regulation has been bad. Rather, it recognizes, as the courts have, the hard fact that basic decisions to be made are national in character. Consider the terminal equipment issue. A private equipment company, for example, might desire to establish a highly specialized, nationwide communications network using sophisticated terminal equipment. The national interest would be severely frustrated if the company were forced to deal with 51 different interconnection requirements ranging from virtually no restrictions, to different protective devices, to an outright ban on all non-telephone company provided equipment. It short, statutory reaffirmation of the Federal preeminence principle is merely ratification of the agency and court decisions which have recognized the national character of communications policy issues.

In considering these concepts in relation to the telecommunications industry as it exists today, one must distinguish between intraexchange or local distribution functions, and interexchange or long-haul transmission functions in the provision of telecommunications services. The intraexchange or local distribution function is associated with communications among user locations within a local geographic area. It includes the collection and concentration of communications traffic destined for other geographical areas and, conversely, for the distribution of communications traffic received from distant areas. The interexchange or long-haul function is associated with the carriage of communications between geographical areas. The distinction between intraexchange and interexchange service is clear in the provision of traditional telephone services, and analogous distinctions can be discerned in other types of communications and transportation networks. While there has been and will continue to be some blurring of the distinction between the local exchange and interexchange functions, we believe that they are fundamental enough to communications networks to remain usefully distinct from a technical, economic, and market standpoint. Thus, they form the basis of our jurisdictional definitions. In the discussion which follows, intraexchange service should be interpreted broadly to mean the provision of all telecommunications services among points <u>within</u> geographical areas that may or may not coincide with existing telephone exchanges. Likewise, interexchange

service should be interpreted to mean the provision of telecommunications services between such geographical areas. The intraexchange service category includes services connecting points within the exchange area to interexchange services (both incoming and outgoing).

The challenge, then, is to structure a regulatory scheme so as to separate those areas where the issues are predominantly national in character from those which are predominantly local. Using this principle, and (1) considering the fact that local telecommunications services will continue to be monopoly offerings in most localities for at least the immediate future, and (2) recognizing the special sensitivity to local needs and interests that state regulation can provide, we recommend that the states be given juridiction over intraexchange facilities and services. This jurisdiction would include authority over the rates and quality of all service at the local exchange level[2/], the power to grant franchises and establish franchise boundaries, and, under a statutory guideline, to define local exchange boundaries. The statutory guideline would restrict the size of the local exchange area so that no local exchange area which includes part or all of one Standard Metropolitan Statistical Area (SMSA) shall include any significant part of another SMSA.[3/] This restriction is necessary to preclude states from establishing artifically large local exchange areas and thereby oust Federal regulation of true interexchange service. We belive such an arrangement would provide the states with adequate flexibility to establish local exchange areas based on technical, economic, community of interest or other factors peculiar to their area, while preserving the Federal interest in interexchange regulation. In addition to their authority over rates for intraexchange services, we also recommend that the states

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2. The term local exchange is used here to designate a district within which telecommunications services are subject to state regulation. The boundaries of these state regulatory districts will not necessarily coincide with those of existing telephone exchanges but need not differ from today's boundaries if the states decide to retain them.

3. Existing exchange boundaries which cross the borders of contiguous SMSAs could be maintained.

be given jurisdiction over the rates charged for the origination and termination of interexchange communications over the local exchange network.[4] These charges would be subject to a ceiling established in the legislation to assure that they do not discriminate unreasonably against interexchange telecommunications users. We further recommend that Federal jurisdiction be established over all interexchange facilities and services and any local exchange facilities and services used exclusively for interexchange communications. The sale or lease of equipment that may be connected to telecommunications facilities should not be regulated by either state or federal authorities. Technical standards for the interconnection of terminal equipment and for the interconnection between intraexchange and interexchange facilities would be established by the Federal Communications Commission.

In parallel with the division of jurisdictional authority just described, and in harmony with the principles concerning continued access to basic telephone service that we will recommend later, the individual state regulatory commissions and the companies under their jurisdiction would be responsible, with continued direct financial assistance from the Federal level, for assuring subscriber access to local exchange service. The Federal regulatory commission would be responsible for assuring that the local exchanges (and hence the subscribers they serve) would have access to the interexchange networks.

We are convinced that such a division of authority and responsibility would have substantial advantages. While these advantages will become more apparent as the remainder of our recommendations are presented, the major benefits can be summarized as follows: First, by giving the states jurisdiction over the rates

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4. The interexchange origination-termination charge plays a crucial role in our approach for assuring continued subscriber access to basic telephone services. While this charge may, in some respects, resemble the access charge now applied to certain competitive interstate services, there are basic differences which will become evident as the concept is described in greater detail.

charged for the origination and termination of interexchange communications via the local exchange network, it is possible to avoid many of the basic problems which are inherent in divided Federal-state responsibility for regulating the prices of telephone local distribution services. Meaningful Federal regulation of origination and termination rates would require jurisdictional separation of non-traffic sensitive costs in the telephone local exchange. Because these costs are very significant (they represent nearly one-half of the telephone industry's total revenue requirement) and because they are not economically attributable to the carriage of interexchange traffic, jurisdictional separation of these costs is extremely difficult to accomplish in a dynamic market without seriously distorting economic incentives, and without eroding the ability of the states to be effective in the regulation of local services. By minimizing Federal regulatory involvement in this area, we believe that state regulators and local operating companies will be able to respond most effectively to the changing communications needs of local homes and businesses.

The second advantage of the exchange-based division between Federal and state jurisdictions is that it results in a jurisdictional boundary which is reasonably distinct from a technological standpoint. While it is true that no jurisdictional boundary will be totally free of engineering and accounting problems, we believe that the exchange-versus-interexchange distinction is the cleanest of the available options. Third, the exchange boundary coincides with the boundary between the increasingly competitive intercity communications market and the local communications market in which competition is developing more slowly. Fourth, state regulators, with undivided responsibility inside the local exchange, will be in a stronger position to encourage the adoption of economically efficient pricing methods for local services. Restructured, usage-sensitive pricing of local telephone service, for example, may be an important tool for ensuring the affordability of subscriber access to basic local exchange services. Finally, the proposed jurisdictional boundary provides a clean division of responsibility for assuring the availability of essential telephone services; i.e., the state regulator would be responsible for subscriber access to basic local exchange services and the Federal regulator would be responsible for local exchange access to interexchange services.

### 3. The Transition

We have proposed full and open competition in the provision of all interexchange services. However, we acknowledge that the conditions necessary for such competition will not immediately exist because of the dominance and monopoly power of established common carriers in the intercity markets. The market power of these monopoly carriers can be expected to erode as new firms enter the interexchange market and compete head to head with the established carriers, but there is a transitional problem of assuring that competition can take hold in a telecommunications market that is still characterized by market dominance. The difficulty in resolving this transitional problem stems from two conflicting desires: the desire to avoid the chilling effects of regulation and the desire to protect the customers of firms with dominant power.

In attempting to resolve this issue, we have considered options ranging from immediate full deregulation of the interexchange services of the dominant carriers to full common carrier regulation (as it exists today) of all of their interexchange services. Under the option at one extreme, the monopoly carriers would be completely free to change rates, to add or withdraw services, and otherwise act like any other competitor. The consuming public would be protected against excessive rates by existing and potential competition, by state regulation of intraexchange service, and by a statutorily mandated resale requirement.[5]

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5. As the FCC stated in its 1976 decision on resale:

Removal of these tariff restrictions on resale and sharing would create further pressures on carriers to provide their services at rates which are wholly related to costs. When similar services are available from a single carrier, but one service is available in unit quantities while the other service is available on a bulk discount basis, resale and sharing of the bulk quantity service would compel the carrier to price the bulk offering at rates wholly related to cost savings in providing the bulk quantity. If the carrier priced the bulk offering at rates not wholly related to attendant cost savings, a reseller could profitably subscribe to the bulk quantity, pay the bulk rates, and resell the capacity in unit quantities at rates below the tariffed unit quantity rate. The underlying carrier would then have to realign the relationship between unit and bulk rates to make that relationship wholly cost related or else lose the business of small-volume users who shift their demands to the reseller.

Note that resale offers protection to both the monopoly customer and the competitors.

Competitors would have the protection of the antitrust laws and the mandatory resale provision. While this alternative is clearly the most desirable one in the long run, it does not provide sufficient protection against monopoly power during the transition period. This is so because the enactment of new legislation will not have an immediate impact on the existing industry structure. There will, by necessity, be time required to obtain financing, and to begin construction, during this initial start up period. As a result, the benefits of resale and deregulation will not be immediately obtainable.

Under the option at the other extreme, all of the monopoly carriers' services -- both competitive and monopoly -- would be subject to full rate regulation as it is practiced today: In principle, this would maximize the protection to monopoly customers. The drawback is that while it is arguable that regulation can be applied effectively to a single homogeneous service, it may well be detrimental to the interaction of producers and consumers in a rapidly changing multi-service environment. The requirements of administrative procedure alone often make regulation a serious burden -- with a rapidly evolving technology, a hearing may last longer than the product or service being investigated. The situation is exacerbated when delay itself rebounds to the advantage of competitors. Furthermore, there may be a tendency on the part of regulators to artifically protect entrants from the full force of competition. Regulation can thereby evolve into cartel management. There is also some evidence suggesting that in an environment of regulated competition, participants will compete with their lawyers rather than with their salesmen. Thus, we are convinced that the continued regulation of all of the dominant carriers' services would stifle much of the very competition we are advocating. If the public is to reap the full benefits of competition, while avoiding the types of problems that have been attributed to Government regulation of surface transportation services, then the established carriers must be allowed to respond to the dictates of an increasingly competitive marketplace.

Having rejected options at these two extremes, we recommend a compromise that would offer protection against excessive rates for non-competitive interexchange services (such as message toll services) and against predatorily low rates for competitive services during the transition period. Under this approach the Commission first would review the operations of all carriers to determine which have dominant market power in the interexchange market. Those carriers found not to have dominant market power for any services would be deregulated, while those found to have dominant market power would continue to be regulated.

Obviously, a critical issue relates to how dominant market power is to be defined. We view market power, fundamentally, as the ability of the carrier to control its level of sales (and indirectly profits) by changing its prices. For example, if a carrier that increases its rates for a given service by 10 percent were to lose 50 percent of its sales to competitors, we would regard it as being unable to exercise dominant power. But if the 10 percent rate increase were accompanied by a sales reduction of only a few percent, we would certainly view this as evidence of dominant power.

This concept of market dominance does raise several questions. First, relationships between prices and sales are dependent on the time frame for adjustment. A carrier that substantially increases rates might suffer little immediate sales loss because customers need time to adjust in seeking out competitive alternatives or by changing their habits in order to cut back on purchases. Moreover, a carrier that comes out with, say, a new advanced communications system may enjoy temporary high prices and profits until other firms have a chance to commercialize competitive alternatives--a prospect that does not disturb us since firms will take the risks of developing and offering such new services only if they perceive prospects for financial reward. Thus, we would define the relevant price-sales relationships as those that take place over the longer term--say 1 to 3 years--as users and competitors have time to respond.

Second, since price-sales relationships can span such a wide range of possibilities, one must draw a line between conditions of dominance and non-dominance. The Commission must have the responsibility for drawing this line, or

more likely a zone, and for applying its judgment to take into account circumstances of individual carriers in determining where they fall.

Third, these relationships can vary for an individual carrier by route and by region, in addition to nationwide averages. We are primarily concerned with nationwide and in some circumstances, regional dominance. If a carrier has price-sales relationships showing dominance over only a few specific routes we would not be concerned, largely because that dominance is unlikely to continue for long in the face of customer needs that can be satisfied by new alternatives developing in a growing and innovative industry.

Regulation would be applied most heavily to those services that are the source of market dominance. In these cases, the carrier would have to file tariff on ninety days' notice; for competitive services of dominant carriers, the tariff could take effect in only thirty days. While these tariffs could take effect in thirty days, the Commission would have the power to reject them, if contrary to established rules or policy, set them for hearing and investigation, and prescribe interim rates. Following the hearing, which would be required to be completed within one year, the Commission could accept the tariff or find it to be unlawful. The Commission could prescribe a just and reasonable rate or order the filing of a new tariff. It could require refunds to rate payers or award treble damages to competitors found to be injured by predatory action of the dominant carrier. Under this proposal the Commission would have more authority over dominant carriers than it appears to have over common carriers today. For example, the Commission's power to reject tariffs or to specify some interim rates appears either limited or in doubt today, and it has no treble damage authority.

These provisions, if applied fully, would certainly protect both consumers of the dominant carriers' services and the fledgling competitors. They might also, however, so restrict the carrier that it could not respond actively and strongly in the competitive markets. To deal with these concerns, we would further require the Commission to determine which of the services offered by the dominant carrier are subject to a reasonable level of competition. For these services the Commission could impose structural or behavioral conditions. The dominant

carrier would comply with these structural and behavioral requirements, and this in turn would enable it to offer competitive services under the presumption that they are just and reasonable. While this presumption could be challenged by a party opposing the tariff, the burden would be on the opponent to make a substantial showing that the conditions adopted by the Commission were insufficient to protect against predatory conduct. The Commission could respond by adding or revising the conditions or by a hearing directed to any outstanding issue. Thus, the need for a rate hearing would be restricted to such instances.

In establishing conditions for competitive services, the Commission would have broad authority to pick and choose from a wide variety of behavioral and structural terms that it could impose to fit the particular circumstances. These conditions could range from requiring special accounting procedures to requiring fully separated subsidiaries that do not have, for example, directors, employees, financial structure or facilities in common with the parent.

NTIA believes that the dominant carriers should be free to provide all telecommunications services and all services incidental to telecommunications. At a minimum, Congress should make a finding in the legislation that data or information processing and the sale or lease of terminal devices are incidental to telecommunications and may be provided by the dominant carriers. To this extent, the 1956 Consent Decree, insofar as it has been construed to prevent AT&T from offering either data processing or the sale of terminal devices on an unregulated basis, should be explicitly overruled. The Commission would decide on a case by case basis whether other services would be categorized as incidental to telecommunications. The Commission should also have the authority to require the dominant carriers to establish separate subsidiaries, accounting practices, or other procedures for the provision of services incidental to telecommunications.

In order to enhance or preserve diversity in the market for mass media services, NTIA urges that the dominant carriers be precluded from providing to customers such services as broadcasting, cable or pay television, electronic publishing or newspaper services, or information retrieval. The dominant carriers could, of course, make their facilities available to other firms for the provision of

these services. Again, the Commission would decide disputed cases concerning whether activities constitute the provision of mass media services.

In addition, there is a special problem that should not be lost sight of in the approach I have outlined. This is the effect upon the men and women who work within the present industry structure of the Commission's authority to use structural solutions. In particular, when separate subsidiaries or other structural changes are required, full protection should be granted to existing worker rights such as retirement, seniority, and union rights. The problems of workers affected by structural change were accommodated in the 1934 Act where mergers took place.[6] A similar approach should be adopted in new common carrier legislation.

In sum, Mr. Chairman, we have tried to outline a framework in which the interexchange market could be made more competitive in the immediate future. Regulation would be substantially reduced at the outset, would be reexamined periodically, e.g., a report to the Congress at three year intervals, and would end in ten years, unless Congress acted to continue it. Many of the basic policy decisions would be resolved by Congress in the legislation. Regulation of dominant carriers under this proposal could, in the optimal case, be limited to only those noncompetitive services that require close scrutiny. In time, of course, we would expect open entry and technological progress to bring meaningful competition to all service markets.

### 4. The Availability of Basic Services

There is little disagreement that certain basic telephone services are essential to society and should be available generally to the public. NTIA believes that local switched telephone exchange service and long distance message toll service constitute the bedrock services that Congress should address in this legislation. We would urge that enhancements of these services such as

6. 47 U.S.C., Section 222 (f) (1970).

abbreviated dialing and call forwarding, or other more advanced services such as data transmission or video teleconferencing, be left to the marketplace. In our opinion, there is no need for the government to guarantee the availability of these services because, first, there is not political or social consensus that all citizens need them and, second, the cost of such a commitment would be inordinate. However, the ability to receive and make local calls and to call long distance to others across the country is a fundamental necessity to most Americans.

Consistent with the jurisdictional boundaries discussed earlier, reponsibility for assuring the availability of access to basic telephone service should be divided between the Federal Communications Commission and the individual states. Since state jurisdiction would, under our proposal, encompass local exchange telephone service, the states would have primary responsibility for assuring the availability of this service. Similarly, since the Federal Communications Commission would have jurisdiction over interexchange service, it would be obligated to assure that access to this service is extended to local exchanges. The mechanisms employed to achieve these objectives would not include any form of interjurisdictional cost assignment procedures such as those embodied in the existing separations and settlements process. Today, of course, the separations and settlements (or division of revenues) process is the principal mechanism by which revenues flow from toll telephone services to local telephone operating companies. Although the process is subject to regulatory oversight, it is not readily susceptible to public accountability. Because billions of dollars in common costs must be assigned to services to which they are not directly attributable, a substantial degree of judgment has entered into the development of separations formulas. Though these formulas are often defended on social grounds, there is surprisingly little evidence which would indicate that the separations process has been efficient in achieving the commonly cited social objectives. On the other hand, the established separations process is fundamentally incompatible with full competition and deregulation in the interexchange market and it is a source of distorted economic

incentives at the exchange level[7]. For these reasons, NTIA urges that the separations and settlements process be discontinued.

Under our proposal, the states would be authorized to establish specific charges for the termination and origination of interexchange calls over intraexchange facilities. Thus, a subscriber placing an interexchange call would pay an interexchange origination charge for the use of the local network to reach the interexchange carrier of his or her choice, a charge for interexchange service, plus a charge for termination of the call in the distant local exchange (billing responsibility could be assumed by either the local telephone company or the interexchange carrier or responsibility could be divided between the carriers in various ways). To facilitate this entire process, interexchange networks would interconnect with local exchange telephone systems only at authorized interface points which conform to uniform national standards for network interconnection and which do not economically or technically discriminate against any interexchange carrier. These authorized interface points or designated points of interconnection could be selected to accommodate both long term and short term national defense or national security requirements.

In most exchanges, the origination-termination charges could initially be set to produce a revenue flow equivalent to that which is now received by local

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7. The established separations process is a product of rate-base regulation in a monopoly market with physically overlapping Federal and state jurisdictions. Adjustments in the cost separations procedures are made through a process which often requires complex studies and protracted interjurisdictional negotiations. This process inherently lacks the sensitivity and responsiveness necessary for tracking changes which must be permitted to occur freely and quickly in a competitive market. In the interstate market, the separations process has led to pricing distortions which have been sustained by continued regulatory intervention in the market. In the local exchange, the separations process has led to significant distortions in the assignment of costs to local services. There can be little doubt that such distortions bias local engineering and management decisions which are strongly influenced by projected local revenue requirements.

telephone companies through the separations and settlements (or division-of-revenues) process. The average impact on both local and long-distance telephone rates would therefore be minimal. It is likely, however, that quite high rates would be necessary in some exchanges if they are required immediately to be self-supporting. We therefore recommend that the state regulatory commissions be empowered to require the pooling of a clearly identified portion of the revenues derived from origination-termination charges throughout the state. Revenues from this state pool would then be redistributed as necessary to achieve state-determined price and service objectives. Federal assistance in the form of low interest loans would continue to be available to qualified local companies through the REA telephone program.

There is, of course, some danger that state regulators would permit exorbitant origination and termination charges as a means of lowering local telephone rates. Within reasonable limits, this is regarded as a judgment which can properly be made at the state level, provided that the charges do not discriminate between interexchange carriers or between local users. Unlike the situation which exists under the present separations process, the state regulator and the telephone operating company will have to answer to local consumers for the cost burden imposed on all services which utilize the local telephone plant. If origination or termination charges become unreasonably high, effective opposition can be expected from local users of interexchange services, particularly large users of short-haul interexchange services.

The possibility of grossly excessive origination or termination charges is nevertheless a problem which cannot be ignored in the legislation. Under some circumstances, such charges would constitute a significant obstruction of interstate commerce. In the long run, it is expected that this danger will be substantially reduced by the growth of substitute services which are not subject to price regulation. In most areas, however, it will be a number of years before telephone origination and termination services will face effective competition. For this reason, we suggest that a transitional ceiling be imposed on the state-wide

aggregate contribution which origination and termination charges may make to the common costs of providing local service.[8] The ceiling would prevent grossly excessive charges, while retaining a high degree of pricing flexibility under the jurisdiction of the state regulators. By minimizing the role of Federal regulation in this process, it is believed that pricing will be more responsive to changing local conditions, and that certain problems associated with divided regulatory responsibility can be effectively avoided.

The transitional contribution ceiling is based on interstate toll revenues reported for the calendar year immediately preceding the year of enactment. This figure is used because it should be readily available, and because it is highly correlated with the present interstate contribution to those non-traffic sensitive costs which are common to local and toll services. Multiplying the revenue figure by 0.5 yields a dollar amount that is generally greater than the present interstate toll contribution to common costs. Dividing this product by the number of minutes of interstate toll traffic then gives an approximate upper bound on the present average contribution per minute of interstate toll usage. This figure, adjusted for inflation, is used as the ceiling for the average per-minute contribution from origination and termination charges during the first four years following the effective date of the Act.[9] That is, the total statewide contribution from

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8. This proposal is set out in H.R. 3333. The transitional ceiling applies only to the contribution that origination and termination charges make to costs which are common to origination, termination, and other local exchange services. Origination and termination charges would, in addition to this common-cost component, include all costs which are directly attributable to the provision of the origination or termination service.

9. It must be stressed that the transitional ceiling would be imposed on the state-wide aggregate contribution to common costs. The structuring of individual origination or termination rates would be left to the local operating companies and their state regulators. Provided that the rates do not discriminate among carriers or users, the actual contribution per minute of use could vary between exchanges or with the time of day, duration of call, total monthly usage by an individual subscriber, or any number of other factors.

origination and termination charges, when adjusted for inflation, cannot be greater than one-half of the base-year interstate toll revenues multiplied by the ratio of current interexchange usage to base-year interstate usage.

Beginning with the fifth year following the effective date of the Act, the weighting factor is decreased from 0.5 to 0.4. There are two principle reasons for this. Modest downward pressure on the contribution from origination and termination charges is believed to be economically desirable. In those cases where the drop from 0.5 to 0.4 actually requires a reduction in the contribution, the four-year period will provide time for making necessary adjustments. In most cases, however, the expected growth in interexchange traffic (based on the current growth of interstate toll traffic) will have driven the contribution ceiling well above present contribution levels. The second reason for reducing the weighting factor is to offset the substantial increases in the contribution ceiling which would otherwise occur as a result of increasing interexchange traffic. Following a similar line of reasoning, the weighting factor is decreased from 0.4 to 0.25 in the eighth year following the effective date of the Act. In most states, it is anticipated that these adjustments in the weighting factor will actually allow for a moderate increase in the contribution ceiling over the first ten years following the effective date of the Act. It is assumed (subject, of course, to future Congressional review) that the development of substitute services will permit the removal of the ceiling at the end of the ten year transition period.

The affordability of subscriber access to the local telephone network can be further enhanced by adopting a price structure in which access charges and local usage charges are "unbundled." As the measurement of local usage becomes more cost-effective with the introduction of modern telephone switching equipment, we believe that the telephone operating companies should be encouraged to move toward this type of price structure. So far as is practical, factors which significantly affect the marginal cost of usage should be reflected in the usage prices (this might, for example, result in relatively low rates for off-peak usage and higher than average rates for extended-area calls). There is some justification

for dividing the non-usage sensitive costs of local service between the subscribers who wish to access the network and the callers who wish to access individual subscribers. The "subscribers' share" of the non-usage sensitive costs would be recovered in the form of a fixed monthly subscriber access charge. Essentially all of the remaining non-usage sensitive costs would initially be included in the interexchange origination-termination charges (assuming that they are based on local costs formerly assigned to toll telephone services). If competition forces a gradual reduction in the origination-termination charges, the "callers' share" of non-usage sensitive costs could be spread (perhaps on the basis of inverse elasticity) among the origination, termination, and other local usage charges without substantially altering the subscriber access charge.

Turning to interexchange services, a reasonable approach is to give the Federal Communications Commission the responsibility for assuring that the local exchanges (and thereby the subscribers they serve) would have access to the interexchange networks. In other words, the Federal regulator would be responsible for basic telephone service between (not within) state regulated exchanges. In a fully competitive marketplace, we must expect some deaveraging of interexchange rates to occur and, in extreme cases, we must provide for the possibility that carriers might find the provision of interexchange service to or from certain exchanges to be unprofitable. It would be inappropriate to force a carrier to provide unprofitable service in a competitive market. Freedom of exit must go hand in hand with freedom of entry. However, no exchange will be abandoned under our proposal. Fortunately, the major portion of the cost variation in interexchange networks appears to be in the toll connecting trunks, i.e., the trunks between the local exchange and the interexchange networks, and this portion represents a relatively small part of the total cost. Therefore, on the whole, we believe that toll rate deaveraging may be relatively modest. Moreover, in the long term, satellite and other technologies may further lower the cost of reaching more remote exchanges. Nevertheless, we think that it is necessary to recommend a means of protecting the public against loss of affordable service.

A possible standby plan would operate in a manner similar to that provided in the airline deregulation law. If, on a particular interexchange route, no carrier is willing to initiate service or to continue to offer interexchange message telephone service at affordable rates, then the Federal regulator would request bids for providing service. For this purpose, the Federal regulator would determine minimum service requirements and would accept the lowest bid consistent with those standards. A fund maintained by the Treasury of the United States, to be known as the Interexchange Telecommunications Compensation Fund, would provide service subsidies where needed. Such sums as necessary to carry out the program would be appropriated to this account on an annual basis.

The subsidy mechanisms described above may provide the best means of attaining our social goals. The subsidies would be explicit, visible, and under direct public control. No permanent subsidy from one jurisdiction to another, with all the attendant problems, would be involved. This is in contrast to the existing process which perpetuates a dependent relationship that diminishes the incentives of state jurisdictions to be self-sufficient, creates continuing inequities among competitors, and provides an incentive and a mechanism for continued -- but unnecessary -- Federal regulation. Only minimal exit controls would be necessary so that interference with the marketplace would be minimal. Some economic inefficiency would result from the underpricing of certain services, but we believe that the magnitude of these distortions would be substantially less than that which currently exists. Finally, we believe that the mechanisms we have proposed are fair to all competitors and to all consumers.

There has been some concern expressed that the technical quality and ultimately the availability of telephone service offered to U.S. consumers may be adversely affected by the presence of competing interexchange networks. This concern is distinct from the question of affordable rates discussed above, and goes instead to the question of "network integrity." Succinctly stated, it is maintained that the public switched telephone network must be planned and managed by a strong, single entity — namely the Bell System. It is alleged that the entry of

numerous, large competitors in the interexchange message toll market will split traffic among several competing networks and dissipate the control of the existing carriers, and thus make it impossible for the Bell System and its independent telephone company "partners" to plan or operate a network in an optimum fashion. Questions are then raised as to whether new organizations or arrangements can be developed to insure that these functions are carried out in the future.

As proponents of full interexchange competition, we take these concerns very seriously. But they must be kept in proper perspective in relation to our proposals, for it must be understood that we are not suggesting that the underlying basis for the existing "partnership" be disturbed. The individual Bell Operating Companies and the approximately 1600 independent telephone companies which provide local exchange service could continue to collect and distribute interexchange traffic in cooperation with the Long Lines Department of AT&T, just as they do today. Moreover, these local operating companies (Bell and Independent) could continue to provide portions of the interexchange network on a joint service basis. No additional "partners" need be brought in because we would not mandate the provision of joint services with new carriers. The public switched network now provided by the "partnership" would remain intact. The partners could, for example, continue to establish technical standards through the United States Independent Telephone Association (USITA)-Bell System technical committees and through international organizations such as the CCITT.

Under our proposal, the local operating companies would have to provide local distribution services to all carriers on a non-discriminatory basis; interexchange carriers with dominant market power would have to provide facilities to other competing carriers when directed to do so by the Commission; and competing carriers would be free to build their own interexchange facilities. Thus, other carriers would be free to establish competing service offerings using combinations of their own facilities and those of the established dominant carriers. However, the traffic or service networks would be entirely separate even though

they might use common facilities.[10] They could have different technical characteristics, have distinct numbering plans, and serve entirely different markets or identical ones.[11] The important point is that the existing public switched network can remain a separate service -- planned and operated on the same basic principles as it is today. It simply would not be the only such network offering interexchange message toll service.

We believe this concept of separate service networks (which rests on the premise of voluntary rather than mandatory joint service offering) is a sound one.[12] However, the advent of separate, competing interexchange toll service network does have other implications that must be addressed. First, the long-range traffic forecasts, and hence the construction forecasts for the existing public switched network, will be made more difficult by the presence of other networks.

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10. The service versus facility distinction is an important one. Telecommunications networks can be seen as being composed of two levels. At the lower level is the actual transmission and switching equipment composing the facilities networks. This facilities network (or portions of it) can be used to create a myriad of different service networks.

11. This is actually the case today, of course. There are a whole range of private and shared service networks using various combinations of private and common carrier-provided facilities and equipment. These are often designed and optimized to perform to entirely different standards than the public switched network. The Federal Telecommunications System, AUTOVON, and packet switched data networks provided by Telenet, Tymnet, and others are familiar examples.

12. Not only would a mandatory joint service requirement fragment the existing public switched network, it would also force the established carriers and new carriers into a form of cooperation that could only lead to a cartel-like arrangement. When a service is provided on a joint basis, each carrier's portion must conform to the others in terms of design, pricing, and performance. This does little to encourage a diversity of offerings. The full benefits of competition will only be realized if the multiple services remain separate.

We submit that this is a problem faced by all firms in a marketplace oriented, free enterprise economy. We believe any costs associated with this increased volatility will be more than offset by competitive pressures to refine forecasting procedures, to minimize underutilization of plant, to avoid losing customers to competitors because of inadequate facilities, and the host of other benefits associated with competition.[13/] Although we are wary of imposing statutorily mandated reporting requirements on other than dominant carriers and believe that voluntary reporting is preferable, the carriers could be required to submit facility construction plans to the Commission. This might reduce some of the forecasting uncertainty.

The industry has expressed specific concern about the impact of competing carriers on local exchange network planning. Because of the way competition developed, the specialized common carriers are interconnected at individual local central offices in the local exchange network. They appear almost as subscribers on these central offices, rather than as other interexchange carriers. That is, their traffic is distributed or collected throughout the local exchange area much as if they were a local subscriber. This presents technical problems and possible economic burdens on the local exchange network if large amounts of traffic are moved from one central office to another due to competitive shifts, in the competitive marketplace for example. Although space does not permit us to deal with these particular concerns in detail, we are convinced that these impacts can be eliminated by properly selecting the designated point of interconnection and through proper tariff or contract arrangements. One possibility would be to funnel all interexchange carriers through a common "toll center" and/or tandem office for collection and distribution of traffic to the appropriate central office. This toll center would become the designated point of interconnection or gateway. In this

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13. Under competition rather than regulation, we can also expect price changes to reflect excesses or shortages of capacity. In other words, the marketplace will optimally ration capacity as it does in other sectors of the economy. Under rate regulation, prices would tend to go up rather than down when facilities are under-utilized.

way, technical performance would be improved and minimal costs would be incurred as traffic moved from one carrier to another as competition develops. Protection against any residual cost burden could be offset by cancellation liabilities in the tariffs. We offer this suggestion only as an example. The carriers, of course, have great flexibility to work out any solutions which are technically and economically feasible.

A second implication of the presence of competing interexchange service networks is that without proper safeguards, the job of managing the traffic on the public switched network on a short-term (i.e., an hour-to-hour basis) could be made much more difficult. While space again does not allow us to go into detail, we are convinced that this problem can be dealt with by keeping the service networks separate as outlined above, by properly controlling in a non-discriminatory way the flow of traffic between networks, and by suitable tariff arrangements. For example, a specific problem raised by the established carriers concerns the partnership's existing public switched network becoming the network of the last resort. The problem could arise when a competing carrier builds a very low cost but unreliable network which uses the existing public switched network as a backup or for overflow traffic. The public switched network would then be, in effect, subsidizing the less reliable network.

We believe this problem can be solved by non-discriminatory traffic controls at the designated points of interconnection, and by the established carriers employing suitable peak-load pricing and standby capacity charges. Traffic entering the local exchange or interexchange network via private facilities (e.g., through private automatic switchboards -- PBXs) rather than the designated point of interconnection can be handled in a similar fashion by segregating and controlling the respective trunks from the PBX.

It should also be recognized that the basic assumption underlying this problem may not be true. It could just as well develop that new carriers will develop <u>higher</u> quality services so that <u>they</u> will be used as the carrier of last resort. Moreover, there will be strong incentives for the emerging carriers to develop their own backup facilities and procedures (e.g., alternate route capabilities) so that they do

not lose customers. We would also expect certain carriers (including AT&T, perhaps) to offer backup capacity to other carriers as a form of insurance against outages. When the insuring carriers' back up capacity is not being used, we would antitipate that the capacity would be used to offer an interruptible service. Consumers may well benefit from the proliferation of different interexchange networks with independent failure modes.

This last point raises the question of service restoration due to natural disasters or other disruptions. Again we would note that under our proposal, the "partnership" could continue to manage its network just as it is doing today and, as we just noted, reliability can even be enhanced by the presence of alternative networks. Operators of different networks can agree on restoration priorities and networks not directly involved in a particular disruption can utilize excess and standby capacity to aid the affected network. The restoration priorities should reflect the critical nature of the service being provided and should not discriminate among carriers. Since the actual traffic carrying capacity of telecommunications networks may decrease when overloaded, agreements will be needed on the control of traffic between networks. We see no impediments to the negotiation of non-discriminatory agreements of this type.

The third implication of competing interexchange service networks stems from the fact that certain of the independent telephone company "partners" in the provision of the existing public switched network may also want to offer competing interexchange services.[14/] Hence, the independent telephone company would be a "partner" as well as a competitor. The possible anticompetitive abuses that could arise from such an arrangement are obvious. While requirements for regulatory oversight of the "partnership" meetings and structural or behavioral restrictions on the independent companies are possible remedies, we prefer the much simpler approach of subjecting the partnership arrangements to the full force of the antitrust laws.

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14. GTE's recent purchase of Telenet is an example.

## DISCUSSION OF SENATE BILLS

S. 611 and S. 622 go far toward balancing the complex regulatory and competitive pressures arising from the dynamic growth of more diverse telecommunications services in the common carrier field. The Committee and its staff have demonstrated a thorough and most commendable understanding of these issues as reflected by these two proposals.

Having discussed the principles which NTIA believes should guide the Congress in amending the 1934 Act, we would now like to discuss S. 611 and S. 622 in relation to those principles. NTIA agrees with the underlying concepts expressed in S. 611 and S. 622--that common carrier rate regulation need not be applied to all carriers serving the interexchange market. Regulation is intended to protect the public and should only be authorized in circumstances where the marketplace will not function adequately. Indeed, the application of regulation when it is not needed is probably a net loss to the public.

In this regard, there are three areas in the proposed bills which give rise to major concern:

(1) The Commission has great discretion in both the scope and duration of regulation to be applied to competitive or potentially competitive services without clear standards or guidelines which would lead to eventual deregulation.

(2) Under the fully separated carrier approach of S. 611, it appears that the separated carriers or entities of Category II carriers will continue to be subject to extensive Commission regulation and that benefits derived from economies of scope, scale or integration may be lost as a result of the rigid application of the separated carrrier approach.

(3) The definition of "interexchange telecommunications" to include the origination and termination of telecommunications within exchange areas will result in regulatory responsibility for the local telephone exchange being divided between state and Federal authorities, with many of the economic and institutional problems of the existing jurisdictional separations process. We discuss these and some other troublesome points in more detail below.

## S. 611

1. Congress should explicitly state its goals and objectives for the telecommunications industry and not leave fundamental policy decisions to the Commission.

In our previous discussion of the four principles that NTIA believes should guide Congress in amending the Communications Act of 1934, we emphasized that Congress should, in so far as possible, explicitly state in the legislation the results it wishes to obtain, rather than leave fundamental policy decisions to the discretion of the independent regulatory body.

In a number of the key provisions of S. 611, the Commission is given broad discretion to determine both the scope and duration of regulation. More specifically, the Commission may exercise this discretion and use the full array of its regulatory tools on competitive and potentially competitive offerings. The Commission has broad discretion to classify carriers and services, to determine what are essential services, to require 214 certification, to determine the scope of regulation on resellers, to award franchises, to deny or require entry, to impose structural conditions -- this list is illustrative, not exhaustive. We raise this issue of Commission discretion because we believe any new statute should give the regulatory body a clear mandate to move the telecommunications industry toward full and fair competition and to achieve this goal by deregulating as competition becomes the rule rather than the exception.

We do not raise this concern because we doubt the present Commission's ability to regulate wisely or to use its power judiciously. But Commissions can change. We know that regulators tend to regulate. Further, the exercise of discretion by necessity requires making choices. Such choices, without clear guidelines and standards, have the potential of resulting in more regulation or continued regulated competition which we believe to be the worst of both worlds. An example of recent legislation which was intended to promote regulatory reform

but which has failed to produce the desired results is the Railroad Revitalization and Regulatory Reform Act of 1976 (commonly known as the 4R Act). From the Department of Transportation's "Report on the Regulatory Reform Provisions of the 4R Act," it is apparent that the 4R Act has accomplished few, if any, of its deregulatory objectives.

Experience under the "market dominance" provision of the 4R Act provides a graphic illustration of the problems which may be encountered in an effort to bring about price deregulation without mandatory structures to force that result. Although intended to eliminate ICC regulation over most railroad rates, the vagueness of the market dominance concept and inappropriately restrictive ICC implementing regulations resulted in continued ICC regulation, even where unnecessary or unintended. The ICC's rules implementing the market dominance concept of the 4R Act result in a substantial portion of all rail rates remaining subject to ICC maximum rate regulation. In spite of the opposing efforts of the railroads and the Departments of Justice and Transportation, the ICC regulations were upheld by the U.S. Court of Appeals "in a decision based almost entirely on deference to the ICC's presumed expertise."

The 4R Act also provided for changes in the ICC's authority over minimum rate regulation. The Act states that "No rate which contributes or which would contribute to the going concern value of such a carrier shall be found to be unjust or unreasonable, or not shown to be just and reasonable, on the ground that such rate is below a just or reasonable minimum for the service rendered or to be rendered." According to the DOT report, "The ICC did not even begin a proceeding to define the relevant terms underlying the 4R Act minimum rate regulation provision until November, 1978. Today, three years after passage of the 4R Act, the Commission has not yet defined the cost terms used in this provision."

The obstacles to deregulation in the transportation industry are, of course, different from those in the communications industry. But the failures of the 4R Act do reinforce the need for precise statutory guidelines. Deregulatory provisions

which rely on the judgment of the regulator must provide a reasonable statutory basis for testing the regulator's judgment in the courts. Indefinite continuation of price regulation for some communications firms, while competing firms are freed of price regulation, cannot realistically lead to deregulation unless the regulator is aggressive in pursuing a vague mandate to create an environment in which the currently dominant firms can be deregulated.

In this regard, we are concerned that S. 611 gives the Commission unnecessary discretion in extending regulation to the interexchange telecommunications market. Section 204(c) would classify a carrier as a "Category II carrier" if it either offers a service, on a national or regional basis, which is "not subject to effective competition" or is deemed to be essential to the public interest and is unlikely to be provided at reasonable rates under competitive conditions. This standard is so broad and imprecise that a future Commission that has a predilection toward regulation could legally regulate nearly all services in the interexchange market simply by finding that they are not subject to "effective" competition and by deeming them to be "essential" to the public. Given the fact that the courts generally defer to the Commission's expertise when it is regulating in areas where Congress has given it broad discretion, we believe that a more precise standard must be applied.

NTIA believes that the Commission should only regulate a carrier's rates when it has the ability to exercise dominant power[15] in the interexchange telecommunications market. A carrier with such power could, for example, maintain predatorily low rates for its competitive services and offset this loss of revenues by raising the price of its "monopoly" services. Thus, both the consumers

15. Dominant market power is specifically defined as the ability of a firm to either raise or lower prices for services in a substantial portion of the interexchange market without significantly affecting the quantity of service demanded.

of "monopoly" services and rival firms in competitive markets would be harmed. In order to do this in today's telecommunications environment, however, a firm would have to be able to control prices over a substantial portion of the market. Otherwise, under the current open entry policy competitors could enter the "monopoly" market and drive the price back down. Given physical and financial restraints on entry, however, a firm with control over a substantial part of the total market could withstand entry for a considerable period of time -- sufficient perhaps to drive its competitors from the market.

In addition, we would argue that market share alone does not provide sufficient information to base a presumption of competitiveness or for purpose of imposing regulation. Depending on the conditions of a particular market, a firm with a low share could be relatively dominant and a firm with a high share could possess relatively little market power. We believe that the proper test to apply to assess a firm's market power is whether it can raise or lower prices of its services in a substantial portion of the market without its action having a significant effect on demand for its services. This is the test that we would have the Commission apply to all carriers for purposes of classification. Due to the structure of the Interexchange market, a firm would have to have a significant share of the MTS business to be found dominant. In this regard, we expect that AT&T may be the only firm at this time capable of exercising dominant market power.

NTIA strongly believes that the statute should identify clearly defined conditions under which any carrier can be freed from maximum regulation. We further recommend that key definitions be refined to the degree that there can be no uncertainty in identifying firms which are not subject to rate regulation. If the language is uncertain or the tests for deregulating unclear, there is a substantial danger that the regulatory body will interpret ambiguous phases to retain its regulatory jurisdiction in as many instances as possible. Such a course will continue to lead us down the road of regulated competition and not towards an environment which will encourage innovation, provide a wide variety of price and service options, and enable full competition.

2. The language of Section 204(c) requiring Category II Regulation of "Essential Services" is too broad and imprecise and will result in extending regulation over the entire interexchange telecommunications market.

NTIA is strongly committed to assuring the availability of basic local and basic interexchange message telephone services as we indicated in our discussion above. S. 611 would provide support for some level of generally available basic telephone service as well. However, as we read Section 204(c) of S. 611, the Commission, after determining that any telecommunications service is both essential to the public interest and unlikely to be generally available at reasonable rates under competitive conditions, must regulate, as a Category II carrier, any carrier authorized to provide such service.

We believe this provision is troublesome for a number of reasons. If the goal of this section is to assure the availability of basic telephone service, we are certain that that goal may be achieved through means other than continued full regulation. The social goals of universal service and reasonable interstate toll rates may be obtained through adjustments in pricing methods and, where necessary, through explicit subsidies. Such solutions are preferable to restricting competition and continuing full regulation over a number of rapidly changing services and markets. If it is believed that these means are inadequate to sustain some level of basic telephone service, then the term "essential service" should be defined narrowly and precisely to avoid any competitive or potentially competitive service being brought within the regulatory sweep. While the legislation may be looking toward an elasticity test, we suspect that the result will more likely be a subjective evaluation of the service. This could result in a broad extension of regulation since all services could in some sense be determined to be essential. NTIA believes that a service such as MTS could well be viewed as essential, but urges that a dominant market test would result in this service being regulated anyway.

We find the provisions of Section 204(c) troublesome in another way. It is difficult to see how the Commission could make the determination that a service would not be generally available at reasonable rates under competition by looking at the marketplace now. If we do not give the competitive marketplace a chance to provide a wide variety of telecommunication services, how are we to know if competition will not assure reasonable rates and availability of service? At what point would the Commission intervene and make a finding that competition cannot work?

As we stated previously, NTIA believes that during the transition to full competition and deregulation, only those firms that can exercise dominant market power in the interexchange telecommunications market should continue to be regulated. Further, the degree of transitional regulation to be applied to these firms is a fundamental policy decision that should be made by Congress. In any event, we are convinced that the marketplace can and will provide adequate service at reasonable rates and if, in a limited instance, the process proves deficient it would be better to provide a direct subsidy than to continue to regulate indefinitely.

3. The regulatory/accounting approach to preventing cross-subsidization may not be fully effective, but rigid application of structural remedies must be avoided.

As indicated by our earlier arguments, we generally support the presumption in S. 611 "that there are no basic technological, operational, or economic factors which would preclude the provision of any interexchange telecommunications service under conditions of effective competition." However, we have acknowledged that the conditions necessary for full and open competition do not exist because of the market power and overall dominance of the established carriers in the intercity market. Perhaps the most elusive and difficult problem is finding ways of protecting the customers of these carriers with dominant market

power from bearing the costs of the firms' competitive ventures during the transition to full competition. As we understand it, S.611 would give the Commission substantial powers to protect the competitiveness of markets by preventing cross-subsidization and other anticompetitive practices, and to protect the interests of consumers of noncompetitive telecommunications services. Quoting directly from the S. 611, these powers over Category II carriers

"... may include but are not limited to: reporting of information; accounting rules; authorization of facility construction and use; approval of tariffs; interconnection of consumer equipment; and any other requirement relating to corporate ownership or organization. In addition, the Commission may impose any requirement relating to separation of such carrier's telecommunications services from such carriers' nontelecommunications activities or services, or from the nontelecommunications activities or services of any affiliated entity; or relating to separation of such carrier's telecommunications services for which it is subject to effective competition from those telecommunications services for which it is not subject to effective competition."

These powers reflect both of the two basic ways of preventing cross-subsidization: structural and regulatory/accounting. No doubt we cannot rely exclusively on one approach or the other; however, the degree of emphasis is extremely important.

The regulatory/accounting approach takes a cost-price perspective to competition. Relying on accounting and other data and using a cost accounting and cost allocation manual, dominant carriers would find their rates and charges subject to cost justification. Put another way, rates of return would be computed by service and compared as a check against cross-subsidization between competitive and non-competitive services. This in fact is the approach which the courts, Commission, customers, and carriers are struggling with today. We might add that success has been elusive for a number of reasons. First, the data to support these computations is not readily available through the present Uniform System of Accounts. This has led the Commission to propose a new USOA, which may take anywhere from 3 to 15 years to fully implement. Secondly, the concept of cost in itself is elusive. Historical cost, which is the basis for accounting, is verifiable and objective but, especially in the context of rapidly changing technology, often irrelevant. Future or prospective costs are relevant, but

extremely difficult to verify in any objective sense. Moreover, cost allocations, where common costs are substantial, inherently lead to a wide degree of discretion and to an exercise in accounting judgment. Such allocations have little if any basis in economic or financial theory. Adding the questions of economies of scale only confounds an already difficult problem. We can conclude that the difficulties inherent in the regulated cost-price approach have the unhappy distinction of combining unsolvable theoretical problems with substantial practical problems of implementation. While we do not favor total abandonment of this approach, we believe that undue reliance upon it will only frustrate our attempts to achieve fair competition.

S. 611 seems to reflect some of our pessimism about the regulatory/accounting approach. It not only gives the Commission broad structural powers, but it also mandates certain restructuring of the major telecommunications carriers. As we understand it, the provision of interexchange service would be separated from the provision of intraexchange service, the provision of intraexchange service from the manufacture or provision of equipment, and the provision of competitive interexchange service from the provision of non-competitive interexchange services. While S. 611 would allow for exceptions in the provision of telecommunications equipment and information services by interexchange and intraexchange carriers, and in the provision of intrastate interexchange service by carriers providing exchange service, the remaining structural changes are mandated and the Commission would have no power to waive them.

While we agree that structural remedies of the type contemplated in S. 611 may be the only practical way to solve the cross-subsidization problem (at least in the short to medium term), we have several major reservations about the actual approach chosen. First, while simple in principle, the structural approach is extremely complex in practice. The distance between the subsidiary and the parent may range anywhere from a purely legal distinction to actual divestiture. For a particular company, the number of entities required could range from two

(one for monopoly and the other for competitive services) to many, i.e., one for each competitive service. S. 611 appears to take an aggressive position with respect to the relationship between subsidiaries (and parent) and, as we described above, the number of subsidiaries. In particular, S. 611 would require the subsidiaries to be fully separated which is defined to mean not having common directors, officers, employees, or financial structure or commonly owned facilities and having the subsidiaries deal with each other in the same arms-length manner as they deal with any unaffiliated entity or carrier.

This provision could be construed to require each entity to construct its own facilities. While this degree of separateness and this number of entities may be appropriate in some instances and, in fact, actual divestiture may be warranted because of antitrust considerations (a matter on which we, of course, express no position), it must be recognized that there are costs associated with separate subsidiaries. These costs include some possible duplication of personnel and facilities, the loss of economies of scale, increased transaction costs, and perhaps loss of creative initiatives. While these costs may be outweighed by the improved ease with which cross-subsidization can be guarded against and even by some competitive tensions among the separate subsidiaries themselves, we are troubled by the rigidity with which it must be applied. We believe the Commission must have flexibility to impose conditions that are appropriate to the particular situation. In all cases the subsidiary should be allowed to lease facilities from the parent on terms and conditions available equally to unrelated parties. Another aspect of separation the Commission may examine is the degree to which the subsidiary must depend on its own financial resources to obtain debt and equity capital. The inflexibility of S. 611 is particularly troublesome because, as we interpret the bill, services offered by a fully separated subsidiary of a Category II carrier could still be subject to the complete panoply of regulatory/accounting measures, including the filing and approval of tariffs, new construction approval, etc.. The restructuring of the telephone companies and the application of full regulation to each new corporate entity would be the worst of all combinations -- loss of economies of scope, scale, and integration, and potentially stifling over-regulation.

Rather than this approach, we would recommend the alternative we outlined earlier, in which the Commission would be required to determine which of the services offered by dominant carriers were subject to a reasonable level of competition. The Commission would then establish appropriate structural and behavioral requirements which would enable the dominant carrier to offer competitive services under the presumption that they are just and reasonable. Under this approach, the public would be protected and the carrier would not necessarily face the rigors of the competitive market with the handicap of full regulatory controls.

As a final comment, we should note that the separate subsidiary approach is not a panacea. In addition to the costs cited above, policing the requirement for no preferential treatment of the subsidiary would be difficult. In short, how can a regulator really determine whether a particular transaction was accomplished at arms-length? Unless some outside ownership was required, the board of directors of the subsidiary would still be chosen and controlled by the parent and the incentive would still be to maximize the profits of the firm as a whole. Thus the potential would remain to price the monopoly services high and the competitive services low.

This latter observation leads us again to the resale issue. One effective way of ameliorating this tendency is to mandate the opportunity to resell all services of firms having dominant market power whether or not they offered through separate subsidiaries. Then, if the dominant carrier attempts to price its competitive facilities or services too low, other firms would simply resell them and thereby undercut the monopoly offerings. We are convinced that the legislation should contain language preventing dominant carriers from prohibiting the resale of their services, thus allowing this arbitrage function. Note that the resale will not be effective if the dominant carrier has an exclusive franchise to provide a particular interexchange service or facility, since under that condition, they would not face the loss of the monopoly revenue. This provides an additional, important reason for the Congress to declare all interexchange communications open to competition, and to proscribe the Commission from granting any monopoly in that market.

4. Regulatory responsibility within the local exchange should not be divided unnecessarily between state and Federal authorities.

As we indicated in the discussion of our basic principles, NTIA believes that jurisdictional responsibilities for telecommunications regulation should be divided between state and Federal authorities in a manner consistent with the structure of the telecommunications market; intraexchange telecommunications should be subject to state regulation and interexchange telecommunications should be subject to Federal regulation. If we correctly understand the intent of S.611, there is no basic disagreement in principle. The bill would establish "exchange telecommunications areas" which are generally consistent with our perception of the structure of the telecommunications market in the foreseeable future. The Federal Communications Commission would have jurisdiction over interexchange telecommunications, while telecommunications facilities and services within the exchange areas would, with specific exceptions, fall under state jurisdiction. The bill also calls for discontinuation of the jurisdictional separations process, a step which is fully consistent with our basic principle. There are, however, certain provisions of the bill which we fear would produce other than the desired consequences.

Much of our concern stems from the fact that "interexchange telecommunications" is defined to include the origination and termination of telecommunications within exchange areas. It follows from this definition that regulatory responsibility for virtually every part of the local telephone exchange plant would be divided between state and Federal authorities very much as is the case today. Inherent in this division of responsibility are many of the economic and institutional problems that have proven difficult in the existing jurisdictional separations process. The jurisdictional separation of origination and termination services from other local telephone services establishes a jurisdictional boundary which has no natural basis in terms of cost causation, plant utilization, or industry structure. This not only adds to the complexity of regulation, but it also creates an artificial regulatory discontinuity which unnecessarily adds to the distortion of

market forces. In this regard, it is of particular concern that divided Federal-state responsibility for rate regulation would almost certainly require the continuation of some form of jurisdictional cost separations, involving nearly every part of the local telephone exchange. In an era of changing consumer needs and rapid technological progress, we believe that this is undesirable because it creates an unnecessary level of potential economic distortion in the regulatory process and, at the same time, restricts the capacity of state agencies to regulate effectively in a changing market.

The preferable alternative, we believe, is to define origination and termination services as intraexchange services and place them under state jurisdiction. This would avoid divided Federal-state reponsibility, except at designated points of interconnection and in certain cases where it is economically or technologically infeasible to separate interexchange and intraexchange functions or facilities. State jurisdiction over origination and termination services would almost totally eliminate the need for jurisdictional separation of non-traffic sensitive costs, and would substantially reduce the areas in which traffic sensitive costs could not be assigned totally to a single jurisdiction. We believe that the need for Federal control over origination and termination services is minimal. It is generally in the self-interest of local operating companies to originate and terminate interexchange traffic in accordance with the needs of their customers. As a general rule, state regulators would be subject to the ire of local consumers if such services were not available at an acceptable price. We do, however, recommend specific statutory safeguards. We would require that origination and termination charges not discriminate among interexchange carriers or among local users. We would require that interexchange carriers be permitted to interconnect with exchange networks on a nondiscriminatory basis. Interexchange carriers under Federal jurisdiction would be permitted to serve local customers directly, provided that their facilities were not used for intraexchange communications. Under these conditions, it is probable that the growth of substitute services would gradually force a reduction in origination and termination charges which are excessively high.

As we have previously indicated, we support the concept of a state-defined exchange area which represents a single local community of interest. Furthermore, we agree that an exchange area which includes a major part of one Standard Metropolitan Statistical Area (SMSA) should not be permitted to include any significant part of another SMSA. We believe, however, that Sec. 226(a) of S. 611 is overly restrictive to require that no exchange area shall extend beyond the boundaries of any SMSA. First, the boundary of an SMSA does not necessarily represent a reasonable boundary for a local communications network. Certainly it would not be reasonable to require that existing telephone exchanges be rebuilt to conform to SMSA boundaries. It is probably not economically desirable to require that all future local telecommunications systems conform strictly to SMSA boundaries. Second, it may be socially undesirable to exclude from an SMSA exchange the non-urban area immediately surrounding the SMSA.

5. <u>The 214 Authorization Process should be eliminated entirely and protection to the public obtained by other means.</u>

Section 214 of the Communications Act of 1934 requires carriers to seek the Commission's approval before they construct, acquire, or operate new communications lines or extensions of existing lines. Similarly, the carrier must seek the Commission's approval before discontinuing or reducing service. The Commission may require the carriers to provide facilities in order to offer service. The Commission also has the power under Section 214 to attach conditions to its approval.

In theory, the Section 214 process is designed to protect the consumer against unwise or imprudent investments in facilities by the regulated carrier. Otherwise, under rate-of-return regulation and in the absence of competition, the costs of the uneconomical investment can be passed on to the carrier's customers rather than to its stockholders. The 214 process is also designed to protect the public against an unjustifiable withdrawal of service.

As we understand it, S. 611 would modify the existing Section 214 process in four ways. First, it would apply only to Category II carriers, i.e., carriers that provide any service which is not subject to effective competition or is deemed essential to the public interest. Second, the 214 process would no longer be mandatory even for the Category II carriers. Third, it would allow the Commission to approve a long-term facilities plan to avoid the necessity for Category II carriers to obtain approval for each element of such a plan. Fourth, it would significantly expand the scope of the process to encompass all interexchange telecommunications facilities, including switches and short lines. While we are convinced that the need for the entire 214 process is questionable, we believe the above steps, with the exception of the expansion of scope of the last point, are in the right direction.

However, upon closer examination, we believe that the Section 214 process and the large paperwork burden it imposes on both the carriers and the Commission will be unnecessary in the future. We urge the Congress to reach this conclusion now, rather than relying on the Commission to do it. Sufficient, real, and potential competitive forces have already been unleashed to deter Category II type carriers from making substantial uneconomic investments in facilities. Put another way, if interexchange carriers of any type make imprudent investments in facilities, they will lose business to more sophisticated carriers; they will be unable to recoup their investment because of competitive pressures; and their stockholders will eventually bear the burden.

Moreover, even assuming that the Section 214 process is still desirable in theory, we are most dubious of its effectiveness in practice. The Commission simply does not have the staff to examine each and every item of a multibillion dollar construction plan. These plans almost always involve extremely complex choices among various technologies, and they depend upon highly judgmental forecasts of future demand. It is simply unrealistic, and perhaps even unwise, to expect the Commission to substitute its judgment in such a dynamic marketplace -- especially when competitive pressures are apt to to prevent any

egregious abuses. Furthermore, the Section 214 process is one of the higher and more visible costs of regulation to the carrier and, if the Commission is really expected to provide more than a pro forma approval of Section 214 applications, it will be extremely costly to the taxpayer as well. In practice, this section has been used primarily as a means of controlling entry to the telecommuncations market. Carriers file petitions to deny the applications of prospective competitors because the administrative delay involved can be a significant barrier to entry. We maintain that the ability of the Commission to restrict entry to the interexchange telecommunications marketplace should be eliminated altogether. Entry regulation distorts the competitive market by raising the cost of entry and disserves the public by denying it the benefits of full competition. Finally, we would point out that the Commission has another option for protecting customers from having to absorb the costs of an imprudent investment by a Category II carrier (or as we would prefer it, a carrier with dominant market power): it can simply disallow the investment in a rate case.

We also recognize that the Commission has used its power to condition Section 214 authorizations as a means of forcing a carrier to do or refrain from doing certain things. However, we believe that the need for many of these conditions will disappear with the passage of this legislation and, in any event, the Commission can still act effectively through its rulemaking powers or in tariff proceedings.

So far, we have focused on the Section 214 process as it relates to the approval of new facilities. As we noted earlier, the process also seeks to protect the consumer against unjustifiable withdrawal of, or reduction in, service by a carrier. We believe that in a competitive environment, freedom of exit must go hand-in-hand with freedom of entry. In such an environment, competitive fairness requires that no carrier be forced to provide service at a loss because it would be disadvantaged in other areas of their business where it might try to recoup its losses. Instead, we believe that a direct subsidy awarded to the lowest cost carrier willing to provide the service is the appropriate remedy. In a rapidly advancing

field such as telecommunications, such an approach is infinitely better than entry restriction designed to protect the excess profits necessary to allow internal subsidies. However, we are concerned about the abrupt withdrawal of interexchange message telephone service from an exchange and, therefore we would recommend the mechanism for continuing service described earlier.

6. AT&T should be allowed to provide all telecommunications and information services, but competitive services provided through subsidiaries should not be fully regulated.

We support the provision in S.611 (Section 229) which would permit telecommunications carriers, including AT&T, to offer all telecommunications and information services. Currently, the scope of AT&T's authority to provide facilities and services with an information component is in doubt because of provisions of the 1956 Consent Decree. This Decree terminated the 1949 antitrust suit between the United States and AT&T. It enjoins AT&T from engaging in any business other than the furnishing of communications common carrier services. Common carrier services are defined as "communications services and facilities...the charges for which are subject to public regulation under the Communications Act of 1934, or any amendment thereof, or would be subject to such regulation...furnished in interstate commerce." AT&T can, however, provide services which are "incidental to telecommunications", but this phrase has never been satisfactorily defined.

The 1956 Consent Decree was written in an era when telecommunications services and information services were clearly separate and distinct. Indeed, as recently as 1971, when the Commission issued its rules in the first Computer Inquiry, it was thought that a meaningful distinction could be drawn between communications and information services. We believe that such a distinction can no longer be drawn, and that in the future, the telecommunications and information

technologies will continue to merge. In this environment, a telecommunications carrier that must restrict its involvement in the information market will be operating at a distinct disadvantage. S. 6ll recognizes this reality and provide for it in a positive manner. As we noted above, however, we would not give the Commission the authority to prevent AT&T or any other carrier from offering a telecommuications service or a service incidental to telecommunications. Such a restriction is unnecessary under S. 611 since the Commission is given ample authority to protect the public through structural or regulatory means. It simply gives competitors another opportunity to fight one another in the regulatory arena rather than the marketplace.

With regard to mass media services, e.g., broadcasting, cable and pay cable, electronic publishing, and electronic information retrieval services such as teletext, we believe that AT&T should be prohibited from providing the service itself but should be permitted to offer facilities to unaffiliated companies so that the services may be made available to the public. We take this position because diversity in mass media services enhances the flow of information to the American public. We believe that the entry of AT&T into the media market, because of the size and wealth of the firm and its control over the facility infrastructure, would tend to work against diversity by discouraging other firms from entering. We recognize that there is a problem in defining mass media services, particularly in the information area, but in view of the importance of the values we are trying to protect, we would leave it to the Commission to define the terms in cases of dispute.

With regard to the current antitrust suit brought by the United States against AT&T, we believe that the evidence in the antitrust case should be evaluated on the merits by the courts, and that they should be free to fashion a remedy in the case based upon that evidence and all factors before them. If the approach we have advocated is adopted by Congress it will, of course, be considered by the courts, but it should not be determinative, since Congress would presumably not making a definitive judgment on the merits of the current industry structure.

7. Tariff procedures for competitive offerings of dominant carriers should be streamlined.

The tariff procedures required under the current statute have proved to be unsatisfactory. The Commission's power to reject tariffs is limited, and hearings have been known to continue for years. Before a hearing on one tariff is completed, a succeeding tariff may be filed, thereby throwing the hearing process into confusion. S. 611 has substantially improved on this process by giving the Commission broader authority to reject the tariff, and the new authority to prescribe a rate prior to hearing. In addition, the Commission is authorized to promote negotiations on tariffs prior to hearing.

NTIA believes that the public can best be protected by giving the Commission substantial authority to regulate the non-competitive services of the dominant carriers. While tariffs for non-competitive services should take effect in 90 days, and for competitive services by a dominant carrier in 30 days, the Commission should have the authority to reject the tariff for good cause, to prescribe an interim rate, and to designate a tariff for hearing. The hearing process should be flexible enough to permit the Commission to consider the matters involved based upon the filing of written pleadings, rather than have a complete adjudicatory hearing. An accounting order should be used to protect consumers against unreasonably high rates, and the Commission should have the authority to assess treble damages when rates are found to be predatorily low.

We support the provisions of S. 611 which establish a more liberal tariff process for the competitive services of a Category II carrier. We believe it is necessary to recognize that a carrier cannot compete in a competitive market if it is limited by regulatory restraints. NTIA, therefore, recommends that the Commission be required to establish conditions for competitive services (similar to those suggested in Section 205(b) of S. 611). With such conditions the burden would be on the opposition to show that the conditions are insufficient to protect against

cross-subsidization. If this showing were made, the procedures specified above would be applicable. We would urge the Subcommittee not to give the Commission the authority to prevent carriers from engaging in any telecommunications service, or any service incidental to telecommunications other than media services.

8. Interconnection requirements are essential, but the requirement for mandatory provision of joint services is unwise.

Section 207 of S. 611 requires that "every telecommunications carrier which provides an exchange, interexchange, or international telecommunications service or facility for which it is not subject to effective competition shall establish physical connections with any other carrier upon request therefor." We fully support this provision and believe it is crucial to assuring the transition to fair competitive conditions. In addition, we recommend that the legislation contain language proscribing such carriers from applying or enforcing unreasonable restriction on the resale or sharing of interexchange services or facilities. As we described earlier, unrestricted resale and sharing of services provided by firms with dominant market power would create important pressures against exorbitant rates and cross-subsidization.

While we strongly support mandatory interconnection of facilities and services for unlimited resale or sharing, we are equally convinced that it would be unwise to give the Commission the power to compel joint operations among Category II carriers, or among such carriers and Category I carriers. Section 205 of S. 611 would convey such powers. While the difference between mandatory interconnection of facilities and services, on the one hand, and mandatory joint provision of services, on the other hand, is a subtle one, we believe, as we pointed out earlier, that the difference is crucial to assuring the integrity of individual service networks and to assurring true competition. To reiterate what we said before, we believe that mandatory joint service would not only discourage diverse offerings and encourage cartel-like behavior, it would also seriously fragment the public switched network. The requirement that dominant carriers provide physical

facilities and services, coupled with mandatory resale, is sufficient to insure that carriers lacking dominant market power will have the technical freedom to establish competing service networks under fair conditions. The mandatory joint service provision is both unnecessary and unwise.

## S. 622

S. 622 differs in a number of respects from S. 611, but it shares one common, positive attribute: it is a marked improvement over the current statute and is much more compatible with today's telecommunications environment than is the 1934 Communications Act. Like S. 611, S. 622 contains provisions that we strongly support and provisions we would propose to alter. We shall not repeat in this discussion, however, our views on issues already analyzed in relation to S. 611. Instead, we shall focus our comments on thos aspects of S. 622 that are unique to it.

S. 622 explicitly calls for deregulation of common carrier telecommunications regulation over a fixed six year transition period. We believe that it is important that Congress adopt this approach of a transition period fixed in time. All interested parties, the carriers, the regulators, and the consumers, will then know the direction in which they must move and can plan accordingly. An unlimited transition priod encourages the development of a program of regulated competition that can be very difficult to end, even when the market conditions are right. While we would propose a transition period of ten years, we note again that this is not based upon any sure judgment that the market conditions will be right to end regulation at that time, but rather that this is an appropriate period for Congressional reexamination of the matter.

S. 622 calls for an access charge to be paid by common carriers interconnecting with local telephone facilities. As we testified above, NTIA supports the access charge approach but we would have the charges be approved by the individual state commissions rather than by the Federal Commission as is

proposed in S. 622. Under our proposal the states could then order the distribution of the funds collected in a manner consistent with their own individual circumstances. The only Federal interest in the access charge approach is the need for assurance that the access charges will not impede interstate commerce. This can be accomplished by putting a cap on the amount that can be collected within each state.

Carrier offerings of competitive services can under S. 622 be tariffed under a much more flexible rate procedure than is the case today. During the first two years of the transition, rates can be raised by up to 5 percent or lowered as much as 10 percent. During the last four years of the transition the percentages are 10 and 20 percent, respectively. The Commission can, however, set such rates for hearing if it believes an investigation is needed. We believe there is no need to regulate the rates of non-dominant vendors. For dominant carriers we have urged an approach under which the Commission will have flexibility to impose conditions to assure fair competition, including whether safeguards, such as separate subsidiaries, should be employed. While S. 622 does authorize the Commission to require subsidiaries, it does not recognize that fully separate competitive subsidiaries can be treated differently with regard to rates than the parent company or a subsidiary with a monopoly base.

While there are other details of S. 622 that merit commendation, our discussion of common carrier legislation has already assumed great length. In conclusion we note one particular section of S. 622 (Section 225(d)(2)(I)) which we believe summarizes the direction which legislation should take. It mandates that the Commission regulations provide for adjusting the level of transitional regulation to remove marketplace deficiencies, anticompetitive behavior or other practices which frustrate the purposes of this section, i.e., competition and deregulation. This is a goal which we support and which both S. 622 and S. 611 seek to achieve. With this degree of consensus apparent, we are optimistic that sound legislation can be achieved.