Chapter 5

A STATE REGULATOR'S VIEW OF THE PRESENT SITUATION IN TELECOMMUNICATIONS AND OF THE CHANGES IN THE INDUSTRY

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I appreciate this opportunity to present my views on the changes in the telecommunications industry, both those that are occurring and those that have been proposed. I will address this issue from my perspective as a state regulator and from the point of view of the consuming public. In fact, I believe it is a major responsibility of state regulators to see to it that the consumer's point of view on this important issue is fairly represented, specifically with respect to the federal court's Consent Decree and the development of pending telecommunications legislation in Congress. This is especially true since it is clear that other interested parties, including AT&T and its competitors, are very well represented in these proceedings.

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I believe it is fair to say that the New York Public Service Commission has been a leader in fostering competition in the telecommunications field and has done so in the belief that a more competitive telecommunications industry is in the long-term interests of New York consumers and the nation. After a decade of evolving competition and deregulation, we continue to hold that view. We are, therefore, prepared to resist the calls by some to retreat from the challenges of change. There are those who would return to the more comfortable days before competition, when we didn't have to face the uncertainties and dislocations (for example, major shifts in the way telephone services are provided and priced) that must occur in order to promote a more efficient use of resources and to ensure competition.

We do, however, have some serious concerns about the revolution that is occurring in the field of telecommunications. These concerns, which are shared by most state regulators, involve the pace at which changes are to occur, and the process by which they are to be made.

I believe that, to the greatest extent possible, necessary changes should be introduced at a pace that will minimize the impact on local rates and public inconvenience; and that, in implementing necessary changes, we must never lose sight of important public policy considerations, especially our interest in the universal availability of basic telephone service at a reasonable cost. I also believe that the nature of the process by which decisions concerning telecommunications policies are made is extremely important. Important policy decisions should be made with a full opportunity for input by all interested parties, and should reflect the overall public interest, not merely the narrow interests of certain parties or the public policy views of one governmental agency. As I shall explain later, we are particularly concerned with the making of major policy decisions in the context of the Consent Decree.

In order to provide a clearer understanding of the potential impact on local rates of the changes that have been proposed by the FCC, the Consent Decree, and federal legislation, I will try to quantify the revenue effect of several of the proposed changes for New York State. While these estimates are in the nature of a "worst case scenario," their likelihood is sufficient to require our serious consideration.

COST IMPACT OF POTENTIAL CHANGES

There are four major forces acting on telephone rates today. These are changes in the configuration of the industry, changes in the jurisdictional boundaries between the FCC and state regulators, cost separations, and capital recovery changes.

Industry Changes

The FCC has deregulated all new customer premises equipment as of January 1, 1983, and has begun deliberations as to the fate of the existing (embedded) equipment. The Consent Decree calls for the transfer of all terminal equipment from the Bell Operating Companies to AT&T. Additionally, proposed federal legislation in the House and that already passed by the Senate call for the deregulation of terminal equipment.

The effect of terminal equipment deregulation is twofold. First, this category has been priced above its embedded costs, thereby providing support for other intrastate services. Second, a portion of terminal equipment costs has been allocated to the interstate jurisdiction, an allocation used to subsidize local exchange service. Deregulation would result in the loss of both of these sources of support.

INTRASTATE IMPACT

	Amount (Millions)*	Monthly per Main Station
Customer premise equipment contribution	$ 23	$0.24
Jurisdictional separations of customer premises equipment	121	1.26

*All of the estimates are in constant 1980 dollars.

Both the Consent Decree and some legislative proposals prohibit the local Bell Operating Companies from providing certain services. The most significant service that had been eliminated from the local telephone operation before Judge Greene's modifications was direc-

tory advertising (Yellow Pages). Of lesser significance today, but of great potential significance, is the elimination of the so-called "enhanced services." Both the FCC and the Consent Decree prohibit Bell Operating Companies from providing enhanced services. These services, such as message storage, are essentially adjuncts to existing exchange service and would allow multiple use and financial support of exchange facilities. Since the loss of these services is not of significance today, no impact is estimated.

INTRASTATE IMPACT

	Amount (Millions)	Monthly per Main Station
Yellow Pages	$ 73	$0.76

The Consent Decree and, to some degree, legislative proposals require the separation of the local operating companies from the rest of the Bell System and prohibit the provision of joint services by the separated entities. This split by itself raises the possibility of an adverse impact upon the local exchange rates of the operating companies because of higher prices for purchases from Western Electric reallocation of administrative overheads and refinancing of debt and equity.

In 1980, New York Telephone purchased approximately $445 million in equipment, excluding terminal equipment, from Western Electric, purchases that would continue after divestiture. Western's price levels are 19 percent below the lowest priced equivalent equipment supplier, which indicates that it could raise its prices by 23.5 percent and still be competitive with other suppliers. After divestiture, we would have no alternative but to pass these higher costs on to New York Telephone's customers. If Western raised its prices to the level of other suppliers, New York Telephone would pay an additional $105 million annually, of which as much as $100 million would be borne by customers of intrastate services.

Second, divestiture and/or transfer of some local operating company services to separate subsidiaries would reduce New York Tele-

phone's ability to spread its administrative overhead costs over as large a base of services as it now does. If New York Telephone is prohibited from providing these administrative functions, such as billing, for the divested or separated operations, the remaining intrastate services would have to bear an additional $152 million of these costs annually.

Third, the reorganization necessary to accomplish divestiture could conceivably require the refinancing of a considerable portion of New York Telephone's existing long-term debt. If all debt were refinanced at current market rates, its intrastate costs would rise $238 million annually. While this refinancing is highly unlikely, it is a possibility.

INTRASTATE IMPACT

	Amount (Millions)	Monthly per Main Station
Western Electric	$100	$1.04
Administrative Overheads	152	1.58
Debt and Equity	238	2.48

Jurisdictional Changes

Federal legislation would transfer jurisdiction over intrastate interexchange service, predominantly intrastate toll, to the FCC. Additionally, the exchange-interexchange corporate restructuring required by the Consent Decree would provide further impetus for a shift of jurisdiction over interexchange service to the FCC.

The impact upon the remaining intrastate services of the jurisdictional transfer is a function of the jurisdictional separations procedures. Under the current separations procedures (Ozark Plan), the New York Telephone intrastate operation would actually benefit by over $150 million annually. That is, the transfer of costs to interstate would exceed the transfer of revenues by over $150 million. If, however, the interstate allocation of non-traffic-sensitive costs were entirely eliminated, the result would be the opposite, with the loss

of revenues exceeding the loss of intrastate cost assignment by $90 million. Thus, under the worst case, the loss of jurisdiction over intrastate toll services would increase the revenue requirement for the remaining intrastate services by $90 million.

INTRASTATE IMPACT

	Amount (Millions)	Monthly per Main Station
Loss of Intrastate Toll Jurisdiction	$90	$0.94

Separations Changes

Under proposed federal legislation and through current FCC actions, the level of cost assignment to the interstate jurisdiction would be reduced. The FCC, in Docket 80-286, has already taken steps to phase out the current interstate allocations of customer premises equipment over a five-year period starting January 1, 1983, and to freeze, as an interim measure, the primary separations factor, Subscriber Plant Factor (SPF), at 1981 levels, effective April 1, 1982. The FCC proceeding (Docket 80-286) is currently addressing the final resolution of the Subscriber Plant Factor issue.

While the FCC proceeding is continuing, the Other Common Carriers (OCCs) are challenging the validity of the entire separations process in federal court, and the Consent Decree states that access charges by the Bell Operating Companies should be "cost based." Both these peripheral actions add further pressure to reduce the current level of exchange cost allocation to interstate.

It has already been resolved that the customer premises equipment portion of subscriber plant will be eliminated from separations over a five-year period. This could occur sooner if the OCCs' court challenge is successful. The prognosis is that the interstate allocation of the remaining subscriber plant will also be substantially reduced or totally eliminated. The impact of the Customer Premises Equipment (CPE) separations reduction is already included in the foregoing discussion of terminal equipment deregulation. If the interstate allocation of the remaining subscriber plant were eliminated, intrastate costs would increase by $529 million.

INTRASTATE IMPACT

	Amount (Millions)	Monthly per Main Station
Separations (non-CPE)	$529	$5.51

Capital Recovery Changes

The FCC has ordered two accounting changes, both aimed at more rapid recovery of plant investment. The first, expensing of station connections, charges the cost of customer premises wiring to current operating expense rather than to the capital investment accounts. Existing inside wire investment would be gradually amortized. This change increases the "up front" revenue requirement associated with inside wire installations but would, over time, reduce the revenue requirement associated with existing investment as it is amortized. The New York Public Service Commission (PSC) has approved a "phase-in" plan for New York Telephone that mitigates the initial impact, but, even under this plan, the intrastate annual cost levels will increase by $150 million in the near future.

The second FCC action increases depreciation rates by adopting a different depreciation method, Equal Life Group (ELG) depreciation, which recovers more investment in the early years of an asset's life. Although this method would be gradually phased in under the FCC plan, it would increase New York Telephone's annual intrastate costs by $36 million in less than three years. This impact is over and above the general trend toward higher depreciation rates because of a shortening of service lives from competitive and technological causes. The Public Service Commission increased New York Telephone's depreciation rates by $61 million annually in the most recent rate case.

INTRASTATE IMPACT

	Amount (Millions)	Monthly per Main Station
Station Connection Expensing	$150	$1.56
ELG Depreciation	36	.38

SUMMARY OF INTRASTATE IMPACT

	$(Millions)	$/Mo./Line
1) Industry Changes		
CPE contribution above embedded cost	$ 23	$ .24
Separations effect of removal of CPE	121	1.26
Yellow Pages	73	.76
Western Electric Prices	100	1.04
Reallocation of overheads to exchange service	152	1.58
Possible debt refinancing	238	2.48
2) Jurisdictional Changes		
Loss of intrastate interexchange	90	.94
3) Separations Changes (exclusive of CPE)		
Elimination of all subscriber plant from Separations formula	529	5.51
4) Capital Recovery Changes		
Station connection expensing	150*	1.56*
ELG depreciation	36	.38
	$1,512.	$15.75
% Increase	227%	227%

*This cost would more likely be recovered in one-time Service Connection Charges of about $90 for residence and $120 for business customers.

THE CONSENT DECREE

We were one of the many parties to take advantage of the opportunity to submit comments to Judge Greene. Our comments indicated that we do not oppose the basic objective of the Decree and that we believe that the divestiture of the Bell Operating Companies (BOCs) could foster competition in the telecommunications industry. We cautioned, however, that if the divestiture process imposed unfair financial burdens on the BOCs or unnecessary restrictions on their opportunities to grow and prosper in the future, their ability to deliver local service at reasonable rates could be severely damaged and the competitive process seriously harmed.

One of our major objections to the Decree is that it does not provide for separate representation of the interests of the BOCs prior to completion of the reorganization process. It is clear to us that the BOCs are still completely dominated by AT&T. Evidence of this is in the testimony of Bell Operating Company presidents before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee on Energy and Commerce of the House of Representatives (Wirth Subcommittee) and in other forums, in which they consistently refuse to criticize the Consent Decree, despite the substantial restrictions it would impose on the BOCs. They support the Decree on the grounds that it was the best settlement that "we" (i.e., AT&T) could obtain from the Justice Department. Because it is impossible as a practical matter for the BOCs to aggressively represent their own interests, we fear that the divestiture will be carried out in a way that maximizes the advantage to the competitive AT&T and maximizes the potential harm to the so-called monopoly Bell Operating Companies.

The second major flaw in the Decree, and it is related to the first, is the substantial restrictions to be imposed on the operations of the BOCs. AT&T Chairman Charles L. Brown has stated that these restrictions "weren't our idea" and that AT&T is opposed, generally speaking, to restrictions on any party. According to Assistant Attorney General Baxter, the restrictions are a necessary ingredient to the divestiture. He apparently believes that the only acceptable resolution of this case is a total structural separation of monopoly and competitive services. I believe that this approach is simplistic and that even Mr. Baxter's proposed settlement is not consistent with his

theory. For example, he did not require a structural separation between AT&T Long Lines and Western Electric and Bell Labs. He justifies this aspect of the Decree on the grounds that the interexchange market is competitive, and notes that "market share does not mean market power." Yet MCI won the biggest antitrust award in history because this market, although *legally* competitive, was subject to illegal anticompetitive behavior by AT&T. Also, the Wirth Subcommittee staff analysis of the interexchange market concluded it was not yet workably competitive and would not be for several years. Furthermore, the markets that the Decree would leave to the BOCs can no longer be considered clear monopolies. The Decree itself permits AT&T to compete against the BOCs for exchange business while forbidding the BOCs from competing against AT&T for any interexchange business. The fact of the matter is that *all* parts of the telecommunications industry are now or are potentially competitive, including the local exchange operation. There is simply no basis for a rigid position that the BOCs are monopolies and Long Lines is a competitive supplier. We have urged rejection of this over-simplistic view, and have supported the adoption of a pragmatic and balanced approach with respect to the restructuring of AT&T. Specifically, we support the lifting of all limitations on the BOCs. Others argue that more limitations should be put on Long Lines, such as an arms-length subsidiary provision as is contained in H.R. 5158 or a full divestiture as urged by some of the other critics of the Consent Decree. We would prefer, however, that the least restrictions possible be placed on both AT&T and the divested BOCs.

There are other provisions in the Decree to which we take exception, but they are much less important than the two major problems I have outlined. The restrictions on the BOCs are anti-competitive and they dim the future of these companies and their ability to serve the public. Unless some provision is made for separate representation of the interests of the BOCs and for the active involvement of the FCC and state regulators in the divestiture process, there is an unacceptably high risk that the division of physical assets and personnel and the terms of compensation for these assets and intangibles—such as the value of the Bell System logo, the access to trained people, "the going value" of some lines of business, which may exceed their book value—will be resolved in favor of AT&T.

FEDERAL LEGISLATION

I appeared before the Wirth Subcommittee on March 10, 1982, to support the prompt passage of comprehensive telecommunications legislation by Congress. I did so because I believe that Congress is the proper forum for the setting of telecommunications policy. As it stands right now, the Consent Decree will, directly or indirectly, have a major impact on telecommunications policy. And, as I have just mentioned, it will do so without the full and active involvement of the local Bell Operating Companies, state regulators, and the consuming public. It is principally because of the necessity of establishing national policy in the proper forum and correcting those portions of the Decree which need correction that I support legislation now.

As you may know, the Wirth Bill changed noticeably between the mid-March staff drafts and the one that finally passed the Subcommittee by a 15-to-0 vote. It appears that many provisions to satisfy special interests were included or modified in order to achieve greater political support. The Bill, as it stands now, has been described as a "Christmas tree." AT&T, of course, wants no legislation at this time and certainly not anything that looks like the present version of H.R. 5158. It would prefer implementation of the Consent Decree in its present form, perhaps with minor changes, and no federal legislation. While there are important provisions of H.R. 5158 which we favor, there are also provisions which are contrary to the interests of the local ratepayer, as well as other provisions which appear to deal harshly with AT&T and unfairly advantage its competitors. Should Congress decide to enact this legislation, I hope that improvements will be made in the Bill prior to its final passage. We have suggested some specific amendments to improve the Wirth Bill in terms of its impact on local operating companies and local exchange ratepayers, and we have acknowledged to our Congressional delegation that AT&T's opposition to some provisions of the Bill has merit.

The major points in the Wirth Bill which we feel are important and which we support in their current form are the following.

1. The separation of the BOCs from AT&T prior to the valuation of assets. *After* establishing new officers and distribut-

ing securities, AT&T and the BOCs would present proposed valuations—at market value—to a transitional joint board, dominated by state regulators, which would render an advisory opinion to the Attorney General who would determine the final asset values. The key here is separating the BOCs *before* valuation of assets and having oversight by governmental officials, including state regulators.

2. Yellow Pages would be returned to the BOCs. This is worth $73 million per year in profits to New York Telephone: $.75 per month for each access line.
3. For a transition period, patent royalties would be returned to the BOCs to provide compensation for past contributions to Bell Labs through the license contract.
4. Ownership of what is commonly called the "Class 4 Switch," the one that routes calls in and out of exchange areas, would be vested in the BOCs rather than in AT&T, as is provided in the Consent Decree. This would improve the quality of access and avoid the unnecessary duplication of facilities.

There are, however, a number of major changes we would like to see in the Bill prior to its enactment.

1. Access charges should be set by state regulators and not by the FCC. The FCC would simply not be able to cope with the large number of cost-based access tariffs that would result under the Consent Decree. Furthermore, each PSC is best able to determine the level of access fee necessary to maintain local exchange rates at a reasonable level.
2. We support amending the Bill to treat the BOCs the same as any other telephone company is treated. In addition, we specifically oppose the three-year hiatus in the BOC provision of new customer premise equipment as unworkable and unnecessary.
3. We object to the transfer of jurisdiction over intrastate interexchange service to the FCC. This change sounds good from a theoretical perspective, but as a practical matter there is no reason to usurp state jurisdiction in an area where local regulation has been effective.

4. We oppose the ban on centralized procurement by the BOCs until 1993 and instead propose limitations on Western Electric prices during a transition period during which BOCs will be essentially captive customers of Western Electric.
5. We oppose the provision that requires the FCC to reconsider its cellular radio decision in the name of increasing competition. A reconsideration would further delay the providing of this service. New York City has the largest chronic backlog of orders for mobile radio service in the nation and its citizens deserve a chance to enjoy this technology now.

AT&T objections to various other provisions of the Bill have some merit. These objections include the exemption of AT&T competitors from paying equal charges for exchange access, and some of the information disclosure provisions which at least arguably go beyond the amount of information necessary for competitors to design compatible equipment. Further, AT&T objects to restrictions on its ability to provide information services and alarm and environmental sensing services. We see no valid reason for these limitations; they appear to be simply special interest provisions.

STATE LEGISLATION AND OTHER INITIATIVES

New York not only supports deregulation initiatives in federal legislation and in FCC proceedings, but we have begun our own deregulation initiatives at the state level. First, the Commission has taken regulatory action to foster competition in the areas of terminal equipment, inside wiring, and radio telephone services. We were the first state to allow connection of customer-provided equipment to the telephone network without an expensive connecting device. We were also the first state to allow customers to provide their own on-premise wiring subject to relatively simple guidelines. Both of these actions preceded FCC action.

Along with these actions to foster competition, we have also begun to reduce the scope and/or complexity of our regulatory process in areas where competition provides adequate consumer protection.

For example, in the radio telephone field, we have adopted simplified carrier certification with a presumption in favor of granting all certificates where FCC spectrum authorization has been obtained. We will not bog down an application just because a competitor wants to keep out a new entrant.

After a carrier is certified, we permit the filing of "flexible tariffs." Flexible tariffs, whether for terminal equipment or for radio telephone service, specify a range of rates within which the carrier can change simply by giving notice to customers and to the Commission. No justification need be presented for changes within that range.

We also issued a policy statement on merchandising practices of telephone companies in which we found that all sales of equipment never in the companies' rate bases were not utility service and hence were not subject to tariff regulation. We issued accounting guidelines to companies to identify costs and revenues from such merchandising, and cautioned that utility revenues could not be used without our permission to fund nonutility ventures. Several companies now sell new terminal equipment both within and outside their normal franchise territories on an unregulated basis.

We have also proposed state legislation to give the Commission discretion to reduce or eliminate regulation where competition is adequate to protect the public interest. In 1981, we were successful in enacting legislation deregulating telegraphic services provided by telegraph companies. Under this law, the Commission could reimpose regulation only upon a finding that the public interest required it. This experiment appears to be working. After 11 months, we have had no problems with Western Union and we have at least one new telegraph carrier, ITT World Communications, that has decided to offer telegraph services in the New York City metropolitan area in competition with Western Union.

Unfortunately, our efforts to enact legislation deregulating radio telephone and regular telephone services have not met with success so far. Even though former Governor Carey made telecommunications deregulation part of his own 1981 and 1982 legislative programs, objections from within the industry have held up the proposed changes. Most of the opposition comes from New York Telephone, which has opposed any deregulatory efforts because of

its fear that the 1956 Consent Decree would prevent it from competing in any unregulated business. Even with the FCC ruling, subsequently confirmed by the Decree Court, that the deregulation of terminal equipment and the provision of enhanced services does not violate the Decree, New York Telephone continues to oppose this legislation.

We believe that the present statutory framework in New York has impeded development of competition in both radio telephone and landline markets. Some companies simply refuse to expose themselves to state regulation, and therefore our citizens never get a chance to try their services. MCI, Southern Pacific, and other interexchange carriers have avoided the intrastate provision of service because of the requirement of regulation. We have no intrastate resale carriers either, partly because they would have to be regulated and partly because of restrictions in telephone company tariffs. We have just ordered these restrictions removed in the hope that we can encourage development of a resale carrier industry even if it has to be regulated.

CONCLUSION

Technological advance is clearly the driving force behind the changes occurring in the telecommunications industry. Competition in the manufacture of hardware and in the distribution and provision of hardware and services holds the promise of more and better consumer services at lower prices than would be likely under regulation. The future is clearly competitive, perhaps even for basic exchange telephone service. As a state regulator concerned principally with the protection of the consuming public, I do not seek to inhibit the development of competition in telecommunications. I do, however, seek a reasonable transition to avoid severe rate increases over unduly short time periods. I also seek a fair consideration of valid public policy concerns and an active involvement of representatives of local consumers in the resolution of the difficult telecommunications policy issues we now face. With these protections for the consuming public, we can look forward confidently to the significant benefits that should flow from continuing development of telecommunications technology well into the future.