Comments on

"ACCESS CHARGES, COSTS, AND SUBSIDIES: THE EFFECT OF LONG DISTANCE COMPETITION ON LOCAL RATES"

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The telecommunications industry is in the process of significant restructuring as a result, in large measure, of the changing regulatory policies of the Federal Communications Commission and the antitrust settlement agreement between AT&T and the Justice Department.[1] In its *Computer II* inquiry decision,[2] the Commission allowed AT&T to enter unregulated markets and provide "enhanced" services which it had been restricted from supplying, and changed the treatment of terminal equipment by removing it from the rate base of regulated services. Other decisions have fundamen-

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tally altered the treatment of inside wiring and depreciation techniques used by the telephone companies.[3] The settlement agreement between AT&T and the Justice Department provides that AT&T shall divest the local exchange and local exchange access operations of the Bell Operating Companies (BOCs) and that the BOCs shall file exchange access tariffs providing nondiscriminatory cost-justified access to all intercity carriers, including AT&T. These decisions will affect the way that competitive intercity common carriers (OCCs) do business in the future. Of primary importance to the OCCs is the charge that will have to be paid in order to access the local network and the form of interconnection that will be provided by the local operating telephone companies.

The OCCs began offering switched voice intercity services in competition with AT&T in the mid-1970s.[4] These intercity carriers, as is the case with the similar intercity system operated by AT&T, are dependent on the use of monopoly local exchange facilities controlled and operated by the BOCs in order to connect their intercity terminals with the telephones of the calling and called parties. The Commission and the courts have established that the BOCs have a legal obligation to interconnect with OCCs in a nondiscriminatory fashion in order to provide such local distribution.[5] Subsequent to an explicit order of the U.S. Court of Appeals in 1978,[6] AT&T and the BOCs filed a tariff with the Federal Communications Commission entitled "American Telephone and Telegraph Company and the Bell System Operating Companies Tariff FCC No. 5," which contained AT&T's proposal for implementation of this legal obligation. Affected intercity carriers filed petitions against that tariff with the Commission, pointing out the severe technical and pricing problems in the tariff that demonstrated the BOCs' noncompliance with the court's mandate and the legal obligations of the BOCs. Since the assured, uninterrupted availability of these facilities was essential to the emerging competitive carriers, and because of the perceived complexity of the issues, the carriers negotiated an interim solution to these problems with AT&T under the aegis of the Commission. This agreement, known as the ENFIA (Exchange Network Facilities for Interstate Access) Interim Settlement Agreement, was presented to the Commission by the parties, and the Commission accepted and approved it in April 1979.[7]

The agreement called for AT&T to file a tariff setting forth the agreed-upon charges for local distribution, as well as certain formulae that would govern rate changes (i.e., increases) during the initial term of the agreement. The agreement did not change the technical form of local interconnection that the new intercity carriers had been using up to the time of its signing. In essence, this form is physically and operationally identical to normal home or business telephone service.[8] However, the intercity carriers have always taken the position that they are entitled to be treated not only as a *customer* of the BOCs, but as a *carrier* interconnecting with the BOCs. Therefore, the BOCs are under a legal obligation to provide forms of interconnection—and pricing therefor—that are nondiscriminatory vis-á-vis the form and pricing of interconnection provided by them to their present affiliate, AT&T (as well as to themselves when they function as intercity carriers).[9]

The AT&T antitrust settlement agreement will have a significant impact on both the form and the cost of the interconnection provided to the OCCs. The agreement deals explicitly with the interconnection of the OCCs with the operating telephone companies. It states that the interconnection offered to all intercity carriers shall be equal in type and quality to that provided to AT&T. Complete equivalency will not be achieved, however, until there is a new nationwide numbering system, probably around the turn of the century. The cost of service will reflect differences in the quality of service provided. Thus, carriers receiving less than equal access should pay less for it. The rates are to be unbundled for each element of access service. Finally, the settlement restricts the BOCs from using the Division of Revenues process to compensate local companies for use of their facilities.

On June 4, 1982, the FCC released its Fourth Supplemental Notice in the access charge proceeding[10] which addresses the rules to determine rates for access to Message Toll Service (MTS), Wide Area Telephone Service (WATS), Private Line and ENFIA services. It offers a number of proposals for allocating non-traffic sensitive costs. The investment in the equipment is presently approximately 50 percent of the BOC's total plant in service assigned to the interstate rate base. Because the proposed settlement will eliminate the Division of Revenue process, the notice also deals with the mechanisms to replace it.

Before we can address the merits of an access plan or define an equitable plan, it is important to define the goals that we expect it will achieve.

GOALS OF AN ACCESS CHARGE PLAN

There are two primary goals that should be achieved by an access charge plan. First, the access charges should be cost based. Second, and related to the first, any subsidy that is deemed necessary to achieve social goals must be explicitly provided for. This subsidy goal is largely reactive to the subsidy which is intertwined in the separations process today. Both goals, however, reflect the new pro-competitive telecommunications environment.

In their article, Cornell and Pelcovits highlight the need for access charges, as well as all local rates, to be cost based. We strongly support this goal. Adherence to it should ensure that a service that incurs costs will bear their full burden. To do otherwise would be to distort the actual cost of services and violate the principles of cost-based pricing that are vital to a viable competitive telecommunications industry.

Related to this goal is one of uniform and nondiscriminatory rates for equivalent service. That is, if access to the local network by the newer intercity carriers is the same as that of a local residential or business customer, then the price should be the same. The OCCs, no less than any other class of telecommunications service ratepayers, are entitled to obtain service at nondiscriminatory, just and reasonable, cost-based rates.

Although half a century ago the U.S. Supreme Court in *Smith* v. *Illinois Bell Telephone Co.*,[11] mandated that costs be allocated among jurisdictions based upon a reasonable consideration of the facilities being used, allocations to interstate service are currently weighted through the "Subscriber Plant Factor" (SPF). The alleged result of SPF is artificially to raise costs of interstate service, and lower costs of local exchange service. There is no way to trace the subsidy, however. When there was only one interexchange service provider, such a subsidy may have been acceptable; but it is totally inappropriate in the current competitive environment. Therefore, in order to determine cost-based prices, the present allocation of non-traffic sensitive plant must be significantly modified since it is inconsistent with the principles underlying a true cost-based separations process.

Should there be a need to subsidize local telephone rates beyond costs in particular circumstances (for example, based upon population density or unusually high costs of service that have been demonstrated rather than assumed), that subsidization should be labeled as such and should occur outside the separations or cost allocation process. It should be a matter for the appropriate governing body to impose directly under its tax power.

Usually, it is a relatively easy process to arrive at a general concensus concerning goals that are to be achieved. This is true whether the goals are for a business or for an industry (as in this case). There is probably little disagreement, for example, about the desirability of a cost-based pricing system in this environment which supports competition. However, it is much more difficult to come to agreement concerning the means to achieve that end. Therefore, we must identify strategies to achieve such goals and examine the constraints that exist.

STRATEGIES TO ACHIEVE THE GOAL OF COST-BASED PRICING

In order to achieve cost-based pricing, it will be necessary to revise the separations process that forms the basis for the allocation of costs between the interstate and intrastate jurisdictions. More detail concerning the separations process is therefore warranted.

The process of jurisdictional cost separations developed as a response to the provisions of the Communications Act, which gives states jurisdiction over intrastate telecommunications and gives the FCC jurisdiction over interstate services and rates. Development of separate rate bases for regulatory purposes is thus required, even though much of the plant items involved are actually used jointly for both such service categories. The original intent of separations was not ratemaking per se, but the development of a reasonable method of assignment of costs to the interstate and intrastate jurisdictions. Since 1930, the proceedings that have culminated in the establishment of the *Separations Manual* now embodied in the Commission's Rules, 47 C.F.R. Part 67, have represented a comfortable relationship between three classes of interested parties: the regulatory agencies (both the state commissions and the FCC), independent telephone companies, and AT&T. The result of previous separations proceedings has been a system that maintains rates for local exchange service at artificial levels by weighting the costs assigned to the interstate rate base. These arrangements were satisfactory to all concerned.

During the 1970s, however, there emerged a significant new variable affecting the appropriateness of separations, i.e., competition in telecommunications, particularly in interexchange services. The decisions of the FCC and the courts that such competition is lawful and in the public interest has spawned a new class of parties interested in and affected by the jurisdictional separations process. It is no longer sufficient that the separation of exchange plant costs between interstate and intrastate be accomplished in a manner satisfactory only to the "partnership" of independent telephone companies and AT&T which jointly offers interstate services. These new competitive carriers are no less entitled to obtain service at just and reasonable, nondiscriminatory rates based upon actual costs of providing service to them than is any other class of communications ratepayers. Any scheme or process of cost allocation that denies the OCCs that entitlement has no place in today's environment.

Although the *Separations Manual* has not been modified in a decade, separations procedures have changed dramatically. The current *Manual* nowhere mentions OCCs, ENFIA, or anything else related to competitive carriers. Thus, at present, there exists an undocumented, unregulated further allocation process within separations which is under AT&T's complete discretion.

The AT&T antitrust settlement requires that the BOCs file tariffs for the provision of exchange access to intercity carriers. The tariffs shall identify unbundled schedules of charges for exchange access services, and the tariffs shall replace the Division of Revenue process for allocation of revenues for exchange access between BOCs and AT&T. There is still a need, therefore, for a way to separate the plant between that used specifically for local service and that used for intercity service, and to allocate costs to the various categories of services (i.e., MTS, WATS, Private Line, ENFIA) and jurisdictions (i.e., intrastate, interstate).

Direct assignment of costs whenever possible, as identified by Cornell and Pelcovits, is a way of ensuring nondiscriminatory pricing. Direct assignment will assure that a service that incurs costs unique to it will bear the full burden of those costs. To do otherwise would result in distortions in the actual cost of services. To spread the cost of an investment made specifically for one service over all services results in lower costs for that one service and higher costs for all others, which must share the burden of the investment cost. Alternatively, having a low cost service share the cost of plant which it does not use artificially raises its cost. This direct assignment of costs is essential in a competitive environment where the distribution of costs that lowers the price of a service may reduce, or even eliminate, the potential for competitive entry. Therefore, direct assignment of costs to specific services should be accomplished in all instances where such assignment is possible.

Furthermore, the cost of all commonly used plant should be equitably allocated either to those services jointly using it or to the user himself, as in the case of a telephone subscriber loop. An important corollary to this principle is that customers or services not using that plant or equipment should not receive an allocation of its costs. This corollary is particularly significant to nonpartnership interexchange carriers. They do not and cannot now use the local exchange network in the same way it is used by "partnership" message services (i.e., MTS and WATS). Some equipment is not used at all, and some is used in a very different manner. The costs assigned to the OCCs for access vis-à-vis the other interstate service categories should reflect these differences.

Presently, the OCCs pay for exchange access under the ENFIA tariff. According to the tariffs, a price discounted from what AT&T claims is the cost of local access for Long Lines is charged to the OCCs. The fundamental error in this costing formula is that the services provided are not comparable. Rather than applying a discount, an appropriate formula should have been identified. A very simple illustration of the discrepancy between the MTS-type service and OCC's (ENFIA) service is that OCC customers dial 23 to 25 digits to place a call. First, a customer must dial the local 7-digit number; a computer answers and the customer punches in a 6- to 8-digit authorization code and then the 10 digits of the party being called. If that same customer called over AT&T's Long Lines network, only 10 or 11 digits would be needed. It is clear, therefore, that the ENFIA rates that are derived from the cost to Long Lines of the use of local exchange plant are in no way cost based.

It is unavoidable that the OCCs offer their service at a lower rate because the service is inferior to MTS service, as the above example demonstrates. In addition to the high number of digits required to place a call over an OCC service, the quality of the service is often lower. This degraded quality is a function of the inferior form of access offered to the OCCs, and it forces them to add quantities of additional equipment to compensate for the poor signal.

Cost-based exchange access pricing should produce proper economic signals to AT&T and its competitors. That is, the price of the various forms of interconnection should reflect their quality. If the proper relationship between the interconnection now provided and equalizing enhancements that must be forthcoming under the settlement is not maintained, full competition will not develop. To determine appropriate service prices that will not discriminate among carriers, we have supported the unbundling of the exchange access tariffs. The unbundling should be developed to allow carriers to select among alternative components of exchange access service and to compensate the local operating companies for only those components used. This has been called the "menu" approach to local exchange access tariffs.

Under the terms of the settlement, the BOCs will file unbundled tariffs for exchange services which replace the Division of Revenues process. Specifically it states:[12]

> Each tariff for exchange access shall be filed on an unbundled basis specifying each type of service, element by element, and no tariff shall require an interexchange carrier to pay for types of exchange access that it does not utilize. The charges for each type of exchange access shall be cost justified and any differences in charges to carriers shall be cost justified on the basis of differences in services provided.

The definition of the exchange access "elements" in the unbundled tariff will be critical to the proper allocation of costs and to an assurance that the types of access that are not used by an individual carrier are not paid for by that carrier. For example, the OCCs presently do not use operators to complete their calls. Therefore, the charge for operator services should be unbundled to allow other carriers to purchase it, if so desired. Other carriers would not be forced to pay for any part of operator services if they do not purchase this service.

The Department of Justice's *Competitive Impact Statement*, issued February 2, 1982, goes further in defining the unbundled tariff:[13]

> Such access arrangements must be offered on an unbundled basis with separate, cost-justified charges for each element of access. Section IV defines "exchange access" to mean the provision of exchange services for the purpose of originating or terminating interexchange telecommunications. These services include any activity or function performed by a BOC in connection with the origination or termination of interexchange telecommunications, including, but not limited to, the provision of network control signalling, answer supervision, automatic calling number identification, access codes for the interexchange carriers, directory information services, testing and maintenance of facilities, and the provision to the interexchange carrier of information necessary to bill its customers.

We support the Justice Department's direction. The identification of individual tariff elements should result in cost-based prices. Further, it should restrict the BOCs' ability to charge carriers for services not received.

Even though under the settlement the structural alterations in the Bell System should lessen the opportunity and incentives for anticompetitive abuse, many aspects of AT&T's structure will remain in place. Therefore, it is likely that some incentives for tailoring exchange access services and prices to AT&T's needs will remain. AT&T will continue to influence the BOCs and to be the principal provider of interexchange services. It will retain control over Bell Labs and Western Electric and will therefore be a major supplier of research and development and telecommunications equipment. The OCCs, on the other hand, will deal with the BOCs only as customers purchasing local distribution facilities. It would be difficult to believe that AT&T will not have more influence over the BOCs than will the OCCs.

Further, dissolution of the corporate structure does not automatically eliminate or terminate long-held loyalties and convictions. The realities of human nature strongly suggest that the present BOC management will not be governed solely by economic considerations when dealing with AT&T management with whom they have worked for years. Similarly, the BOCs may have strong feelings about AT&T's competitors who were obviously a major impetus behind the modified decree.

CONCLUSION

There has not yet been full and fair competition in the telecommunications industry. The OCC competition has discovered that there is a market for lower quality, discounted service. However, the OCCs combined have less than 5 percent of the long distance switched services market. The access service provided to the OCCs is inferior to that offered to AT&T Long Lines, and the price set for this access to the local monopoly bottleneck facilities is negotiated rather than cost based. The settlement decree promises to alleviate some of the problems faced by competitors through the removal of AT&T's control over these local facilities. The flow of funds throughout the system under Division of Revenues, which obfuscates the real cost of providing local service, will be removed. It is to be hoped that the result of the settlement will be the increased incentive of the local operating companies to provide fair treatment to AT&T's competitors.

Payment to the local telephone companies—primarily, but not exclusively, to Bell Operating Companies—represents the largest expense category in most OCC operations. The OCCs' cash flow, its marketing strategies, and its growth are affected by these payments. It is axiomatic that the establishment of fair and equitable prices for its exchange access is a matter of gravest import to these new carriers.

We strongly support the concept of cost-based pricing for access service elements. As is recognized by the settlement, it is imperative to provide competitors with the flexibility to develop differentiated services and products if those competitors are to survive. To charge all competing carriers equally, irrespective of the services used, or to fail to charge one competitor for all services rendered, would undermine the incentive to offer alternative services and would jeopardize the existence of the competition.

The Cornell-Pelcovits article, while its fundamental tenor may seem radical to those used to the historic industry structure and practices in telecommunications, in fact embodies a philosophy whose time has come. If these concepts are not implemented during

10. Fourth Supplemental Notice of Inquiry and Proposed Rulemaking, 90 FCC 2d 135 (1982).

11. 282 U.S. 133 (1930). See Section 202(a) of the Communications Act, 47 USC § 202(a).

12. Appendix B, Paragraph 2, page 3.

13. *Competitive Impact Statement* of Department of Justice in CA No. 82-0192, filed February 1982, at 32.