

The AT&T Settlement:

***Terms
Effects
Prospects***

THE AT&T SETTLEMENT, LOCAL OPERATING COMPANIES,
AND THE CONTESTABILITY OF LOCAL DISTRIBUTION MONOPOLIES

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The Justice Department's justification of the Consent Decree is based largely on anti-trust considerations rather than necessarily on the public interest criteria of the Communications Act of 1934. But even within the former standards there are flaws which offset the pro-competitive aims of the Decree.

The primary problem is the strict containment of the Bell Operating Companies (BOCs) by Section II(D) of the settlement document: "...no BOC shall, directly or through any affiliated enterprise:

1. provide interexchange telecommunications services or information services;
2. manufacture or provide telecommunications products or customer premises equipment (except for provision of customer premises equipment for emergency services); or
3. provide any other product or service, except exchange telecommunications and exchange access service, that is not a natural monopoly service actually regulated by tariff."

The rationale for this provision is, from the Justice Department's Competitive Impact Statement:

"The prohibition contained in paragraph II(D)(2) against the manufacture or provision of customer premises equipment (or other telecommunications products) by a divested BOC will prevent the reemergence of the same incentive and ability to leverage regulated monopoly power into the customer premises equipment market as exists in AT&T as presently structured." (p. 41). Specifically, it is feared that a local distribution monopoly will permit the cross-subsidization of prices and development costs of competitive services by the regulated ones, thus causing an unfair advantage over rivals and creating barriers to entry.

Through these provisions we have reached the complete reversal of the pre-Carterfone situation. Where once the BOCs were, in effect, the only suppliers of equipment with access to customer, the Decree now grants such rights to everyone except them. If the goal of anti-trust policy is to promote competitive markets, these provisions are counterproductive by their creation of a category of huge but static and potentially stagnant communications companies. For example, on what competitive grounds should BOCs be prevented from entering markets in areas outside their local exchange territory?

Neither is it clear why BOCs should be restricted as severely as they are in their operating areas. Before the Decree, national telecommunications policy had evolved rapidly toward the concept of the fully separated subsidiary for the provision of unregulated service, and under Computer II the FCC could allow a BOC's entry into an untariffed enhanced service. The same principles should

also apply to the BOCs, who could spin off subsidiaries of their own. Such subsidiaries would not come close to the economic power of the subsidiary of a pre-Decree AT&T, which had seemed acceptable.

While the underlying economic rationale for containing the BOCs is their ostensible ability to cross-subsidize the unregulated part of their business, the theoretical underpinnings for this assumption are in dispute in the economic profession. William Baumol, outgoing President of the American Economic Association, described in his recent Presidential Address the emerging "rebellion" in the view of industry structure and behavior.* By introducing the concept of "contestable" markets, i.e., those with potential entrants, Baumol and his co-authors demonstrate that an attribute of an equilibrium in such a situation is the inability to maintain a subsidized price, "the fact that price must always at least equal marginal cost--which is important for the economics of antitrust and regulation. For it means that in a perfectly contestable market, no cross subsidy is possible, that is, no predatory pricing can be used as a weapon of unfair competition." (p. 5).

Of course, contestability may never exist in perfect form. The number of potential competitors itself is not conclusive, and contestability could hypothetically be achieved with only a few

* Baumol, William J., "Contestable Markets: An Uprising in the Theory of Industry Structure," 72 AER 1 (March 1982). These views are presented in more detail in Baumol, William J., John C. Panzar, and Robert D. Willig, Contestable Markets and the Theory of Industry Structure, San Diego: Harcourt Brace Jovanovich, 1982.

aggressive entrants. Yet one would expect it to be more closely approached when a group of experienced communications companies--the BOCs--are left to enter and contest, to compete against each other and against AT&T. In the same recent issue of the American Economic Review, Harold Demsetz, another noted economist, attacks the usefulness of public policy designed to offset "barriers to entry"--here the predatory ability of BOCs to underprice their competitive operations--by considering the concept of "barriers" as useless due to, among other reasons, its arbitrariness in defining and excluding costs and benefits of economic activities.*

One cost of the 1956 Decree had been its slowing down of the diffusion of several technological innovations; Computer II was a public policy response to the issues raised by these restrictions. Hence, it seems counterproductive, from a pro-competitive point of view, to put even more onerous restrictions on able and willing entrants.

The BOCs' entry into customer premises equipment (CPE) and unregulated services through fully separated subsidiaries would increase the number of competitors in these markets and reduce the market dominance by the future AT&T. On the other hand, by excluding BOCs from equipment manufacture, and given Western Electric's historic relation with the operating companies, the BOCs' equipment purchases may remain as a practical matter captive to AT&T for a long time.

Neither is it clear why the--money-losing--white pages

* Demsetz, Harold, "Barriers to Entry," 72 AER 47 (March 1982).

should remain with the BOCs while the latter seem to be precluded from providing the highly profitable Yellow Pages, despite the complementarity of the two operations. Furthermore, there seem to be several outright inefficiencies in the choice of the point of separation between BOC and interexchange service. The Decree appears to assign the ownership of "Class 4" switches in their interexchange routing function to AT&T, leaving BOCs without switching points to provide access to other carriers, thereby necessitating the creation of duplicative facilities as well as giving AT&T a competitive advantage over other long distance carriers.

Ultimately, it is a belief in the permanence of local distribution monopoly by telephone companies that leads to policies that restrict different modes of telecommunications to specific turfs. Yet even in local distribution a dynamic element exists due to the emergence of cable television as an alternative distributor and restraining force.

Much has been made of the BOCs' ability to offset the lost AT&T cross-subsidy from long distance service by imposing access charges. But their ability to set prices substantially above marginal cost is weakened by the possibility of having their local distribution network bypassed altogether through the use, at least for high volume traffic, of broadband cable communication distribution with appropriate switching capability.

A second set of communications wires--those of cable television--has come into existence, partly because of the past cable

cross-ownership restrictions on AT&T. Its use for competitive distribution purposes seems inevitable. Being under no universal service and common-carrier obligation, cable carriers could underprice telephone companies, or at least reduce their ability to subsidize one class of customers by the contributions of another.

Furthermore, cable companies are free to supply an array of complementary communications service such as pay programming and interactive services, none of which telcos can offer under the Decree. The likely consequences of this imbalance are then either that the telephone companies will increasingly serve marginal customers, at higher rates, or that service obligations and regulatory restrictions be extended to cable operators so as to make competition between the two transmission modes more equitable. Yet the most logical approach for a public policy predicated upon the encouragement of competition would be to permit willing and able entrants to contest each other.

Under the Decree, AT&T seems free to provide cable television services, and this has caused some opposition by the cable industry. Less clear, though potentially more important, is the extent of a BOC's right of entry into cable transmission. It could do so if cable television were a "natural monopoly" and were provided under a tariff. The former issue has been in dispute, though a recent statistical production function analysis by the author* indicates that cable distribution strongly exhibits the primary

* Noam, Eli, "Is Cable Television a Natural Monopoly?" Paper delivered at the annual meeting of the American Economic Association, Washington, D.C., December 1981.

characteristic of natural monopoly, i.e., steadily falling average costs.

The second condition for a BOC communication service, namely its provision on a tariffed basis, is an issue for state commissions. It is possible that in the future BOCs would start to push into the direction of providing broadband video transmission on a regulated common-carrier basis as one of the few avenues of expansion left to them. The results could be hence, in the long run, an increasing overlap of local telephone operations and of cable television, with each invading the other's previously monopolistic turf. This is a positive development, since it reduces two major monopolistic bottlenecks in telecommunications: local telephone distribution, and local cable television franchises (the latter coupled with programming control over scores of video channels). The positive potential of these trends, however, is reduced if BOCs are left with unequal service obligation and few of the business opportunities which other communications companies enjoy, i.e., if they are vulnerable in their own markets and precluded from invading those of others.

One explanation to the II(D) restrictions on BOCs, one must suspect, lies in the parent AT&T's unwillingness to foster its future competitors. This is understandable from AT&T's economic point of view, but is it in the public interest?

The details as well as the principles of the divestiture have put the BOCs' interests into conflict with those of AT&T, their present master but future competitor. Ironically, it has

been left to state commissions to protect, indirectly, "their" BOCs before Judge Greene. A more direct way ought to be taken, such as court appointments of independent representatives for each BOC's interest.