

CHAPTER

7

THE FEDERAL-STATE FRICTION BUILT  
INTO THE 1934 ACT AND  
OPTIONS FOR REFORM

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No other western country besides the United States has a two-tiered level of telecommunications regulation. The sole exception was Canada, until its Supreme Court's *Alberta Government Telephones* decision,<sup>1</sup> which left little in provincial jurisdiction. This makes the United States a minority of one. How can one explain the existence of a two-tiered regulatory structure in U.S. telecommunications?

This is not just an issue of theoretical concern. These two tiers have often been at odds in recent years, and this conflict affects the development of telecommunications policy. So we need to understand the dynamics of state-federal friction.

It is frequently and mistakenly believed that telecommunications regulation by the federal government originated with the 1934 Communications Act. In fact, its antecedents can be traced to the founding of the nation. The U.S. Constitution assigned Congress the general power "To regulate Commerce . . . among the several states" as well as, more specifically, "To establish Post Offices and post roads" (Art. I, Sec. 8). Such authority over interstate commerce and the postal infrastructure provided the background for subsequent federal interest in telecommunications, which was first executed through Congress and the Post Master General.

Federal intervention in telecommunications appeared with the very dawn of telegraphy. In 1843, Congress appropriated \$30,000 so that Samuel F.B. Morse

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<sup>1</sup>*Alberta Government Telephones v. CNCP Telecommunications, CRTC, and the Attorney General of Canada.* (1989) 2 S.C.R. 225.

could build the telegraph line from Washington to Baltimore over which he first demonstrated the practicality of his invention. Within 20 years, the Federal government was regulating telegraph rates under the Pacific Railroad Act of 1862, which provided for Congress and the Post Master General to set rates if railroad and telegraph annual profits exceeded 10% of cost.

In the first years of the 20th century, the states, led by Wisconsin and New York, began exerting their own authority over railroads, energy, and communication. With reasoning that varied from state to state,<sup>2</sup> states began to establish public service commissions and take over telephone regulation from municipal authorities, which had been regulating the new service as part of their control over public rights of way within their jurisdiction.

In 1910, Congress attempted to distinguish federal and state roles in telecommunications with the Mann-Elkins Act,<sup>3</sup> which gave the ICC regulatory authority over interstate telecommunications. The distinction between federal and state jurisdiction was based on the physical test of *interstate* versus *intrastate* segments of communication.

#### FEDERAL-STATE JURISDICTIONAL AUTHORITY AND THE COURTS

Very shortly thereafter, the Supreme Court decided the so-called *Shreveport* cases,<sup>4</sup> which, although being cases about railroads, had a lasting effect on relations between the states and federal regulators in telecommunications as well. The Texas Railroad Commission had been trying to win competitive advantages for Texas ports by imposing discriminatory railroad rates affecting a rival port, Shreveport, Louisiana. The ICC intervened against the Texas Commission, and the U.S. Supreme Court upheld its action. As a result, the ICC assumed powers over intrastate tariffs where such tariffs had substantial impact on interstate commerce. This became known as the *Shreveport* test, which in the 1920s reduced the role of the states in railroad regulation.

When the 1934 Communications Act was being drafted, ostensibly only to move the ICC's telecommunications jurisdiction to a new, specialized agency without any policy changes, most of the states strongly lobbied for excluding the *Shreveport* railroad standard from telecommunications regulation. And indeed, they won several sections, most particularly Sec. 2(b)(1), which says "nothing in this Act shall be construed to apply or to give the [FCC] jurisdiction . . . for or in connection with intrastate communication service of any carrier." In other words, the pre-*Shreveport* jurisdictional separation was re-established through language that is

<sup>2</sup>For example, Wisconsin's PUC emerged in part from Governor Robert La Follette's Progressive reform efforts, and New York established state regulation in part to stave off European-style nationalization of infrastructure sectors. (See Gabel, 1987.)

<sup>3</sup>49 U.S.C 10301 (1982).

<sup>4</sup>See especially, *Houston, E. & W. Tex. Ry. v. United States*, 234 U.S. 342 (1914).

both an exclusionary clause and a rule of construction—a powerful protection to the states that sought it.

The ICC, which was getting out of the telecommunications business, had little incentive to oppose this. The FCC had not been created yet and could not fight for its jurisdictional prerogatives. And AT&T, the giant in the industry, actually liked the provision, as did the smaller independent telephone companies. They understood that the FCC, part of the New Deal “alphabet soup” of activist agencies, began on the left of the political spectrum, that is, focused on redistributive goals and was very much proconsumer. The state commissions had been around for a while, and had traveled further through the life cycle of regulatory commissions, which often includes a period of vigorous youth, followed by maturity characterized by a “subtle relationship in which the mores, attitudes, and thinking of those regulated come to prevail in the approach and thinking of many commissioners” (Bernstein, 1955, p. 78).<sup>5</sup> AT&T, the world’s largest corporation, preferred to deal with the state commissions, most of which had no more than a handful of staff to regulate several industries. The comfortable state devils it knew were preferable to the unknown federal ones. Therefore, it was lining up in favor of maintaining or protecting state regulation.

From its perspective, AT&T’s concerns were justified. One of the FCC’s first actions after it was created was an investigation of the telephone industry, led by Commissioner Paul Atlee Walker. That investigation led to the Walker Report of 1939,<sup>6</sup> which, though not adopted by the Commission, led after World War II to an antitrust lawsuit (1949) that resulted in the 1956 Consent Decree, which in turn begat the next antitrust lawsuit and the AT&T divestiture.

The initial policy divergence between the states and the FCC soon disappeared, however. This happened in part because the FCC was also being gently moved by the interplay of powers into an equilibrium similar to the states’. Thus there emerged from the late 1930s and into the 1970s a remarkable system of *co-regulation*, characterized by a substantial cooperative spirit. The states were mostly in charge of local service; the FCC was mostly in charge of long-distance service. Both were solicitous of AT&T, which steadily extended service throughout the nation at declining real rates and established what was widely recognized as the best telephone system in the world. Moreover, AT&T’s financial stability throughout this period made it a model investment for many Americans, creating still another broad constituency in favor of the status quo.

This structure started to program its own decline when it began to draw on long-distance service to subsidize local residential rates. The decision was made by state regulators, shortly after World War II, partly in response to political

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<sup>5</sup>For other perspectives on capture or life-cycle theories, see for example, Stigler (1971, 1975), Posner, (1974), Peltzman (1976), Edelman (1964), and Olson (1982). For earlier critiques that also analyzed the ties between regulators and the regulated, see Huntington (1952) and Jaffe (1954).

<sup>6</sup>Federal Communications Commission, *Investigation of the Telephone Industry in the United States*, H. Doc. No. 340, 76th Congress, 1st Sess., Washington: GPO, 1939.

pressure. U.S. Senate Majority Leader Ernest W. McFarland (D-Arizona), who also chaired the Senate Communications Subcommittee, was the spearhead. The trend was supported by AT&T, which saw it as part of an implicit bargain in which it would hold residential rates low through cross-subsidies from long-distance service in return for entry barriers to potential competitors.<sup>7</sup>

At the same time, the policy of "universal service" was pursued throughout the country, in which networks connected new subscribers beyond the point of purely economic equilibrium. Redistributory mechanisms took hold through which the majority of the network users, via political means, extracted a subsidy from a minority of the network users. As redistribution grew, some users wanted to leave the network, at least for part of their communications needs, if legally permitted to do so. As this process developed, it led to the rift between the states and federal officials.

Federal regulators were more amenable to local competitive entry because the long-distance rates for which they were responsible were declining. The federal regulators had the rare privilege to preside over an industry segment whose prices dropped as performance rose. They were also at a comfortable distance from any grassroots discontent, in contrast to state regulators, who in some states are elected and generally are held more directly responsible for telephone rates. As a result, the FCC, which started out during the New Deal to the left of the states, moved to the right of the states.

The rift first opened over the interconnection of terminal equipment not supplied by the Bell system. Many states, led by North Carolina, opposed the connection of subscriber-owned terminal equipment until they were decisively rebuffed by the courts,<sup>8</sup> which held that the states' jurisdiction was limited to local services and facilities, as well as matters "that in their nature and effect are separable from and do not substantially affect the conduct or development of interstate communications."<sup>9</sup> Because the court's decision concluded that even the handset in the customer's home affected interstate communications, it in effect mooted the 1934 Act's separation of intrastate and interstate that had been the legal linchpin of the cooperative system.

## JURISDICTIONAL IMPACT OF CHANGES IN NETWORKS

When the AT&T network monopoly began to disintegrate and rivals emerged, their interconnection with the traditional network became essential, which has

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<sup>7</sup>See, for example, deButts' (1973) speech to the National Association of Regulatory Utility Commissioners, which argued that competition in the telecommunications sector "cannot help but in the long run hurt most people," by destroying the system that allowed monopoly providers to furnish dependable, economical service (quoted in Coll, 1986, p. 40).

<sup>8</sup>*North Carolina Utilities Commission v. FCC*, 537 F.2d 787 (4th Cir. 1976); *cert. denied*, 429 U.S. 1076 (1976); 552 F.2d 1036 (4th Cir. 1977); *cert. denied*, 434 U.S. 874 (1977).

<sup>9</sup>537 F.2d at 793.

two implications. First, through the addition of interface points, the network over time becomes increasingly modularized. Second, new entrants begin cream-skimming, that is, they attack the above-cost segment. Interconnection arrangements were established, for example, in the *Carterfone*<sup>10</sup> decision that allowed subscriber-owned terminal equipment to connect to the network, and the *Execunet*<sup>11</sup> decision, which allowed long-distance carriers to interconnect into the local loop of the traditional network.

Modularization and interconnection are not just of historical interest. Modularization will inexorably continue and will have profound implications on federal-state relations. At the simplest level, the states have opposed many interconnection arrangements such as those just described because they identified their interests with those of the monopoly.<sup>12</sup> The myth is that in the *North Carolina* case, for example, the states were not really opposed to interconnection of terminal equipment but were really fighting for states' rights. This is reminiscent of the argument that the Civil War was fought primarily over a procedural—the scope of states' rights—rather than over a substantial policy disagreement. In telecommunications, there was also a substantive policy disagreement. States believed that local telephone rates could be kept down by the contribution from equipment profits. This was AT&T's argument. From the consumer's perspective it was flawed, but many state regulators accepted it.

As the modularization of the network increases, ever greater parts of telecommunications service will be composed of multiple blocks or modules. As a direct consequence, notions of interstate and intrastate services will blur because the component modules of each service will cross jurisdiction: some of them will be interstate, some of them will be intrastate, some of them will be international, and others will exist nowhere physically. Networks are becoming relational, not locational.

The traditional notion of jurisdictional separation found in the 1934 Act was based on a linear, spatial concept of what a network was, borrowed from earlier railroad regulation: local was close, long distance was far, international still farther. This was based on network architecture, which was in turn based on technology and economics. Networks were largely configured to minimize transmission distance. But today, transmission has become a much smaller portion of telecommunications costs and will continue to decline, making telecommunications relatively distance insensitive. As a result, the nature of the network architecture changes, with a series of consequences for the jurisdictional question.

Network modularity and interconnectivity affect not only transmission, but also switching, including local switching, which traditionally was the essence of

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<sup>10</sup>*Use of Carterfone Device*, 13 FCC 2d 420 (1968).

<sup>11</sup>*MCI Telecommunications Corp. v. FCC*, 561 F.2d 365 (D.C. Cir. 1977). (*Execunet I*); see also *MCI Telecommunications Corp. v. FCC*, 580 F.2d 590 (D.C. Cir.), *cert. denied*, 439 U.S. 980 (1978), (*Execunet II*).

<sup>12</sup>See the discussion of *North Carolina Utilities Commission v. FCC*, *op. cit.*, *supra*.

intrastate jurisdiction. The FCC's *Arco* decision, which allowed users to interconnect to the local exchange of their choice as long as it is "privately beneficial without being publicly detrimental,"<sup>13</sup> marked a significant step toward breaking the grip of state jurisdiction on switching, even though it received little attention. The FCC's decision, which in effect permitted one telephone company to interconnect into another telephone company's central office, suggests that just as one can plug a "Mickey Mouse" telephone or a PBX into the network, one can also plug an entire network into the network. And although in this instance it was one Texas-based LEC versus another (Southwestern Bell vs. GTE), there is no reason why interconnection on this scale could not occur across state lines. Once that happens, local switching may just as easily be interstate as intrastate.

Another issue arises with the emergence of private networks, first for large users and user groups such as banks, universities, manufacturers, and their suppliers and dealers. This means that a network ceases to be a territorial concept and becomes a group concept. It becomes a functional rather than a spatial arrangement. The concept of "intrastate" will become a relatively meaningless concept in this environment. For example, the interconnection of stock markets was begun as merely an arrangement to facilitate data transfer. But in time, with computers talking to computers located everywhere in the world, the physical location became meaningless. The network has become the market, and the market exists in no physical location. As the notion of the "New York market" loses its meaning, so does that of the "New York network."

This evolution can also be moved beyond group networks. Just as we now have personal computers, which only two decades ago was a concept that people did not anticipate, we can also think of personal networks in the future. These are custom-tailored, individualized networks that are configured along the lines of individual needs. As we look ahead, then, we can expect arrangements that do not fit the traditional notion of what a network looks like and the jurisdictional basis for its regulation.

The increasing importance of software also contributes to the diminished locational aspect of telecommunications networks. It is very difficult to say exactly where network software is physically located. For example, software can mean control functions that interact and that are distributed. It can mean interaction of databases, programs, and processes undertaken at locations that are far apart from each other.

Another prospect is that the fiber-based fast-packet-type network of the future may create a kind of "fiber ether." Communications will no longer move on a point-to-point line but along an increasingly dense matrix through which the information routes itself. This would be the case in a fast-packet environment such as envisioned in SONET. In such an arrangement, it would become impos-

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<sup>13</sup>*In re Atlantic Richfield Co., Memorandum Opinion and Order*, 3 FCC Rcd 3089 (1988) at 3091, *aff'd sub nom., Public Utility Comm'n of Texas v. FCC*, 886 F.2d 1325 (D.C. Cir. 1989).

sible to determine how the information moves, much less whether it moves interstate or intrastate. In fact, it can be both at the same time, with part of the information in a single call moving one way and part of it moving another way.

What are the implications of these technological changes? One is that in the future the core of identifiably intrastate communications activities will shrink continuously. Furthermore, the share of communications activities generally that are regulated by anybody is going to shrink. The net result is a shrinking share of a shrinking share, which means that state regulation will be under continuous pressure.

In this evolution, the courts, until recently, have given the FCC most of what it wanted to deal with changed circumstances. For example, the North Carolina case referred to earlier established an "adverse effect test." The court said, in essence, that if the FCC believed a state's action was adversely affecting federal regulation, the court would support the FCC.

However, the courts have in recent years become generally more involved in resolving telecommunications policy disputes and significantly more likely to overturn FCC decisions in recent years. In the first 35 years after the Communications Act was passed, 37 common carrier decisions were reviewed by the circuit courts. Of those 37, only 5 (16%) were reversed or remanded. From 1970 through 1978, a period during which the FCC began opening the markets for network equipment and long-distance service, these same courts reviewed 61 common carrier decisions and reversed or remanded 14 of them (about 23%). As deregulation took hold and the network disintegration process outlined earlier gained momentum from 1979 through 1989, the courts took on 129 of the Commission's common carrier decisions (an average of one every month) and decided against the FCC in 38 cases, or 30% (Blau, 1990).

Against that background, it is not surprising that in several cases (e.g., *Louisiana*,<sup>14</sup> *California*,<sup>15</sup> *NARUC III*<sup>16</sup>) courts have pulled back from the adverse effect test that presumed in favor of the FCC. This change is a result of a coalition of results-oriented liberals and states'-rights oriented traditionalists. Conservatives had always had a dilemma on the issue of preemption, as they favored both deregulation and states' rights. Both are conservative values, but they tend to conflict when the FCC tries to impose deregulatory rules on the states. The Reagan administration, having to make the choice, picked deregulation as the priority and left states' rights as less important when the chips were down. Some conservative judges did, too. For example, Warren Burger, when he was still a circuit court judge, upheld federal jurisdiction, writing: "Any other determination would tend to fragment the regulation of a communications activity which cannot be regulated on any realistic basis except by the central authority. Fifty states

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<sup>14</sup>*Louisiana Public Service Commission v. FCC*, 476 U.S. 355 (1986).

<sup>15</sup>*People of the State of California v. FCC*, 905 F.2d 1217 (9th Cir. 1990).

<sup>16</sup>*NARUC v. FCC*, 880 F.2d 422 (D.C. Cir. 1989).

and myriad local authorities cannot effectively deal with bits and pieces of what is really a unified system of communication."<sup>17</sup>

However, his successor, Chief Justice William Rehnquist, has been considerably more states'-rights oriented, and Justice Brennan, one of the Court's longtime liberals, also took a very "original intent" approach to the Communication Act's jurisdictional separation in the *Louisiana* decision.

What is thus emerging, in particular in the *California* case, is a return to a very literal reading of the 1934 Act. And this as if the underlying environment has not changed dramatically: In 1934, 98% of all calls were intrastate and all the new telecommunications services and network architectures previously described did not exist. The environment has changed radically, yet the courts are returning to a very literal reading of what is intrastate and what is interstate.

## POSSIBLE SOLUTIONS

This raises the question of what the right way to deal with this problem may be. There are several types of nonconflicting regulation.

***Total Deregulation.*** Eliminate regulation and the jurisdictional problems disappear, but it is unlikely that total deregulation is feasible for some time. In a partly competitive system with bottlenecks, numerous functions remain for expert agencies to ensure the functioning of a pluralistic network. For example, interconnection issues such as financial charges and content access may require a regulatory arbitrator.

***Exclusive Federal Regulation.*** The concept of a regulatory "czar" is based on an essentially romantic notion that one decisive person or agency might be able to overcome all of the contradictions in the various pulls and pushes of society.

A variant is:

***Exclusive Federal Jurisdiction With Some Regional Variation.*** This might entail an arrangement like the field offices of the FCC that would differentiate, for example, between the more rural U S West region and the more urban NYNEX territory.

***Exclude Federal Jurisdiction Altogether.*** This is the other extreme, and it creates problems of an absence of cohesion, particularly now that the Bell system, which used to provide uniformity standards nationwide, has been splintered.

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<sup>17</sup>*General Telephone Co. v. FCC*, 413 F.2d 390 (D.C. Cir.), cert. denied, 396 U.S. 888 (1969).



If one looks at the jurisdictional issue in a detached way, as illustrated in chapters 5 and 6, one can find the benefits derived from both federal and state involvement. For example, to have only federal jurisdiction would mean that the federal government would have total regulatory rights over local franchising. Federal regulators would control the way in which local governments would grant rights of way. Exclusive federal jurisdiction would also forfeit the "laboratory" function that the states now serve and states' ability to tailor policies to local conditions and traditions. Yet to have only state regulation would lead to needless duplication and contradiction in regulatory efforts, and would forfeit the benefits of national integration.

There is thus a logic to co-regulation, though it must be much improved. Here, the options include:

*The Status Quo.* That may well be the way things will turn out because the existing system is very hard to change. Too many interest groups have a stake in the status quo, and advocates of change must outnumber traditionalists by a wide margin for policy to actually change. But the lesson from recent history in Eastern Europe is that institutions that are not responsive or capable of changing themselves sooner or later will be in trouble. If the system does not work well, it will eventually be changed. This applies to telecommunications regulation as well.

*Clarify or Modify the Respective Regulatory Spheres.* This is an attractive notion: Perhaps we can draw the line more brightly, and possibly shift it a bit in light of changed circumstances. However, it is unlikely that this can be done in a way that would be superior to the present interstate-intrastate separation. If one chooses to assign state or federal jurisdiction based on, for example, functional distinctions, new problems would emerge immediately. For example, if consumer complaints become solely a state regulatory responsibility, then questions immediately arise about the applicability of federal consumer protection law. Rather than separate the spheres, the only result is to shift the focus of the dispute to other lines.

*Joint Regulation.* This option would entail a body, such as a joint board, consisting of federal and state representatives, which would have full authority. That may be a good idea in theory, but in practice, everything would depend on the composition of the board. If there are more state representatives than federal ones, state prerogatives would likely prevail. Under the reverse scenario, the federal side predominates. Therefore this approach does not seem to solve anything.

*Broad Federal Rules and Authority That the States May Implement Flexibly Within Well-Defined Parameters.* This arrangement may require the modification of the preemption rules. For example, a test could be established that gives the FCC authority to define issues of national jurisdiction, but assign it a burden

of proof that nonconforming state regulation would create substantial harm to specified national policies and goals. Such a test would enable the FCC to create a unified national policy, still allowing state experimentation and responsiveness to local needs as long as the state does not actually contravene federal policy. In some instances, this may mean an expansion of federal jurisdiction into state territory, but the reverse is also true. States could regulate some interstate services as long as they do not negatively affect stated national policies and goals. This would substitute a test of nationally necessary policy standards versus decentralized rules for the increasingly unworkable interstate-intrastate separation, and reflects the necessity for national policy as well as the possibility of having local policy. As a result, the focus would stay on achieving policy goals rather than maintaining legal distinctions.

I have argued that the technical-economic trends are against the states because the core of what is intrastate will continue to shrink, regardless of what the courts may say. Thus, even if one fears that this option would in some instances reduce the authority of the states, this is going to happen anyway.

This proposal would in effect establish several regulatory ranges. First, the one assigned by law and preemption to the FCC; second, one delegated by the FCC for state treatment, subject to its broad overall rules; third, those areas not meeting the preemption criteria for the FCC, which would be state regulated; a fourth area may be established for new issues for which there is no national policy determination.

How does one get there from here? The first alternative is to amend the 1934 Act. For example, a subclause could be added that, after describing the role of the states and of the FCC, would specify its ability to preempt, its ability to delegate, and the states' ability to experiment. But the problem with any legislation is the ability of interested parties to block change. Even more important questions do not get resolved, so there is little room for optimism that an amendment to the 1934 Act would be addressed. If anything, Congress would likely give itself more powers as the result of any rewrite, as may occur in 1994.

*Focus on Developing Better Federal-State Relations.* The final option is essentially cooperative. In the past, the FCC was not adept in keeping relations with the states positive. On the other hand, state regulators created a common denominator based on a "solidarity of the oppressed." Too often this has resulted in a knee-jerk opposition.

As for the FCC, it must affirm the value of state experimentation. Such experimentation would get states to be more evenly distributed around the FCC's pole along the axis described earlier, which is closer to the ideal in a federal system. Under those conditions, national policy stands roughly at the center of state policies, which indicates that it has widespread acceptability. Such conditions yield policy diversity although not fundamentally different policies, because by definition state policies will be, on the average, similar to the federal one. As

a result, the choice of regulatory forum would be less outcome determinative than it is now, when most states fall to the left, or redistributory side, of the FCC. Such an outcome would also benefit the states, who would find that because their policies were more evenly distributed around federal policy, there would be far less incentive for preemption by federal regulators. The process has been quietly taking place for the past several years.

A cooperative federal-state approach will also be crucial to address equity or redistribution issues in the future, because it will be hard for states to do it alone. Under the old monopoly system, redistribution to keep local rates low was achieved internally through cross-subsidies from long-distance service, described already as part of the evolution of networks under pressure for universal service. Under increasingly competitive conditions now emerging in the telecommunications sector, it will become difficult to generate money for such subsidies. Competition normally has the effect of driving rates down toward marginal costs, thereby eliminating the source of cross-subsidies. Indeed, as experience has demonstrated, the first areas in which competition emerges is for the above-cost segments of the industry, especially long-distance service. These conditions dry up the traditional sources for redistribution. In light of these problems and realities, the only way to move forward is to substitute an explicit form for the traditional internally generated and ad hoc contributions. Yet for any state to initiate this would lead to an out-migration of communications business and traffic. Thus, any explicit charges need to be implemented, if at all, on the federal level, with the revenues then distributed to the states for use as they see fit, according to their priorities.

In other words, it is necessary to establish again a cooperative model and realize that in the era of the network of networks, the maximization of jurisdictional spheres is a game for bureaucrats, not for policymakers. There is probably no longer a single optimal locus or size for a jurisdiction. Some issues are local, others national, others state, and others regional—it depends on the issue. There is no reason to believe that this is static. Napoleon created a system of administrative “departments” based on the distance that a man on horseback could cover in one day. The emergence of powerful telecommunications has probably made the optimal jurisdictional size much larger. In that sense, states should not mourn some loss, over time, of jurisdiction over some telecommunications functions, but rather understand that this reflects their success in creating ubiquitous and powerful communications media. There is plenty of work left for everybody.