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THE UNIVERSAL TELEPHONE SERVICE PRESERVATION ACT (S.1660, H.R.3621)

INTRODUCTION

American consumers are confused and worried that their telephone bills will soon increase dramatically. The nation's local telephone companies are requesting price hikes of more than $6 billion from state utility commissions and new billing methods are being proposed. And there is uncertainty regarding the impact of the American Telephone and Telegraph (AT&T) breakup.

Senator Robert Packwood (R-OR) and Representatives Timothy Wirth (D-CO) and John Dingell (D-MI) have responded to consumer unease with the Universal Telephone Service Preservation Act (S. 1660 and H.R. 3621). These bills would levy more taxes on long-distance customers and use these revenues to subsidize certain local rates. Proponents expect that this will make the pending rate increases unnecessary by forcing long-distance callers to continue to subsidize local phone users.

A brief review of recent telephone history shows that substantial gains recently made by consumers are primarily the result of deregulation. The Universal Telephone Service Preservation Act would reverse this trend, frustrating further improvements in services and pricing. In short, it would weaken the competitive forces that deregulation has unleashed.

BACKGROUND

Prior to the 1960s, there was virtually no competition in telephone services in the U.S. Telephones were rented from the local operating company, through which all calls were placed, and all long-distance calls were routed through the Bell system's long-lines monopoly.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

In the late 1950s, companies with offices spread across the country sought authority for private communications systems. They petitioned the Federal Communications Commission (FCC) for permission to use the radio frequencies above 890 megacycles to establish private microwave communications networks. AT&T protested, arguing that private users would disrupt the unified national telephone system.[1] The FCC disagreed. The Commission's "Above 890" decision, in 1959, created the first chink in the Bell system monopoly.

Another important step took place in 1963, when Microwave Communications, Inc. (MCI) requested permission to establish a common carrier communications link between St. Louis and Chicago to provide data and voice services to private-line users. MCI contended that existing telephone links were not well suited to serve the rapidly developing computer technology and that an independent microwave system would overcome many of the problems.[2]

AT&T again protested, but the Commission responded that MCI had identified a totally new market and was equipped to serve it. MCI's request was approved.[3] The decision opened the door for several new common carriers to challenge parts of the Bell long-lines monopoly.

Meanwhile, the Carter Electric Company was challenging the telephone companies' monopoly of equipment. The telephone companies argued that their total control of equipment was necessary to ensure the network's "systematic integrity."[4] When the Carter Company petitioned the FCC to allow it to sell equipment directly to consumers, AT&T objected that this would endanger the system's integrity, and claimed that competitors were interested only in "cream-skimming" the most profitable parts of the market--profits that AT&T was using to subsidize local rates, thus making universal service possible. Allowing competition in equipment supply, argued AT&T, would unfairly penalize Bell customers by jeopardizing subsidies for the local service.[5]

The FCC held, however, that AT&T failed to establish that Carterfone and other competitors would harm the system. By

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1 Leland L. Johnson, Competition and Cross-Subsidization in the Telephone Industry (Santa Monica, California: Rand Corporation, 1982), p. 14.

2 Ibid., p. 25.

3 Ibid., p. 26. It is interesting to note that MCI's chairman testified that his company spent $10 million in regulatory and legal costs to secure permission to build a $2 million facility linking St. Louis and Chicago.

4 Stanley M. Besen and John R. Woodbury, "Regulation, Deregulation, and Antitrust in the Telecommunications Industry," Antitrust Bulletin, forthcoming issue, p. 4. This control over telephone equipment was so complete that it extended to the plastic covers consumers could (or could not) use to protect their telephone books.

5 Ibid., p. 5.

allowing equipment to be plugged into the network, this FCC decision stimulated competition in equipment supply and equipment innovations.

In 1975 MCI went on to initiate the Execunet service, a long-distance network competing directly with the Bell system's long-lines operations. The FCC held that MCI was not authorized to offer such a service, since AT&T's regulated monopoly status required federal protection of its long-lines operations.[6] MCI went to court, challenging the long-lines monopoly, and the courts declared the AT&T monopoly to be against the public interest. This landmark decision opened up the long-lines industry to the fierce price competition that has characterized long-distance communications ever since. It spawned the MCI network, SPRINT, and other networks that have lowered long-distance costs for millions of Americans. Deregulation has brought consumers more services at lower prices. There is little reason to suppose this trend will not continue if the present environment is maintained.

THE IMPACT ON LOCAL TELEPHONE SERVICES

Whenever a monopoly is thrown open to competition, more than technology changes. The structure of cross-subsidies and uneconomic pricing is also forced to change to a more rational system--to the benefit of consumers. The telephone industry is no exception. Competition is transforming the traditional pricing system, which gave local users a subsidized service at the expense of long-distance users, and is causing prices to move toward the true cost of service.

As a result of this change, however, local charges will rise in the short term. Rate hike requests now before state utility commissions understandably concern customers. But instead of rushing to block these changes, "consumer advocates" should study the regulatory framework, the reasons for the requests, and the full implications of price restructuring for the telephone customer.

Traditionally, the FCC has concerned itself only with interstate rates, while state public utility commissions set local and intrastate long-distance rates. The public utility commissions assess the costs associated with providing service, determine how those costs should be passed on to consumers, and then set rates to provide what they consider a reasonable return for the operating companies. A key component of assessed costs is the value of fixed capital. The portion of this capital cost applied to local rates depends on the depreciation allowed by state commissioners.

Depreciation rates. Recent FCC decisions concerning depreciation schedules have contributed to higher rate requests. The

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6 Johnson, op. cit., pp. 40-41.

FCC has preempted state commissions' powers to set acceptable depreciation rates. It allows companies to pass on costs to customers in annual increments on the basis of the useful life of the equipment, rather than at the slower rate usually required by states. The FCC will also let local companies pass on immediately the full cost of telephone wiring installed inside buildings, rather than spreading it over many years.

State commission policy has been to depreciate fixed capital equipment at a much slower rate than its useful life would justify, so the new rule will enable companies to recover the cost of equipment more rapidly through higher charges to customers. Since local phone companies are strapped for funds to adjust to rapidly changing technology, this change will help companies to improve service--but it will mean higher local charges.

These increases should be seen in context. The average local telephone rate is only $10.[7] And between 1972 and 1982, the cost of local telephone service, when adjusted for inflation, actually fell by one-third.[8] It is necessary for operating companies to regain some of this lost ground if they are to bring their equipment up to date. Moreover, the cost of financing has increased substantially during the past decade. To attract investors the new local telephone companies need to offer larger returns.[9]

Public utility commission policy. The rate requests should also be seen for what they are--requests, not decisions. Public utility commissions have historically granted no more than 25 to 40 percent of requested rate increases.[10] So companies compensate by inflating pending rate requests. The current debate has focused on requests, largely ignoring the record of decisions.

The access charge decision. The fundamental problem in establishing a price for telephone service arises from the fact that the fixed plant, located primarily in local exchanges, is used for both long-distance and local calls. Furthermore, maintenance costs do not vary with traffic. It is impossible, therefore, to determine the share of costs long-distance and local companies ought to bear. A flat fee for access to the system is one reasonable method of pricing.

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7 "A Plan to Support Ma Bell's Children," Business Week, December 20, 1982, p. 23.

8 Christopher Byron, "Stalking New Markets," Time, January 23, 1982, p. 55.

9 Robert W. Nichols, Consumers Union, Statement before the Senate Committee on Commerce, Science, and Transportation and the House Committee on Energy and Commerce, July 29, 1983, p. 6.

10 William G. McGowan, MCI Corporation, Testimony before the House Committee on Energy and Commerce and the Senate Committee on Commerce, Science, and Transportation, July 29, 1983, p. 3.

Under a recent FCC access charge decision, a flat fee will be added to all residential and business phone bills after January 1, 1984. This access charge seems to be the primary reason for the pending legislation. Yet the access charge accounts for less than 15 percent of the requests before the utility commissions.[11] Furthermore, this charge always has been included implicitly in long-distance rates. Shifting to an access charge means lower long-distance phone rates, while those using the system only for local calls will pay closer to the real, unsubsidized cost of their calls. The access charge will not shift the burden from corporate long-distance customers to residential customers. In fact, 55 percent of long-lines calls are made from residential phones,[12] and, according to MCI, almost half of all long-distance revenues come from individual consumers.

The AT&T divestiture. The court enforced break-up of AT&T has also been cited as a cause of escalating local phone rates. Many observers doubt, however, that the divestiture has had a measurable impact on local rates,[13] although the net effect on local rates is difficult to determine accurately. Modifications made in the original breakup order, for instance, transferred some highly profitable portions of the AT&T system, such as the Yellow Pages, to the local operating companies. In addition, local companies will control one-half of the business created by the new cellular radio technology, expected to expand greatly the market for mobile telephones.[14]

BENEFITS OF DEREGULATION

Too much attention has been given to the apparent costs of deregulation and too little to how consumers stand to gain from the innovation and competition unleashed by deregulation.

Long-Distance Rates

While local rates will edge up, other portions of the typical phone bill already have fallen and will continue to decline. Take long-distance charges. The real cost of a peak-period coast-to-coast Bell System call, for instance, has fallen by half in the last few years. Moreover, MCI's long-distance rates are often half those of AT&T. Other competitors offer even cheaper alternatives.

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11 Statement of the International Communications Association, July 29, 1983, "Exhibit A," pp. 2 and 3.

12 McGowan, op. cit., p. 3.

13 See, for example, Nichols, op. cit., pp. 3-4; McGowan, op. cit., p. 1; and "Effect of the AT&T Settlement on Local Telephone Rates," Task Force on Congressional and Regulatory Reform, April 21, 1982.

14 "What the Spinoff Will Mean to the Customer," Business Week, September 5, 1983, p. 76.

Cost of Equipment

Another component of a telephone bill is the cost of equipment. Deregulation has allowed customers to purchase telephones from competing suppliers; this is much less expensive than renting their phones from the Bell system. Future price reductions of basic telephones could mirror the experience of calculators' plunge in price. Competition will mean steadily lower telephone equipment bills. Indeed, the price of a residential telephone is falling so rapidly that most local and regional operating companies have virtually abandoned the equipment business.[15]

Metered Calls

Metered local rates also could benefit the average residential consumer. One analyst noted recently that metered prices reflect the new uses of telephone lines. "Without measured service, for example, a computer use can tie up a phone line for hours--without paying one cent more than a customer making a three-minute phone call."[16] For those families using their phones primarily during the less costly evenings and weekends, metered rates should reduce phone bills. The current flat rate system provides no incentive for customers to avoid peak periods and keep calls short. Instead, the careful user today subsidizes the extravagant.

Innovation

Newer technology installed in response to competition and improved depreciation rates will reduce the cost of providing telephone service. Thus, while rates may rise in the short term, as the local and regional companies reinvest, they should fall substantially as more efficient technology is introduced.

THE UNIVERSAL TELEPHONE SERVICE PRESERVATION ACT (S. 1660, H.R. 3721)

The deregulation trend begun in the late 1950s can be continued, as competition provides the spur to new technology and lower prices. Alternatively, Congress can turn back the clock by reintroducing cross-subsidies in an effort to maintain an obsolete price structure.

The latter approach is embodied in the Packwood-Wirth-Dingell Universal Telephone Service Preservation Bills. The stated goal of this legislation is to ensure that deregulation does not threaten the "universal telephone service" by what the authors see as a "meteoric rise in local rates."

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15 Ibid.
16 Ibid., p. 72.

Provisions of the Bills

The Access Charge. The bills would overturn the FCC's decision that local customers must pay an access charge reflecting the fixed costs associated with supplying both long-distance and local telephone service. S. 1660 and H.R. 3621 would force long-distance customers to pay an undue share by imposing a per minute tax surcharge on long-distance calls, using this to subsidize local rates.

Rural Subsidy. The proposed legislation would establish a Universal Service Fund, made up of federal and state regulators, to provide subsidies to those local exchanges with costs more than 10 percent above the national average--primarily rural areas.

Tax on "Bypassers". Recognizing that shifting the costs of access back to the long-lines customers would create an incentive for large business users to develop private networks, the measures also contain provisions to deal with such "bypassers." The owners of private systems will still have to pay a charge reflecting the cost of the alternative public phone network.

Other Provisions. The House version of the bill would return the responsibility for setting equipment depreciation rates to the state utility commissions and would require a subsidized basic "lifeline" service to be available to any customer.

ANALYSIS

There are many problems with the proposed legislation stemming mainly from a misunderstanding of the true impact of deregulation.

1) The legislation ignores the fact that most residential telephone customers make long-distance calls. Although the legislation would relieve these customers of local access charges, they would have to pay more in long-distance rates. But since more than half of such long-distance calls originate from residential telephones, and (according to MCI) residential consumers account for 60 percent of the total minutes of use on the long-lines, the per minute surcharge would fall most heavily on residential customers--not businesses.

2) Since the subsidies are to be provided regardless of the efficiency of the local operating company, the proposed legislation removes the incentive for efficient management. Moreover, subsidizing high-cost exchanges reduces the incentive to develop lower-cost methods of providing local telephone service. Just as high prices for long-lines led to the development of competing cheaper technologies in a lower-cost service, so allowing the price of the local service to rise to its true cost will encourage entrepreneurs to search for new ways to serve communities less expensively. Subsidizing these exchanges will merely reduce this pressure.

The local subsidy also fails to differentiate between customers who genuinely need financial help and those who can afford to pay for the services they use. It is surely the former group--if anyone--who should receive financial assistance, not all customers of that particular exchange.

3) Identifying and taxing "bypassers" would create enormous difficulties and costly inefficiencies. U.S. business will waste millions of dollars devising new methods to evade the latest definition of "bypasser."

4) By shifting back to the states the responsibility for determining the rates of depreciation that may be passed on to customers, the legislation threatens the fundamental technological changes taking place. Past experience suggests that state utility commissions will move to slow down the cost-recovery schedule, which in turn will reduce the pace of innovation.

CONCLUSION

Rapidly changing technology and new market demands facing telecommunication firms will make it impossible for regulators to continue any significant oversight of the industry. As deregulation and new technology intensify competition, the market will tightly control price and profit to the benefit of the consumer.

Naturally there must be a transition period, as pricing adjusts to competitive forces. Local rates will rise in the short run (though all local telephone bills may not increase, given the decline in equipment costs). If this transition is to be kept short and rapid innovation maintained, the disruption of market incentives by public policies must be kept to the minimum.

The bills before Congress, however, are a giant step backwards for the telephone user. In their desire to protect consumers from change, the bills would delay the introduction of new equipment and services and frustrate efficient pricing and tough competition--all of which would otherwise bring better, less expensive service to the consumer.

Competition is already developing at the local level, as cable companies and other industries seek to provide data transmission and other revolutionary new services to the public. It is naive for Congress to assume that local telephone companies are immune from competition--just as the government was short-sighted when it believed that long-lines were a natural monopoly and that competition would be damaging. Congress should be demonstrating a firm commitment to further deregulation and competition in the telephone industry, not entertaining bills that would hurt consumers while claiming to help them.

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