UPDATE

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SENATOR DOLE'S WELCOME PROPOSAL FOR TELECOMMUNICATION FREEDOM

(Updating *Issue Bulletin* No. 191, "A Guide to Telecommunications Deregulation Legislation," June 3, 1994.)

Facing a crowded legislative calendar before adjournment, Congress is rushing to complete work on the most sweeping overhaul of the nation's telecommunications system in sixty years. The pending legislation takes important steps to deregulate the system by allowing the Regional Bell Operating Companies (RBOCs), or "Baby Bells," to enter the long distance and equipment manufacturing markets and by ending the ban on competition between telephone and cable companies. Yet disagreement still exists in the Senate over the extent and pace of deregulation.

A modified version of the original Senate proposal—S. 1822, The Communications Act of 1994, sponsored by Senator Ernest F. Hollings (D-SC)—passed the Senate Commerce Committee on August 11 by an 18-2 margin, but controversial elements of the package are certain to create problems when the bill is debated on the floor. Although Senators could attempt to amend S. 1822 when it reaches the floor, they should consider substituting another alternative that may be introduced. Senator Robert Dole (R-KS) recently has circulated a staff discussion draft, entitled the "Telecommunications Deregulation and Competition Act of 1994," which goes much further toward complete deregulation than any other proposal ever considered by Congress. Unlike the pro-regulatory proposals of the House and Senate, it would rapidly eliminate current regulatory barriers without imposing new requirements and would completely deregulate other sectors not mentioned in the House and Senate legislation.

True telecommunications reform offers tremendous benefits for the economy. If the Senate adopted the Dole proposal instead of S. 1822, it would radically transform the heavily regulated telecommunications industry into a much more vibrant, competitive sector of the U.S. economy. More jobs would be created, prices for telecommunication services would fall, and consumers would have more products and services from which to choose. Congress should use the Dole discussion draft as the foundation of all telecommunications reform, whether it occurs this year or next and reject any legislation that is the product of backroom deals whereby today's carriers divide the market and find ways to exclude would-be competitors.

THE COMMERCE COMMITTEE'S PRO-REGULATORY COMPROMISE

Since passage last month of the House reform package, the Senate Commerce Committee has been struggling to craft legislation acceptable to the diverse supporters of deregulation. Negotiations have focused on a variety of proposals, all of which fall well short of comprehensive telecommunications reform. The leading Senate proposal, S. 1822, has been under attack from Senators and industry groups seeking either to slow down or to speed up the deregulatory process. Unfortunately, backroom negotiations between Commerce Committee members and major industry players have produced a compromise that is deregulation in name only. One indication

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of this is the growing size of the bill, which has grown from 106 pages to approximately 200 as adopted by the Senate Commerce Committee. If implemented, this "deregulatory" bill would:

- ✘ **Require extensive waiting periods and entry tests** before competition is allowed in certain markets. Although Senator Hollings actually eliminated more restrictive language from his original draft, the current proposal retains requirements that Baby Bells prove to the Department of Justice that they will not impede competition in the long distance market and that their entry is "consistent with the public interest, convenience and necessity." Likewise, telephone companies seeking to enter the cable market could face lengthy delays, and Baby Bells wishing to enter the alarm monitoring services industry would have to wait six years. Finally, almost every provider entering a new market must do so through a separate affiliate that keeps entirely separate accounts. The inevitable bureaucratic delays caused by these entry tests and separate affiliate requirements would deny consumers the benefits of immediate competition.

- ✘ **Impose protectionist manufacturing requirements** on the Baby Bells once they are allowed to enter the equipment market. The bill would prohibit a Baby Bell from manufacturing equipment outside the United States. Likewise, all manufacturing components must be procured domestically unless companies can prove they first made a good-faith effort to buy domestic parts but could not obtain them from an American firm; and even if the FCC allows these companies to purchase needed foreign components, the amount spent cannot exceed 40 percent of the revenue derived from the sale of their final product. Besides violating America's trade agreements with other countries, these protectionist measures actually could raise prices by forcing producers to buy high-cost, poor-quality components.

- ✘ **Expand universal service requirements** instead of eliminating the massively inefficient subsidization and rate-regulation mechanisms that supposedly help Americans gain access to telephone service. The package of universal service items that must be provided to all consumers is expanded from basic telephone service to include every service to which a majority of residential consumers will have access. Interpreted broadly, this requirement would force the government and private carriers to spend significantly more to provide expensive new minimum package services. Such costly mandates not only will force up costs, but also will make it easier for larger existing carriers to continue dominating the market, since generally they will be the only ones able to afford the package.

- ✘ **Provide public organizations generous access to networks** at low rates or for free. Private carriers would be forced to dedicate 5 percent of their network capacity to schools, libraries, health care facilities, museums, or 501(c)(3) organizations.[1] This would place a costly burden on carriers, many of whom already are required to carry much public material over their networks.

- ✘ **Allow the Federal Communications Commission to impose arbitrary interconnection and other standards on the industry.** Such top-down interconnection orders rarely are satisfactory to either party and often are written poorly. Voluntary contracting and mutual industry agreements between carriers would better establish workable industry-wide standards.

- ✘ **Place numerous restrictions on merger, acquisition, and alliance activity.** For example, the legislation would limit the equity interest of Baby Bells in electronic publishing joint ventures, limit their financial interest in nearby cable TV providers to 10 percent, and prohibit joint ventures between local telephone and cable operators. Such arbitrary restrictions would impede the efficient operation of the market and deny consumers the benefits of such cooperative activity.

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1 501(c)(3) organizations are nonprofit entities, such as The Heritage Foundation. Therefore, as currently written, S. 1822 would compel private carriers to grant The Heritage Foundation access to their networks.

✘ **Increase the likelihood that firms will sue each other when faced with competition.** S. 1822 would allow firms that feel they have been injured by new competition to sue competitors and recover damages for commercial losses. Firms could seek damages if they could prove to any federal district court that the new competitor was violating the terms of entry as established in S. 1822. In one case, the legislation would allow injured competitors to sue for threefold damages plus an attorney's fee. By encouraging an onslaught of litigation, the bill would discourage competition in the very markets it hopes to make competitive.

Overall, the bill grants the Federal Communications Commission dozens of new rule-making powers, ensuring that any deregulation that does take place occurs many years after enactment. Not only will little deregulation take place, but expanded FCC powers will create new problems that Congress will have to correct in the future.

THE DOLE SOLUTION

Like the other congressional proposals, the Dole discussion draft addresses numerous issues involving deregulation of the industry. Unlike the others, however, the Dole proposal could achieve deregulation more effectively because it:

❖ **Eliminates the Modification of Final Judgment (MFJ) two years after enactment.** The MFJ, the decree that broke up the telephone system in 1982, remains the primary obstacle to telecommunications competition because it prohibits the Regional Bell Operating Companies, the "Baby Bells," from entering long-distance and resale markets and from manufacturing equipment. By scrapping the MFJ unconditionally, the Dole proposal would ensure more competition in these markets, thereby lowering prices while encouraging an increase in jobs and exports.[2]

❖ **Immediately removes many of the artificial government entry barriers to telephone competition** and prohibits the erection of any new barriers against potential new entrants. The discussion draft states clearly that "no Federal, State or local requirement, shall prohibit or have the effect of prohibiting the ability of any entity to provide interstate or intrastate telecommunications services." Although S. 1822 also would take this step, the Dole proposal goes further by requiring the FCC to repeal a host of specific regulations if carriers are subject to competition. Regulations that might be repealed include:

- ✓ the requirement that carriers file rate schedules, or "tariffs," with the FCC;
- ✓ the regulation of the terms and conditions of service in any area;
- ✓ the requirement that carriers obtain permission before constructing new facilities or expanding others;
- ✓ requirements that carriers assign costs from uncompetitive services to competitive services.

The draft would give the FCC 120 days to determine whether or not a carrier which applied for permission to free itself from these regulations was subject to competition. A carrier would be considered subject to competition "if an entity not affiliated with the provider offers at least the same level of service in the area to at least the same extent and at least the same rates as the provider." If the FCC does not act within 120 days, the provider is considered automatically subject to competition, and all restrictions are eliminated. In addition, federal loan assistance from the Rural Electrification Administration would be eliminated for

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2 Four of the Baby Bells recently entered a motion with the United States District Court for the District of Columbia to vacate the MFJ. In accompanying affidavits, the motion received the support of over 50 respected academics and regulators, including four recipients of the Nobel Prize in Economics. The overwhelming conclusion of these experts was that the MFJ line-of-business restrictions discouraged competition, harming consumer welfare through increased prices and lost job opportunities. *United States of America v. Western Electric Co., and the American Telephone and Telegraph Company, Motion of Bell Atlantic Corporation, Bell South Corporation, NYNEX Corporation, and Southwestern Bell Corporation to Vacate the Decree,* United States District Court for the District of Columbia, Civil Action No. 82-0192 (HHG).

competitive providers. Finally, the draft proposal virtually abolishes rate-of-return regulation, which establishes the maximum profit a telco is allowed to earn.

- **Repeals the Cable Act of 1992,** which, by discouraging the expansion of cable firms into new markets, also has discouraged greater competition between cable and telephone firms. The draft also would eliminate the "cable-telco cross-ownership ban," which restricts ownership of a cable firm by a telephone company and vice-versa and prohibits competition between the two most likely rivals in most markets. Therefore, its immediate repeal will increase the likelihood of local telephone competition. Finally, the states would not be allowed to re-regulate the industry once it is deregulated.

- **Begins serious spectrum reform by allowing holders of an electromagnetic spectrum license to use their slice of spectrum to provided alternative services.** Cellular, Personal Communication Services (PCS), and other wireless technologies currently are adding to consumer options in the wireless market, providing increased competition for traditional wireline providers. This move toward more flexibility in using the spectrum would encourage greater competition from the wireless sector as current licensees use leftover spectrum to enter new markets such as PCS. The draft also requires the FCC to examine further spectrum reform with a view to moving closer to a market-based system of spectrum operation.

- **Allows other public utility companies to enter the telecommunications industry,** which they have been restricted from doing under the Public Utilities Holding Company Act of 1935. This will encourage competition from an entirely different sector and also help ensure service to many rural areas, since these firms already have the needed infrastructure in place. Simple technological modifications can turn these old utilities into new competitors within the telephone industry. S. 1822 also would allow utility entry into telecom, but not without numerous restrictions on their activities that the Dole proposal does not require.[3]

- **Radically reforms the provision of universal service.** The Dole proposal offers a unique approach to achieve the goal of universal service. Instead of requiring the continued masquerading of subsidies as rate regulation mechanisms, the draft would require that all universal service subsidies be explicit to minimize their inefficient or anti-competitive effects. Currently, universal service subsidies are arranged to siphon off revenues from high-revenue sectors and channel them to high-cost areas of service. This arrangement is highly inefficient and hides the true cost of service from telephone consumers.[4]

  To eliminate this problem, the proposal creates a single Universal Service Fund to which all providers would contribute equally. Subsidies then would be taken directly from the fund and given to "carriers of last resort" to pay for the difference between the low prices charged for rural service and the actual cost of providing that service. In addition, states would be prohibited from creating new subsidization schemes that might favor one provider over another. Most beneficially, all universal service subsidization of a carrier of last resort would be terminated once that carrier was subject to competition from other providers. This new procedure would streamline the subsidization process and decrease the likelihood that one carrier would be given a substantial advantage over another.

- **Creates a sensible interconnection policy for the entire industry by requiring carriers to enter good faith negotiations with each other.** Interconnection will be important in the future as rivals seek access to

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3 For example, S. 1822 would require that any utility entering the telecommunications industry do so through a separate affiliate and would prohibit any sharing of profits between that telecom affiliate and the utility. The bill would require strict rate regulations to prohibit such profit sharing. The Dole proposal would not require that any new regulations be enforced once utilities entered the telecommunications market.

4 For example, subsidies flow from long-distance providers to local providers through substantial "access charges." Likewise, subsidies flow from urban business users to rural residential customers. Therefore, the price of long-distance and business service in general is greatly inflated through rate regulation to ensure that excess profits can be channeled to rural residential areas, which cost more to service.

each others' networks. For example, a cable provider and telephone provider within a given locality will need to agree on a plan to provide one another with access to their customers.

Under the Dole proposal, any interconnection problems that arise, such as concerns over technical interoperability, will be handled through a private dispute resolution mechanism rather than through FCC intervention. Because it encourages private resolution of technical issues, this approach will prove superior to arbitrary FCC rulings, which often are unsatisfactory to both parties.[5]

- **Requires the FCC to conduct annual regulatory reviews of all telecommunications regulation to ensure that useless or uncompetitive rules are scrapped as soon as possible.** The review would focus on remaining telephone regulations while forcing the FCC also to examine the usefulness of restrictions on the ownership of radio and broadcast stations. For example, the FCC could review uncompetitive foreign ownership restrictions, which unwisely restrict ownership of domestic carriers by foreign-owned firms, as well as agency rules that arbitrarily limit the number of TV or radio stations a single firm can own.

BENEFITS OF THE DOLE APPROACH

Compared with the alternatives currently being considered in Congress, the Dole discussion draft is superior for several reasons.

- **The Dole draft does not impose burdensome entry tests upon providers hoping to enter new markets.** Both the legislation adopted by the House and the bill reported by the Senate Commerce Committee contain numerous restrictions governing how providers will be allowed to enter new sectors. For example, Baby Bells would not be allowed to enter long-distance markets unless they prove to the Department of Justice that they will not impede competition in those markets and that their entry is "consistent with the public interest, convenience and necessity." The Dole approach wisely rejects such an approach, allowing open competition in all segments of the industry once current regulations are repealed. This would eliminate bureaucratic obstacles that would delay increased telephone competition for years.

- **The Dole draft does not require telecom firms to establish separate affiliates for each new service they want to provide or to obey exclusive purchasing or domestic production requirements.** The Dole plan also wisely rejects requirements found in the House and Senate bills that would force firms entering new sectors to do so through separate affiliates. Such duplication of facilities to provide new services is inefficient and unneeded. Instead of worrying that cross-subsidization will lead to monopoly, the Dole draft encourages increased competition that would discourage monopolization of a market.

  Likewise, the Dole plan also rejects the crude protectionism, found in both these bills, which mandates that any equipment manufacturing by Baby Bells be done in America using only domestic parts. The Clinton Administration wisely opposes such requirements because they betray U.S. trade agreements with other countries and encourage other nations to close, rather than open, their borders to American goods.

- **The Dole draft covers important issues ignored by other proposals, ensuring that consumers will benefit from deregulation much sooner than under any alternative approach.** The Dole discussion draft is the only telecommunications reform proposal that can be labeled truly comprehensive. Going beyond simple telephone deregulation, it eliminates all cable regulation, allows utilities freely into the industry, pushes for serious spectrum reform, radically reforms rate and subsidy regulation, and implements a regulatory review mechanism that will remove remaining rules in future years.

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5 For example, in 1992 the FCC mandated that dominant providers physically "co-locate" competitors' equipment on their premises to ensure that interconnection was achieved. Yet not only was the arrangement unsatisfactory for many within the industry, but the U.S. Court of Appeals for the District of Columbia recently found that such a mandate went beyond the FCC's authority and, therefore, could not be enforced. See *Bell Atlantic Telephone Co. v. FCC*, U.S. Court of Appeals for the District of Columbia, No. 92-1619, June 10, 1994, and "FCC Lacks Power to Order Phone Companies to Set Aside Space for Their Competitors," *Daily Report for Executives*, Bureau of National Affairs, Inc., DER 112 d20, June 14, 1994.

With its comprehensive deregulatory approach, the proposal will ensure that the benefits of telecommunications competition are captured by consumers much sooner than would be the case with any other approach. The WEFA Group, a Burlington, Massachusetts, economic forecasting firm, found recently that if all telecommunications regulations were removed, some 3.6 million more jobs would be created by 2003 than would have been expected without deregulation. Likewise, the economy would grow, on average, some 3.3 percent per year with telecommunications deregulation, but only 2.9 percent annually without.[6] Consumers would also benefit from the increase in services available to them. Again, the WEFA study finds that consumers could expect savings of approximately $63 billion a year with deregulation.[7] Exports of high-tech telecom products, in which America currently has an advantage, also could increase greatly if more companies are allowed to manufacture equipment. The Dole approach is superior to alternative proposals because it would bring about these gains far more rapidly.

How to Improve the Dole Plan

Although the Dole discussion draft is the boldest telecom deregulation plan now pending, three changes would strengthen it even more.

- **Improving Universal Service Reform.** While the Dole proposal improves the existing universal service system, it still retains some of the current system's structure. For example, the proposal would retain a regulatory requirement that rates for rural telephone customers be no higher than those for urban customers. While "rate averaging," as it is known in the industry, might appeal to legislators and regulators in theory, in practice it discourages competition in rural areas by artificially lowering the price of servicing those regions. Consequently, new providers prefer to seek entry into urban markets where prices are kept artificially high to subsidize rural areas. Therefore, new entrants are discouraged from extending service to rural areas, and this makes it difficult to inject competition which could then result in lower, more affordable rates.

  Any system which attempts artificially to control costs and prices will always distort the proper functioning of the market. One recent study found that the telephone industry loses from $1.5 billion to $10 billion per year by attempting to provide universal service in this manner.[8] Just as television programming has been extended to nearly every American home without government mandates—including 91 percent of poor households[9]—telephone service would be provided even in the absence of federal requirements and subsidies.

- **Eliminating license fees for alternative users of the spectrum.** Although the draft would allow holders of spectrum slices to use their portions to provide alternative services, in exchange they would be forced to pay the federal government a compensation fee. The practical effect of such a fee could be to discourage spectrum licensees from providing alternative services that encourage greater competition. In addition, while the draft rightly allows more flexible use of existing spectrum licenses, more comprehensive reform is needed. The FCC should be required to establish a spectrum privatization plan that would place the frequencies in private hands. Once the government's role is limited to enforcing property rights in the spectrum, wireless technologies would have a much better chance to mount serious competition to traditional wireline providers.

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6 The WEFA Group, *Economic Impact of Eliminating the Line-of-Business Restrictions on the Bell Companies*, July 1993.

7 *Ibid.*

8 David L. Kaserman and John W. Mayo, "Cross-Subsidies in Telecommunications: Roadblocks on the Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation*, Vol. 11 (Winter 1994), p. 121. Kaserman and Mayo argue that these estimates are likely to be too low since "they do not consider the incalculable losses resulting from the distortion of dynamic market incentives to create and adopt technological advances that make more efficient use of the long-distance network."

9 U.S. Department of Energy, Energy Information Administration, *Housing Characteristics 1990*, May 1992, p. 115.

- **Making deregulation unconditional.** The draft would eliminate many useless and inefficient regulations, such as requirements to file rates or to receive permission before expanding networks or constructing new facilities. To gain exemption from these and other regulations, however, the FCC would be required within 120 days to find that a provider faced competition. Although this test is less restrictive than similar tests found in other bills, it is still unneeded. For example, if the FCC did not find competition, it would still require rate or tariff filings, which encourages cartel-like activity within the industry by allowing firms to price service in tandem. Many economists have suggested that this is what is fueling the unified rate increases currently seen within the long-distance industry.[10] Instead of waiting for the FCC to determine arbitrarily when to eliminate regulations, such rules should be scrapped immediately.

Deregulatory legislation also should eliminate foreign ownership barriers that restrict foreign investment in the American industry, immediately repeal any station ownership laws governing how many radio or TV stations a company may own, and ensure that merger and acquisition activity within the industry is not blocked arbitrarily by regulators or judges.[11]

CONCLUSION

Senator Dole's bold draft proposal to deregulate telecommunications would end over six decades of industry micro-management by the federal government. While the other proposals before Congress would allow bureaucrats to continue to exercise considerable power over the industry, the Dole discussion draft would unleash the competitive forces within the industry and allow consumers the right to choose freely which telecommunication services are best for them. Just as the computer industry has prospered without the continuous intervention of regulators and legislators, so can the telecommunications industry. The Dole discussion draft represents a substantial step in that direction.

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10 See *Affidavit of Jerry A. Hausman* and *Affidavit of Paul W. MacAvoy* in *United States of America v. Western Electric Co., and the American Telephone and Telegraph Company, Motion of Bell Atlantic Corporation, Bell South Corporation, NYNEX Corporation, and Southwestern Bell Corporation to Vacate the Decree*, United States District Court for the District of Columbia, Civil Action No. 82-0192 (HHG).

11 See Adam D. Thierer, "A Guide to Telecommunications Deregulation Legislation," Heritage Foundation *Issue Bulletin* No. 191, June 3, 1994, pp. 20-22.