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A GUIDE TO TELECOMMUNICATIONS DEREGULATION LEGISLATION

INTRODUCTION

The technological boundaries between long-distance telephone service, regional telephone service, cable television, computer technology, and other multi-media communications services are becoming increasingly blurred. Innovation in the telecommunications industry is occurring so rapidly that the same service today can be carried by different technologies and industries. Within ten to twenty years, to refer to these technologies as separate sectors will be meaningless. These many voice, video, and data services are rapidly combining to create a new communications medium known commonly as "the information highway." Once in place, this highway will allow Americans to access these combined services right from their living room through their television sets, telephones, or computers.

In essence, the information highway represents nothing more than removal of regulatory barriers that have been artificially holding back these innovations. Today, the development of an information highway is being constrained by a patchwork of different federal, state, and local regulations that have erected artificial barriers between the local telephone, long distance, cable, broadcast, and computer informational services industries. The result of government intervention throughout this century has been monopolistic markets preserved through government protection.

Congress may at last be poised to remove many of these barriers, and so speed the creation of a fully interactive telecommunications system. Lawmakers are considering legislation that, if passed, will free the telecommunications industry of some of the archaic regulations which now restrain innovation and consumer choice. Two bills in the House, the Antitrust Reform Act (H.R. 3626), sponsored by Representatives Jack Brooks (D-TX) and John Dingell (D-MI), and the National Communications Competition and Information Infrastructure Act (H.R. 3636), sponsored by Representatives Edward Markey (D-MA) and Jack Fields (R-TX) have been reported by the House Judiciary and Energy and Commerce Committees. Meanwhile, in the Senate, the Communications Act of 1994 (S. 1822), sponsored by Senator Ernest Hollings (D-SC) combines elements of both House bills. If implemented, the legislation will:

- ✓ **Allow the Regional Bell Operating Companies (RBOCs) or "Baby Bells" into the long-distance market after certain criteria are met.** The court agreement that led to the break-up of AT&T into regional telephone companies restricted the so-called Baby Bells to local phone service and legally prevented them from entering the long-distance market. Removing this barrier would mean even greater competition will develop within long-distance markets, bringing consumers greater savings.
- ✓ **Eliminate other "line-of-business restrictions" on the Baby Bells.** These restrictions currently prohibit the Baby Bells from manufacturing telephone equipment, providing alarm monitoring systems, and reselling long-distance telephone service. Removing these barriers also would increase the number of providers of telephone equipment and service, and so offer consumers better quality goods and services for lower prices.
- ✓ **Eliminate the "cable-telco ban."** This prohibits telephone companies, or "telcos," from delivering video and data services over their networks. The barrier represents the most serious impediment to the creation of an information highway. Ending the ban would allow it to develop more rapidly and efficiently.

While these bills break down regulatory barriers, they also contain several flaws which will offset many of these gains and slow down the development of the information highway. To ensure this does not occur, Congress would be wise to amend the current proposals to:

- ✓ **Remove competitive entry requirements.** The proposed legislation would require that Baby Bells and cable companies meet multiple requirements before they are allowed to enter new markets. These restrictions are supposed to make sure that no firm can gain an unfair advantage in any new field it hopes to enter. However, the effect of these restrictions would be to act as barriers to entry and so deter competition. For example, requirements allowing telcos into each other's markets only after they prove their local markets are competitive will backfire since those markets will only become competitive by allowing new firms to enter immediately.
- ✓ **Eliminate separate affiliate requirements.** The legislation requires that the telephone and cable firms wishing to expand into new markets do so only via affiliated businesses to prevent them from using profits from a regulated portion of its business to subsidize an unregulated division. (Regulated portions of the telecom industry often have their profits guaranteed by regulators.) Such operating limitations are intended to protect rate payers from having to pay for industry expansion. However, this problem could be more easily solved by reforming or eliminating rate regulation for firms whose rates have been bureaucratically maintained and sheltered from market competition.
- ✓ **Tackle monopolistic concerns by removing governmental barriers to competition.** Although government intervention at all levels was intended to address the danger of monopoly, this intervention has contributed more to the creation of monopolies than private firms have. The legislation unwisely expands antitrust enforcement instead of focusing on removing government barriers to competition. Expanding antitrust enforcement would discourage competitive alliances and mergers, which are needed in this industry, while greatly increasing litigation costs.

- ✓ **Reject the temptation to expand the definition of “universal service.”** Both the Senate and the House bills mandate communication providers to expand the package of basic services that every household receives. Instead of the simple telephone service now required, companies would have to provide a broader package which later would be defined by the Federal Communications Commission (FCC). While this is intended to provide Americans with a wider array of communication and information services, it could lead instead to two or three large companies dominating the market. The reason: smaller providers, lacking the economies of scale of larger firms, will be ill-equipped to provide a comprehensive basic service and consequently would be less competitive and perhaps forced out of business.
- ✓ **Eliminate exclusive purchasing and domestic production requirements.** The legislation mandates that the manufacturing of equipment by the Baby Bells must be undertaken within the U.S. and that a specified percentage of their parts must be purchased from domestic producers. Such protectionist provisions make little economic sense since they would encourage companies to divert their resources to less productive uses and would deny customers access to the best value for money. In addition, domestic content requirements have been found by the Clinton Administration to be in violation of existing trade agreements.

In addition, Congress should take advantage of this important opportunity to complete the deregulation of the telecommunications industry. There are a number of steps that need to be taken to free up the cable, broadcasting, and emerging technologies from regulations in order to promote competition and technological innovation. Congress should take the following steps or order the appropriate agencies to carry them out:

- 1) **Repeal the Cable Consumer Protection and Competition Act of 1992.** The new cable rate restrictions will limit the cable industry’s ability to compete successfully along the information highway by restricting the amount of capital they can re-invest in new ventures.
- 2) **Create a more flexible spectrum allocation process to ensure the rapid deployment of new technologies.** Over six decades of inefficient spectrum management by the federal government has consistently discouraged the competition which potentially could have flowed from wireless services, such as cellular telephones, personal communication services (PCS), and satellite technologies. Privatizing the spectrum would finally remove barriers to full-fledged wireless competition and ensure that wireline providers are faced with a formidable challenge.
- 3) **Allow mergers and acquisitions to go forward without threat of antitrust enforcement.** Restricting telecommunication alliances among the various industry segments, such as the recent AT&T-McCaw Cellular merger order by the courts, will destroy the rapid and efficient spread of the information highway. Congress should instruct the Department of Justice and encourage the courts not to block such beneficial merger and acquisition activity.
- 4) **Allow any company to own as many television or radio stations as it wishes.** Traditional television and radio broadcasters will play an important role in the development of the information highway, but only if Congress lifts ownership restrictions that limit their efforts to extend service. These restrictions simply

prevent the dissemination of programming and further discourage competition with other industry segments.

- 5) **Encourage a broader role for private sector firms, cooperative groups of firms, or other private organizations when setting standards for emerging technologies.** Instead of pushing arbitrary standards on the industry, as it often does elsewhere, Congress should order that the FCC allow private interests the time to freely test and develop standards that will produce marketable products. Mandating a single standard before it has proven worthy could slow industry innovation.
- 6) **Eliminate foreign ownership barriers.** Currently, foreign firms cannot own more than 25 percent of an American telephone company or 20 percent of a radio license. These protectionist barriers restrict industry expansion and competition by turning away much needed capital and technological know-how. Congress should order the FCC to eliminate them immediately.
- 7) **Devise a schedule for the phase-out of federal, state, and local rate regulation.** All levels of government regulate rates in the name of consumer protection. However, rate regulation has sheltered larger service providers from competition by creating an unfair and inefficient rate structure. States and municipalities have more responsibility over rates, but if competition is sharpened by federal deregulation, the argument for state and local regulation evaporates. Thus together with federal deregulation, Congress should encourage the state and local reform process by developing deregulatory recommendations for the area of jurisdiction to permit rates to adjust freely to accommodate market demands in the more competitive environment.

The time is long overdue for comprehensive telecommunications law reform. Failing to act while the opportunity exists could slow industry innovation and future competitiveness. In addition, inaction means consumers will not be able to access numerous technologies for a low cost. And without comprehensive reform that encourages intense rivalry and innovation, the American economy will suffer as domestic firms are forced to turn elsewhere for superior products or do without these technologies. The era of sheltered, regulated monopolies must give way to an age of multiple, competitive telecommunications providers if America hopes to retain its status as a leader in this industry — and in the many industries that depend on its products and services.

AN OVERVIEW OF TELECOMMUNICATIONS REGULATION

Federal, state, and local governments have regulated the telecommunications industry throughout this century. Although the intent of regulation was to extend service to as many Americans as possible, the price paid for that social goal has been the creation of uncompetitive, sheltered monopolies. Not only has government regulation meant monopolies within several segments of the industry (such as telephone, cable television, and most broadcasting), but it has protected those monopolies from competition. In addition, the regulatory split between local, state, and federal regulatory agencies creates jurisdictional headaches for firms and for consumers. When viewed in its entirety, this system is responsible for the complex web of inefficient, and often contradictory, regulations that discourage true telecommunications competition and have triggered demands for deregu-

lation. Consequently, unlike a competitive market, the telecommunications market is distorted by inefficient pricing, a lack of product and service innovation, and limited entry by new firms.

How the AT&T monopoly developed. The telecommunications industry used to be considered a textbook case of natural monopoly. A natural monopoly is said to exist when a single firm is able to control most, if not all, output and prices in a given market due to the enormous cost barriers facing new entrants and economies of scale favoring the largest producers. For example, telephone service traditionally has required laying an extensive cable network, as well as the construction of numerous call switching stations and the creation of numerous support services, before service can actually be initiated. Obviously, with such high entry costs, new firms can find it difficult to gain a toehold in this industry. These problems are compounded by the fact that once a single firm overcomes these initial costs, their average cost of doing business drops rapidly relative to newcomers.

Overlooked, however, is the extent to which federal and state governmental actions throughout this century helped build the American Telegraph and Telephone (AT&T) or "Bell system" monopoly. As Robert W. Crandall of the Brookings Institution notes, "Despite the popular belief that the telephone network is a natural monopoly, the AT&T monopoly survived until the 1980's not because of its naturalness but because of overt government policy."¹

In the early years of this century, vigorous competition did exist within many local telephone markets. Although patent protection allowed the Bell system to develop without threat of competition throughout the late 1800s, by the turn of the century the number of independent firms was rising dramatically and over 3,000 competitors existed. Illinois, Indiana, Iowa, Missouri, and Ohio each had over two hundred telephone companies competing within their borders.² By 1907, non-Bell firms operated 51 percent of the telephone businesses in local markets.³ Many urban subscribers, moreover, were able to choose among competing telephone providers, driving prices down considerably. AT&T's profits and prices during this period began moving downward thanks to this increased competition. Whereas AT&T had earned an average return on investment of 46 percent in the late 1800s, by 1906 their return had dropped to 8 percent.⁴

AT&T offered to attempt to extend telephone service to every American while not acquiring other rivals in exchange for limited government protection from competition. AT&T's proposed policy, referred to by company executives as "universal service," was adopted as federal regulatory policy when, during World War I, the federal government took over the entire telephone industry for one year for national security reasons. This

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- 1 Robert W. Crandall, *After the Breakup: U.S. Telecommunications in a More Competitive Era* (Washington, D.C.: The Brookings Institution, 1991), p. 41.
 - 2 Gerald W. Brock, *The Telecommunications Industry: The Dynamics of Market Structure* (Cambridge, MA: Harvard University Press, 1981), p. 111.
 - 3 Leonard S. Hyman, Richard C. Toole, & Rosemary M. Avellis, "Organization, Development, and Breakup of the Telephone Industry," *Industry Briefs*, Delran, N.J.: McGraw-Hill, Inc., July 1989, p. 104.
 - 4 *Ibid.*

turned out to be the nail in the coffin of competition. As industry historians Leonard S. Hyman, Richard C. Toole, and Rosemary M. Avellis note:

During this period of government ownership, the decision was made to set standard long-distance rates throughout the country, based on average costs. In other words, subscribers calling from large cities would pay above costs in order to provide a subsidy to those in rural areas. So, early in the century cross-subsidization began, embraced by the industry, which rarely question the premise behind the arrangement that the ability to communicate with subsidized subscribers was of value to the subsidizing subscribers. *As long as the telephone industry had a monopoly and regulators approved of the arrangement, it did not matter what subscribers wanted. They had no choice.*⁵

Despite attempts to inject competition into the system after World War I, the overriding goal of universal service required a firm with the economies of scale only AT&T possessed. Without the size or financial resources of AT&T, non-Bells could not meet government demands for lower rates on rural service. Universal service was finally codified as the *raison d'être* of the Federal Communications Commission under Section 151 of the Communications Act of 1934.⁶ The policy was attractive to the activist government of the period since telephone service was increasingly considered a necessity for all Americans. Hence, owing to a federal policy that placed higher value on immediate universal service over competition, the Bell monopoly was solidified.

Franchising and Monopoly. At the local level, a similar process allowed cable monopolies to develop as both the federal and local governments shielded providers from competition. Despite initial FCC efforts to restrain competition to ensure the then-powerful television broadcasters' monopoly remained intact, cable systems developed rapidly after 1970.⁷ Yet, at the same time, municipalities were awarding exclusive franchises to cable television providers, partially in exchange for their agreement to broadcast a certain amount of locally produced programming. This policy allowed cable monopolies to develop in 97 percent of local markets.⁸

5 *Ibid.*, p. 105-106 [emphasis added].

6 Despite the fact that vigorous competition was encouraging the expansion of telephone service across America, legislators apparently believed rate regulation could spread the benefits of service even faster. Although manipulation of the telephone rate structure probably did encourage rapid dissemination of service, the policy had the added consequence of allowing AT&T to monopolize the entire system since it controlled most long-distance service. During this same period, moreover, an agreement was reached between the government and AT&T known as the "Kingsbury Commitment," supposedly to rein in AT&T's growing power. Instead, the government had merely given the firm its blessing to swap local telephone monopolies with independent competitors and interconnect with them instead of building competing lines. The net result of this action was to discourage direct competition and it led to AT&T's monopoly over the entire industry. Similarly, once the government nationalized the entire radio spectrum in the Radio Act of 1927, any hope of competition via new wireless technologies was crushed. Until the 1980s, the federal government used its control of the electromagnetic spectrum to restrict new entrants and protect AT&T's monopoly status.

7 See David B. Hack, "Cable Television—and Eight Other Contributors to Competition in Multichannel TV Service," *CRS Report for Congress*, Washington, D.C.: Congressional Research Service, November 3, 1992, p. 3-5.

8 *U.S. Industrial Outlook 1993*, Washington, D.C.: U.S. Department of Commerce, p. 30-10.

The FCC and Congress have often made it much easier for these local monopolies to maintain their dominance by blocking the most logical competitors—local telephone companies—from entering the market. An FCC decision dating from the early 1970s that restricted telephone companies from providing cable television (or any video programming) was codified by Congress in the 1984 Cable Communications Policy Act. The result of this “cable-telco ban,” as it is known, is that monopolistic cable franchises are shielded by the government from potential competition with both local and long-distance telephone companies.⁹ The Cable Consumer and Protection Act of 1992, which imposed rate regulation on the industry, would probably not have been necessary if telcos were allowed to provide video services. This competition would have driven down rates naturally.

Franchising or licensing policies can have anti-competitive effects in other arenas. For example, competition within local cellular markets is arbitrarily limited to the two firms that may receive federal spectrum licenses to provide service in each region. One of the two licenses must always be awarded to the local telephone company, presumably to appease their concerns about rising competition. (This type of spectrum licensing could continue to create problems as wireless technologies are developed that require additional spectrum space.) Likewise, television broadcasters have traditionally been granted protection in local markets since federal regulators grant only three VHF licenses per market. New common telephone carriers also are required to obtain operating licenses from the FCC, which artificially limits the number of firms in any given market.

The Breakup of the Bell System. During the early 1970s, the Department of Justice (DOJ) began to recognize that the Bell system, which essentially was created by government action, discouraged competition by restricting entry. In 1982, after an eight-year antitrust investigation, the DOJ and AT&T came to an agreement on the terms of a divestiture agreement to break-up the company. U.S. District Court Judge Harold H. Greene presided over the agreement, referred to as the Modification of Final Judgment (MFJ). It went into effect on January 1, 1984.

The MFJ required that AT&T surrender control of its 22 local operating companies to seven new regional service providers referred to as the Regional Bell Operating Companies or, as they are more commonly known, the “Baby Bells.” The agreement prohibited AT&T from holding interest in any of the Baby Bells and limited it to providing long-distance service between the telephone exchanges. AT&T was allowed to enter the computer industry, though, and to continue to produce telephone equipment and conduct research and development. The Common Carrier Bureau of the FCC regulates its service and rates.

The seven new Regional Bells were also given distinct operating guidelines. Aside from providing local phone service, they were required to furnish all long-distance providers access to customers in their region, purchase equipment and services from a variety of providers, and were prohibited from providing long-distance services, manufac-

⁹ The equally important flip side is that most cable firms are prohibited from offering local telephone service through both federal and state regulations. Consequently, the leading contender to compete successfully against the Bell System has been prohibited from doing so through government restrictions.

turing telephone equipment (although they could sell it), or from delivering informational services. (In 1991, the ban on informational service delivery was lifted after a successful court challenge.) The Baby Bells were restricted from entering these markets since policy makers believed they would use profits from the regulated portion of the business to subsidize these other sectors, keeping competitors out. These "line-of-business restrictions" and the requirement that the Baby Bells provide service only within a specific Local Access and Transport Area or "LATA," means fully fledged competition between the RBOCs and the interexchange carriers (IXCs or long-distance firms) cannot take place.

Rate Regulation. The final, and perhaps most important piece of the regulatory puzzle, is telephone rate regulation. Federal, state, and local rate regulation has existed for decades and continues to plague efforts to bring competition to the marketplace. Two justifications have been advanced for rate regulation. First, rates must be "fairly" assessed (that is, low-cost) for customer service, it is said, since in most cases only one monopolistic provider exists to serve each region. Second, the regulated firm must be permitted to earn a stable profit to ensure continuous service.

In line with these objectives, rates today are manipulated by local regulators to ensure universal service requirements are satisfied. Due to legislative pressure at both the state and local level, regulators subsidize more costly rural and residential service by raising the rates of long-distance and business customers. Not surprisingly, this arrangement has been found to be extraordinarily inefficient. Estimates by economists of the efficiency losses due to these discriminatory rate charges run between \$1.5 billion to \$10 billion per year.¹⁰ Rarely can more than one firm in a region afford to meet these regulatory requirements and built-in inefficiencies. Thus, a single telco typically services the area and is provided with sustained revenues, not because of consumers, but because of actions by regulators. In the long-distance market, the rates of smaller providers, such as MCI and Sprint, are not heavily regulated by the FCC. But AT&T, as the "dominant carrier" of long-distance service, still is heavily regulated. A recent shift in FCC regulatory policy from rate-of-return to price cap rate regulation¹¹ has helped eliminate some of the inefficiencies created by regulation by encouraging greater innovation, but it is still no substitute for market competition. Some states have followed the FCC's lead by switching to more pro-competitive regulatory policies, but the disincentives created by cross-subsidization of residential service still exist.

10 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.

11 Rate-of-return regulation sets the maximum allowable profit for a telephone company within a business year. Typically, a variation of the formula $R = O + B(r)$ has been used to determine the overall revenue requirement (R) a firm needs to earn to stay in business. Regulatory commissions find (R) by estimating what the firm's operating requirements (O), rate base (B), and rate-of-return on investment (r) need to be in order to continue to provide service. Besides the obvious difficulty of conducting rate-of-return calculations, such a regulatory system is inefficient since firms have little incentive to innovate lacking a profit motive. Price caps generally encourage greater innovation by allowing company profits to fluctuate freely, but instead places an overall limit on the prices they charge customers for telephone service.

WHY DEREGULATION IS NEEDED

With technological innovations, as well as industry mergers and acquisitions, occurring so rapidly, legislators and government officials now realize that regulations on the books since the early 1930s are ill-suited to govern how competition within the industry takes place today. Even the 1982 Consent Decree is now considered out-of-touch with the reality of modern technology. Note William J. Baumol of New York University, and J. Gregory Sidak of the American Enterprise Institute: “[T]elephony, broadcasting, cable television, and mobile communications are fast becoming activities whose main difference is their regulatory treatment, rather than their technological or economic characteristics.”¹²

Despite the many regulatory hurdles firms face, the industry is innovating rapidly. With the advent of cellular services, advanced satellite delivery equipment, computerized communication technology, digital compression technology, fiber optic wiring, pagers, advanced cable systems, and specialized business communications equipment, the American telecommunications industry is in the midst of a breathtaking technological revolution. These new industry spinoffs have forced analysts and regulators to reassess the entire state of competition within many markets. As Peter Huber, senior fellow with the Manhattan Institute notes, what DOJ lawyers and Judge Greene failed to realize when they handed down the MFJ decision was that many of these technologies were already converging at the local level to create more competitive markets. Most important, wireless networks were developing to challenge the Bell system’s monopolistic wireline services.¹³

Today, competition in local markets has spread rapidly. As *Business Week* wrote in 1992, “Almost nine years after the regional companies were spun off...[the Baby Bells] are feeling queasy. Competition and new technology are crowding into their lucrative monopolies in local phone service.”¹⁴ For example, rival local cellular networks have experienced explosive growth. According to wireless consulting firm Herschel Shosteck Associates, cellular penetration of the business market has risen from a negligible level in 1983 to 16.8 percent in 1989 and, the firm projects, will continue to rise to nearly 70 percent by 1995 and 97 percent by 2005. Competitive Access Providers (CAPs) and Metropolitan Area Networks (MANs) have also arisen in local business districts to provide a viable alternative to local telephone exchange companies. These alternative access providers or “ALTs” as commonly known in the industry, provide high-capacity, fiber optic-based services primarily to urban businesses and long-distance firms so they can bypass the local telephone companies entirely.¹⁵ Satellite-based technologies, such as Personal Com-

12 William J. Baumol and J. Gregory Sidak, *Toward Competition in Local Telephony* (Cambridge, MA: The MIT Press, 1994), p. 14-15.

13 See Peter Huber, "Telephones, Competition, and the Candice-Coated Monopoly," *Regulation*, No. 2 (1993), p. 34-43.

14 Peter Coy, Robert D. Hof, and James E. Ellis, "The Baby Bells' Painful Adolescence," *Business Week*, October 5, 1992, p. 124.

15 Such bypass activity is likely to increase if service and rate deregulation is not pursued since companies will continue to search for ways to innovate around regulations to satisfy customer needs. Ironically, if this occurs, the same individuals regulators were attempting to help through discriminatory cross-subsidization will be hurt when companies grow tired of the scheme and find a way to avoid it. As David L. Kaserman of Auburn

munication Systems (PCS), will also create a formidable challenge to both traditional local and long-distance wireline providers. PCS will allow crystal-clear point-to-point communication between individuals who may be in different countries.

Many traditional industry barriers to competition are likely to fall in the face of these advancing technologies, as well as the rapid rise of merger and acquisition activity within the industry. For example, regulators have long been concerned with the supposed "bottleneck" local providers may impose on residential consumers. The fear is that customer access to services could be denied if regulations did not require the local companies to guarantee interconnection with all long distance providers. Yet recent industry activity, such as the merger of AT&T and McCaw Cellular Communications, could make this supposed entry barrier irrelevant. If approved by the court, this merger would marry the technology of the nation's largest long-distance provider to the largest cellular provider, effectively creating a vertically integrated telecommunications firm.¹⁶ AT&T then would possess the wireless capabilities to overcome the entry barriers remaining at the local level since they will no longer have to rely on local wireline networks to reach customers.¹⁷ A similar deal recently has been announced by MCI Communications (AT&T's leading competitor), who plans to acquire interest in Nextel Communications, a new wireless firm.¹⁸ MCI has also allied with Comcast (a cable/cellular firm) and the wireless giant Motorola in an attempt to develop the first nationwide PCS network.¹⁹ Meanwhile, the Baby Bells have also been merging with alternative telecommunication service providers at a rapid pace.²⁰

The Need for Change. Although competition is evolving and technologies proliferating, government action still is needed to remove the remaining barriers along the information highway. The fact is that many technological innovations have come about as an effort to adapt to regulations, not so much because of some new market opportunity. So instead of finding creative ways around the current regulatory structure, firms should be allowed to find more innovative ways to provide consumers the services they want.

University and John W. Mayo of the University of Tennessee note, "Bypass is a symptom of inefficient prices. The longer such prices remain, the more large business customers will choose to escape paying subsidies by circumventing the public network, and the higher the rates will become for customers remaining on the network. Those who claim to champion the cause of small residential customers by defending the current pricing system and downplaying the threat of bypass actually harm those vary customers in the long run." See Kaserman and Mayo, *op. cit.*, p. 138-139.

16 Unfortunately, Judge Harold Greene recently blocked the merger temporarily, arguing that it runs counter to the MFJ. The deal could still go ahead if AT&T can prove to Judge Greene that it would not be anti-competitive.

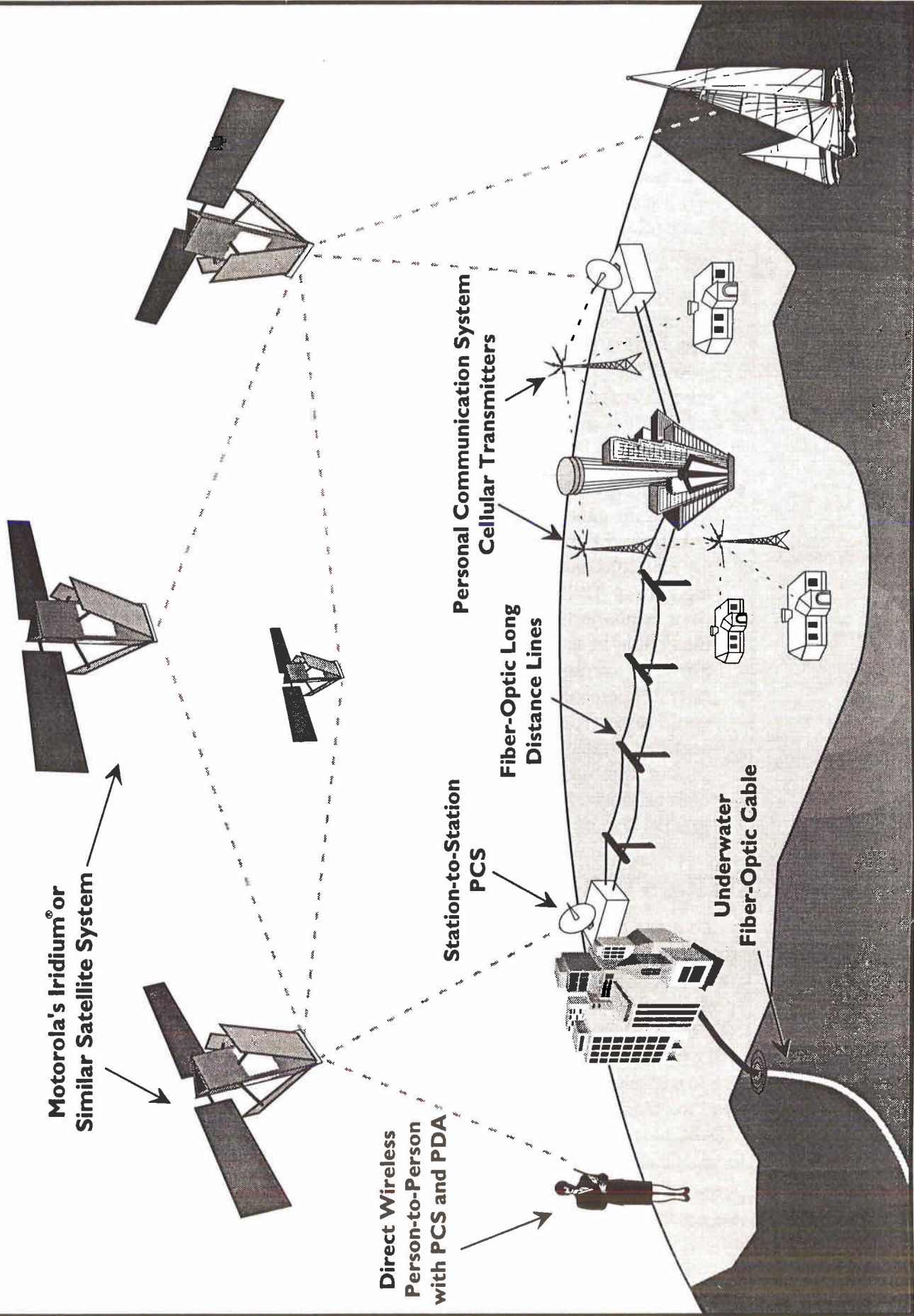
17 Cindy Skrzycki, "AT&T's Deal: A Giant Steps Into New Arena," *The Washington Post*, August 22, 1993, p. H1.

18 Edmund L. Andrews, "MCI Plans Big Nextel Stake As a Move Into Wireless," *The New York Times*, March 1, 1994, p. D1.

19 See "Money Goin' Out," *The Economist*, March 5, 1994, p. 78; Kathryn Jones, "MCI Joins Wireless Phone Venture," *The New York Times*, November 18, 1993, p. D5.

20 See "A Year of Turmoil in Communications," *The New York Times*, October 14, 1993, p. D11; Stephan Kreider Yoder and G. Pascal Zachary, "Digital Media Business Takes Form as a Battle of Complex Alliances," *The Wall Street Journal*, July 13, 1993, p. A1.

The Telephone Network of the Future?



Among the benefits of eliminating these regulatory barriers:

- ✓ **It would encourage competition between industry segments.** Competition between various industry segments has been restricted by many years of governmental protection of monopolies. For example, regulation has established monopolies and then restricted entry into the telephone, broadcast, and cable industries. But once competition is allowed to develop between cable and telephone firms, local and long-distance telephone firms, wireless and wireline telephone services, and between other industry segments, any vestiges of monopoly will soon disappear.
- ✓ **It would speed the development of the information highway.** Regulation is the major impediment to the completion of the information highway. Besides restricting competition between industry segments and creating monopolies, regulation has slowed the efforts of many firms wishing to build the highway. Recent decisions by the FCC to reregulate the cable industry, and Judge Greene's decision to prevent the AT&T-McCaw merger, illustrate why firms cannot progress as rapidly as they might like.
- ✓ **It would greatly benefit the American economy and citizens.** Regulation has also limited the general competitiveness of the industry. For example, the Baby Bells are not allowed to manufacture telephone equipment. Allowing them to do so would create new jobs and exports for the economy. The WEFA Group, an economic forecasting firm in Burlington, Massachusetts, estimated last year that if all telecommunications regulations were removed, some 3.6 million more jobs would be created by 2003 than could be expected without deregulation. The firm estimated that the economy will grow, on average, 3.3 percent per year with telecommunications deregulation, but only 2.9 percent annually without.²¹ In addition to the new job opportunities that could result from deregulation, consumers would also benefit from the increase in services available to them. The WEFA study found that consumers could expect savings of approximately \$63 billion a year with deregulation.²² Exports of high-tech telecom products, in which America currently has an advantage, could also increase greatly if more companies are allowed to manufacture equipment.

THE DEREGULATORY LEGISLATION IN CONGRESS

To make possible the many benefits of deregulation, three bills recently were introduced in Congress. These would help correct some of the flaws in today's system of regulation. A Senate bill would combine elements of two House bills and takes a more comprehensive approach to deregulation overall. The three bills are: the Antitrust Reform Act (H.R. 3626), sponsored by Representatives Jack Brooks (D-TX) and John Dingell (D-MI); the National Communications Competition and Information Infrastructure Act (H.R. 3636), sponsored by Representatives Edward Markey (D-MA) and Jack Fields (R-TX); and the Communications Act of 1994 (S. 1822), sponsored by Senator Ernest Hollings (D-SC).

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

22 *Ibid.*

Although the White House backs the general goals of the proposed legislation, the Clinton Administration has also proposed to add a new Title VII to the Communications Act of 1934, which would apparently streamline the regulatory process for emerging cable and telephone competitors. Although the Administration's proposal might ensure minor gains relative to the legislative approach to continuing regulation, unfortunately it is the continuing regulation itself that poses the greatest hurdle to increased competition. Such minor process reforms will be of little overall consequence.

H.R. 3626 has been reported out by the House Energy and Commerce Committee and the Judiciary Committee, and is expected to reach the floor once the chairmen complete negotiations on which version should be considered. H.R. 3636 has cleared the House Energy and Commerce Committee, which had sole jurisdiction over it. The Senate Commerce, Science, and Transportation Committee has held hearings on S. 1822, but there has been no other action yet in the Senate.

While each bill makes important deregulatory contributions, each also contains flaws that need to be addressed before the measures are merged and potentially become law.

WELCOME FEATURES OF THE BILLS

The Senate and House bills contain several important reforms that would encourage the expansion of industry rivalry and benefit consumers in the process:

- ✓ **Elimination of RBOC operating restrictions.** Under H.R. 3626 and S. 1822, the Baby Bells are allowed to apply immediately to federal regulators for entry into *inter*-state interexchange or long-distance markets between states, provided certain requirements are satisfied (outlined below). The version of H.R. 3626 that recently passed the House Judiciary Committee makes an exclusive requirement that in cases dealing with RBOC application for entry into *intrastate* long-distance and resale markets, the Justice Department and state regulators must determine jointly whether the application will be accepted. The Energy and Commerce Committee version does not include this requirement, but instead requires the RBOCs simply to charge their new long-distance affiliates the same access charges they force other long-distance providers to pay. The Baby Bells also are allowed under H.R. 3626 and S. 1822 to apply for permission to manufacture equipment through a separate affiliate and build their own nationwide telephone networks. After five years, the Baby Bells may apply for permission to provide alarm monitoring systems. S. 1822 also allows the Bells' cellular operations to extend beyond local boundaries.

Removing these legal barriers would mark the political recognition of what is already occurring naturally — the barriers between local and long-distance telephone services are disappearing. If these legal barriers are removed, integrated, nationwide competition can quickly become a reality. This means companies would be able to devote their time and resources to direct competition instead of using their creative talents to find ways to circumvent existing regulations.

- ✓ **Elimination of the cable-telco ban.** Both H.R. 3636, and S. 1822 would eliminate the most important barrier to the information highway—the “cable-telco ban.” As long as they do not violate certain criteria (outlined below), telephone and cable firms would at last be allowed to compete against one another. Removing this legal barrier to competition would help dissolve the governmentally induced monopolies of these

firms and ensure that consumers are provided a broader array of services in their homes.

Other beneficial elements of the legislation include:

- ☞ H.R. 3636 and S. 1822 both mandate a review of the usefulness of broadcast ownership restrictions, which limit the number of stations broadcasters may own. S. 1822 also requires the FCC to study the usefulness of federal restrictions on the ownership of syndicated programming by broadcasters.
- ☞ Rep. W.J. Tauzin (D-LA) successfully offered an amendment to H.R. 3636 that would allow broadcasters more flexible use of their spectrum allotments. For example, they could provide messaging or home shopping services over their section of the spectrum.
- ☞ H.R. 3626 and S. 1822 would require that greater attention be focused on user privacy rights as they relate both to the introduction of new technologies and the regulations governing the system. It would ensure personal customer information is not divulged by companies without permission.
- ☞ H.R. 3636 and S. 1822 prohibit states and municipalities from creating entry barriers to local competition. The states and the FCC are also encouraged in the bills to adopt more flexible forms of rate regulation where competitive markets exist, but unfortunately are to retain strict rules for markets deemed to be uncompetitive. Complete rate deregulation would be more constructive and pro-competitive than continued regulation.

UNWELCOME FEATURES OF THE BILLS

Unfortunately, the proposed legislation adds several new restrictions at the same time as it knocks down other regulatory barriers. Chief among these new and unhelpful restrictions are:

- ✓ **Restrictions on RBOC entry into new markets.** Under H.R. 3626, a Baby Bell company would not be able to move ahead with its plans to enter new markets if the government finds that the company applying for permission to do so could use its supposed monopolistic power to impede competition in that market. Entry would be allowed only if the FCC “finds that granting such request is consistent with the public interest, convenience, and necessity.”²³ Various requirements a firm must meet before entry is allowed include:
 - ☞ **An assurance that rates will be reduced** (especially for residential consumers);
 - ☞ **The demonstration of the firm’s ability to deliver new services immediately to consumers;**
 - ☞ **An assurance that the firm will not be able to use “predatory pricing” techniques to undercut competitors;**

23 H.R. 3626, "Antitrust Reform Act of 1993," November 22, 1993, p. 6.

- ☞ **An assurance that monopolistic concentration will not result among firms entering new markets; and**
- ☞ **An assurance that the FCC will be able to continue to enforce its regulations governing alarm monitoring systems.**

Likewise, under S. 1822, RBOCs are permitted to enter long-distance markets immediately only if the Bell company concerned faces “actual and demonstrable” competition in its local market and could not use its local market power to impede competition in the long-distance market.

Such requirements to allow telcos into each others’ markets only after meeting arbitrary competition tests are self-defeating because they give the firms currently controlling the market an opportunity to lobby against the entry of potential rivals. The best way to ensure that vigorous competition develops in these markets is to allow more firms to enter immediately. Currently, legal barriers such as the cable-telco ban and the Baby Bell operating restrictions deny market access to new entrants. These regulations must be eliminated if legislators ever hope to see telephone and cable monopolies disappear. Yet, the legislation currently before Congress contains numerous tests (specifically for Baby Bell entry into long-distance markets) which will discourage immediate competition.

Long-distance companies argue such tests are necessary since they feel RBOCs could use their substantial profits from the “access charges” they levy on long-distance providers to finance entry into long-distance markets. These access charges to local markets are substantial, representing almost half the cost of providing long-distance service.²⁴ The long-distance firms hope that within a few years local markets will become more competitive, thereby more widely disseminating who receives the access charges and placing the RBOCs on equal footing with the long-distance firms. But this reasoning is flawed since local markets are quickly becoming competitive, thereby diminishing the scope of RBOC power. In addition, the long-distance firms continue to enjoy the advantages of organizing alliances and acquisitions to strengthen their position. Long-distance deals with cellular or other wireless firms, such as AT&T-McCaw merger and the MCI-Nextel deal, could allow them to bypass the Baby Bells altogether and service customers directly.

In the Senate, Senators John Breaux (D-LA) and Bob Packwood (R-OR) have proposed an amendment to S. 1822 that would wisely eliminate such arbitrary and anti-competitive requirements. Their amendment would allow immediate inter- and intra-state competition for telephone service one year after the bill’s enactment. The amendment also would require equal regulatory treatment of telephone and cable providers such that a cable firm would not be able to provide telephone service where a telco is prohibited from providing video services.

24 Kaserman and Mayo, *op. cit.*, p. 127.

- ✓ **Separate affiliate requirements.** Even if the Bells pass these tests and gain entry to new markets, all three bills still contain a variety of requirements they must abide by once in those markets. For example, under H.R. 3626 and S. 1822, Baby Bells who wish to manufacture equipment must do so through a separate business affiliate to avoid cross-subsidization of one branch by another. And under H.R. 3636, unless they are a small rural provider of service, telcos wishing to provide video services may do so only through an affiliate to insure they are not able to cross-subsidize video service with profits from telephone service. Similarly, cable operators offering telephone service must not cross-subsidize that service with their cable profits. Finally, Baby Bells and their existing affiliates may not use their equipment to deliver electronic publishing services, such as home on-line financial or shopping services. They must instead establish a separate affiliate or enter into joint ventures to do so, and are not allowed to cross-subsidize other services with profits from those activities. Electronic publishing regulations would expire on June 30, 2000.

Congressional concerns about cross-subsidization arise from the fact that if a telco were allowed to subsidize service of a deregulated portion of its operations with revenues from its regulated business(es), rate payers would be unfairly burdened with costs they are not responsible for. Although there is truth to this fear, the solution is not to continue to require separate affiliates for each new service. Rather, it is to reform or end rate regulation altogether.

- ✓ **Monopolistic concerns and buy-out restrictions.** Closely related to fears of cross-subsidization are concerns about monopoly in the legislation. Various restrictions are included in an apparent attempt to curb the development of monopolistic markets. For example, H.R. 3626 would prohibit RBOCs from "tying" the sale of one of its services to any other product or service for fear it could create monopolistic advantages (that is, they could not require a customer to purchase voice and video services as a package). Similarly, if an RBOC slowly came to control a market it had entered, private firms adversely affected by such competition would be able to file a civil suit and be eligible to recover treble damages and attorney's fees. Likewise, H.R. 3636 prohibits telcos from buying out competing cable systems within the region they offer service, although they would be able to own a controlling interest or form a joint venture with those serving rural areas. S. 1822 is even more stringent: cable and telephone companies would be allowed to own only up to 5 percent interest in an existing cable operator in their service area and joint ventures, and partnerships with local cable operators would be prohibited.

This concern about monopoly is misguided. As mentioned, telecommunication monopolies traditionally have resulted from extensive and unneeded government regulation which protects dominant carriers, not from any natural tendency toward monopoly. Although legislators and regulators like to argue that monopolies would have occurred in the absence of regulation anyway, the fact remains that only a regulation approach has been tried; it has stifled competition and actually fostered monopoly. The sections of the proposed legislation allowing competing firms to sue under an antitrust rationale will only cause an avalanche of lawsuits by inefficient firms trying to thwart new competitors. Lawmakers should instead recognize that the best defense against monopoly is to make it as easy as possible for new competitors to enter the market.

FEATURES THAT WOULD UNDERCUT DEREGULATION

Finally, the proposed legislation contains two provisions that, if passed, would undermine one of the main goals of the legislation to promote an innovative, competitive industry. They are:

✓ **Expanded definition of universal service.**

H.R. 3636 and S. 1822 contain language that, although vague, requires the FCC to expand the definition of universal service from basic telephone service to an as yet undefined package of advanced informational services. For example, although not strictly defined, H.R. 3636 requires the FCC to establish a "Federal-State Joint Board" that will outline what basic services telcos must provide to each customer. And S. 1822 would mandate that every service provider contribute resources and services to achieving universal service objectives according to guidelines to be developed by the FCC. These FCC guidelines would most likely expand the definition of basic service from what is now referred to as "POTS" or "plain old telephone service," to what many jokingly refer to as "PANS" or "pretty amazing new services." PANS could include anything from simple two-wire voice and video service to the home from different companies to complex technologies such as on-line informational and educational services. The legislation does not specifically outline which services would be included, but undoubtedly it would be more than merely basic telephone service. Although the states would be in charge of implementing these regulations, the FCC could enforce them if they are not carried out properly. Periodic FCC reviews would follow passage of the legislation to ensure full service compliance by telcos.

While the rhetoric of universal service sounds equitable, such requirements in the past in the case of telephone service has resulted in a government-sanctioned monopoly.²⁵ Requiring communications providers to expand the package of services that every household receives would most likely create an environment most favorable for the industry's largest firms, since only they would be able to provide such a broad range of services. Smaller providers, lacking the economies of scale of larger firms, would be less equipped to provide the services. More important, legislators run the risk of creating what Michael Schrage of *The Los Angeles Times* refers to as a "welfare state ethic in cyberspace."²⁶

25 As shown by the AT&T example outlined earlier, when governments manipulate rates and control the provision of service, it acts as a disincentive for smaller firms for two reasons. First, only larger firms typically are able to provide such extensive service. Second, regulators favor monopolies or cartels since they find it easier to control their actions rather than the actions of multiple competitors. Hence, in the quest to achieve social policy goals, regulatory commissions end up depending upon one, or a handful of firms to provide all the industry's output. Consequently, competition is made difficult, if not impossible. As regulatory economist Alfred E. Kahn notes, "When a commission is responsible for the performance of an industry, it is under never completely escapable pressure to protect the health of the companies it regulates, to assure a desirable performance by relying on those monopolistic chosen instruments and its own controls rather than on the unplanned and unplannable forces of competition." Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions, Vol. 2: Institutional Issues* (Cambridge, MA: The MIT Press, 1971, 1991), p. 46.

26 Michael Schrage, "Let's Not Put Data Highway On-Ramps on the List of Our Inalienable Rights," *The Washington Post*, January 7, 1994, p. G2.

In addition, mandating broad universal service requirements would require continued oversight by federal and state regulators, encouraging the growth of the very bureaucracies that legislators are attempting to eliminate. The Federal-State Joint Board is an example of such a potentially suffocating new bureaucracy. Real competition does not result from extra "pro-competitive" red tape, regulation, and micro-management. Just as the case of television sets and video cassette recorders illustrates, it is allowing competition, and not mandates, that ensures consumers are provided with the services they desire at a reasonable price.

✓ **Exclusive purchasing and domestic production requirements.**

H.R. 3626 and S. 1822 would require any manufacturing by the Bell affiliates to be conducted within the United States. Likewise, any parts used in the manufacturing process by the affiliates must be produced domestically. Affiliates may use foreign-manufactured parts only if they cannot purchase domestic products at a reasonable price. Even then, the aggregate cost of foreign parts purchased for use by affiliates must not exceed 40 percent of the annual sales revenue from the sale of that equipment. Penalties may be enforced by the FCC for violations of this provision. Attempts to remove this provision from H.R. 3626 failed in the House Energy and Commerce Committee. In addition, H.R. 3626 permits any competing American manufacturer who feels it has lost business due to an affiliate's illegal use of foreign parts to file suit for recovery of damages.

Such domestic production requirements are crude protectionism and would hold back the industry and raise prices for consumers. Legislators seem to fear that once the Baby Bells are given the freedom to manufacture equipment that they will immediately establish their factories overseas to take advantage of cheaper labor. Yet, this is unlikely to be the case. Most manufacturers can be expected to remain in the domestic market to take advantage of the greater technological advantages provided by the highly skilled work force, adjoining industries, and various other educational or engineering institutions. In addition, transportation costs will be higher, and delivery times longer, if firms establish factories overseas, offering an incentive to remain at home. If, despite these advantages, companies turn to overseas suppliers, it is because they produce a superior product for the price. They should not be prohibited from taking advantage of trade in this way.

Forcing firms to produce or procure all or even most of their equipment and parts domestically is not how to promote competitiveness and trade deficit reduction. Instead, it discourages improvements in efficiency, and the use of the most cost-effective and innovative products, thereby forcing up prices and decreasing overall quality of service. Attempts to promote domestic manufacturing in one sector through protectionism requires the movement of workers and resources away from sectors where American firms currently hold competitive advantages over rivals. Hence, firms allocate their resources less efficiently and could lose export advantages they currently hold in high-tech telecom products. For example, domestic production and purchasing requirements might encourage some providers to refocus their efforts on the production of low-value-added or low-technology products, such as telephone receivers or fax machines, to satisfy the new (but artificially created) market demand. Yet, as Thomas J. Duesterberg of the Washington-based Hudson Institute points out, American producers currently have exporting advantages in high-tech, high-value-added telecom equipment such as satellite, cellular, and microwave systems.²⁷ Therefore, producers might gain some small short-term profits by

switching to low-tech industry segments, but could lose out in more important and more profitable high-tech sectors in which they currently hold an exporting advantage.

U.S. Trade Representative Mickey Kantor has also pointed out in a letter to Congress that domestic content requirements violate the General Agreement on Tariffs and Trade and the North American Free Trade Agreement. Kantor rightly believes that these protectionist provisions would "seriously jeopardize ongoing telecommunications negotiations with the European Union."²⁷ The U.S. has a long-running effort to break down foreign barriers that bar America's high-tech telecom exports, items not fully addressed in the recent Uruguay Round GATT Agreement. Establishing domestic barriers when many countries, such as the United Kingdom, are tearing down their own, discourages further gains and invites retaliation.

RECOMMENDATIONS FOR ADDITIONAL ACTION

Even if the pending legislation were amended to include the recommendations above, telecommunications deregulation would still be far from complete. And incomplete deregulation would leave the industry full of numerous inefficiencies that would blunt potential competition. For example, failing to deregulate cable or the broadcast industry completely would result in less rivalry being stimulated in those sectors. So traditional providers could remain protected from the entry of new competitors and the information highway might not become a full reality. If Congress and the Clinton Administration truly want the industry to respond to market forces, become innovative, and expand their exporting potential, they should view deregulation more broadly to include the following steps:

- 1) **Repeal the Cable Consumer Protection and Competition Act of 1992.** The Cable Act of 1992 was an unfortunate mistake. In an attempt to restrain rate increases, the FCC promulgated a set of confusing regulations that failed to cut rates to legislatively desired levels. Not surprisingly, the FCC was then forced to make a second round of rate cuts to appease legislative and consumer concerns. As the recently abandoned mergers between Bell Atlantic Corp. and Tele-Communications Inc., and Southwestern Bell Corp. and Cox Enterprises Corp. illustrate, these rate reductions now threaten to slow the cable industry's ability to participate actively in the building of the information highway by restricting the amount of capital they can re-invest in new ventures. In addition, rate regulation threatens to limit funding of quality cable networks, such as the Arts & Entertainment Television Network (A&E), or cut off funding for proposed channels such as the History Channel. As A&E President Nickolas Davatzes says of the regulations, "[They] will unquestionably hinder the [cable] industry's ability to invest in new technologies and programming and create jobs. [T]he unintended victims of the FCC action are the cable programmers, who today find themselves confronting an uncertain and difficult future."²⁸ If Congress wants to ensure lower rates and better service in the long term, it should repeal the 1992

²⁷ Michael Kantor, Letter to Rep. John D. Dingell and Rep. Edward J. Markey, February 28, 1994.

²⁸ Nickolas Davatzes, "Quality Cable at Risk," *The Washington Post*, April 27, 1994, p. A23.

Cable Act and instead focus on completely deregulating the industry and allowing other communications suppliers to enter the market freely.

- 2) **Create a more flexible spectrum allocation process to ensure the rapid deployment of new technologies.** Increasingly, the most vigorous competition within the telecommunication industry is from the wireless communications sector. Cellular, PCS, and other wireless technologies all use electromagnetic waves to transmit voice and data messages that can compete directly with traditional wireline technologies. Yet, these technologies demand large chunks of spectrum space to provide service. Federal spectrum allocation policies typically have been slow to respond to these needs and often allocate the spectrum space poorly. For example, despite the fact that the initial requests for cellular telephone spectrum allocations were made in 1968, it was not until 1981 that the first cellular license was granted.²⁹ Although the FCC's recent move to reallocate certain frequencies and auction off others for PCS, paging, and messaging services were steps in the right direction, more substantial reforms are needed.

To ensure new wireless technologies become vigorous contenders for telecommunication customers, federal spectrum policies must be reformed. First, Congress should require the FCC to adopt a flexible spectrum management policy that would allow those who operate spectrum-based services to use their slice however they wish. Currently firms are required to use their slice only for pre-determined purposes. Holders of the spectrum slots are also prohibited from reselling their slice to another party. This inflexible policy results in the inefficient use of the spectrum. Representative Tauzin's amendment to H.R. 3636 would make spectrum use more flexible, but complete deregulation should follow.

Second, the FCC should formulate a spectrum privatization plan that would place frequencies in private hands. Auctioning off the spectrum for private use is the best way to ensure new technologies have a chance of competing against traditional wireline services. The government's role then would be limited to enforcing spectrum property rights.³⁰

- 3) **Allow mergers and acquisitions to go forward without threat of antitrust enforcement.** Concerns over merger and acquisition activity within the telecommunications industry are ill-founded. Constructing the information highway will require extensive resources and know-how. It is unlikely, therefore, that many firms will be able to bear this burden on their own. Multiple and complex alliances already have been developing to solve the problems of scale. For example, the proposed merger between AT&T and McCaw Cellular would represent the first fully integrated attempt to bypass local telcos completely and compete using wireless services. Such cooperation should not be viewed as non-competition. As alliance and acquisition activity has picked up in recent years, competition has intensified, not diminished. This is because technological

²⁹ Lawrence Gasman, *Telecompetition: The Free Market Road to the Information Highway* (Washington, D.C.: Cato Institute, 1994), p. 72.

³⁰ See *ibid.*, p. 126-140.

innovation is creating new market opportunities as rapidly as new firms organize to exploit them. Alliances are forming to capitalize on the more expensive industry technologies by turning them into innovative consumer products at lower prices. Hence, threats of antitrust action from both Judge Greene and the Justice Department should be discouraged by Congress, to allow many types of competitive service consortia to develop.

4) Allow any company to own as many TV or radio stations as it wishes.

Currently, no company can own more than 12 TV stations, 18 AM radio stations, and 18 FM radio stations. Although this "12-18-18" rule is better than the "7-7-7" rule that once existed, station ownership restrictions are archaic, counter-productive, and should be abolished. Legislators and regulators are concerned that allowing any firm to own as many radio and TV stations as it wishes, could result in certain broadcasters monopolizing the marketplace and airing only one-sided news and opinions. However, this argument makes little sense with the amount of informational service available in an era of 500-plus channel cable TV systems, proliferating radio broadcast competition, and on-line computer networks. Congress should force the FCC to grant broadcasters the freedom to own as many stations as they wish. This will allow them to compete on equal footing with the many emerging technologies and companies along the information highway.

5) Encourage a broader role for private sector firms, cooperative groups of firms, or other private organizations when setting standards for emerging technologies. Perhaps the most insupportable justification for existing federal regulatory oversight is that the government is in a better position to set standards for emerging technologies in an efficient and cost-effective manner. As the recent case of High-Definition Television (HDTV) illustrates, the private sector is usually in a better position to determine an industry standard. An alliance of several American firms produced an all-digital HDTV standard that is superior to those developed by the Japanese and Europeans, whose governments heavily funded and guided the development of an inferior standard.³¹ The government rarely has the insight of consumers when choosing high-tech standards. For example, Beta and VHS video recorder standards were allowed to compete freely for allegiance until consumer choice finally dictated that VHS was the preferable standard. If bureaucrats had decided to pick one early in their development, they might well have opted for the Beta standard, making Sony a *de facto* monopolist in the field. Instead, consumers chose the competitive, less-costly VHS standard.

Even in those industry segments of the telecommunications industry where multiple standards are emerging, such as PCS, it would be foolish for the FCC to attempt to impose arbitrarily a single standard on the industry. As wireless communications expert Dr. Herschel Shosteck argues, "[M]ultiple standards will stimulate technology innovation, lower costs, and enhance services. From both

³¹ See Cynthia A. Beltz, "Lessons From the Cutting Edge: The HDTV Experience," *Regulation*, Vol. 16, No. 4 (1994), p. 29-37.

economic and engineering perspectives, multiple technologies will prove more efficient than would have been the case with a single [PCS] standard.”³²

Hence, Congress should request that the FCC not attempt to mandate standards until the private sector has been given a reasonable amount of time to establish their own independently. Even then, the FCC role should merely be consultative and mediating.

- 6) **Eliminate foreign ownership barriers.** Currently, foreign telcos are only allowed to only allowed to own 25 percent of an American-owned telco and only 20 percent of a license. Such foreign ownership restrictions are counterproductive. They are archaic laws left over from the interwar period when America feared that broadcast information could be dominated by a foreign power. While legislators have given up defending the restrictions on such grounds, they allow them to remain in an apparent attempt to protect jobs or encourage domestic development of new telecom technologies. But protectionism can only save a job or help create a new technology by raising costs and slowing innovation in other sectors of the economy. Drawing productive resources away from more efficient uses will hinder, not help, American competitiveness.

Congress should allow foreign telcos to enter the American market immediately. The financial resources and technology they could bring to America would mean lower consumer costs, new jobs, and more vigorous competition and innovation. Likewise, American firms should be allowed to freely ally with foreign firms to take advantage of their resources and know-how. Finally, all restrictions on the procurement of foreign equipment, such as those found in H.R. 3626 and S. 1822, should be rejected to ensure American firms have access to the finest technology available.

- 7) **Devise a schedule for the phase-out of federal, state, and local rate regulation.** Rate regulation, at all levels, continues to distort accurate pricing within telecom markets. The regulatory regime established by the local public utility commissions have long encouraged the development of monopolistic markets. The long-standing opposition of regulators to cost-based pricing of telephone service has ensured traditional telcos are provided sustained profits and preferential regulatory treatment. This process has discouraged competitive entry.

All levels of government need to devise a program of rate deregulation if these market inefficiencies are ever to be eliminated. “Chicken Little” scenarios of a world without telephone competition resulting from rate deregulation are far-fetched. Not only is the multitude of new potential providers in the industry hungry for consumer loyalty, but the new technologies the new firms offer would ensure rural callers have the same access to telephone service as they have traditionally received. Rate deregulation also would end the cozy relationship local telcos have with their regulatory agencies. The end of sustained profits and

32 Dr. Herschel Shosteck, "Next Generation Cellular/PCS Technologies," *Wireless Communications Forum*, Vol. 1, No. 1, (July 1993).

protected markets would allow new competitors to enter the market and eventually force down rates.

Congress should initiate the process of decontrol by requiring the FCC to establish a deregulatory schedule and then provide guidance to the states to immediately begin their own programs. Representative Tauzin successfully introduced an amendment to H.R. 3636 that would mandate that states use price cap regulation instead of rate-of-return regulation for local telcos. This would go far toward correcting the hugely inefficient "rate-of-return" regulatory scheme many state regulatory agencies still use. Still, rate regulation of any kind would remain riddled with inefficiencies and feather-bedding. Sustained competition can never result from guaranteed monopoly profits and discriminatory charges on long-distance and business service.

Including these deregulatory initiatives to the reform legislation would turn a modest piecemeal reform into a full-fledged, pro-competitive reform. If policy makers fail to take these important initiatives, the bold goals of their legislation are unlikely to be met because the industry will remain constrained by the remnants of an out-dated regulatory structure.

CONCLUSION

The role of government in the telecommunications industry has traditionally been one of a creator and protector of monopolies, not of a stimulus to competition. A century's worth of regulatory micromanagement created the very problems that legislators are now trying to remedy. Lawmakers hope to ensure the industry will be the source of more and better paying jobs, the exporter of high-tech products and services, and the provider of the important information infrastructure of the 21st Century. The only way to achieve these goals is to rid the telecommunications industry of the governmental impediments to competition that have restricted growth and rivalry in the past.

Missing this rare opportunity to reform telecommunications law completely would be very unfortunate, and despite the proposed legislation's welcome reforms, its new mandates and missing deregulatory measures will make intense new competition within the industry unlikely. Looking at telecommunications deregulation more broadly to include the removal of all barriers to increased competition is therefore crucial to the industry's future success. Legislators must stop believing that only regulators understand how to achieve competition — before they prevent it from ever fully becoming a reality.

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APPENDIX:

COMMONLY USED TELECOMMUNICATIONS TERMS

Access charges: Fees long-distance firms must pay to local telcos for access to their networks. Approximately 40 percent of all long-distance company revenues are spent paying these access charges.

Analog: Older method of information transmission using radio waves to carry electronic pulses of voice or data info. Analogous waves match the sender's voice or data patterns.

Bottleneck: The technological barrier that long-distance firms must pass through to gain access to residential and business customers in a local telephone market. Traditionally, this bottleneck has been caused by the existence of only one provider in each local market. Regulators demand open access for all competitors to local networks to overcome this problem. Yet, new technologies (such as fiber optic wiring), merger activity among long-distance and wireless firms, and increased local competition could allow bypass of the networks altogether, thereby making the bottleneck problem irrelevant.

Bypass: The use of alternative voice and data delivery technologies (such as CAP, cellular, PCS, and satellite services) to circumvent existing telephone services. Telcos are concerned about the increase in bypass since these unregulated services can attract valued customers and, therefore, diminish their rate base.

Bundling: The sale of two or more telecom services as part of a package. Legislators and regulators usually require that the sale of services be "unbundled" for fear that bundling them together would create monopolistic advantages for larger firms.

CAP: A "Competitive Access Provider" is a telco that competes with local telephone companies by providing high-capacity, fiber optic-based services primarily to urban businesses and the IXCs. These advanced technologies are often superior to the older technologies used by the LECs. CAPs are also referred to as MANs ("Metropolitan Area Networks") or ALTs ("Alternative Access Providers").

Cable TV: Transmission of video signals along coaxial copper wires. The advent of fiber optic-based wiring will increase transmission quantity and quality, allowing cable firms to deliver voice and data services and compete with telcos. For example, in the future an individual could use his or her cable system to deliver video messages to family members across the nation or to access visual materials from a library on the other side of the globe.

Cable-telco ban: Federal restriction prohibiting telcos from offering video and informational services over their networks. It has played an important role in ensuring cable monopolies are free from competition and able to raise their rates freely. It would be abolished if the proposed legislation is adopted.

Cellular: Most common wireless service which transmits calls among geographic cells within a region. Inferior to PCS technology since waves are transmitted using analog method, which can diminish signal quality in certain areas.

Common carrier: A telephone company whose rates and services are regulated by a federal, state, or local regulatory agency.

Cross-subsidy: Can have two meanings: (a) When a telco uses resources from one branch of its operations to finance the activities of another, it is said to have "subsidized" the other sector. Regulators and legislators discourage or ban cross-subsidies fearing a regulated telco could use resources from the regulated side of its business to provide an advantage to its non-regulated side. Since regulated services are virtually assured a profit by regulators, this would mean telcos could tap guaranteed resources to fund risky, unregulated ventures; (b) The assessment of higher rates for long-distance, business, and urban service to subsidize residential calls from rural areas. Local rate regulators employ cross-subsidization techniques extensively to appease legislative and constituent pressures for lower local telephone rates. In effect, this means service cannot be priced according to usage.

Digital: Newer method of information transmission using binary coded computer language. Electronic pulses send bits of information through networks in the form numbers (ones and zeros).

Digital compression: The conversion of an analog signal to digital code can shrink the amount of space needed to transmit that information over a network. When signals are compressed, telcos are able to send larger amounts of information more rapidly.

Electronic publishing: The delivery of general news, financial information, entertainment, advertising, shopping services, public and governmental services, and many other forms of information via electronic instead of print means. For example, a person could use a home computer to monitor financial markets, directly trade stocks and bonds, and carry out all other financial transactions (see also: Information highway).

Fiber optics: Cables which utilize glass fibers and beams of light to transmit information. Fiber optic cables have greater voice and data capacity than traditional copper-based wires. Many of the services carried over the information highway will require the capacity of fiber optic technology.

HDTV: "High Definition Television" that will vastly improve picture quality will likely be used to access information highway services.

Information highway: The result of the marriage of voice, video, and data communication services and the elimination of the regulatory barriers between them. Info highways will deliver electronic publishing services as well as traditional telephone service in more rapid and effective fashion. For example, individuals will be able to turn on their HDTV and immediately access a list of travel agencies, send a request for tickets to a specific city, for a certain cost, on a given day, and then switch over to a financial services channel or on-screen video phone to conduct other business while the computer searches for the best travel deal available. When found, the computer would interrupt and display a list of potential arrangements so that travel plans could be instantly finalized.

Interconnection: The connection of telephone networks, usually mandated by law, that allows subscribers of one network to call members of another.

- IXC:** “Interexchange carriers” are long-distance firms, such as AT&T, MCI, and Sprint, that are allowed under the MFJ to provide long-distance telephone service between LATAs or inter-LATA.
- LATA:** “Local access and transport areas” are the regional boundaries established under the MFJ which determine where the RBOCs can provide service. They are not allowed to provide service between LATAs; they must pass such interLATA calls to the IXCs. For example, a midwestern RBOC, Ameritech, can provide service to Chicago and Indianapolis, but cannot connect calls going to Los Angeles or New York.
- LEC:** “Local exchange carriers” are the main providers of local business and residential service, operated by the RBOCs. Long-distance firms are not allowed to own them under the MFJ.
- MFJ:** Refers to the “Modification of Final Judgment,” which is the consent decree formulated by AT&T and the Department of Justice in 1982. The MFJ established the regulatory regime telcos currently operate under. The most important result of the MFJ was that long-distance and local competition were made independent of each other.
- PCS:** “Personal Communication Services” are digital wireless telephone networks that will deliver voice and data services more clearly than cellular systems. It will allow an individual to have one phone and one phone number at which he or she could be contacted anywhere in the world, at any time. Personal communication networks should be operational by 1995 and in widespread use by 1997-1998.
- PDA:** Refers to “Personal Digital Assistants,” which are hand-held devices that can transmit both voice and data messages over wireless networks. PDA and PCS technologies are similar and could be married. A handful of PDAs have already been introduced into the market.
- RBOC:** “Regional Bell Operating Companies” are the seven major providers of regional telephone service more commonly referred to as the “Baby Bells.” They include Ameritech, Bell Atlantic, Bell South, NYNEX, Pacific Telesis, Southwestern Bell, and US West. Under the terms of the MFJ they took control of the LECs.
- Spectrum:** The electromagnetic “spectrum” is the full range of waves through which sound and light travel. Wireless telecommunications relies on the radio spectrum to provide service. The spectrum is controlled by the FCC has been allocated among telcos and radio and TV broadcasters through licensing since 1927.
- Telcos:** Short for telephone companies.
- Telephony:** Telephone service in general. Now includes wireless as well as traditional wireline services.
- Universal Service:** Originally adopted as AT&T’s corporate philosophy, after World War I, the federal government codified the requirement that every American should have access to telephone service. Legislators now argue this “universal service” mandate on telcos should include any electronic publishing services they offer as well.
- Wireless networks:** Provision of service over the spectrum using cellular, PCS, and satellite technologies.
- Wireline networks:** Provision of service via copper or fiber optic cables such as that provided currently by the RBOCs and the CAPs.