Exporting U.S. Telecom Policy: The Case of Local Telecommunications

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Paper Presented At the American Enterprise Institute Conference

Telecommunications Policy as Trade Policy: Negotiations with Japan over Interconnection Pricing

December 12, 2001

The passage of the 1996 Telecommunications Act and its subsequent implementation by the Federal Communications Commission (FCC) has provided U.S. trade authorities with a blueprint that it believes is the *sine qua non* for opening telecommunications markets around the world. But just because the U.S. was among the first to liberalize its telecommunications sector, it is far from clear that it has a monopoly on the route to competitive markets. Indeed, it is my belief that time will expose the U.S. policy towards opening local telecommunications markets as being far too complicated excessively regulatory. In particular, the renewed emphasis on cost-based regulation is surely misguided, and it is even likely the requirement that incumbents share their networks with entrants will simply not work. It may be somewhat early to try to render a definitive verdict, but I believe that the American experience with local telecom market liberalization is far from the successful model that U.S. trade authorities apparently believe it is.

I. A Short History of U.S. Liberalization Policies[1]

The United States began t open its telecommunications markets to competition several decades ago. Progress was very slow at first, but it began to accelerate after AT&T was broken up in 1984 as the result of an antitrust suit.[2]

[1] This section draws heavily on a paper by the author and Jerry Hausman, "Co mpetition in U.S. Telecommunications Services: Effects of the 1996 Legislation," in Sam Peltzman and Clifford Winston (eds), *Deregulation of Network Industries*, AEI-Brookings Center for Regulatory Studies, 200.

[2] See Robert W. Crandall, *After the Breakup: U.S. Telecommunications in a More Competitive Era*. Brookings, 1991, for an analysis of the effects of the AT&T antitrust decree.

A. Long Distance Services

In the 1970s, the first breath of liberalization swept over the U.S. telecommunications sector as the FCC began to permit limited competition in the market for interstate *dedicated* business connections. This competition spread eventually to all long distance services*, against the FCC's wishes*. The FCC attempted to block entrants from offering ordinary, switched long distance services, but lost in the U.S. Court of Appeals. Subsequently, the FCC reversed course and allowed the new entrants to interconnect with AT&T's local companies at a discounted rate that was not based on any estimate of costs.

At about the same time the FCC won a battle with state regulators to open the market for terminal equipment (telephone handsets, answering machines, modems etc.) to competition. The states had challenged the FCC's right to invalidate state tariffs that required subscribers to use telephone-company supplied terminal equipment. Presumably the state regulators saw competition in terminal equipment as a threat to their attempt to maintain high rates for company-provided business equipment in return for low local residential rates.

The path to increased competition in long distance services and terminal equipment was not without its problems. When AT&T used its control of local facilities to frustrate competition in long distance services and terminal equipment, a major antitrust suit was filed by the federal government resulting in the 1984 divestiture from AT&T of its local operating companies.[3] The antitrust decree imposed quarantine on the divorced local Bell Operating Companies that prevented them from offering long

distance services in competition with the national long distance carriers - AT&T, MCI and Sprint - or from manufacturing telephone equipment such as handsets, modems and switches.

When AT&T was broken up, the interconnection charges for interstate long distance calls totaled more than 17 cents per minute at both ends.[4] The FCC recognized that these charges were excessive, but it could not muster the political will to reduce them to a level that approximates long-run incremental cost. Instead, these interconnection or "access" charges were reduced slowly, and monthly per-line charges were substituted for them. Even at the dawn of the new competitive era ushered in by the 1996 Telecommunications Act, however, interstate access charges were still more than 6 cents per minute, substantially above any reasonable measure of cost. In 1999, the Commission finally entertained a proposal to drive per minute access charges down to a level that is presumably close to long-run incremental cost, but it still has not proposed a rule to require a cost-based (or market-based) approach to setting these charges.[5] Moreover, intrastate access rates remain far above incremental cost in most states.[6]

Nevertheless, the real price of long-distance service has declined substantially. By 1999, the average price of long distance service had fallen to 11 cents per minute.[7] Many consumers today pay less than 10 cents per minute under various discount plans. As the states and the FCC begin to admit the banished Bell companies into the long-distance

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[3] *U.S. v American Telephone and Telegraph Company*, Civil Action 74-1698 (D.D.C. November 20, 1974).
[4] U.S. Federal Communications Commission, *Trends in Telephone Service*, Industry Analysis Division, Common Carrier Bureau, August 2001, Table 1.2.
[5] The "CALLS" coalition, comprised of incumbent local carriers and long distance companies, offered its proposal in July 1999. The FCC eventually approved a modification of this proposal in May 2000. See Federal Communications Commission, *Sixth Report and Order in CC Dockets 96-262 and 94, Report and Order in CC Docket 99-249, Eleventh Report and Order in CC Docket 96-45,* May 31, 2000.
[6] See the paper by Jeffrey Rohlfs and J. Gregory Sidak presented at this conference for details.

markets on a state-by-state basis, these rates have come under even more pressure. Indeed, these rate pressures are now so severe that U.S. financial market analysts now routinely question whether long distance companies can profitably survive offering only long-distance services.

B. Local Access Markets

After the 1984 AT&T breakup the terminal equipment market became very competitive. However, long distance rates remained substantially above their competitive levels, and competition in local telecommunications grew very slowly because state regulators limited entry and controlled local rates. For twelve years the court administering the AT&T decree wrestled with a large number of difficult issues in implementing the decree, and the Regional Bell companies chafed at their continued exclusion from long distance services. The long distance carriers were equally concerned about the slow progress towards competition in local markets, a problem beyond the reach of the AT&T decree.

As a result of these concerns, the US Congress was finally prodded to reform the entire telecommunications regulatory structure through the passage of the 1996 Telecommunications Act.[8] This legislation opened all telecommunications markets to competition, including local services. For the first time, the Congress addressed interconnection charges directly. The 1996 Act requires that incumbent carriers interconnect with entrants at any "feasible" point on their networks, that these incumbents lease unbundled network elements to entrants, and that the charges for

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[7] FCC, *Trends in Telephone Service,* August 2001, Table 14.5.
[8] *Telecommunications Act of 1996*, Pub. L. No. 104-104, 110 Stat. 56 (1996).

interconnection be based on "cost" – where cost is divined in some fashion other than a traditional rate-of-return regulatory proceeding. Thus, unlike earlier exercises in deregulating network industries in the United States, the 1996 Act provides a massive increase in the scope of regulation and an unfortunate return to cost based regulation. [9]

1. Local Interconnection Rates

The last five years have witnessed an intense struggle over a myriad of issues that have arisen in implementing the 1996 Act. Perhaps none has been as contentious as the debate over the proper costing standard for interconnection rates. In late 1996, the FCC decided that all local interconnection charges should be set at a measure of forward-looking cost – Total Long Run Incremental Cost (TELRIC). At first, this appeared to be substantially below the incumbent local carriers' imbedded historical cost. As a result, the incumbents challenged this standard and even the FCC's authority to dictate it to the states, which have responsibility for regulating local services. The incumbents lost the legal argument over FCC jurisdiction,[10] but the lawfulness of the TELRIC standard is still being tested in the courts. Thus, nearly six years after the passage of the 1996 Act, the U.S. courts still have not upheld the standard that U.S. trade negotiators are attempting to force on the rest of the world.

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[9] The Commission had instituted price cap regulation – a regulatory regime that limits the rate of annual price increases for various groups or 'baskets' of services – in order to divorce rate increases from cost increases. This change was instituted to simplify the regulatory process and to provide greater incentives for carrier efficiency since reductions in a carrier's costs would not require a reduction in regulated rates. Many states followed the FCC's lead and imposed their own price-cap regimes for regulating intrastate and local rates. Favorable effects on technological progress and innovations were also an expected result of the shift to price caps

[10] *AT&T Corp. v Iowa Utilities Board*, 119 S.Ct. 721, 142 L.Ed.2d 835 (1999).

2. Unbundling

Despite the fact that there had been no prior experience with mandated network sharing in telecommunications, the 1996 Act requires that the incumbent local companies, principally the divested Bell companies, "unbundle" their networks and lease the unbundled network elements to new entrants. Such unbundling is required if the network facility – local loop, switching port, inter-office transport link, etc. – is deemed "necessary" for the development of competition or if the denial of such an element would "impair" competition. Under this language, the FCC could have mandated unbundling of only those facilities that are "essential facilities" – *i.e.*, monopoly bottlenecks, such as local subscriber lines or "loops," that cannot be replicated economically by entrants.[11] Instead, the Commission chose to require the unbundling of virtually everything in the incumbents' networks, subscriber lines, switches, interoffice transport, and signaling.

When the Supreme Court ordered the FCC to reconsider this ruling, the Commission essentially held its ground and even expanded the definition of unbundling to include the sharing of the copper loop (in addition to the outright lease of the entire loop) so that entrants could offer advanced broadband services without having to build their own subscriber network lines.

Until recently, the new entrants, or Competitive Local Exchange Carriers (CLECs), were generally disinterested in using unbundled elements ("UNEs"), despite the FCC's attempt to keep their prices artificially low. (See Figure 1) However, this changed when the FCC began to require that incumbents offer the entire "platform" of

unbundled elements as a single package at TELRIC rates. This approach essentially allows entrants to obtain access to the entire incumbent network at a very low price, thereby entering without having to invest in network facilities. As a result, the use of unbundled network elements has begun to grow.

3. Resale

The U.S. may be the only country that attempts to mandate resale discounts for entrants who simply wish to offer the incumbent's services under a different name. These discounts are supposed to reflect the incumbent's "avoided cost" of retailing, which is generally estimated at 18 to 22 percent of local monthly retail rate. It is far from clear, however, that any entrant could profitably operate by simply reselling an established local company's services at the margins afforded by the resale discount.[12] At best, resale must be seen as a transitional or supplemental strategy for an entrant that has something to offer besides the renaming of an existing service.

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[11] This was the approach that Justice Breyer offered in his separate opinion in *Iowa Utilities Board*.

[12] Even AT&T tried to use resale as an entry strategy, but it found that it could not compete profitably with resale.