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DEREGULATION OF TELEPHONE SERVICES IN OHIO

by

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In recent years, a new regulatory and philosophical approach has affected the communications industry.¹ Starting with the deregulation of some equipment services by the FCC in 1968, and through the divestiture of AT&T which was effective January 1, 1984, technology, markets, and regulators have fundamentally altered the structure of telephone and related services.² These changes have led to a re-evaluation of the traditional form of cost-based regulation at all levels of government.³ Ohio's adoption of House Bill 563 represents yet another step in

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¹ See generally M. DERTHICK & P. QUIRK, THE POLITICS OF DEREGULATION (1985).

² See, Levitz, *Separate Subsidiaries, the Interim Cost Manual and AT&T Divestiture*, in THE IMPACT OF DEREGULATION AND MARKET FORCES ON PUBLIC UTILITIES: THE FUTURE ROLE OF REGULATION 209 (1985).

³ ARIZ. REV. STAT. ANN. §40-281(E) (1985); COLO. REV. STAT. §§40-15-101 to 40-15-404 (Supp. 1989); CONN. GEN. STAT. ANN. §§16-247f(b), 16-247i (West Supp. 1989); FLA. STAT. ANN. §364.337 (West Supp. 1990); GA. CODE ANN. §46-2-23 (Supp. 1990); IDAHO CODE §§62-601 to 62-622 (Supp. 1989); ILL. ANN. STAT. ch. 111 2/3, para. 13-101 to 13-803 (Smith-Hurd 1988); IND. CODE ANN. §§8-1-2.6-1 to 8-1-2.6-8 (Burns 1988); IOWA CODE ANN. §476.1 (West Supp. 1990); MICH. COMP. LAWS ANN. §§484.103a-f (West Supp. 1989); MINN. STAT. ANN. §§237.57-237.711 (West Supp. 1991); MISS. CODE ANN. §77-3-35 (Supp. 1989); MO. ANN. STAT. §§392.190-392.530 (Vernon Supp. 1990); MONT. CODE ANN. §§69-3-801 to 69-3-824 (1989); NEB. REV. STAT. §§86-801 to 86-811 (1986); NEV. REV. STAT. ANN. §704.040 (Michie Supp. 1989); N.M. STAT. ANN. §§63-9A-1 to 63-9A-20 (1988); N.D. CENT. CODE §§49-21-01 to 49-21-22 (Supp. 1989); OHIO REV. CODE ANN. §§4927.01 to 4927.05 (Anderson Supp. 1990); OR. REV. STAT. §§757.810-757.870 (1989); S.C. CODE ANN. §58-9-230 (Law Co-op. Supp. 1989);

this transition.

On March 17, 1989, the adoption of Amended Substitute House Bill 563 significantly changed Ohio laws's coverage of some of the services provided by telephone companies.⁴ However, new provisions do not mandate a different regulatory approach. Rather they place the ability to alter the basic structure of regulation in the discretion of the Public Utilities Commission of Ohio (PUCO). Before a telephone company may offer services at prices set by market forces rather than regulatory fiat, the PUCO must make a determination that deregulation of the service is in the public interest and that there is either competition for the service or reasonably available alternatives.⁵ Thus, the PUCO is directed to make a determination about its continuing authority to regulate telecommunications.

The Commission's ability to regulate under House Bill 563 raises some questions concerning the nature of future telephone service. The statute itself recognizes some of these concerns in that it directs the PUCO to maintain universal and low cost basic telephone service while promoting continued innovation, diversity of supply, and regulatory flexibility.⁶ However, as noted by several witnesses during the legislative hearings on the new law, the statute fails to provide specific guidance regarding the balance to be struck among these factors.⁷

In any case, it is not at all clear that the commission will even use its new authority. Prior to and after federal divestiture and deregulation, Ohio communications regulation has been structured to maintain the position of the existing companies, which hold monopoly positions over facilities. This regulation may have also created significant subsidies which deregulation and a competitive environment will not support. However, as noted above, there are significant pressures which may not permit the commission to continue that approach. Furthermore, it may not be in the best interest of the local exchange companies for the commission to do so. Whether the competing concerns of low costs and maintenance of subsidies and universal service can be accomplished within this new environment remains a difficult, if not impossible, question to answer. It is clear that the commission will need to adopt alternative forms of regulation (and

S.D. CODIFIED LAWS ANN. §§ 49-31-1 to 49-31-4.3 (Supp. 1990); TEX. REV. CIV. STAT. ANN. art. 1446c (Vernon Supp. Code Ann. §§54-8b-1 to 54-8b-4 (1990)); VT. STAT. ANN. tit. 30, §§202c-d, 226a, 227a (Supp. 1990); WASH. REV. CODE §§80.36.300-80.36.380 (Supp. 1991); WIS. STAT. §196.195 (1987-88).

⁴ Codified, in part, at OHIO REV. CODE §§ 4927.01-05 (Anderson Supp. 1990).

⁵ OHIO REV. CODE § 4927.03 (Anderson Supp. 1990).

⁶ OHIO REV. CODE § 4927.02(A) (Anderson Supp. 1990).

⁷ Testimony of MCI Telecommunications Corp. at Hearing on H.B. 563 before the Subcommittee on Telecommunications, Ohio House of Representatives, at 2 (undated).

deregulation, in some cases) if the apparent goals of the legislation are to be met.

To this end, the commission might consider using its new authority in a manner which is consistent with the basic economic model on which it appears to be based. In theory, at least, the commission could deregulate those services that are competitive and adopt price regulation which encourages better performance of telephone monopolies for those services which are not in competitive markets. To accomplish these goals, the commission must consider tools that it has not used in the past, and it may be forced to draw from the antitrust literature for some guidance. While these changes pose some significant departures from traditional regulation, they also present a better method of coping with various competing interests and changes in the marketplace which appear to be inevitable.

In order to address the various concerns raised by this general grant of authority given to the commission, this article is divided into several sections. Part I reviews the market changes that exist and which, in part, drive the regulatory changes and have emerged because of them. Parts II and III establish the basic regulatory schemes that existed prior and subsequent to divestiture and deregulation at the federal level. Part IV sets out the Ohio regulatory structure which previously controlled the actions of the Ohio commission. Parts V and VI then address the response of the Ohio commission and supreme court to the changes at the federal level and note some potential institutional barriers to deregulation. Part VII introduces the legislative response to deregulation, House Bill 563. Part VIII then suggests how the commission may use the economic model on which deregulation and divestiture are based and suggests some concerns drawn from antitrust and regulatory literature about developing effective regulatory oversight of the monopoly and "competitive" portions of the Ohio telecommunications market.

THE CHANGING MARKETPLACE OF TELECOMMUNICATIONS

Change is a truism of telecommunications in all respects. In part, technological innovation in the market triggered these changes. As a result of innovation, some writers suggest a fundamental breakdown in the market divisions recognized in the federal, state, and judicial definitions that governed telephone service.⁸ Though regulation remains a significant element in the telecommunications business which is likely to continue,⁹ it is no longer business as usual for the regulators, the regulated, or the consumers. The changing market has seen to that.

⁸ McKenna & Slyter, *The Modification of Final Judgment: An Exercise of Judicial Overkill*, 9 COMM/ENT 9, 14 (1986).

Market Changes

One of the keys to understanding the rapidly changing legal environment is to look at the effects which the FCC and judicial efforts to deregulate have had on the telecommunications market. Market segmentation, price and cost shifting, and the introduction of new players and services are some of the more dramatic outcomes.

First, market shares have shifted. AT&T has retained dominance in the interstate market with a seventy percent share, while MCI has as much as twelve percent, and Sprint has eight percent.¹⁰ While the AT&T market share has decreased, total traffic has increased.¹¹

One must also be sensitive to divisions within the markets. According to one survey of eighty-seven companies, the AT&T share appears to be decreasing in the business market. AT&T held sixty-two percent, MCI twenty-seven percent, and Sprint ten percent.¹² The erosion of the AT&T market share will likely continue as corporations seek to diversify their supply of communications services. Customers appear to be responding to concerns about transmission quality, reliability and price, rather than an interest in brand loyalty.¹³

At the same time, new efforts are developing in various segments of the market that did not previously exist. The residential and small business portions represent seventy percent of the total long distance market.¹⁴ To make up for income lost as a result of the decreasing margins available in the large business sector, there is increased pressure on the long distance carriers to seek residential and small business customers.¹⁵

Segmentation is translated into specialized products by several competitors. AT&T has promoted a number of special rates differing from its standard MTS (measured toll service) tariff for the small residential user. "Reach Out America" is for the large residential user, "Pro America" is aimed at the small business, and "Megacom" is for the large business.¹⁶ AT&T has also sought to

¹⁰ Carnevale, *Finance World Is Newest Turf in Phone Battle*, Wall St. J., Nov. 15, 1989, at B1, col. 6 and B7, col. 1.

¹¹ J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *EVALUATING COMPETITIVENESS OF TELECOMMUNICATIONS MARKETS: A GUIDE FOR REGULATORS* 102 (1988).

¹² Carnevale, *supra* note 10, at B9, col. 1.

¹³ *Id.* at B9, cols. 1 and 2.

¹⁴ *Id.* at B9, col. 3.

¹⁵ Keller and Carnavale, *Long-Distance Battle Shifts to Homes, Small Businesses*, Wall St. J., Dec. 20, 1989, at B1, col. 3.

¹⁶ Trebing, *Apologetics of Deregulation in Energy and Telecommunications: An Institutional Assessment*, 20 J. ECON. ISSUES 613, 622 (1986).

provide highly specialized tariffs for several large customers.¹⁷ Other inter-exchange carriers have responded innovatively. To encourage additional calling during low usage periods, MCI has introduced discount calling plans for residential callers and tie-ins with other companies such as American Airlines.¹⁸

Second, price effects are an interesting element of the deregulatory mix. In some instances, prices are tightening. Though there is some evidence of limit pricing in the telecommunications market,¹⁹ the cost of long distance service decreased thirty-nine percent between 1984 and 1989.²⁰ Corporate communications costs have been reduced by as much as fifty percent.²¹ At the same time, the spread between AT&T and its competitors predictably decreased as the handicapping created by regulation has eased.²² On the other hand, local rates increased about thirty-five percent based on a five year average,²³ though the increased costs may have been offset by the freedom to purchase telephone equipment and the net reduction in rental costs for phones.²⁴ Overall, the cost of telephone service has increased by about sixteen percent, which when adjusted for inflation results in a slight decrease in cost.²⁵

A third obvious effect of recent changes in regulation is the greatly increased entry, the variety of products and services available for telecommunications and diversification. In private point to point communications, one of the first areas to develop along competitive lines, there appears to be a healthy competition, though market shares would still indicate a dominant position for AT&T.²⁶ The Bell companies have sought to enter international markets as a means of finding new sources of revenues under divestiture.²⁷ Making use of IBM's radio system and Motorola handheld computers, the two companies will offer a service by which computers can be taken directly to the field and communicate

¹⁷ See *infra* text accompanying notes 238-45.

¹⁸ Keller and Carnevale, *supra* note 15, at B2, col. 4 (For each one minute of service, the customer receives five frequent flier miles.).

¹⁹ Trebing, *supra* note 16, at 622.

²⁰ *Dealmakers Are Burning Up the Phone Lines*, BUS. WK. 138, 139, March 13, 1989 (hereinafter as *Dealmakers*).

²¹ Labich, *Was Breaking Up AT&T a Good Idea?* FORTUNE 82, 83, Jan. 2, 1989.

²² Trebing, *supra* note 16, at 618-19.

²³ Labich, *supra* note 21, at 82. From 1983, long distance rates decreased twenty-eight percent and intrastate rate two percent while local service increased forty-three percent, according to AT&T. Tanzillo, *Flood Gates Open*, COMM. NEWS, Jan. 1989, at 49.

²⁴ Labich, *supra* note 21, at 83.

²⁵ *Id.* at 83.

²⁶ J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 32 n. 12.

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²⁷ *Dealmakers*, *supra* note 20, at 144.

information back to corporate computers.²⁸ Despite some early failures, AT&T appears to be successfully moving into the area of computer sales, especially in some targeted markets requiring high speed minicomputer applications.²⁹ Locally, Ohio Bell and other local exchange companies have filed tariffs for the provision of caller identification, automatic call back, and phone screening.³⁰

In summary, following deregulation and divestiture, the telephone system looks less like a single network. In its place, several potentially competitive markets have emerged.

The Role of Competition in the Future

For the future, the role of competition is both certain and enigmatic.³¹ The Justice Department study prepared by Peter Huber for the first triennial review of the Modified Final Judgment³² offers a strong suggestion that competition will be at the heart of the interstate and intrastate telecommunications markets. Arguing that the system will move to greater decentralization, with more paths between points (the "geodesic network"), Huber suggests that the current industry strategy is to design methods to bypass the local operating companies.³³ In particular, carriers are attempting to avoid the use of switching and local transmission facilities that form the basic bottleneck associated with local service.³⁴ Local exchange carriers face competition for switching from private branch exchanges (PBXs) and direct interconnection with the interexchange carrier. Additional competition for specific segments of transmission may arise from satellite and data services.³⁵ In addition to competition in switching at the local level, there exists competition for hauling or transmission in the form of

²⁸ Carroll, *IBM, Motorola Plan Radio Link for Computers*, Wall St. J., Jan 29, 1990, at B1, col. 6.

²⁹ Keller, *Reaching Out: In Computer Industry, No One Is Laughing At AT&T's Effort Now*, Wall St. J., Jan. 12, 1990, at A1, col. 6.

³⁰ Lafferty, *Busy Signals: High Technology May Soon Pit My Phone Against Your Phone*, Columbus Dispatch, Jan. 14, 1990, at C1, cols. 1 and 2.

³¹ "Emerging competition in [the local services market] consists of PBX and CENTREX competition and competition for operator services. The competition in the PBX and CENTREX market is largely for custom-built switching systems. ... [C]ustom-made orders are not conducive to tacit collusion. The competition for operator services is largely between AT&T and the local operating companies. These services are largely homogeneous. Customer purchases of most telephone services tends [sic] to be frequent, small, and regular which is a condition favorable to tacit collusion. The existence of posted tariffs for nearly all telephone services compounds the conditions already present for tacit collusion." J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 33.

³² See *infra* text accompanying notes 148-76 and 246-60.

³³ See P. HUBER, *THE GEODESIC NETWORK: 1987 REPORT ON COMPETITION IN THE TELEPHONE INDUSTRY 1.8* (1987).

³⁴ *Id.*

³⁵ *Id.* at 2.13 to 2.18.

private lines, microwave, and fiber optic systems.³⁶ Indeed, one of the curiosities of the current system of regulation is the aspect of local exchange companies providing a private line service to interexchange carriers which bypasses the local exchange network.³⁷

On the other hand, there are several potential barriers to the creation of the competitive network described by Huber and others. Huber himself describes some of the problems that may prevent the interconnection necessary to relieve the bottleneck that currently defines monopoly local service and potentially prevents effective competition at all levels of the telecommunications system. First, high costs of entry exist in many markets.³⁸ Second, the fundamental structure of the telecommunications system remains basically unchanged, despite the rapid movement of computer technology into various telecommunications functions.³⁹ It still requires a line connecting two points; the local component may always be essentially a monopoly based on scale economies. Third, the market remains highly concentrated in several areas where competition would appear most likely to occur.⁴⁰ Moreover, in areas where monopoly connections are truly significant, such as local exchange service, the concentration is even more obvious.⁴¹ Finally, there remains the residual problem that only the affluent can afford the range of opportunities that may develop.

The major carriers can build around the [Regional Bell Operating Companies]. They will resell [Regional Bell Operating Companies] services while they do, and then migrate major customers on to fully independent, end-to-end, service networks when the job is completed.

³⁶ *Id.*

³⁷ *Id.* at 3.27.

³⁸ Even in the competitive equipment market, there is some doubt that one could consider it "contestable" within the meaning suggested by the economic theorists. *See id.* at 1.12 ("Building the next generations of optical super-switches and super-computers will require enormous concentrations of capital, talent, and sustained engineering effort. ... This not a market that the largest players enter lightly, or that smaller players enter at all."). In the area of enhanced services, the barriers to entry (such as exorbitant start up costs to establish them) are extremely high, while the cost of use by additional customers is low. *Id.* at 1.25.

³⁹ *Id.* at 1.18. There are no effective substitutes in the market for local exchange company access for small users. *Id.* at 3.7.

⁴⁰ Enhanced communications services tend to be very concentrated. "Two firms provide 70 percent of the public packet switching service in the U.S. ... In voice storage and retrieval services, the top four firms hold over 50 percent of the market; in electronic mail, the top three have over 80 percent." *Id.* at 1.25. Nearly eighty percent of the switched access lines are controlled by the Bell operating companies. *Id.* at 2.5.

⁴¹ IntraLATA toll amounts to about a third of all switched toll traffic and about a quarter of toll revenues. *Id.* at 3.5. The Bell operating companies account for nearly all of this traffic and revenue within their areas. *Id.* Nationally, the local companies earn about \$15 billion in revenues from the service. *Id.* This problem may be compounded by the lack of equal access that remains. *Id.* at 3.15.

. . . [T]he [Regional of Bell Operating Companies] will remain system integrators for the poor, the tired, and the hungry.⁴²

Others have forcefully argued that the future portends limited competition. For example, Kenneth Flamm tends to discount the likelihood of significant success by telecommunications companies in entering other high technology areas.⁴³ Flamm further rejects the notion that a fundamental shift in costs that would result in decentralization of the telecommunications network has occurred.⁴⁴ Flamm also suggests that the costs of producing the geodesic network suggested by Huber will generally be higher than the traditional centralized network, but will offer safer performance (redundancy and lower level of casualty from interruptions of service).⁴⁵ Whether this tradeoff is sufficient to fuel growth and competition is uncertain.

It may be fairly concluded that some portions of the telecommunications market are not competitive.⁴⁶ This is particularly true of the local exchange monopoly that is maintained by current regulation. The Bell operating companies continue to retain a heavy concentration of the local and access market. In 1988, access charges amounted to \$20.4 billion (about 20 percent) of Bell company revenues.⁴⁷ Furthermore, even the most generous economic theory does not seem to support deregulation of some Bell services.⁴⁸

Nor is this situation likely to change, according to some writers. In contrast to the conclusion reached by Huber that the growing interconnectedness results in a reduction of monopoly control, Lee Selwyn suggests the maintenance of the network itself is a factor which will result in increased dangers of bottleneck control.⁴⁹ Moreover, the extent to which the current competition in the long distance market is the result of current pricing and other handicaps imposed on the divested Bell system or successful competitive entry is not

⁴² *Id.* at 1.23.

⁴³ Flamm, *Technological Advance and Costs: Computers versus Communications*, in *CHANGING THE RULES: TECHNOLOGICAL CHANGE, INTERNATIONAL COMPETITION AND REGULATION IN COMMUNICATIONS* 13, 58-59 (R. Crandall and K. Flamm, eds. 1989).

⁴⁴ *Id.* at 60-61.

⁴⁵ *Id.* at 408-10.

⁴⁶ Selwyn, *Assessing Market Power and Competition in the Telecommunications Industry: Toward an Empirical Foundation for Regulatory Reform*, 40 *FED. COMM. B.J.* 193, 196 (1988).

⁴⁷ Irwin, *The Demise of State Telecommunications Regulation?* *TELECOMM.* 70 (Dec. 1986).

⁴⁸ See Gabel, *Deregulation: Should the Local Telephone Market be Next?* 24 *NEW ENGLAND L. REV.* 39 (1989) (arguing that the theory of contestability did not apply to the local provision of dial tone and access service).

clear.⁵⁰

Finally, consolidation appears to be growing at the same time that increased competition and entry are possible due to the reduction of regulatory barriers. Consolidation is particularly evident in the area of equipment production.⁵¹ Some analysts believe that current consolidation will result in five or six giant firms.⁵² The effects of consolidation, however, may be limited by the introduction of foreign competition. This is, in fact, already happening. A nearly ten-fold increase in the foreign trade deficit in communications equipment occurred with deregulation.⁵³ In sum, the future of competition is far from clear or certain.

The State-Local Market and Competition

The problems of deregulation really manifest themselves at the local level. The market for equipment and long distance services that formed the first wave of deregulation was, in its own way, relatively discrete. Deregulation at the state level, however, more closely touches sensitive political and economic nerves. Much has already been written about the intractable problem of subsidies and their maintenance in an age of deregulation. In particular, a growing amount of bypass may threaten to expose the remaining customers to much higher telephone costs. In addition, regulatory control is difficult to maintain in a partially regulated environment with limited state resources. Labor consequences are also an immediate and real fallout. Finally, change increases consumer dissatisfaction with telecommunications services. These problems reflect back to legislators and regulators in a way that often makes the rhetoric of deregulation very difficult to implement.

First, deregulation has upset the balance of apparent local subsidies under the prior federal-state scheme.⁵⁴ Historically, three forms of subsidy existed within the regulatory structure. Long distance service provided a subsidy to local service. Business rates subsidized residential rates. Averaging of rates created a subsidy from lower-cost, high-density urban service to higher-cost, low density rural service.⁵⁵ As discussed more fully below,⁵⁶ political pressures preclude

⁵⁰ Kahn & Shew, *Current Issues in Telecommunications Regulation: Pricing*, 4 YALE J. ON REG. 191, 192 (1987).

⁵¹ *Dealmakers*, *supra* note 20, at 138.

⁵² *Id.* at 139.

⁵³ Labich, *supra* note 21, at 85.

⁵⁴ In addition to the text that follows, see *infra* text accompanying notes 94-107.

⁵⁵ Breyer, *Antitrust, Deregulation, and the Newly Liberated Marketplace*, 75 CAL. L. REV. 1005, 1028 (1987).

⁵⁶ See *infra* text accompanying notes 201-13 regarding access charges.

rapid migration from those policies. "The court [in ordering the divestiture of AT&T] may have altered the industry's structure, but it has not yet curbed the general political appetite for subsidized local telephone service. The result thus far has been ad hoc political intervention in an effort to accommodate the mutually exclusive goals of (court-supported) cost-based prices and (congressionally and regulatorily supported) subsidized prices."⁵⁷

Because of past regulatory practice, utilities and their customers face significant cost shifting if large customers migrate away from the monopoly system and strand prior investments made on their behalf on the remaining customers. Bypass of the local system appears to be a real growing concern. Major business customers have led the way in the use of bypass technologies with the creation and purchase of fiber-optic equipment, satellite antennas, microwave systems, and digital switches.⁵⁸ An effect of bypass is to eliminate customers which provide the most substantial portion of toll revenue, and in some cases the loss of the customer is permanent.⁵⁹ Moreover, some firms that have bypassed the telephone system now offer to sell their excess capacity to others, which aggravates the problem, by compounding the effects.⁶⁰

An example of a growing bypass method is a fiber-optic system to connect the end user to the long distance provider. This carriage, which is called local transport or teleports, in essence bypasses a portion of the local system that carries messages from the local switch to the interexchange carrier.⁶¹ On the positive side, the provision of local transport by fiber-optic carriers may provide for some efficiencies of scale based on improved technology, lower construction costs, and the aggregation of traffic. Teleports may also provide superior grades of service at a better price,⁶² and a back-up to traditional phone carriage.⁶³ However, on the negative side, there is the potential that prior investment to serve the former customers will be stranded and the costs shifted to the remaining, less flexible and affluent customers.

Among smaller users, there also exist opportunities for bypass in the form of shared systems. In a shared system, the tenants of a building or several

⁵⁷ MacAvoy & Robinson, *Losing By Judicial Policymaking: The First Year of the AT&T Divestiture*, 2 YALE J. ON REG. 225, 261 (1985).

⁵⁸ Irwin, *supra* note 47, at 72.

⁵⁹ Note, *Local Access Bypass*, 37 FED COMM. L.J. 325, 340-41 (1985).

⁶⁰ Irwin, *supra* note 47, at 74.

⁶¹ Radford, *Fiber-optic Networks Nibble Away at the Bell Local Monopoly*, 124 PUB. UTIL. FORT. 4, 4-5 (Dec. 21, 1989).

⁶² Lopez, *Fiber-Optic Network Take the Baby Bells by Surprise*, Wall St. J., Dec. 27, 1989, at B1, col. 6.

buildings combine their telephone needs through a private switch and take advantage of the economies of scale to lower their costs.⁶⁴ In effect, several customers act as though they had the same phone needs of one very large business. Like corporate bypass, the problem with shared tenant services is the likelihood that the loss of large users of the system will result in stranded investment and a potential increase in rates to the remaining customers. To some extent the costs of service will be decreased by the loss of customers. On the other hand, certain fixed costs may not be recovered, and will have to be spread among the remaining, less flexible customers.⁶⁵

Second, changes in the regulatory and industrial structure place additional demands on regulators. A partially deregulated system presents opportunities for the remaining monopoly to leverage its monopoly power in competitive markets.⁶⁶ Recent evidence suggests that just such action is likely. An FCC audit determined that purchases by regulated utilities from unregulated subsidiaries of Nynex (one of the holding companies created as a part of the AT&T divestiture) were padded by as much as \$120 million. In effect, the unregulated subsidiary, inflated prices of goods and services provided to the regulated subsidiary, which had adopted a policy to purchase its capital equipment from the unregulated entity.⁶⁷ The monopoly customers thus were paying a premium that was passed back to investors.

Third, there have also been significant labor effects of deregulation. In attempts to lower labor costs, many of the regional holding companies have directed major labor force reductions.⁶⁸ A Pacific Telesis plan called for the elimination of 11,000 of 69,000 jobs. Bell Atlantic planned to eliminate 1,200 positions, US West offered early retirement incentives to 20,000 of its 22,000 managers, and Nynex offered a similar plan to 10,000 of its 27,000 management employees.⁶⁹

Finally, the deregulation of various services has resulted in consumer disenchantment due to the loss of a single provider for all parts of the system. In the case of phone equipment, for example, "[t]he customer can no longer simply rely on the telephone company to provide a quality instrument and to replace or

⁶⁴ See *infra* text accompanying notes 409-29.

⁶⁵ Powers, *Public Interest Implications of Telecommunications Deregulation*, 16 POL'Y STUDIES J. 146, 150-51 (1987).

⁶⁶ See *infra* text accompanying notes 121-23.

⁶⁷ Wilke & Carnevale, *Nynex Overcharged Phone Units for Years, an FCC Audit Finds*, Wall St. J., Jan. 9, 1990, at A1, col. 6 and A6, cols. 1-4

⁶⁸ Lopez, *Pacific Telesis Plans Job Cuts of About 11,000*, Wall St. J., Jan. 5, 1990, at A2, col. 3.

repair that instrument as needed."⁷⁰ There is also a growing awareness that competition is not a panacea for all problems. A recent analogy is cable television. Rapid increases in rates and subscriber complaints of price gouging have resulted in congressional proposals to regulate cable television by permitting additional local regulation of prices.⁷¹ A similar episode relating to telecommunications emerged in the area of alternative operator services.⁷²

These complex economic, political, and legal effects in telecommunications offer a striking contrast to the relatively predictable environment that existed prior to deregulation. However, the assumptions that deregulation drives this change are themselves a partial result of the perceived failure of the stable system of cost based regulation to meet societal goals.

THE TELEPHONE MONOPOLY AND ITS REGULATION

Prior to deregulation and divestiture, regulation of telecommunications at both the federal and state level followed the basic "rate of return" regulatory model. In fact, the actions of the regulatory commissions and the Justice Department helped create the vertically integrated structure of the industry and maintained it for several decades by protecting it from competitive forces. Inherent in that choice was faith in rate-of-return regulation and a complicated federal-state arrangement of costs to promote low-cost local service.

The Theoretical Structure of Monopoly Regulation

In the traditional model of welfare economics, regulation is justified in those instances in which market failure lead to inefficiency.⁷³ First, an industry may be regulated so that its prices reflect the full costs, both internal and external, of its production. A common example of this form of regulation is that established to internalize the cost of pollution.⁷⁴ Second, regulation may be used to reverse the effect of informational difficulties. For example, "[a] role for government may arise if workers remain ignorant of [a] risk to their health. ... [G]overnment may exploit its coercive sanction and economies of scale in the collection, analysis,

⁷⁰ Powers, *supra* note 65, at 148.

⁷¹ Carnevale, *Congress Seeks to Rein In Cable TV*, Wall St. J., December 11, 1989, B-1, col. 4. Potential competitors have complained that the deregulated cable television companies have used the excessive profits from captive customers to buy up programming and competitive systems. *Id.* at B-1, col. 6.

⁷² In October 1990, Congress passed the Telephone Operator Consumer Services Act. The Act requires alternative operator services to provide extensive information to consumers and threatens full price regulation is the market fails to drive price down. 136 Cong. Rec. H8744 (daily ed. Oct. 2, 1990). See Darr, *The Regulation of Alternative Operator Services*, __ HIGH TECH. L.J. __ (forthcoming 1991).

⁷³ Aranson, *Theories of Economic Regulation: From Clarity to Confusion*, 6 J.L. & POL. 247, 249-50 (1990). See generally, S. BREYER, *REGULATION AND ITS REFORM* 15-35 (1982).

and dissemination of information to overcome this problem."⁷⁵ Third, government may intervene by direct price regulation in those industries in which monopolies develop due to production factors or government intervention. In the case of a natural monopoly,⁷⁶ the government substitutes price and entry regulation because the market power of the monopolist will permit it to establish prices above those a competitive market would provide.⁷⁷

Rate regulation of a natural monopoly is premised on a "compact" between the utility and the state. The compact "promises a utility the opportunity to earn a reasonable return on its investment in exchange for the utility's obligation to serve all customers in its service area free of retail competition."⁷⁸ The rate-making formula used by commissions to establish what a utility is entitled the opportunity to earn is rather innocent looking: Revenue = Operating Expenses + (Rate of Return x Ratebase).⁷⁹ Operating expenses are those costs associated with providing utility services.⁸⁰ Rate of return is a weighted average of the cost of debt and equity to the company.⁸¹ Ratebase consists in general of the cost of equipment necessary to provide the required service, less accumulated depreciation.⁸² The formula is deemed cost-plus because the utility recovers its expenses and a return on its investment.

Initial Federal Regulation of Telecommunications

Federal regulation of communications adopted the basic rate of return model of regulation. In 1910, Congress passed the Mann-Elkins Act, providing for the Interstate Commerce Commission (ICC) to regulate interstate telegraph and telephone services.⁸³ Following its approach to the regulation of railroads, the ICC imposed a uniform system of accounting and initiated valuation studies.⁸⁴ However, due to the limits of ICC efforts and the growing telephone market, and prompted by presidential encouragement of a separate regulatory

⁷⁵ *Id.* at 254.

⁷⁶ A natural monopoly occurs when a single company is the most efficient means of supplying a market because it has a declining marginal cost over the relevant market. *Id.* at 253-55.

⁷⁷ *Id.* at 255-58.

⁷⁸ Steinmeier, *Where Theory Meets Reality: The Case Against PUHCA "Reform,"* ELECTRICITY J. 50 n.7 (Jan./Feb. 1990).

⁷⁹ E. GELLHORN & R. PIERCE, REGULATED INDUSTRIES 89 (2d ed. 1987); R. POSNER, ECONOMIC ANALYSIS OF LAW 321 (3d ed. 1986); F. WELCH, CASES AND TEXT ON PUBLIC UTILITY REGULATION 258 (rev. ed. 1968).

⁸⁰ R. POSNER, *supra* note 79, at 321.

⁸¹ *Id.*

⁸² E. GELLHORN AND R. PIERCE, *supra* note 79, at 107, 131-34; J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 191-223 (1961).

⁸³ Pub. L. No. 218, 36 Stat. 539 (1910).

⁸⁴ C. PHILLIPS, THE REGULATION OF PUBLIC UTILITIES 636 (1984).

agency, Congress passed the Federal Communications Act of 1934.⁸⁵

Initially, the Act created the Federal Communications Commission (FCC), and directed it to regulate in a manner which would provide "rapid, efficient, Nation-wide" service "with adequate facilities at reasonable prices," assist in the national defense, promote safety, and centralize regulation.⁸⁶ However, jurisdiction extended only to interstate and international communications. Intrastate communications remained a matter for the states.⁸⁷

The Act fails to define explicitly the kind of regulation that the FCC is supposed to engage in. Instead, it directs the FCC to regulate so that there is the provision of adequate services at just and reasonable rates.⁸⁸ It further directs that common carriers may not discriminate in rates or services.⁸⁹ It requires that tariffs be filed with the FCC,⁹⁰ sets up a complaint process,⁹¹ permits the commission to value property using original cost methods,⁹² and requires determination of public convenience before installation or abandonment of lines is permitted.⁹³ Finally, the common carriers are directed to file annual reports describing their costs, equity, and debt in accordance with accounting standards established by the FCC.⁹⁴

Though the Act did not prescribe a particular formula for setting rates, the FCC followed an original cost approach consistent with the rate of return model. In a series of investigations spanning over thirty-five years, the FCC adopted original cost valuation and revised depreciation schedules.⁹⁵ Following these efforts, the FCC revisited the basic rate of return mechanism in a second major series of investigations from the mid-1960s to the mid-1970s.⁹⁶

Though the FCC's efforts developed along the traditional line of rate of return regulation, the commission did face one rather unusual and recurrent

⁸⁵ *Id.* at 636-37.

⁸⁶ 47 U.S.C. § 151 (1988).

⁸⁷ 47 U.S.C. §§ 152(a) & (b). For a discussion of the recent problems the dual structure of regulation has caused, see Darr, *Overview*, in 13 *Public Utilities Law Anthology* xvii (1990).

⁸⁸ 47 U.S.C. § 201 (1988).

⁸⁹ *Id.* § 202(a).

⁹⁰ *Id.* §§ 203 & 204.

⁹¹ *Id.* §§ 205, 208, & 209.

⁹² *Id.* § 213.

⁹³ *Id.* § 214.

⁹⁴ *Id.* §§ 219 & 220.

⁹⁵ C. PHILLIPS, *supra* note 84, at 639.

⁹⁶ *Id.* at 610. For a summary of the 1967 orders concerning rate base, depreciation, and separations, see 2 A. PRIEST, *PRINCIPLES OF PUBLIC UTILITIES REGULATION* 687-703 (1969).

problem: the division of revenue between the long distance monopoly, the AT&T Long Lines Department, whose rates it regulated, and the Bell and independent operating companies that connected with Long Lines for the completion of interexchange calls, whose rates state commissions regulated. The process devised pursuant to the Communications Act⁹⁷ was called "separations and settlements." Acting through a joint board of federal and state officials, the FCC set three formulas for the distribution of funds. "Separations" served to allocate the costs and revenues between federal and state jurisdictions.⁹⁸ "Settlements" allocated revenues between Bell and independent phone companies.⁹⁹ "Division of revenues" then allocated revenues between AT&T Long Lines and the Bell operating companies.¹⁰⁰

"Separations" was the key to the problem. The joint board attempted to allocate costs on the basis of actual use.¹⁰¹ To the extent that particular costs of interstate and intrastate service could be identified with a particular service, that cost and the resulting revenues were distinguished. However, the remainder, which was used for both local and interstate service, was allocated on the basis of relative use.¹⁰² The relative use formula then could be modified with the effect of shifting costs, a potential form of subsidy. In fact, modifications in the separations formula from 1959 to 1970 resulted in a transfer of cost responsibility in the range of \$500 million from local to long distance service.¹⁰³ Estimates placed the actual usage of the system for long distance at roughly eight percent, while the contribution to costs was almost 26 percent.¹⁰⁴

In effect, monopoly and its resulting regulation permitted regulators to reallocate costs through separations.¹⁰⁵ Though some of the literature is less than conclusive about the nature of the subsidies,¹⁰⁶ the effects of past practices in retrospect seem relatively clear in that access and connection charges shifted costs back to local service and away from interexchange.

⁹⁷ 47 U.S.C. § 410 (1982).

⁹⁸ C. PHILLIPS, *supra* note 84, at 206 n.32.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 206-07.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ Fowler, Halprin, & Schlichting, "Back to the Future": A Model for Telecommunications, 38 FED. COMM. L.J. 145, 176 & n.88 (1986).

¹⁰⁵ The state regulatory commissions and the FCC established a process for separations and settlements through a series of agreements that resulted in the adoption of separations manuals. C. PHILLIPS, *supra* note 84, at 206 & n.33.

¹⁰⁶ By one measure of subsidy, Temin and Peters found that a substantial cross subsidy ran from interexchange to exchange service. Temin & Peters, *Cross-Subsidization in the Telephone Network*, 21 WILLIAMETTE L. REV. 199, 213 (1983).

The overpricing of toll services prior to divestiture developed as a convenient means for state regulators to cross-subsidize local telephone service. The excess charges on AT&T long-distance calls were transferred to local telephone exchange carriers through a complicated settlements process. As long-distance costs fell, the federal-state regulatory board that controlled regulatory cost allocations decided to allocate an increasing share of the local nontraffic sensitive costs to the interstate long-distance services, thus increasing the degree of cross subsidy.¹⁰⁷

At the same time federal regulatory agencies were attempting to apply rate of return regulation to AT&T, Justice Department actions sustained the ability to subsidize by isolating the company from competitive markets.¹⁰⁸ Initially, the Department stalled Bell system efforts to buy its telecommunications competition at the local level. In the Kingsbury Commitment of 1913, the company agreed to avoid further purchases of local operating companies and to provide interconnection to independents for long line service.¹⁰⁹ This commitment resulted in joint network planning in which the AT&T Long Lines Department controlled long distance and the Bell operating companies and the independent exchange companies operated the local exchange.¹¹⁰ A 1956 consent decree directing AT&T to make its patents available, precluding it from providing nontelephone services, precluding its Western Electric subsidiary from manufacturing nontelephone equipment, and requiring Western Electric to disclose its costs further isolated AT&T.¹¹¹

Thus, the initial regulation of AT&T at the federal level evidenced an apparent faith that monopoly regulation was the appropriate paradigm. The FCC sought to apply rate of return regulation, and the Justice Department sought to eliminate the specter of a huge monopoly player from related competitive markets. As a result, AT&T held an enormous portion of the telecommunications market. Prior to the divestiture, the Bell system accounted for eighty percent of local calling and ninety percent of long distance communications.¹¹² These

¹⁰⁷ Crandall, *Surprises from Telephone Deregulation and the AT&T Divestiture*, 78 AEA Papers and Proceedings 323 (May 1988). "The policy of restricted entry also allowed cross-subsidization of telephone tariffs. Rate-averaging has resulted in cross subsidization between high and low user density routes, high and low population density areas, and large and small volume interexchange users. Heavy cross-subsidization also developed between interexchange and local services." Knieps & Spiller, *Regulating by Partial Deregulation: The Case of Telecommunications*, 35 AD. L. REV. 391, 396 (1983).

¹⁰⁸ For a discussion of the early Justice Department antitrust actions against AT&T, see Peters, *Is the Third Time a Charm? A Comparison of the Government's Major Antitrust Settlements with AT&T this Century*, 15 SETON HALL L. REV. 252 (1985).

¹⁰⁹ C. PHILLIPS, *supra* note 84, at 621-31.

¹¹⁰ *Id.* at 631.

¹¹¹ *Id.* at 634.

numbers made sense if the industry was a natural monopoly. At the same time, however, changes were taking place that challenged the paradigm.

Despite the attempts to isolate AT&T, the system of regulation was economically unstable. The manner of regulating telecommunications presented some basic problems, apart from arguments concerning its efficiency in particular segments of the market and the likelihood that the "regulated captured the regulators."¹¹³ Subsidies were at the root of the concerns. The subsidies created incentives for others to enter the market to siphon those customers who were paying the subsidies and could be offered less expensive rates for the same services.¹¹⁴ The subsidies likewise created a strong incentive for discriminatory behavior on the part of the existing monopolies and their regulators to prevent the entry of potential competitors that would upset the program.¹¹⁵

Consistent with these economic concerns, policy changes were afoot to deregulate portions of the market. In particular, the FCC began to permit limited entry into the equipment and long distance markets.¹¹⁶ This policy shift created several incentives which worked against the balancing act represented by the old system of dual regulation. The players acted as expected. When the FCC permitted the entry of competitive equipment, one of the complaints concerning AT&T tariffs for attachment of foreign terminal equipment centered on the rates that rendered the use of the competitive equipment uneconomical.¹¹⁷ Likewise, as competition was introduced in the long distance market, AT&T allegedly made interconnection with local markets more difficult and introduced tariffs selectively to avoid competitive encroachment over vulnerable routes.¹¹⁸ AT&T's response then set off an explosion of antitrust litigation which ultimately led to divestiture.¹¹⁹

¹¹³ An extensive literature concerning the effectiveness of regulation has developed. It is outside the scope of this article to discuss that matter. For a discussion of the literature, see R. HORWITZ, *THE IRONY OF REGULATORY REFORM* 22-45 (1989).

¹¹⁴ Temin and Peters, *supra* note 106, at 205-06.

¹¹⁵ Besen and Woodbury, *Regulation, Deregulation, and Antitrust in the Telecommunications Industry*, 28 *ANTITRUST BULL.* 39, 43 (1983).

¹¹⁶ See *infra* text accompanying notes 136-47.

¹¹⁷ Besen and Woodbury, *supra* note 115, at 43.

¹¹⁸ *Id.* at 45.

¹¹⁹ See *infra* text accompanying notes 148-76.

THE SHIFT IN FEDERAL REGULATION¹²⁰*The Theoretical Framework of Partial Deregulation and Its Limitations*

Once the monopoly paradigm is challenged, a substitute must be found. In those industries in which both competition and monopoly exist, the practical and political problems of regulation become significantly more difficult. When the monopolist operates in both the competitive and noncompetitive market, two economic problems emerge. First, the monopolist may seek to tie its product to the sale of the competitive product or may discriminate against the competition in the sale of the competitive product.¹²¹ In communications, for example, the monopolist has control over the last link to the customer and can use that to leverage higher rates for access to other services requiring that access. Second, the monopolist may misallocate the cost of its competitive service to its regulated one, thus giving it an additional advantage of lower costs in the competitive market.¹²² The example of NYNEX overcharging its customers for equipment bought from its competitive subsidiary is an example of this problem.¹²³ These outcomes of entry by a monopolist thus dictate a more complicated response by the regulator.

The logic of the competitive market would require the regulator to isolate the competitive and noncompetitive services and respond to each accordingly.¹²⁴ First, the commission would identify those services that are competitive and would deregulate them. The regulator would identify those that are not competitive, due to some sort of market failure, and would structure the appropriate form of regulation to address the market failure.¹²⁵ For those services offered by either the divested entities or competitors that require access to monopoly services, the commission would continue to set nondiscriminatory access charges. In form, the program is simple. Reality will prove the program more difficult to implement.

First, there will be an ongoing problem of noncompetitive subsidies. Even

¹²⁰ For a rather complete discussion of the regulatory revisions which took place at the FCC and in the court hearing the divestiture case, see Dempsey, *Adam Smith Assaults Ma Bell with His Invisible Hands: Divestiture, Deregulation, and the Need for a New Telecommunications Policy*, 11 COMM/ENT 527, 538-572 (1989).

¹²¹ Brennan, *Why Regulated Firms Should Be Kept Out of Unregulated Markets: Understanding the Divestiture in United States v. AT&T*, 32 ANTITRUST BULL. 741, 749-57 (1987).

¹²² *Id.* at 757-64.

¹²³ See *supra* text accompanying notes 66-67.

¹²⁴ Brennan, *supra* note 121, at 770-72.

¹²⁵ If the problem is one of natural monopoly, the response is greatly different than if the problem is one of external costs or informational failures. See *supra* text accompanying notes 73-82.

within this framework, there are two opportunities for cross-subsidization. First, interexchange carriers might attempt to subsidize services in competitive service territories from less competitive ones. Second, some of the interexchange carriers' services may be used to subsidize other services within a service area (although this requires that the services be somewhat differentiated.)¹²⁶

Competition may serve to check the use of subsidies. "It is argued that although some telecommunications markets are regulated, the presence of competitive alternatives in those markets reduces the likelihood of successful cross-subsidization. For example, the availability of facility bypass technologies (e.g., microwave facilities) as an alternative to switched access services reduces the likelihood that exchange carriers could recoup target market losses with access service revenues, even though access service revenues are derived from regulated rates."¹²⁷ However, the results of competition on subsidy are far from predictable.

Political constraints to removing subsidies also exist. It may not be a policy that is consistent with political will. (The recent Ohio experience, discussed more fully later, demonstrates that.¹²⁸) For example, commissions may desire to retain some subsidies to account for concerns about universal service. Yet, if cross-subsidies exist in the current rate structure, these will be incentives for competitors to enter and skim off parts of the market. Thus, "[i]f the public authorities desire both subsidizing prices and economies of scale, then the coercive authority of the government must be employed to restrict or prohibit entry into the market."¹²⁹ Government intervention then runs against the grain of deregulation.

Due to the competing economic and political agendas, pricing access remains a fundamental problem.¹³⁰ While the competitive solution would be the application of marginal cost principles,¹³¹ the nature of the entity being regulated may cause undesirable results. Moreover, the cost shifting from pricing access and other services at marginal cost may result in a decline in the welfare of the lowest third of the population. Approximately eighty percent of the benefits

¹²⁶ J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 137.

¹²⁷ Larson & Sievers, *On the Effectiveness of Price Floors in Telecommunications Regulation*, 25 WILLAMETTE L. REV. 89, 95-96 (1989).

¹²⁸ See *infra* text accompanying notes 327-514.

¹²⁹ Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AM. ECON. REV. 966, 972 (1975) (emphasis deleted).

¹³⁰ See *infra* text accompanying notes 209-211.

¹³¹ Since the cost of access is not a joint cost in the economic sense (i.e. access cost is not a fixed proportion of usage cost), marginal costing is the appropriate formula for setting cost of products. Kahn & Shew, *supra* note 30, at 202.

would flow to the highest one-third of the population.¹³²

The major concern is the recovery of costs. Under monopoly there is a tradeoff between efficient pricing and covering costs of production. On the one hand, marginal pricing will result in supracompetitive profits if marginal costs are increasing. If costs are decreasing, marginal pricing will result in revenues less than costs and may require a government subsidy to restore profitability to the regulated entity.¹³³

Another problematic consideration for the commission is the likelihood that its role in the market place will actually increase. One of the outcomes of partial deregulation already noted at the federal level is the increased scrutiny necessary to regulate on a service-by-service basis.¹³⁴ Commission involvement at the state level is also likely to increase as the level of detail and the number of potential entities increase.¹³⁵

These basic concerns and tradeoffs of partial regulation are readily apparent in the federal efforts. On the one hand, federal efforts have broken the back of the former paradigm and its subsidies. On the other, the FCC has faced considerable political wrath and incurred new regulatory duties to make the system work. The result is a significant experiment in determining whether partial regulation is viable.

The FCC's Actions Prior to Divestiture

Small cracks in the monopoly paradigm appeared in the 1950s, and major change was well on its way by the 1970s. The movement at the FCC to deregulate saw two primary candidates, equipment and interexchange carrier service.

The FCC directed its earliest efforts at deregulating the monopoly control over equipment. In 1956, the commission approved the attachment of a cup-like device that shielded conversation noise over a challenge by AT&T that the attachment threatened the integrity of the telephone system.¹³⁶ Twelve years later, in the *Carterfone* case,¹³⁷ the FCC opened the door to real competitive entry in the equipment market by permitting the attachment of foreign equipment

¹³² *Id.* at 253-54.

¹³³ J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 78.

¹³⁴ See *infra* text accompanying note 689.

¹³⁵ Knieps & Spiller, *supra* note 107, at 403.

¹³⁶ *Hush-A-Phone Corp. v. United States*, 238 F.2d 266 (D.C. Cir. 1956).

¹³⁷ *Use of the Carterfone Device in Message Toll Service*, 13 F.C.C.2d 420, *aff'd on reconsideration*, 14 F.C.C.2d 571 (1968).

(non-Bell owned) to the network. The FCC, however, spent seven more years before it approved a process for making attachments.¹³⁸ The transition prior to divestiture essentially ended with the *Computer II* decision to deregulate all customer premises equipment, permit end users to seek out the most appropriate provider on an unbundled basis, and permit some competitive activity in computer related services (referred to as "enhanced services") on the part of AT&T, through separate subsidiaries.¹³⁹

Parallel with the decisions concerning equipment, the FCC, with prodding from the courts, opened the way for the introduction of competitive carriers into the interstate interexchange market. Initially, the FCC permitted creation of microwave facilities for the private carriage in the *Above 890* docket.¹⁴⁰ It then approved point-to-point service between St. Louis and Chicago by MCI in 1969.¹⁴¹ "This approval prompted a deluge of applications seeking authorization of similar microwave facilities."¹⁴² The FCC responded with a rule that permitted carriers to provide private line services.¹⁴³

Court action broadened the effect of the rule-making as MCI sought, in effect, to provide interstate common carrier service. Initially, the FCC attempted to restrict the scope of the service by prohibiting MCI from offering two-way common carriage through its system.¹⁴⁴ The court of appeals reversed the commission and later directed it to approve a tariff filing authorizing the service.¹⁴⁵ Finally, the FCC approved the sale of competitive common carrier services in 1981.¹⁴⁶

¹³⁸ Interstate and Foreign Message Toll Telephone, First Report and Order, 56 F.C.C.2d 593 (1975), *modified on reconsideration*, 58 F.C.C.2d 716 (1976), Second Report and Order, 58 F.C.C.2d 736 (1976), *aff'd sub nom.*, North Carolina Util. Comm'n v. FCC, 552 F.2d 1036 (4th Cir.), *cert. denied*, 434 U.S. 874 (1978).

¹³⁹ Second Computer Inquiry, Final Decision, 77 F.C.C.2d 384, *modified on reconsideration*, 84 F.C.C.2d 50 (1980), *further modified on reconsideration*, 88 F.C.C.2d 512 (1981), *aff'd sub nom.*, Computer and Communications Industry Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983).

¹⁴⁰ Allocation of Frequencies in Bands Above 890 Mc., 27 F.C.C. 359 (1959), *modified on reconsideration*, 29 F.C.C. 825 (1960).

¹⁴¹ Microwave Communications Inc., 18 F.C.C.2d 953 (1969).

¹⁴² Fowler, Halprin, and Schlichting, *supra* note 104, at 155.

¹⁴³ Specialized Common Carrier Services, First Report and Order, 29 F.C.C.2d 870, *aff'd on reconsideration*, 31 F.C.C.2d 1106 (1971), *aff'd sub nom.*, Washington Util. Transp. Comm'n v. FCC, 513 F.2d 1142 (9th Cir 1975), *cert. denied*, 423 U.S. 836 (1975).

¹⁴⁴ In the matter of MCI Telecommunications Corp.—Investigation into the Lawfulness of Tariff F.C.C. No. 1 insofar as it Purports to Offer Execunet Service, 57 F.C.C.2d 271 (1975), *reversed sub nom.*, MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir. 1977).

¹⁴⁵ MCI Telecommunications Corp. v. FCC, 580 F.2d 590 (D.C. Cir. 1978), *cert. denied sub nom.*, United States Independent Tel. Ass'n v. MCI Telecommunications Corp., 439 U.S. 980 (1978).

¹⁴⁶ In the Matter of Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, 84 F.C.C.2d 445 (1981), *aff'd*, 91 F.C.C.2d 59 (1982).

The decisions to permit attachment of foreign equipment and interconnection of other common carriers fundamentally upset the process of regulation of the Bell system and the process of revenue distribution. Pricing access from the local exchange companies to AT&T and the other common carriers became critical. The local companies needed compensation for the connection of their facilities to the new companies. However, because the local companies were under the AT&T umbrella, AT&T had an opportunity to discriminate against its long distance competitors by denying access or discriminating on price. The initial solution was the creation of the Exchange Network Facilities Interconnection Agreement (ENFIA), essentially access charges to be paid by the interexchange companies for connection to the local exchange companies. The ENFIA program sought to set out tariffs for access during a transition to complete interconnection. Initially the FCC and the parties allowed for a form of handicapping. During the transition, ENFIA rates for access were substantially lower for the new entrants, such as MCI, because the service was not as good as that provided to AT&T Longlines.¹⁴⁷

Thus, the basic components of the partial deregulation model were in place by the time of divestiture. The commission began with an approach that directed nonmonopoly services to be more competitively structured and allowed interconnection. As indicated in the *Computer II* decision, competitive and noncompetitive portions of the market were separated. A form of access charge was created. On the other hand, some basic problems became evident. Pricing access, in particular, was subject to factors other than purely economic concerns. Handicapping and maintaining subsidies were already apparent.

*Divestiture of AT&T*¹⁴⁸

At about the same time, divestiture resulted in judicial supervision of the Bell system.¹⁴⁹ In 1974, the Justice Department filed suit against AT&T alleging numerous antitrust violations. As part of the settlement which resulted in the case, the plan of reorganization adopted pursuant to the 1982 Modified Final Judgment (MFJ) separated the long distance portion of the company and created seven regional holding companies to provide local exchange service and access

¹⁴⁷ Fowler, Halprin, and Schlichting, *supra* note 104, at 178.

¹⁴⁸ There is a wealth of literature discussing the divestiture of AT&T from a variety of viewpoints. The notes throughout this work contain references to some of them. For a discussion focusing on the personalities of the participants, see S. COLL, *THE DEAL OF THE CENTURY* (1986). For a discussion of the internal efforts of AT&T to restructure the company, see W. TUNSTALL, *DISCONNECTING PARTIES, MANAGING THE BELL SYSTEM BREAKUP: AN INSIDE VIEW* (1985). For a bibliography of divestiture literature, see Pinheiro, *AT&T Divestiture and the Telecommunication Market*, 2 HIGH TECH. L.J. 303 (1988).

¹⁴⁹ Technically, the decision applies to AT&T and the resulting Bell companies. The effect of the decision is much broader as it defines the kinds of limits placed on other federal and state agencies. See, e.g., *United States v. Western Elec. Co.*, 569 F. Supp. 990, 1008-10 (D.D.C. 1983).

for the interexchange service. Consistent with the model of partial regulation, the MFJ placed numerous restrictions on the kinds of business that the regional holding companies could enter.¹⁵⁰ Three fundamental restrictions applied to lines of business precluded the holding companies from providing interexchange communications or exchange services, manufacturing telecommunications equipment, or providing any other service except exchange access that was not regulated as a natural monopoly.¹⁵¹ However, the court did permit the company to market equipment,¹⁵² provide yellow pages directories,¹⁵³ and enter new markets so long as the company could demonstrate "that there is no substantial possibility that it could use its monopoly power to impede competition in the market it seeks to enter."¹⁵⁴

In its initial enforcement of the divestiture order, the court demonstrated a single-mindedness consistent with the model of partial deregulation. Under the court's scrutiny of the MFJ, the Bell Operating Companies' function was to provide monopoly services and access.¹⁵⁵ This view flowed directly from the court's decision concerning the merits of the government's case on an AT&T motion to dismiss filed at the completion of the government's case in chief.¹⁵⁶ In two areas, control of the customer premises equipment and interexchange access, the court found that AT&T's control of access served to preclude competition. First, the court found that the government had sustained its burden of proof concerning the uncompetitive practices of the company in requiring "protective connecting arrangements" for the attachment of foreign equipment to the phone network.¹⁵⁷ The court found the arrangements were unnecessary to protect the integrity of the system, overengineered to increase the cost of the product so as to make them uncompetitive, and were often delayed by AT&T to the detriment of equipment suppliers.¹⁵⁸ Second, the court concluded that the government had sustained its burden of proof concerning the failure of the company to provide access to other interexchange carriers. Relying on a theory of "monopoly bottleneck" that required the company to make the monopoly local exchange facilities "available to its competitors on fair and reasonable terms that

¹⁵⁰ *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131, 226-34 (D.D.C. 1982), *aff'd*, 460 U.S. 100 (1983).

¹⁵¹ *United States v. American Tel. & Tel. Co.*, 552 F. Supp. at 227-28, 231.

¹⁵² *Id.* at 231.

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 225.

¹⁵⁵ *McKenna & Slyter*, *supra* note 8, at 22.

¹⁵⁶ *United States v. American Tel. & Tel. Co.*, 524 F. Supp. 1336 (D.D.C. 1981).

¹⁵⁷ *Id.* at 1349. Until the FCC adopted a certification process for the attachment of foreign equipment, AT&T was permitted to require the use of attachment devices as a means of protecting the integrity of the phone network.

do not disadvantage them,"¹⁵⁹ the court found that AT&T used its tariffs to impose conditions that were discriminatory, refused interconnection, discriminated on the price of access, entered into bad faith negotiations, and ultimately gouged on rates for less than high quality access.¹⁶⁰

Additionally, the court found several other features of AT&T's activities that appeared anticompetitive. The government demonstrated some efforts at below cost pricing in the private line market as evidence of anticompetitive intent.¹⁶¹ It also showed that AT&T sought to limit purchase decisions of the operating companies to Western Electric products.¹⁶² The court addressed this concern by noting that excessive costs of equipment may have flowed to Western Electric through rate regulation.¹⁶³ Fundamentally, the court felt that the government had demonstrated that AT&T's control over the local monopoly placed it in a position to prevent the introduction of competition in both the equipment and interexchange markets.

The court's concerns were borne out in the its modifications of the consent decree, entered into between the government and AT&T, for the divestiture of the company. The court felt that control of the local facility permitted subsidization of the interexchange carrier and barriers to access.¹⁶⁴ (It is interesting to note that the cost shifting has since been in the other direction, with the effort directed at forcing additional costs on the local exchange companies on the basis of removing past subsidies.¹⁶⁵) To that end, the court agreed to exclude the local exchange companies (the agreement refers to them as the Bell Operating Companies or BOCs) from those activities by which the local exchange bottleneck would permit them to discriminate.¹⁶⁶ Thus, the court placed line of business restrictions on the operating companies, preventing them from entering interexchange service, information service, or manufacturing telephone equipment.¹⁶⁷ In each case, the court determined that the local exchange monopoly provided the operating companies with the incentive and opportunity to impede competition and the restriction would on balance contribute to competitive markets. On the other hand, the court determined that the sale of

¹⁵⁹ *Id.* at 1352-53. For a discussion of the essential facilities doctrine, see *infra* text accompanying notes 626-56.

¹⁶⁰ *United States v. American Tel. & Tel. Co.*, 524 F. Supp. at 1353-57.

¹⁶¹ *Id.* at 1364-70.

¹⁶² *Id.* at 1371-72.

¹⁶³ *Id.* at 1373.

¹⁶⁴ *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131, 162-63, 165 (D.D.C. 1982).

¹⁶⁵ See *infra* text accompanying notes 201-13.

¹⁶⁶ *United States v. American Tel. & Tel. Co.*, 552 F. Supp. at 188 (interexchange services), 189 (information services), and 190 (equipment manufacturing).

equipment did not present a competitive threat since there were not any significant common costs, collusion with manufacturers was unlikely, and a significant counterbalance in the form of Western Electric served to frustrate anticompetitive behavior.¹⁶⁸

The court also introduced an element of "public interest" rationalizing in its modification of the agreement. In its review of the agreement, the court concluded that federal antitrust law required it to make a determination that the settlement was in the public interest.¹⁶⁹ The court identified the public interest to be the maintenance of competition.¹⁷⁰ The court stated, however, that other policies were relevant in determining the proper remedy if the court "concluded that the decree unnecessarily conflicts with important public policies other than the policy embodied in the Sherman Act."¹⁷¹ The court's modification of the provision of the MFJ concerning the creation of advertising directories was a good example of how the court looked to policies other than antitrust to justify its actions. The court offered two reasons for transferring the right to produce advertising directories to the operating companies. First, it found that the transfer was justified as a means of avoiding further concentration in the market.¹⁷² Second, the court felt that the transfer was a means of providing an additional subsidy to the local exchange companies, as directory services tended to earn substantial profits.¹⁷³ (Again, there is an apparent contradiction in the nature of the subsidies associated with the prior system of separations.) In a sense, the court took on the role of a regulator seeking to protect the financial integrity of the local exchange company, an unusual stance indeed.

In addition to prohibiting the operating companies from engaging in certain lines of business, the MFJ also directed the companies to provide equal access. The court directed that access be phased in over several years, but also found that absolute parity was not required due to some practical problems.¹⁷⁴ Thus, the court approved differences in dialing requirements, resulting in dialing additional digits for connection to some carriers other than AT&T.¹⁷⁵ The court further suggested that the imposition of differentials based on quality of service

¹⁶⁸ *Id.* at 191-92. See also *United States v. American Tel. & Tel. Co.*, 1982-2 Trade Cases (CCH) ¶ 64,980 (D.D.C. 1982).

¹⁶⁹ *United States v. American Tel. & Tel. Co.*, 552 F. Supp. at 149.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 151.

¹⁷² *Id.* at 193.

¹⁷³ *Id.* at 194. This entrance into areas other than more narrow antitrust concerns would reappear again as the FCC attempted to shift additional costs away from interexchange rates. *United States v. American Tel. & Tel. Co.*, 569 F. Supp. 990, 998 (D.D.C. 1983).

¹⁷⁴ *United States v. American Tel. & Tel. Co.*, 552 F. Supp. at 196-97.

¹⁷⁵ *United States v. American Tel. & Tel. Co.*, 552 F. Supp. at 197-98.

be set by regulatory commissions.¹⁷⁶

Continued FCC and Judicial Supervision

Since the approval of MFJ and the introduction of competition in the interstate market, the FCC and the district court have faced the ongoing challenge of maintaining competitive aspirations through numerous requests from AT&T and the local companies for expanded authority. These requests have met with mixed success.

1. *FCC Actions*

After the *Computer II* decision, the commission faced a series of questions concerning the creation and financing of the AT&T separate subsidiaries and the use of sister (regulated) company resources for unregulated sales.¹⁷⁷ Throughout 1983 and 1984, the FCC reported on its progress in monitoring AT&T's efforts to create its independent subsidiary.¹⁷⁸ At the same time, the FCC was struggling with the task of setting a new separations policy for revenues related to the new AT&T structure created by *Computer II*.¹⁷⁹

Given the difficulties the federal commission was experiencing with the *Computer II* separate subsidiary requirement, it followed that it would seek to develop an alternative for the local exchange companies. The *Third Computer Inquiry*, begun in August 1985,¹⁸⁰ sought methods of avoiding the monitoring problems while addressing the loss of efficiency created by the separate subsidiaries requirement. In June 1986, the FCC issued an order with several basic findings.¹⁸¹ The commission concluded that basic voice and data services would remain regulated, enhanced services would remain unregulated,¹⁸² and structural separations could be removed under certain circumstances. If the telephone company established nondiscriminatory interconnection through open network architecture (ONA) and comparably efficient interconnection (CEI), it could be relieved of the requirement of separate subsidiaries. The commission

¹⁷⁶ *Id.* at 199.

¹⁷⁷ FCC ANNUAL REPORT 46-47 (1982).

¹⁷⁸ FCC ANNUAL REPORT 44-45 (1983); FCC ANNUAL REPORT 43 (1984).

¹⁷⁹ FCC ANNUAL REPORT 48 (1984).

¹⁸⁰ FCC ANNUAL REPORT 38 (1987).

¹⁸¹ Amendment of Sections 64.702 of the Commission's Rules and Regulation (Third Computer Inquiry), 104 F.C.C.2d 958 (1986), *vacated sub nom.* California v. FCC, 905 F.2d 1217 (1990).

¹⁸² One of the findings of *Computer II* was that enhanced services such as data manipulation would not be regulated. AT&T, however, was excluded from the market at the time because of the computer restrictions found in the 1955 Consent Decree.

ordered local exchange companies to file ONA proposals by February 1, 1988.¹⁸³ On December 22, 1988, the commission approved (with some qualifications) the general direction of the proposals submitted by the regional companies.¹⁸⁴ In essence, the plans provided for "unbundled" service offerings that could be used by enhanced service providers at prices and a quality that would be available to all providers, including those affiliated with local exchange companies.¹⁸⁵ Thus, the commission reasoned, the former barriers to entry on the part of monopoly providers of local connections could be removed.¹⁸⁶

Regulation of carriers was also changing. Following the FCC's approval of interconnection with other carriers, the commission determined that it would not regulate carriers lacking market power and would suspend regulation of resellers from tariff regulation.¹⁸⁷ Known as the *Competitive Common Carrier* cases, the FCC's decisions attempted to determine the kind of regulation necessary in a market filled with several very large companies and many new entrants.

In the first decision in the docket,¹⁸⁸ the commission divided the telecommunications world into dominant and nondominant carriers. Dominant carriers could exert market power in such a way as to extract supracompetitive profits and defeat entry by predatory pricing.¹⁸⁹ Creatively, the commission determined that nondominant firms were those lacking market power.¹⁹⁰ To determine dominance, the commission suggested that several factors were relevant, but placed special emphasis on the existence of bottleneck control of essential facilities. Under this definition of dominance, companies that leased lines from dominant carriers for resale to end users, generally known as resellers, were not dominant. The commission perceived that there were low barriers to entry and exit and no ability to raise or lower prices from competitive levels by these

¹⁸³ Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), 2 F.C.C. Rcd. 3035 (1987).

¹⁸⁴ Filing and Review of Open Network Architecture Plans, 4 F.C.C. Rcd. 1 (1989).

¹⁸⁵ *Id.* at 12.

¹⁸⁶ The status of ONA and the *Third Computer Inquiry* is currently uncertain. On appeal, the Ninth Circuit Court of Appeals concluded that the FCC failed to engage in reasoned decision making and overstepped its authority in attempting to preempt state authority in ordering the implementation of ONA. *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990).

¹⁸⁷ Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities, 91 F.C.C.2d 59 (1982). In succeeding decisions the commission detariffed other services as well. FCC ANNUAL REPORT 45 (1984).

¹⁸⁸ First Report and Order, Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, 85 F.C.C.2d 1 (1980).

¹⁸⁹ *Id.* at 20-21.

¹⁹⁰ *Id.* at 21. Published by IdeaExchange@Uakron, 1991

companies to justify its conclusion.¹⁹¹

Having found resellers nondominant, the FCC then felt it could lower the degree of price and entry regulation in four areas. First, it eliminated the requirement for cost information to support tariff filings of nondominant carriers on the belief that the cost of filing outweighed the benefits to the customer. Second, the commission shortened the notice periods for tariff changes to permit quicker response to the market. Third, the commission revised the grounds for suspending tariffs to prevent the use of the regulatory process to impede competition. Fourth, it substantially revised the provisions for certification of carriers and expansion of service and eased the means for abandoning service by providing for a thirty day notice if other alternatives are available (which, by definition, there must be if the service was competitive.)¹⁹²

In subsequent orders, the FCC broadened the group of nondominant carriers to include domestic satellite carriers, miscellaneous common carriers, and domestic satellite resellers.¹⁹³ The commission also refocused the kind of regulation that applied to nondominant carriers. In 1981, the commission suggested two alternatives: forbearance and reclassification.¹⁹⁴ The first alternative would keep the carrier under FCC regulation but waive tariff filings and authorizations for new service. The latter would have exempted nondominant carriers from all regulation under Title II of the Communications Act. In 1982, the FCC chose to apply forbearance.

In 1985, the commission attempted to take the final step by mandating that nondominant carriers not file tariffs.¹⁹⁵ Many carriers, however, rejected that approach. On appeal, the D.C. Circuit reversed the commission.¹⁹⁶ The court noted that the commission acted outside the constraints of the Communications Act, which required filed tariffs.¹⁹⁷ Despite this setback for the commission, much of the framework for deregulation was (now) in place for new entrants.

¹⁹¹ *Id.* at 29.

¹⁹² *Id.* at 33-49.

¹⁹³ Fourth Report, Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, 92 F.C.C. 554 (1983).

¹⁹⁴ Further Notice of Proposed Rulemaking, Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, 84 F.C.C.2d 445 (1981), *aff'd*, 91 F.C.C.2d 59 (1982).

¹⁹⁵ Sixth Report, Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, 99 F.C.C.2d 1020, *rev'd sub nom.*, MCI Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985).

¹⁹⁶ MCI Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985).

¹⁹⁷ *Id.* at 1195, relying on 47 U.S.C. § 203(a) (1982).

At the same time that the commission was acting on the *Computer III* and *Common Carrier* cases, it was moving in several other areas concerning equipment and transmission. For example, the commission effectively detariffed inside wiring from regulatory control,¹⁹⁸ and sought to preempt state action contrary to that order.¹⁹⁹ The commission also investigated the need to deregulate the provision of shared tenant services, but chose not to preempt state regulation.²⁰⁰

While the FCC deregulated those markets it perceived were competitive, it still faced access charges. In December 1982, it adopted an access charge plan that sought to recover nontraffic sensitive costs (those that had been substantially shifted to long distance tariffs through the separations process)²⁰¹ through a combination of flat fees on end users and carrier charges, based on usage.²⁰² (Until the rates became effective in January 1984, the commission continued to use ENFIA negotiations to set access rates.²⁰³) Political pressure forced the commission to revise the plan by reducing the residential flat fees and extending the transition period.²⁰⁴ The companies responded by filing 43,000 pages of tariffs and 160,000 pages of supporting materials on October 3, 1983.²⁰⁵ On October 19, the commission responded by suspending the tariffs, further delaying their introduction.²⁰⁶ The most politically sensitive change was the customer fee of one dollar per month, which was implemented in June 1985 and increased to two dollars in 1986.²⁰⁷ At the same time these fees became effective, the commission directed AT&T to lower its rates for message and WATS service.²⁰⁸ The FCC continued to put through additional rate reductions in subsequent years and proposed further increases in the residential flat fees for access to the system.²⁰⁹ The commission also ordered a three year phase-in of equal access where switching equipment was available to further assist the transi-

¹⁹⁸ Detariffing the Installation and Maintenance of Inside Wiring, Second Report and Order, 51 Fed. Reg. 8498, 59 Rad. Reg. (P & F) 1143 (1986). The order detariffed the service effectively on January 1, 1987.

¹⁹⁹ Detariffing the Installation and Maintenance of Inside Wiring, Memorandum Opinion and Order, 1 F.C.C. Rcd. 1190, 1192-93 (1986), *rev'd sub nom.*, National Ass'n of Regulatory Util. Comm'rs v. FCC, 880 F.2d 422 (D.C. Cir. 1989).

²⁰⁰ FCC ANNUAL REPORT 45 (1987).

²⁰¹ See *supra* text accompanying notes 102-07.

²⁰² MTS and WATS Market Structure, 93 F.C.C.2d 241 (1983), *modified*, 737 F.2d 1095 (1985), *aff'd*, 737 F.2d 1103 (1984), *cert. denied*, 105 S. Ct. 1224.

²⁰³ FCC ANNUAL REPORT 54 (1982).

²⁰⁴ MTS and WATS Market Structure, 97 F.C.C.2d 682 (1983).

²⁰⁵ FCC ANNUAL REPORT 46 (1983).

²⁰⁶ *Id.*

²⁰⁷ FCC ANNUAL REPORT 40 (1987).

²⁰⁸ *Id.* Rates decreased 5.6% and 12% in 1985 and 1986, respectively.

²⁰⁹ *Id.* at 42; FCC ANNUAL REPORT 41 (1987); FCC ANNUAL REPORT 47 (1988).

tion.²¹⁰

The search for "real" costs, and the encouragement of new technology, also directed the commission in its attempt to reset the allocation of nontraffic sensitive costs (costs that do not vary with the amount of traffic such as the wire connecting the user to the system) and customer premises equipment assigned to interstate rates. The commission announced that its goal was to force cost based rate making.²¹¹ The commission, however, recognized that the changes would disrupt the economics of the higher cost local exchange companies that benefitted from the former formulas.²¹² This concern was magnified as the FCC sought to increase the rate of depreciation of existing equipment to permit large writeoffs as the regulated companies moved to install new technology.²¹³

The change in regulatory philosophy also affected the FCC's approach to price regulation of dominant carriers.²¹⁴ It has attempted to use price caps as an

²¹⁰ MTS and WATS Market Structure (Phase III), 100 F.C.C.2d 860 (1985).

²¹¹ FCC ANNUAL REPORT 49 (1982).

²¹² FCC ANNUAL REPORT 50 (1982).

²¹³ Amendment of Part 31, 87 F.C.C.2d 916 (1981); Proceedings to Allocate Depreciation Reserve, 87 F.C.C.2d 1112 (1981). The alternative rates of depreciation presented increased costs of \$1.1 billion annually. FCC ANNUAL REPORT 48 (1983).

²¹⁴ Policy and Rules Concerning Rates for Dominant Carriers, 54 Fed. Reg. 19,836 (May 8, 1989) (hereinafter as *FCC Price Cap*). California has adopted a similar approach. Alternative Regulatory Frameworks for Local Exchange Carriers, 107 Pub. Util. Rep. 4th 1 (1989) (hereinafter as *California Price Cap*). In its plan, the California commission divided the services offered by Pacific Bell and GTE California into three categories:

Category I services whose rates can be changed only with Commission approval (basic monopoly services); Category II services with downward pricing flexibility (discretionary or partially competitive services); and Category III services which have the maximum pricing flexibility allowed by law (enhanced services, Yellow Page directory advertising services, inside wiring services, and any services found in the future to be fully competitive).

Id. at 13. The California commission decided that the Category II "partially competitive" services to which it would grant downward pricing flexibility were current information access services, high speed special access services, and billing and collection services. The price caps for a particular Category II service will be set at the same level as the rates in effect when downward pricing flexibility for the service is implemented. Price floors will be derived from "direct embedded costs." *Id.*

The Commission will set rates for Category I and III services by reference to an indexing formula whose make-up is very similar to that of the PCI under the FCC plan. Like the PCI, the index includes a component that takes account of inflation by using the Gross National Product Price Index (GNP-PI). The GNP-PI factor is also reduced by a productivity adjustment. However, this productivity offset is four and a half percent, as opposed to three percent under the FCC plan. Finally, the index further resembles the PCI in that it recognizes a "limited category of exogenous factors whose effects [on costs] will not be reflected in the economy-wide GNP-PI", such as changes in tax laws that have a disproportionate impact on local exchange carriers or changes in intraLATA toll pooling arrangements. *Id.* at 14.

One major difference between the FCC and California commission plans is that the California commission adopted a "sharing mechanism" which is "designed to provide protection to both ratepayers and shareholders from risks that the indexing method may over- or underestimate revenue changes needed

alternative to cost of service rate regulation of dominant or monopoly telecommunications service providers. The FCC expresses the belief that price cap regulation will lead to greater efficiency and innovation on the part of the telephone companies in question. It predicts that the anticipated productivity gains under the new regime will benefit shareholders and ratepayers alike, and that price cap regulation will lessen the administrative burdens associated with rate of return regulation. The FCC also purports to provide solutions to the problems of cross-subsidization between regulated and unregulated services. In short, the commission has claimed to create a regulatory environment for the telephone companies that best approximates a competitive market.²¹⁵

The FCC plan divides AT&T capped services among three "baskets".²¹⁶ For each basket there is a price cap index, or "PCI".²¹⁷ Residential and small business services comprise the first basket.²¹⁸ AT&T will not enjoy the "streamlined treatment" afforded by price cap regulation if it raises or lowers the rates for any service category in this basket by more than five percent annually, relative to the change in the PCI.²¹⁹ Furthermore, the FCC requires AT&T to compute an "average residential rate" for the residential services within this basket. This rate may not increase by more than one percent per year, relative to the changes in the PCI, without AT&T losing the benefit of streamlined review.²²⁰

The second basket is made up of all 800 services. The third contains all other capped services, including WATS and private line services.²²¹ Streamlined treatment for these baskets is available if rate increases and decreases for each service category in each basket do not exceed five percent per year relative to the PCI.²²²

The PCI on which the whole mix is based is essentially based on an

to keep the utility financially healthy." *Id.* Under this mechanism, if a local exchange carrier earns more than a rate of return set 150 points higher than the expected market-based rate of return, the excess over the benchmark rate of return will be split equally between ratepayers and shareholders. For 1990, the California commission set the expected market based rate of return at eleven and a half percent, so the benchmark rate of return is set at thirteen percent. Furthermore, any earnings over a rate of return that is 500 points above the market-based rate of return are returned solely to ratepayers.

²¹⁵ FCC Price Cap, 54 Fed. Reg. 19,836 (1989).

²¹⁶ For a more complete description of the rate cap proposal, see Ghosh, *The Future of FCC Dominant Carrier Rate Regulation: The Price Caps Scheme*, 41 FED. COMM. L.J. 401 (1989).

²¹⁷ FCC Price Cap, 54 Fed. Reg. 19,837 (1989).

²¹⁸ *Id.*

²¹⁹ *Id.* AT&T, however, may not increase rates for domestic evening or night/weekend MTS service categories by more than 4 percent annually after adjusting for the changes in the PCI. *Id.*

²²⁰ *Id.*

²²¹ *Id.*

inflation factor of the economy as a whole, and an offset for increased productivity for the telecommunications industry in particular. The PCI reflects the changes in the costs of providing the services within a particular basket.²²³ The inflation component is set by reference to the Gross National Product Price Index (GNP-PI), which is a "broad-based index of price changes in all sectors of the economy."²²⁴ From the inflation component the FCC subtracts a "productivity offset" of three percent.²²⁵ The PCI also contains a component that measures changes in certain "exogenous" costs, those costs which AT&T cannot control and which affect the telecommunications industry rather than the entire economy.²²⁶ Included in this component, among other things, are changes in access charges that the carrier pays to local exchange companies, and possibly tax law changes which have a disproportionate impact on the carrier.²²⁷ Price changes within a basket are further limited by the "API", or actual price index. This index measures the value of aggregate rates in a basket. Unless an "extraordinary showing" is made, the API for a basket may not exceed its PCI.²²⁸ A further restriction on price changes are "SBIs", or service band indexes. Services in each basket are grouped into service categories, and the SBIs reflect rate changes associated with these service categories.²²⁹

The price cap rules required the FCC to set initial levels. The FCC initiated the use of the price caps by setting the rates at levels effective at the end of 1988.²³⁰ Once in place, rate changes could receive streamlined review on a fourteen day notice of filing if the changes were within the limits previously described. "In lieu of traditional cost support, streamlined filings need be supported only by the calculations necessary to demonstrate that the proposed rates are within the limits set by the PCI and the pricing limitations."²³¹ Rates outside the bands would receive increased scrutiny and be subject to comment and ninety days notice.²³² Rates exceeding the caps are subject to full-blown rate review.²³³ Rates that were outside the bands are also subject to review, and must be justified in terms of coverage of cost.²³⁴ New services that "add to the range of options available to customers" are outside the price cap, but must be able to

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.* at 19,838.

²³¹ *Id.*

²³² *Id.*

²³³ *Id.*

²³⁴ *Id.*

demonstrate an increase of net revenue to the company while restructured services, or "rearrangements of existing services," are required to remain within price cap rules.²³⁵

To test the experiment, the FCC proposed to monitor the operation of the price caps for four years, with a full review to begin after three years.²³⁶ The FCC also threatened earlier review if it did not appear that the experiment was working satisfactorily.²³⁷ In any case, the price cap experiment was a major policy change.

Because it remained under some form of price regulation, AT&T continued to find itself with competitive problems in some markets that other interexchange carriers hoped to skim off. Since 1987, AT&T has asked the FCC to permit it to offer "company-specific" packages of services and rates. In April 1987, AT&T filed its first Tariff 12 package, designed especially for General Electric.²³⁸ The company subsequently sought to generalize the filing into a tariff after substantial objections were filed to a company specific tariff.²³⁹ The commission's Common Carrier Bureau approved the filing subject to the installation of certain accounting safeguards.²⁴⁰ Contemporaneously, AT&T filed voice and data tariffs specifically defined for DuPont, Ford, and American Express.²⁴¹ Again, the Common Carrier Bureau approved the packages.²⁴² The FCC subsequently approved the use of specially designed tariffs, as long as the packages would be made available to all similarly situated customers.²⁴³ In addition to the company specific plans, AT&T also filed a discount program for large customers that provided for five to ten percent discounts from its message tariffs to meet competition.²⁴⁴ In contrast to the company specific plans, however, the FCC may have indicated a tighter stance on case-by-case deregulation of the dominant carrier status of AT&T when it suspended the promotional rate plan proposed by the company.²⁴⁵

²³⁵ *Id.* at 19,839.

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ FCC ANNUAL REPORT 43 (1987).

²³⁹ *Id.*

²⁴⁰ *Id.* at 44.

²⁴¹ FCC ANNUAL REPORT 41 (1988).

²⁴² *See, e.g.*, AT&T Communications Tariff No. 12 Rates and Regulations for Virtual Telecommunications Network Service, 3 F.C.C. Rcd. 995 (1988).

²⁴³ AT&T Communications, Revisions to Tariff F.C.C. No. 12, 4 F.C.C. Rcd. 4932 (1989).

²⁴⁴ FCC ANNUAL REPORT 41 (1988).

²⁴⁵ *Carnevale, FCC Suspends Discount Package Offered by AT&T*, Wall St. J., Jan. 22, 1990, at A9, col. 3.
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In substance, the FCC appears to have sought to reduce its role in regulating the telecommunications market by eliminating traditional regulation. The thrust of the approach is that competition is a workable substitute in several sectors of the business, despite the dominant position of AT&T. Certainly, in detariffing the exchange carriers other than AT&T, detariffing inside wiring, applying price caps to dominant carriers, as well as in its rhetoric, the commission has sought to appear less intrusive. In other respects, however, it has created a situation in which it must take much greater care of regulation. For those regulated companies that operate in both competitive and noncompetitive markets, the precision of regulation is heightened because of the concern over cross-subsidies and unfair competition. Thus, the irony of deregulation at the FCC is that it requires much greater monitoring and has great attendant costs.

2. District Court Actions

Following its approval of the MFJ, the district court continued to closely monitor the divestiture. It played a substantial role in defining the system of districts that divided interexchange and intraexchange communications (termed interLATA and intraLATA under the court approved plan),²⁴⁶ and in modifying the plan of reorganization.²⁴⁷ Additionally, the court faced numerous requests for waivers of the line of business restrictions by the local exchange companies. In response, the court established procedures and requirements for handling waivers.²⁴⁸ As a procedure, the court ordered the companies to direct waiver requests to the Department of Justice, which made recommendations to the court.²⁴⁹ Further, the court suggested several substantive safeguards to be part of a waiver request, including the creation of a separate subsidiary, the separation of financing, a ten percent limitation on diversification, and continued Justice Department monitoring of the subsidiary.²⁵⁰ Again, the court's concern about the public interest appeared. In particular, the court stated that the waivers should reflect the central purposes of the decree and a commitment to low cost reliable service by the local exchange companies.²⁵¹

Some of the early waiver requests concerned problems that arose because of shifting FCC regulation of related services. For example, the court granted a waiver of the interexchange carriage prohibition to permit cellular telephone operations.²⁵² Similarly, the court permitted the continuation of weather and

²⁴⁶ *United States v. Western Elec. Co.*, 569 F. Supp. 990, 993-95 (D.D.C. 1983).

²⁴⁷ *United States v. Western Elec. Co.*, 569 F. Supp. 1057 (D.D.C. 1983).

²⁴⁸ *United States v. Western Elec. Co.*, 592 F. Supp. 846 (D.D.C. 1984).

²⁴⁹ *Id.* at 873-74.

²⁵⁰ *Id.* at 870-72.

²⁵¹ *Id.* at 875.

²⁵² *United States v. Western Elec. Co.*, 578 F. Supp. 643 (D.D.C. 1983).

time services, though a strict interpretation of the interexchange and information services provisions would preclude such action.²⁵³

Later requests addressed the expansion and diversification of local exchange company activities. Following the court's direction to present waiver requests to the Justice Department, the court approved requests that authorized equipment leasing and sales, computer sales, entrance into nondomestic markets, the creation of real estate subsidiaries, and investment in cellular systems.²⁵⁴ The court continued to grant waivers in several other areas when the parties demonstrated that the monopoly bottleneck did not pose a threat to competition.²⁵⁵ Nonetheless, waivers were a necessity even when no bottleneck was apparent.²⁵⁶

Once the regional companies began to operate, and especially after the first triennial review of the MFJ in 1987, some cracks began appearing in the wall separating the monopoly and competitive areas. While the court maintained that the monopoly position of the operating companies was essentially unchanged and continued line of business restrictions on interexchange carriage, the court did permit the companies to develop facilities to serve as information service gateways and to enter into unrelated businesses.²⁵⁷ The court subsequently concluded that the operating companies could engage in information transmission (but not generation), voice storage and retrieval, and related equipment services.²⁵⁸ (On appeal, the D.C. Circuit Court of Appeals directed the district court to reexamine its decision concerning information services in light of an alternative standard that appears to be more favorable to the operating companies.²⁵⁹ As has been so often been the case with the divestiture, a great deal of uncertainty

²⁵³ *United States v. Western Elec. Co.*, 578 F. Supp 658 (D.D.C. 1983). Likewise, the court permitted some interexchange carriage that did not appear to present anticompetitive problems. *United States v. Western Elec. Co.*, 578 F. Supp 662 (D.D.C. 1983).

²⁵⁴ *United States v. Western Elec. Co.*, 604 F. Supp. 256 (D.C.C. 1984).

²⁵⁵ *United States v. Western Elec. Co.*, 1986-1 Trade Cases ¶ 66,987 (D.D.C. 1986) (cellular radio); *United States v. Western Elec. Co.*, 1987-1 Trade Cases ¶ 67,452 (D.D.C. 1987) (joint enterprise between two holding companies to extend cellular service); *United States v. Western Elec. Co.*, 1987 Westlaw 4933 (D.D.C. 1987) (advertising); *United States v. Western Elec. Co.*, 1987 Westlaw 10109 (D.D.C. 1987) (advertising); *United States v. Western Elec. Co.*, 1987 Westlaw 10108 (D.D.C. 1987) (advertising).

²⁵⁶ *United States v. Western Elec. Co.*, 627 F. Supp. 1090 (D.D.C. 1986). *See, e.g.*, *United States v. Western Elec. Co.*, 1986-2 Trade Cases ¶ 67,413 (D.D.C. 1986) (denying waiver for design and development of switching equipment); *United States v. Western Elec. Co.*, 675 F. Supp. 655 (D.D.C. 1987) (same).

²⁵⁷ *United States v. Western Elec. Co.*, 673 F. Supp. 525 (D.D.C. 1987), *aff'd in part and rev'd in part*, 900 F.2d 283 (D.C. Cir. 1990).

²⁵⁸ *United States v. Western Elec. Co.*, 714 F. Supp. 1 (D.D.C. 1988).

²⁵⁹ *United States v. Western Elec. Co.*, 900 F.2d 283, 309 (D.C. Cir. 1990). The district court subsequently concluded that it could not sustain the enhanced services restriction under the standard promulgated by the court of appeals. *Camevale, Judge Opens Information Services to Bells*, Wall St. J., July 26, 1991, at B1, col. 6.

remains.) Once again, however, the district court was cognizant of the rate implications of its decisions and considered it a critical factor in determining the appropriateness of deregulation.²⁶⁰

The court thus took on two roles. On the one hand, it played the expected role of servicing the MFJ. In that sense, the court attempted to balance the various competitive interests of the parties and to determine how the philosophy of the decree squared with particular requests for waivers. As the court became more comfortable with the process and was better able to define the kinds of interests it was attempting to protect, it permitted the operating companies the freedom to enter unrelated businesses. In the area of related businesses, and especially those which contradicted the philosophy of the MFJ, however, the court has retained a relatively tight rein. Moreover, the court was likely to raise additional "public policy" concerns, such as the consumer interest in maintaining low rates to support universal service, in restricting the use of "bottleneck" facilities for competitive services.

Summary

The division of regulation at the federal level, has therefore taken on a curious nature. The agency assigned by Congress to make decisions in the public interest, the FCC, takes the position that the market's competitive structure will best serve the companies and their consumers. The court, on the other hand, would appear to have a narrower frame of reference defined by the antitrust laws (though augmented by a public interest review), yet has defined its powers to review waivers of the line of business restrictions in such a way as to entertain arguments that are central to traditional price and entry regulation. At the federal level, at least, irony is in fashion.

THE OHIO REGULATORY STRUCTURE

As a result of changes in the structure and regulation of interstate telecommunications, the states faced some difficult choices. Old forms of subsidy that had proved so successful in mitigating local telephone rate increases were unsettled. The rhetoric of the day, competition, further upset the existing regulatory ethic. Unlike the open-ended federal scheme, however, the statutory basis for action, particularly in Ohio, did not favor a flexible response. Yet, the Ohio commission found ways to claim regulatory flexibility, maintain some of the former subsidies, and even create some new ones with a rhetorical bow to competition.

The Ohio Utility Compact

State regulation of telephone services prior to the adoption of House Bill 563 followed the general formula suggested by the "utility compact."²⁶¹ Each element, franchising, service obligations, and rate approval, remains in the statutory structure.

In Ohio, the regulation of utilities is governed by Title 49 of the Revised Code.²⁶² The PUCO is given the general authority to regulate utilities.²⁶³ Public utilities are defined to include telephone companies.²⁶⁴ An entity is a telephone company "when engaged in the business of transmitting telephonic messages to, from, through, or in this state and as such is a common carrier."²⁶⁵ The commission's jurisdiction, however, extends to only property that is within the state.²⁶⁶ Besides its general supervisory power,²⁶⁷ the commission is directed to maintain public records,²⁶⁸ prescribe the form of records to be filed by utilities,²⁶⁹ require utilities to file annual reports²⁷⁰ and any others the commission may require,²⁷¹ and direct the filing of contracts with the commission.²⁷² For purposes of monitoring a utility, the commission is empowered to order maintenance of accounts concerning new construction,²⁷³ depreciation,²⁷⁴ and a depreciation reserve.²⁷⁵

A telephone company's monopoly is defined by its ability to serve a particular geographical area. In Ohio, the legislature has provided for unique franchises for each local exchange company.²⁷⁶ The franchises may not be infringed by another phone company unless the commission finds that the existing provider is giving inadequate service.²⁷⁷ The Code then requires that a public

²⁶¹ See *supra* text accompanying notes 78-82.

²⁶² OHIO REV. CODE ANN., Tit. 49 (Anderson 1977 & Supp. 1990).

²⁶³ *Id.* § 4905.04 (Anderson 1977).

²⁶⁴ *Id.* § 4905.02 (Anderson Supp. 1990).

²⁶⁵ *Id.* § 4905.03(A)(2).

²⁶⁶ *Id.* § 4905.05.

²⁶⁷ *Id.* § 4905.06.

²⁶⁸ *Id.* § 4905.07 (Anderson 1977).

²⁶⁹ *Id.* § 4905.13.

²⁷⁰ *Id.* § 4905.14 (Anderson Supp. 1990).

²⁷¹ *Id.* § 4905.15 (Anderson 1977).

²⁷² *Id.* § 4905.16.

²⁷³ *Id.* § 4905.17.

²⁷⁴ *Id.* § 4905.18.

²⁷⁵ *Id.* § 4905.19.

²⁷⁶ *Id.* § 4905.24.

²⁷⁷ *Id.* § 4905.24E. Published by donExchange@Uakron, 1991

utility "furnish necessary and adequate service and facilities"²⁷⁸ consistent with the commission-defined service standards for telephone companies.²⁷⁹ If there is a service problem, the commission has several alternatives. Though the commission may not order a merger, it may suggest that a merger take place to solve a service problem and may order the transfer of a franchise if the merger is not completed.²⁸⁰ Furthermore, residents within a franchise may petition for a new provider if current service is inadequate. The commission may also order an adjacent phone company to provide service if doing so would not prevent the adjacent telephone company from earning a fair return.²⁸¹ If the commission transfers the franchise under any of the conditions previously described, the prior franchise holder must suspend service.²⁸² Each local company is therefore an effectively protected monopoly, but cannot neglect customers and hope to retain its service area.

Service is further protected by significant barriers to abandonment. Section 4905.24 limits the right of a utility to abandon service to that approved by the commission.²⁸³ Section 4905.21 then provides that a utility seeking to abandon a service must file an application with the commission, give notice to the public of the application, and demonstrate at a hearing that the abandonment is reasonable.²⁸⁴ Further, no service may be totally abandoned unless it has been available for five years.²⁸⁵

Finally, the commission is given the authority to hear complaints concerning individual practices or rates. Section 4905.26 permits complaints by customers and the commission that rates or classifications are "unjust, unreasonable, unjustly discriminatory, unjustly preferential, or in violation of law", or the complaint of a utility "as to any matter affecting its own product or services."²⁸⁶

While bound to serve all who request service within the geographic area, the utility also receives the opportunity to earn fixed reasonable rates. Two sets of statutes govern the rates charged by a utility. The first dictates those rates in effect and prevents discrimination. Sections 4905.30 and 4905.31 require the

²⁷⁸ *Id.* § 4905.22.

²⁷⁹ *Id.* § 4905.231.

²⁸⁰ *Id.* § 4905.242.

²⁸¹ *Id.* § 4905.243.

²⁸² *Id.* § 4905.244.

²⁸³ *Id.* § 4905.20.

²⁸⁴ *Id.* § 4905.21.

²⁸⁵ *Id.* § 4905.21.

utility to file its rates and special contracts with the commission.²⁸⁷ The utility is then permitted to charge only those rates that are filed and cannot provide refunds or rebates except as are generally available to other customers.²⁸⁸ Section 4905.31 eases the requirements of rate approval by providing for the approval of special arrangements between a utility and customers.²⁸⁹ Though section 4905.31 permits special arrangements or contracts between a utility and a customer, including variable rates, the arrangements must be supported by cost or other evidence demonstrating that the arrangement is reasonable.²⁹⁰ Moreover, discriminatory rates, free service, or service for less than actual cost for the purpose of destroying competition is prohibited.²⁹¹ Section 4905.22 further requires that all charges must be "just, reasonable, and not more than the charges allowed by law or by order of the public utilities commission, and no unjust or unreasonable charge shall be made or demanded for, or in connection with, any service, or in excess of that allowed by law or by order of the commission."²⁹² The commission may change a rate that is unreasonable or unjustly discriminatory.²⁹³

The other statutes provide for rate setting. The primary rate making statute in Ohio is section 4909.15.²⁹⁴ In effect, the section directs the commission to determine a ratebase²⁹⁵, a reasonable rate of return,²⁹⁶ the fair value of the return on rate base,²⁹⁷ and the cost of service.²⁹⁸ The general revenue of the company for a test year²⁹⁹ is then the sum of the fair value of the return on rate base plus the cost of service.³⁰⁰ The commission is directed to order new

²⁸⁷ *Id.* §§ 4905.30 and 4905.31 (Anderson 1977 and Supp. 1990).

²⁸⁸ *Id.* § 4905.32 (Anderson 1977).

²⁸⁹ *Id.* 4905.31.

²⁹⁰ *Id.* § 4905.31.

²⁹¹ *Id.* §§ 4905.33 and 4905.35.

²⁹² *Id.* § 4905.22.

²⁹³ *Id.*, § 4909.26 (Anderson 1977). It is arguable that this section does not apply to all utilities since it sets within a series of provisions dealing with the regulation of railroads, but the language is not specific to the latter. *See also*, Townships of Mahoning County v. Pub. Util. Comm'n of Ohio, 58 Ohio St. 2d 40, 388 N.E.2d 739 (1979).

²⁹⁴ OHIO REV. CODE ANN. § 4909.15 (Anderson Supp. 1990).

²⁹⁵ Rate base is defined as the value of used and useful property, *See Id.* § 4909.05(E), an allowance for working capital and an allowance for construction work in progress (limited by certain completion and valuation ratios). *Id.* § 4909.15(A)(1).

²⁹⁶ *Id.* § 4909.15(A)(2).

²⁹⁷ *Id.* § 4909.15(A)(3) (essentially to multiply rate base by the rate of return).

²⁹⁸ *Id.* § 4909.15(A)(4).

²⁹⁹ *Id.* § 4909.15(C) provides that the test year on which rates are based may consist of six months of actual data and six months of estimated, but the commission may order that the test year consist of three months of actual and nine months of estimated.

rates reflecting the revenue requirements established by the formula.³⁰¹

The rate making statute, however, is not self-effecting. Sections 4909.18³⁰² and 4909.19³⁰³ set out the procedures for approving rate changes. Section 4909.18 provides that rate changes must be by written application.³⁰⁴ If the change does not involve an increase in rates, the commission can order the rate to be filed unless it determines that the rate is unreasonable.³⁰⁵ If the change involves an increase in rates, however, the utility must file a property valuation report, an operating statement for the prior fiscal year, an income statement supporting the rate increase, a statement of financial condition, and a proposed notice for publication.³⁰⁶ Section 4909.19 then provides that the commission begin a study of the proposed rate increase and directs the company to publish the notice.³⁰⁷ After the commission issues a report of its study, the company and other interested parties have thirty days to file objections.³⁰⁸ If no one objects, the report may go to a final hearing.³⁰⁹ If a party does object, however, the commission is directed to set the application for an evidentiary hearing at which the utility has the burden of establishing that its application is reasonable.³¹⁰ The commission will then enter an order setting the revenue requirement and directing the utility to file rates that comply with the order.³¹¹

The commission has several other general and remedial powers. It may review the issuance of securities, and, in the case of domestic telephone companies, may approve mergers.³¹² It may order the correction of existing violations of commission rules³¹³ and order the improvement or repair of facilities.³¹⁴ It may also direct telephone companies to interconnect.³¹⁵ Failure

³⁰¹ *Id.* § 4909.15(D). The commission is given discretion to set rates according to the cost of service but is not required to do so. *Id.* § 4909.151 (Anderson 1977). The commission may make orders to improve quality of service and consider management policies so as to disallow operation and maintenance expenses it finds imprudent. *Id.* §§ 4909.152 and 4909.154 (Anderson 1977 and Supp. 1990).

³⁰² *Id.* § 4909.18 (Anderson Supp. 1990).

³⁰³ *Id.* § 4909.19.

³⁰⁴ *Id.* § 4909.18.

³⁰⁵ *Id.* § 4909.18.

³⁰⁶ *Id.* § 4909.18.

³⁰⁷ *Id.* § 4909.19.

³⁰⁸ *Id.* § 4909.19.

³⁰⁹ *Id.* § 4909.19.

³¹⁰ *Id.* § 4909.19.

³¹¹ *Id.* The commission is also required to conduct local public meetings in some instances. *Id.* § 4903.083.

³¹² *Id.* §§ 4905.40-4905.49 (Anderson 1977 and Supp. 1990).

³¹³ *Id.* § 4905.37 (Anderson 1977).

³¹⁴ *Id.* § 4905.381.

to comply with commission orders³¹⁶ may result in forfeitures of up to \$1000 a day with each day constituting a separate violation and each violation being cumulative.³¹⁷ The commission may direct the attorney general to bring an action to collect the forfeitures³¹⁸ or seek an injunction to prevent violations.³¹⁹ Finally, the code authorizes some consumer³²⁰ and criminal actions for violations of commission requirements.³²¹

Hearings and Judicial Review

Hearings at the commission, whether related to rates or complaints, are governed by their own procedural statutes. Section 4903.09³²² requires that the commission develop a record and issue a written opinion of its findings and conclusions based on those findings. An internal appeal may be accomplished through an application for rehearing.³²³ A further appeal may be taken directly to the Ohio Supreme Court, which has sole jurisdiction to review decisions of the commission.³²⁴ Review by the court, however, is limited to the record of the commission and may be reversed only if the decision is unlawful or unreasonable.³²⁵ Even if an appeal is filed, the commission's decision is generally effective when the commission enters it, unless the appellant files successfully for a stay.³²⁶

Summary

The Ohio regulatory statutes in place prior to House Bill 563 created the expected structure based on a natural monopoly theory. The commission parceled out franchises for the provision of telephone service. While the company had to provide a commission-directed level of service and could not abandon that service except for good cause, the company was compensated by rate levels that entitled it to the opportunity to earn a reasonable return on investment. Thus, the classic utility compact was struck: monopoly service rights for regulated prices.

³¹⁶ *Id.* § 4905.54 (Anderson Supp. 1990).

³¹⁷ *Id.* §§ 4905.64 and 4905.54 (Anderson 1977 and Supp. 1990).

³¹⁸ *Id.* § 4905.57 (Anderson Supp. 1990).

³¹⁹ *Id.* § 4905.60 (Anderson 1977).

³²⁰ *Id.* § 4905.61 (treble damages for violation of commission order).

³²¹ *Id.* §§ 4905.56 and 4905.99 (Anderson 1977 and Supp. 1990).

³²² *Id.* § 4903.09 (Anderson 1977).

³²³ *Id.* § 4903.10.

³²⁴ *Id.* § 4903.12.

³²⁵ *Id.* § 4909.13.

OHIO COMMISSION REACTION TO DEREGULATION

Introduction

In a sense, the PUCO has already faced many of the issues raised by House Bill 563. Federal dissolution of the monopoly deeply affected Ohio and the ability of the commission to retain universal service premised on low basic exchange rates. The state faced the problem of addressing entry into what had been single firm markets. Thus the same questions that faced federal regulators as they began a service-by-service evaluation of sectors of the telecommunications business also had to be addressed at the state level.

Faced with the dramatic changes caused by the divestiture order of Judge Greene and the ongoing efforts of the FCC, the Ohio commission was forced into a reactive posture. Like many other state commissions, the PUCO appeared very concerned that the loss of support in terms of revenues, and the introduction of competition, would limit its ability to regulate the local exchange companies. Further, the commission feared the loss of smaller exchange companies serving rural populations that had been subsidized by the statewide averaging process. Taken together, it translated these concerns into several orders undertaken in general proceedings that had the effect of retaining some of the support from long distance toll that had existed under the prior separations process.³²⁷ Likewise, the commission attempted to place limits and controls on competitive entry in the form of certification and tariffing requirements.³²⁸ The commission carefully circumscribed the ability of competitive services to dislodge local exchange companies in the provision of the previously monopolized activities, such as the provision of PBX services to ever-larger groups of unconnected users.³²⁹ At the same time, the commission attempted to move some previously tariffed items out of the expenses for which customers were responsible, thereby lowering rates.³³⁰ Other sources of business revenue, such as billing and collection services,³³¹ were included in monopoly income. Given this predisposition to maintain the

³²⁷ On May 21, 1984, the Ohio commission responded to the need to set intrastate access charges in an Opinion and Order, *Opinion and Order, Establishment of Intrastate Access Charges*, No. 83-464-TP-COI (May 21, 1984) (hereinafter as *Access Charges*).

³²⁸ *Opinion and Order, The Regulatory Framework for Telecommunications Services in Ohio*, No. 84-944-TP-COI (Apr. 9, 1985) (hereinafter *Regulatory Framework*). *Finding and Order, Regulatory Framework for Competitive Telecommunications Services in Ohio (Phase II)*, No. 86-1144-TP-COI (Aug. 2, 1988) (hereinafter *Regulatory Framework (Phase II)*).

³²⁹ *Resale and Sharing of Local Exchange Telephone Service*, No. 85-1199-TP-COI (Aug. 19, 1986), *aff'd in part and modified in part*, Entry on Rehearing, *id.*, (Oct. 14, 1986) (hereinafter as *Shared Tenant Services*).

³³⁰ *Finding and Order, Detariffing of the Installation and Maintenance of Simple and Complex Inside Wire*, No. 86-927-TP-COI, slip op., (Dec. 16, 1986) (hereinafter as *Inside Wire*).

³³¹ *Opinion and Order, Interexchange Billing and Collection*, No. 86-2174-TP-COI, slip op. (Oct. 6, 1987), <http://icd.cch.com/akronlawreview/vol24/iss2/2> (hereinafter as *Billing and Collection*).⁴²

local monopolies and prior subsidies intact so as to maintain low local rates for basic service, the recent retrenchment and substantial regulation associated with alternative operator service,³³² probably one of the most unlikely of monopoly strongholds, should come as no surprise. In essence, the commission's early efforts to respond to deregulation at the federal level represented a relatively conservative effort to maintain the previous structure of rates and services.

Access Charges

One of the most telling actions on the part of the commission in its attempt to maintain existing revenue levels was its access charge order. As the commission recognized in its order, the goal of the proceeding was the creation of cost based rates, but other concerns entered the picture as well.³³³ Among the other concerns noted by the commission (and which seem to dominate the result) was the maintenance of current revenue flows from interexchange traffic.³³⁴ This interest tied in neatly with a disposition to guarantee universal service to the extent possible.³³⁵ Thus, in its first significant action, the commission clearly intended to maintain some sort of subsidy.³³⁶

To guarantee prior levels of revenue, the commission provided two mechanisms. First, the commission ordered intrastate tariffs for access to mirror the FCC-set interstate rates.³³⁷ In a break from direct rate setting, the commission concluded that the rates would change as the FCC approved new rates at the interstate level.³³⁸ Second, the commission provided that each company would be permitted to earn its 1983 levels of income from toll through access charges and toll revenues. To achieve that result, the commission created a pool into which each local company contributed amounts in excess of its 1983 requirement, and drew out an amount to cover any shortage.³³⁹ Any shortfall after the payments to the pool would be made up by a "carriers presence charge", assessed against the interexchange carriers.³⁴⁰ The net effect of these two provisions was to place the revenue responsibility on interexchange carriers to make up any shortfall in local exchange company revenues. In essence, legal forms for a subsidy from long distance were retained.

³³² Finding and Order, Provision of Intrastate Interexchange Operator Assisted Services in Ohio, No. 88-560-TP-Coi, slip op. (July 18, 1989) (hereinafter as *OSP*).

³³³ *Access Charges*, *supra* note 327, slip op. at 2.

³³⁴ *Id.* at 2.

³³⁵ *Id.* at 3.

³³⁶ *Id.* at 3.

³³⁷ *Id.* at 3.

³³⁸ *Id.* at 4.

³³⁹ *Id.* at 4-7.

³⁴⁰ *Id.* at 7. Published by IdeaExchange@Uakron, 1991

Subfiles A & B

The *Access Charge* docket remained open for several years as the commission sought to administer and refine the process of setting these rates. Initially, the commission created a docket called *Subfile A* for the treatment of questions concerning the administration of access charge rates and the resulting pool.³⁴¹ In *Subfile A*, the commission considered requests of the various local exchange and interexchange companies, for revisions of the original access charge order. Requests included modifications of the 1983 revenue cap, application of the access charges to specific carriers, and administration of the pool.³⁴²

The commission then initiated *Subfile B* to elicit comments on the procedures for creating cost based access charges and the division of excess funds held in the access charge pool.³⁴³ In making modifications, the commission noted that pooling had succeeded in maintaining the revenues of the local exchange companies, while overall costs decreased as the federally set rates declined and were mirrored into state access rates.³⁴⁴ Without cost information to set access rates, however, the commission took several half-measures. First, the commission decided to phase out the pool process over the remainder of 1986.³⁴⁵ Second, the commission ordered the creation of a reserve fund for coverage of any revenue shortfalls during 1986.³⁴⁶ Third, it eliminated the carriers presence charge.³⁴⁷ At this point, there was some movement toward cost based rates.

The structural change, however, paled in light of a transfer of funds from the pool to the local exchange companies. The commission directed a distribution from the pool of excess funds that had been created because the amount of revenue coming into the pool exceeded 1983 statewide revenue requirements. Basing its decision exclusively on comments from the parties,³⁴⁸ the commission ordered a division of the revenues based on relative contributions to the pool and directed the local exchange companies to reduce their toll rates (rather than their access charge tariffs) in an attempt to prevent further pool excesses.³⁴⁹

³⁴¹ Establishment of Intrastate Access Charges (Subfile A), No. 83-464-TP-COI (July 19, 1984) (hereinafter as *Subfile A*).

³⁴² See, e.g., *Subfile A*, slip op. at 2-10 (Feb. 11, 1986).

³⁴³ *Id.* at 10.

³⁴⁴ *Id.* at 11-12.

³⁴⁵ *Id.* at 12.

³⁴⁶ *Id.* at 12.

³⁴⁷ *Id.* at 12.

³⁴⁸ *Id.* at 13.

³⁴⁹ *Id.* at 14-15.

With the division of the pool, the local exchange companies received an apparent bonus. Through the refund, the local exchange companies received extra revenue above the 1983 residual requirements that the commission set in the initial access charge proceeding. While technically not a rate increase, the effect was the same. The commission subsequently denied an application for rehearing challenging the commission's failure to hold hearings and its division of the pool,³⁵⁰ and the Ohio Supreme Court sustained the commission's decision.³⁵¹

Subfile C

Subfile C continued the commission's quest to eliminate pooling and return to more traditional company by company regulation. In an order dated March 31, 1986, the commission created an industry task force of local exchange companies to provide the commission with a plan for implementing cost based access rates.³⁵² The local exchange companies' proposal, and others suggested by consumers and interexchange companies, however, were rejected because the commission found that they were not supported by cost information.³⁵³ In particular, the commission noted that the local exchange proposal calling for the maintenance of the mirroring of federal rates would result in an improper subsidization of local exchange by interexchange carriers.³⁵⁴ Further, interexchange companies noted that a continuing lack of cost information would permit local exchange companies to mix costs for local monopoly service, and competitive intraexchange toll service, to the detriment of the competitive carriers.³⁵⁵

Without cost information, and admitting that the result would likely result in some cross-subsidization, the commission nonetheless determined to cap intrastate access charges at current interstate levels and to allow them to be downwardly flexible.³⁵⁶ Second, the commission directed the elimination of pooling of access charges. As a result, each company was responsible for its own revenue requirement.³⁵⁷ The commission, however, maintained a hardship fund for small phone companies unable to meet their revenue requirements through the end of 1986.³⁵⁸

³⁵⁰ Entry on Rehearing, *Subfile A*, slip op. (March 31, 1986).

³⁵¹ See *infra* text accompanying notes 466-71.

³⁵² Opinion and Order, Establishment of Intrastate Access Charges (*Subfile C*), No. 83-464-TP-COI, slip op. at 3 (March 12, 1987) (hereinafter as *Subfile C*).

³⁵³ *Id.* at 8.

³⁵⁴ *Id.* at 8.

³⁵⁵ *Id.* at 9.

³⁵⁶ *Id.* at 10.

³⁵⁷ *Id.* at 10.

³⁵⁸ *Id.* at 11-12.

The commission also found itself with excess funds to distribute, and it continued its prior course with a vengeance. It ordered a distribution exclusively to the local exchange companies and a further reduction in local company toll rates.³⁵⁹

Finally, in one of the more remarkable provisions of its telephone orders, the commission directed that companies could seek to raise access rates without filing for a rate case as long as the rates sought were no higher than those in effect in June 1984 and would result in the maintenance of the 1983 revenue requirement.³⁶⁰ As the commission made explicit in its order, the "rate reduction restoral" plan was to operate in place of a traditional rate case, pursuant to section 4909.18.³⁶¹ Again, the Ohio Supreme Court sustained the commission's action.³⁶²

Competitive Services

1. Streamlined Rate Regulation (Phase I)

In the same time frame, the commission began to address the problem of entry into traditional single firm portions of telecommunications, such as the provision of long distance. In particular, it attempted to ease the regulatory constraints on entry.³⁶³ Unlike its federal counterpart, however, the commission did not distinguish between dominant and nondominant firms. The commission rejected an attempt on the part of the interexchange carriers other than AT&T to impose additional restraints on dominant carriers.³⁶⁴ It concluded, "[w]hile the Commission is cognizant of the concerns expressed by some of the commenters with respect to telecommunications providers with a dominant market share, it believes that the forces of the marketplace, when coupled with the supervisory oversight of this Commission, will ensure a fair competitive telecommunications environment."³⁶⁵

Once again, however, the regulatory hand was much more apparent than the invisible one. The commission required that all interexchange carriers have a commission certificate to do business, though it reduced the content of the filing.³⁶⁶ To prevent any increase in intrastate long distance rates, the commis-

³⁵⁹ *Id.* at 12-13.

³⁶⁰ *Id.* at 13-14.

³⁶¹ *Id.* at 15.

³⁶² See *infra* text accompanying notes 472-75.

³⁶³ *Regulatory Framework*, *supra* note 328, slip op. at 3.

³⁶⁴ *Id.* at 4.

³⁶⁵ *Id.* at 4.

sion maintained tariffs for message toll service (MTS) and directed that these be flexible downward from the then existing long distance tariffs of Ohio Bell.³⁶⁷ The commission permitted discount rates only if the rates were available to all customers within a designated exchange.³⁶⁸ Once the utility filed flexible tariffs, it could raise or lower prices within the range of the tariffs without commission approval,³⁶⁹ but the commission required that utilities provide twenty days notice of any change in rates.³⁷⁰

Unlike MTS rates, the commission banded the rates that could be charged for other competitive services. The top rate could be no greater than two times the minimum rate, unless the utility provided a special justification.³⁷¹ Despite the banding, the commission did not require the company to provide a cost justification for the tariffs. (However, the commission did note that it would investigate tariffs that appeared to be unjust or unreasonable.³⁷² Presumably, the commission would have given consideration to cost information if a particular tariff were challenged.³⁷³) The commission approved the filing of tariffs containing provisions for trial offerings of a product at a discount for up to thirty days so as to attract new customers.³⁷⁴ If a utility wished to increase its MTS or non-MTS rate above a ceiling, the commission required a full rate hearing.³⁷⁵

Despite the local exchange companies' control of access facilities, the commission concluded that it would permit local exchange companies to file the same kinds of tariffs for its MTS services that the interexchange carriers were permitted to file.³⁷⁶ The current MTS tariff served as a ceiling for the flexible tariff.³⁷⁷ Local exchange companies were also permitted to seek approval for flexible tariffs for services other than MTS, but the commission required the companies to demonstrate that the market for the service was sufficiently competitive to justify the treatment.³⁷⁸ In contrast to the requirements on interexchange carriers, the commission required that the minimum tariff be supported by cost information "in order to insure that a local exchange carrier

³⁶⁷ *Id.* at 5.

³⁶⁸ *Id.* at 6.

³⁶⁹ *Id.* at 6.

³⁷⁰ *Id.* at 6.

³⁷¹ *Id.* at 6.

³⁷² *Id.* at 6.

³⁷³ *Id.* at 6.

³⁷⁴ *Id.* at 7.

³⁷⁵ *Id.* at 6.

³⁷⁶ *Id.* at 11.

³⁷⁷ *Id.* at 11.

³⁷⁸ *Id.* at 12.

does not subsidize competitive offerings with its monopoly offerings.³⁷⁹ The ceiling was set at two times the floor.³⁸⁰

The commission stretched its regulatory reach over new telecommunications entities as well. The commission concluded that interexchange resellers were utilities subject to regulation³⁸¹ and held that the streamlined regulatory approach would also be applied to radio common carriers and cellular radio carriers.³⁸² The commission also found that "for-profit" use of the systems, or other "shared tenant" arrangements, could be subject to commission regulation.³⁸³ (It later determined that some STS services were not within commission jurisdiction.³⁸⁴) The private line services of gas and electric utilities, however, were not subject to commission regulation since they were designed for private uses.

2. Streamlined Rate Regulation (Phase II)

In 1987, the commission sought the comments of the utilities concerning its streamlined regulation. Based on those comments, the commission continued with some minor modifications the program it had established previously.³⁸⁵ The commission again refused to distinguish between dominant and nondominant carriers.³⁸⁶ Several of the interexchange carriers likewise sought to impose additional restraints on the local companies over the latter's competitive offerings. The commission again refused to tighten the requirements.³⁸⁷ Sensing that it was constrained by statutes concerning certification, designation of service territories, and abandonment, the commission also refused to limit the filing requirements for tracking companies subject to the public utility statutes.³⁸⁸

The commission rejected any increase in the range of the banded tariffs. Some commenters suggested ranges of up to 1000 percent, or complete detariffing on the argument that the market place would limit prices to competitive levels.³⁸⁹ The commission rejected these requests on the ground that special

³⁷⁹ *Id.* at 12.

³⁸⁰ *Id.* at 12.

³⁸¹ *Id.* at 4.

³⁸² *Id.* at 9-10.

³⁸³ *Id.* at 11.

³⁸⁴ See *infra* text accompanying notes 409-29.

³⁸⁵ *Regulatory Framework (Phase II)*, *supra* note 328, slip op. at 1-2.

³⁸⁶ *Id.* at 4.

³⁸⁷ *Id.* at 11-12.

³⁸⁸ *Id.* at 4-5.

³⁸⁹ *Id.* at 6.

relief was available, if it could be justified to the commission.³⁹⁰ The commission, however, did agree to shorten the period for notice, reducing it to seven days from twenty.³⁹¹ Additionally, the commission permitted utilities to notify customers of increases in the range either by a bill insert seven days prior to an increase or by newspaper notice thirty days prior to an increase.³⁹² Several companies additionally sought to shorten the process for introducing new tariffs. The commission, however, refused to shorten the review process in the belief that it needed a sixty day period to study new filings.³⁹³

The commission made two changes in the promotional tariff requirements. First, it shortened the period of the effective date to ten days. Second, it extended the time the promotion could run from thirty days to ninety.

The commission also noted some creative rate making that was occurring through the complaint process provided by section 4905.26. Under this section, the commission had approved special increases for services identified for specific "cost causers." The commission rationalized these cases on the belief that the increases were necessary to avoid subsidization by other customers who were not causing the increased costs. Nonetheless, the commission noted a general need to seek legislation to open up rate-setting on a broader basis than the commission felt it was permitted to do.³⁹⁴

The commission also addressed the problem of special contracts filed by telephone companies on behalf of particular clients. It retained a ninety day review process for special contracts filed pursuant to section 4905.31. Importantly, however, the commission initiated a process for preapproval of contract forms that could be used for future arrangements. "Once the terms and criterion for rates are approved by the Commission, contractual arrangements falling within those approved parameters [would] be allowed to take effect immediately upon their filing with the Commission."³⁹⁵

Specific Services

Apart from the general regulatory framework and access charge questions, the commission maintained that it would decide the competitiveness of particular

³⁹⁰ *Id.* at 6.

³⁹¹ *Id.* at 7.

³⁹² *Id.* at 7.

³⁹³ *Id.* at 8.

³⁹⁴ *Id.* at 10.

³⁹⁵ *Id.* at 13.

service offerings on a case-by-case-basis.³⁹⁶ Once again following the lead of the FCC, the commission detariffed inside wiring. Two of the other generic matters, shared tenant services and billing and collections, also offer some insights into the commission's efforts to maintain the dual goals of supporting local companies and depressing local exchange rates while adhering to the rhetoric of competition.

1. *Inside Wire*

The decision of the Ohio commission to detariff inside wiring was triggered by the earlier federal action.³⁹⁷ The FCC order required companies to relinquish ownership of inside wire by January 1, 1987. In addition, the FCC ordered companies to detariff the maintenance of wiring, although it permitted them to continue to offer maintenance contracts for the service on a detariffed basis.³⁹⁸

Also effective January 1, 1987, the Ohio commission ordered the transfer of the beneficial ownership on inside wiring to customers.³⁹⁹ This transfer permitted customers to make any changes in the system they desired.⁴⁰⁰ The transfer of legal title was to be decided on a case-by-case basis until the phone companies had fully amortized the cost of the wiring and abandoned it to the users.⁴⁰¹ The companies were also permitted to sell any embedded wire (though one might wonder how it could be identified separately from the federal portion or the previously amortized state portion.)⁴⁰² The utilities were directed to notify their customers of the impending transfer of ownership and responsibility for maintenance prior to the transfer.⁴⁰³ The commission ordered that the portion of the current tariffs associated with inside wiring be removed and that basic local exchange rates be reduced by that amount.⁴⁰⁴ The commission limited further regulation of local loop wiring to the installation of external wiring and any connection devices. Importantly, the local exchange companies were relieved of the responsibility of being the "provider of last resort" for maintenance services.⁴⁰⁵

³⁹⁶ Entry on Rehearing, *Regulatory Framework for Competitive Telecommunications Services in Ohio* (Phase II), No. 86-1144-TP-COI, slip op. at 7 (Sept. 20, 1988).

³⁹⁷ *Inside Wire*, *supra* note 330, slip op. at 6.

³⁹⁸ *Id.* at 3.

³⁹⁹ *Id.* at 6.

⁴⁰⁰ *Id.* at 6.

⁴⁰¹ *Id.* at 6.

⁴⁰² *Id.* at 6.

⁴⁰³ *Id.* at 8.

⁴⁰⁴ *Id.* at 5.

⁴⁰⁵ *Id.* at 10.

To assist the customers in their new responsibility, the commission directed the companies to make information available concerning the installation and maintenance of wiring.⁴⁰⁶ Additionally, the commission directed the companies to inform the commission of the companies' services on a detariffed basis.⁴⁰⁷

In its entry on rehearing, the commission permitted a form of negative enrollment for maintenance of inside wiring. To the extent that the service offered by the utility did not increase the overall cost of local service, the commission allowed the company to enroll the customer in its service plan without a positive designation of interest. If the maintenance plan increased the cost of service, however, the commission required a positive response from the customer for enrollment.⁴⁰⁸

2. Shared Tenant Services

Shared tenant service (or STS) is "the third-party provision of telecommunications services to the occupants of multi-tenant buildings, complexes, or developed properties through a private branch exchange (PBX)."⁴⁰⁹ The commission stated that it wished to encourage the use of shared tenant services for several reasons. First, it allowed greater aggregation of service, resulting in lower individual costs. Second, it permitted lower usage charges through collected long distance rates and the elimination of some local exchange costs. Third, tenants could enjoy advanced calling features. Fourth, it gave smaller customers the ability to use some other enhanced features, such as voice and electronic mail.⁴¹⁰ In its rhetoric, therefore, the commission sought to achieve the promotion of technological innovation and economic efficiency.⁴¹¹

Consistent with this belief, the commission concluded that local resale and sharing of shared tenant service were not subject to regulation. The seller was not a telephone company because it did not hold itself out as a provider to the general public.⁴¹² Local exchange companies were permitted to serve as resellers of shared tenant services, but revenues would be treated as below the line in order to avoid subsidies. In addition, the commission had to approve accounting

⁴⁰⁶ *Id.* at 8.

⁴⁰⁷ *Id.* at 8.

⁴⁰⁸ Entry on Rehearing, Detariffing of the Installation and Maintenance of Simple and Complex Inside Wire, No. 86-927-TP-COI, slip op. at 6, (Feb. 10, 1987).

⁴⁰⁹ *Shared Tenant Services*, *supra* note 329, slip op. at 1.

⁴¹⁰ *Id.* at 3.

⁴¹¹ *Id.* at 5.

⁴¹² *Id.* at 6.

measures to assure separation of costs.⁴¹³

Deregulation, however, did have its restrictions. As a means of protecting the local exchange, the commission adopted several tariff restrictions on the connection of shared tenant services to local exchange services. The purpose of these restrictions was to prevent the creation of competing local exchange companies which would siphon off revenues from the existing local exchange companies.⁴¹⁴ First, there was a requirement of geographic continuity.⁴¹⁵ Second, if more than one building was involved, "they must have a related business purpose."⁴¹⁶ Third, the commission prohibited the interconnection of different shared tenant systems.⁴¹⁷ Fourth, participation was limited to occupants of the buildings in the system.⁴¹⁸ However, the commission refused a request from the local exchange companies to partition tenants from one another (i.e. prohibition on inter-tenant calling on the system.)⁴¹⁹

Most telling were the tariff provisions for shared tenant system access to the public network. In keeping with the commission's attempt to protect local revenues, the commission permitted the local exchange companies to require a shared tenant service to pay the local measured service tariff, despite the fact that a PBX owner (a single business office, for example) could subscribe to a flat rate.⁴²⁰ The commission's rationale for this limitation was that the shared tenant service was "functionally different in the sense that an STS firm is involved in the business of providing telecommunications services to others rather than simply meeting its own communications needs."⁴²¹ The commission also feared the loss of revenues that would occur as a result of the nontraffic-sensitive nature of a flat rate.⁴²² Finally, the commission noted that costs should be assigned to the "cost causers".⁴²³ Despite this rationale, the commission did acknowledge that the operational characteristics of shared tenant service and a solely owned PBX were identical.⁴²⁴

⁴¹³ *Id.* at 7.

⁴¹⁴ *Id.* at 10.

⁴¹⁵ *Id.* at 11, modified in part, Entry on Rehearing, *Shared Tenant Services*, *supra* note 329, slip op. at 3.

⁴¹⁶ *Id.*

⁴¹⁷ *Id.*

⁴¹⁸ Entry of Rehearing, *Shared Tenant Services*, *supra* note 329, slip op. at 4.

⁴¹⁹ Opinion and Order, *Shared Tenant Services*, *supra* note 329, slip op. at 11.

⁴²⁰ *Id.* at 12.

⁴²¹ *Id.* at 12.

⁴²² *Id.* at 12.

⁴²³ *Id.* at 12.

The commission also tied the hands of the STS service by requiring the STS to pay the business cost of any additional directory listings for its customers.⁴²⁵ In its entry on rehearing, the commission recognized the potential error of such an approach in the case of a residential system, and permitted the use of the lower residential rate if the STS notified the local exchange company of its customers' residential status.⁴²⁶

Another difficult issue presented to the commission was the continuing requirement that the local exchange company provide a shared tenant service customer with the back up service of a direct connection with the local exchange company.⁴²⁷ The commission concluded that the exchange company had a continuing duty to provide direct service at the tenant's request.⁴²⁸ Subscribers were required to pay the same rates as ordinary customers for the same service, even though it amounted to backup protection, and likely would present limited additional variable cost on the system.⁴²⁹

3. *Billing and Collection Services*

Another attempt to protect old schemes of subsidy was the commission's decision concerning billing and collection services. Billing and collection concerns the contracting by local exchange carriers with long distance carriers for the billing and collection for the latter's services.⁴³⁰ With the exception of recording, the commission chose to deregulate billing and collections.⁴³¹ It based its conclusion to deregulate on two findings. First, the commission determined that the service was no longer a utility function. Second, the commission discerned that there was sufficient competition both within and outside of the telecommunications industry to prevent unreasonable practices.⁴³² Due to technical problems, however, the commission required the local exchange companies to provide recording services to all interexchange carriers until conversion to equal access was completed.⁴³³ Interestingly, the commission did not require that the recording service be offered under tariff, though it did require that any income received be treated as part of rate base related income.⁴³⁴ Thus, a competitive

⁴²⁵ *Id.* at 13.

⁴²⁶ Entry on Rehearing, *Shared Tenant Services*, *supra* note 329, slip op. at 4-5.

⁴²⁷ Opinion and Order, *Shared Tenant Services*, *supra* note 329, at 13.

⁴²⁸ *Id.* at 14.

⁴²⁹ *Id.* at 14.

⁴³⁰ *Billing and Collection*, *supra* note 331, slip. op. at 1.

⁴³¹ *Id.* at 7.

⁴³² *Id.* at 7.

⁴³³ *Id.* at 7.

⁴³⁴ *Id.* at 7-8. Published by IdeaExchange@Uakron, 1991

nonutility service was used to subsidize utility rates.⁴³⁵

The Retrenchment: Alternative Operator Services

In several senses, the Ohio commission followed the lead of the FCC, and essentially reacted. The reactive posture in itself suggested the general uneasiness the commission felt with deregulation. Its implementation reinforced that perception. Moreover, when faced with an unexpected new product and a large number of consumer complaints, the commission fell back to direct regulation. Alternative operator service provided the difficult test case.

The commission initiated the proceeding concerning alternative operator services (AOS) as a result of informal complaints. These complaints identified uncertificated interexchange carriers who were providing operator services at rates substantially higher than the filed rates of other carriers.⁴³⁶ In general, alternative operator services amounted to the resale of WATS services to large customers (such as hotels and hospitals) known as aggregators. "[T]he AOS providers proposed to handle the interexchange calls placed from their customers' establishments and then pay those customers commissions on the calls."⁴³⁷

The commission initially established several interim requirements on AOS. First, rates were capped at the Ohio Bell tariffs for similar services.⁴³⁸ Second, the AOS carriers were not permitted to surcharge customers for the services. Third, operator-assisted calls through privately owned pay phones were capped at the local exchange rate. Fourth, the AOS provider was required to identify itself and quote its rates on request. Fifth, the AOS was required to provide access, or information as to how to access other providers from the same phone. Sixth, the AOS was to connect all emergency (911) calls directly to the local exchange company operator. Seventh, the companies were required to file an affidavit in which they agreed to comply with the requirements.⁴³⁹ Finally, the commission reemphasized that each AOS was required to receive an authorization certificate prior to commencing activity within the state.⁴⁴⁰

⁴³⁵ The commission required that billing name and address information be continued on a tariffed basis since it believed that the local exchange companies had a bottleneck on this information. *Id.* at 8. Mixed in with the competitive services of billing and collection was the provision of billing name and address for random or non-presubscribed calls. This information was collected exclusively by the local exchange companies and offered to the long distance carriers on a bundled basis with billing and collections. Under the existing technological standards, only the local exchange companies could provide the information, thus creating a technological bottleneck. *Id.* at 5-6.

⁴³⁶ *OSP*, *supra* note 332, slip op. at 2.

⁴³⁷ *Id.* at 2.

⁴³⁸ *Id.* at 3.

⁴³⁹ *Id.* at 3-4.

⁴⁴⁰ *Id.* at 4.

Following its initial order, the commission performed a study concerning problems associated with the service. Based on the findings of the commission's consumer affairs division, the commission found that AOS was not operating in the public interest. As a result, the commission determined to set minimum standards for all operator service providers.⁴⁴¹

In its second interim order, the commission had great difficulty in defining what constituted alternative operator service. The commission finally focused on the separation of the contracting party from the party responsible for paying for the service. "The customers with whom the AOS providers contract are host facilities, and the owners of those facilities do not actually pay for the processing of the operator assisted calls. The actual end users of the AOS providers' services are members of the transient public with whom the AOS providers have not directly contracted to provide the services, but who actually do pay for the processing of the calls."⁴⁴² For those kinds of providers, the PUCO implemented special regulation.

The commission identified four issues in its second order. First, the commission looked at rates. It concluded that rates would be governed by the provisions applicable to competitive long distance carriers. For interexchange calls, this requirement limited rates to the Ohio Bell tariff levels.⁴⁴³ Additionally, operator assisted rates were limited by the Bell operator rate ceilings.⁴⁴⁴ Rate changes within the cap must be filed with the commission seven days before they were effective.⁴⁴⁵ Additionally, the commission required each operator to identify itself ("brand the call") prior to processing the call, and to post a notice of the AOS provider on the telephone.⁴⁴⁶ The notice must inform the user that the rates could be different than those normally charged.⁴⁴⁷

A second concern raised by the commission was the proper treatment of 911 calls. The commission directed the AOS carriers to completely avoid intercepting and processing 911 calls.⁴⁴⁸

Third, the commission established service and reporting criteria for the

⁴⁴¹ *Id.* at 44.

⁴⁴² *Id.* at 43.

⁴⁴³ *Id.* at 44.

⁴⁴⁴ *Id.* at 44-45 (the ceiling for customer dialed calling card calls was \$1.70; for operator handled calls, \$2.50; and person to person calls, \$4.80).

⁴⁴⁵ *Id.* at 45.

⁴⁴⁶ *Id.* at 45.

⁴⁴⁷ *Id.* at 46, *modified*, Entry on Rehearing, Provision of Intrastate Interexchange Operator Assisted Services in Ohio, No. 88-560-TP-COI, slip op. at 21 (Sept. 13, 1989).

⁴⁴⁸ *OSP*, *supra* note 332, slip op. at 46.

completion of calls. The companies were required to respond to ninety percent of all calls within ten seconds of the appearance of the call to the operator.⁴⁴⁹

Finally, the commission continued many of the prior interim standards. First, it prohibited any surcharges other than those provided by tariff, such as hotel or billing charges. Second, the commission prohibited backhauling charges (payments for the cost of carrying the message on the precise route rather than the air mileage between the connected points). Third, the commission required instantaneous local operator connection by dialing "0."⁴⁵⁰ Each AOS was required to quote its rates for services on request.⁴⁵¹ The commission again required the AOS companies to permit access to other operators. Importantly, the AOS companies were required to provide confidential lists of customers so that the commission could proceed with service checks.⁴⁵²

The AOS order is a curiosity if judged by the competitive nature of the industry. If any part of the industry is competitive, it is the provision of resale long distance service, which is essentially the heart of AOS. AOS companies are essentially resellers with very low barriers to entry and exit. The curious contractual relationships between the parties do not change the competitive pressures the reseller faces from its customers, other AOS companies, and other long distance carriers.⁴⁵³ Yet the commission devised elaborate notice and tariffing provisions. This apparent reaction to a market failure which did not in fact exist, and arguably could be rectified with time as customers became familiar with the emerging service and took notice of the varying levels and costs of service if they existed, suggested a fundamental distrust of the competitive model, even at the competitive center.

Summary

The process of adjusting to divestiture and deregulation at the state level did not suggest a strong correlation between theory and action on the part of the Ohio commission. First, the efforts in Ohio have essentially been reactive to federal actions. At the state level, the decision to establish access charges, the changes in billing and collections, and inside wiring resulted from federal actions.

Second, the commission has protected the status of the monopoly local exchange companies through several devices which sought to maintain revenues at pre-divestiture levels. The most obvious of these is the access charge order, and

⁴⁴⁹ *Id.* at 46.

⁴⁵⁰ *Id.* at 48.

⁴⁵¹ *Id.* at 48.

⁴⁵² *Id.* at 48.

its guarantee of 1983 revenue levels through pooling and the carrier presence charge. Likewise, the commission found methods to direct new revenues to the local exchange companies with above-the-line treatment of revenue from deregulated services and special rates, as in the case of shared tenant service. Similarly, the commission has sought to prevent the costs of basic service from increasing by driving costs through access charges, allocating competitive services income to monopoly rate customers, and, as noted more fully below, through depreciation schedules.⁴⁵⁴

Third, the commission has failed to make an independent factual determination of the competitive nature of the telecommunications market. Instead, it has relied on representations which have not been tested by empirical, or even anecdotal, evidence other than through the process of notice and comment.

Fourth, there may be a growing tendency in the commission to seek regulatory responses to problems rather than to permit the market to adjust the flow of information and the resulting prices. In particular, the commission's decision concerning alternative operator services suggests it may be dissatisfied with the market operation in one of the areas in which competitive forces at the local level are most likely to work.

OHIO JUDICIAL RESPONSE TO DEREGULATION

The problems noted above suggest that the commission's decisions might face significant challenges if appealed. Both substantive and procedural flaws are evident, and a significant forum exists in which to challenge the commission's action. Under Ohio law, the Ohio Supreme Court must hear appeals from decisions of the PUCO.⁴⁵⁵ However, this judicial check on the commission's actions has been limited. Though the court routinely notes that the commission is a creature of statute and lacks any authority to take action not permitted by the enabling provisions of Chapter 49 of the Ohio Revised Code, the court also has recognized that the commission has broad authority to "interpret" the operative provisions of the chapter. The commission has taken full advantage of that authority. Moreover, the court has conceded that the federal actions resulting in deregulation of interstate transactions have required that the commission adopt novel approaches which do not fit cleanly within the legislative structure for determining rates and other matters.

However, a curious irony exists. Under the guise of deregulation, the commission has justified to the court several actions which generally assist the

⁴⁵⁴ See *infra* text accompanying notes 507-09.

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⁴⁵⁵ See *supra* text accompanying notes 322-26.

local exchange companies in maintaining current revenues and their monopoly status. Thus, the banner of deregulation has justified some results which reinforce traditional monopoly rights of the local exchange companies, and has frustrated, at least theoretically, the introduction of competition into the Ohio telecommunications market.

Standard of Review

Part of the court's deference is explained by the statutory standard of review. Though the Revised Code requires appellate review of all cases for which appeal is sought, the standard of review is nonetheless limited. It provides that the decision of the commission will be upheld unless it is "unlawful or unreasonable."⁴⁵⁶ On issues of fact, the court has taken a highly deferential position. The court "will not reverse or modify a PUCO decision as to questions of fact where the record contains sufficient probative evidence to show that the PUCO's determination is not manifestly against the weight of the evidence and is not so clearly unsupported by the record as to show misapprehension, mistake, or willful disregard of duty."⁴⁵⁷ This standard, however, cannot explain the court's deference on matters involving the application and interpretation of statutory authority by the commission. In this area, the court claims to have retained the authority for complete and independent review.⁴⁵⁸

Nonetheless, the court has deferred to the commission's expertise to interpret what the legislature intended, even in instances in which a matter of statutory review is controlling. In a telephone rate case, for example, the commission defined the term "working capital" as contained in the rate base of a utility in such a way as to prohibit the offset of rate base when the commission's calculations demonstrated that income from rate payers exceeded any requirements from investors.⁴⁵⁹ That is, customers' payments covered the company's working capital requirements, which normally are contributed by investors' funds. However, the commission did not reduce the ratebase to reflect that amount. In affirming the commission's decision, the court once again deferred to the commission on a matter of statutory interpretation.⁴⁶⁰ According

⁴⁵⁶ OHIO REV. CODE ANN. § 4903.13 (Anderson 1977) provides, in part: "A final order made by the public utilities commission shall be reversed, vacated, or modified by the supreme court on appeal, if, upon consideration of the record, such court is of the opinion that such order was unlawful or unreasonable."

⁴⁵⁷ *MCI Telecom. Corp. v. Pub. Util. Comm'n of Ohio*, 38 Ohio St. 3d 266, 268, 527 N.E.2d 777, 780 (1988), *reh'g denied*, 39 Ohio St. 3d 710, 534 N.E.2d 93 (1988). *See also* *Dayton Power & Light Co. v. Pub. Util. Comm'n of Ohio*, 4 Ohio St. 3d 91, 447 N.E.2d 733 (1983); *Columbus v. Pub. Util. Comm'n of Ohio*, 58 Ohio St. 2d 103, 388 N.E.2d 1237 (1979).

⁴⁵⁸ *MCI Telecom. Corp. v. Pub. Util. Comm'n of Ohio*, 38 Ohio St. 3d 266, 268, 527 N.E.2d 777, 780 (1988), *reh'g denied*, 39 Ohio St. 3d 710, 534 N.E.2d 93 (1988).

⁴⁵⁹ *Office of Consumers' Counsel v. Pub. Util. Comm'n of Ohio*, 32 Ohio St. 3d 263, 266, 513 N.E.2d 243, 247 (1987).

to the court, the absence of a specific definition within a controlling statute indicated that "the General Assembly has vested the PUCO with broad discretion."⁴⁶¹ The effect of these kinds of decisions is to place a great deal of power in the hands of the commission.

Judicial Treatment of Telecommunications Cases

In this regard, the court conceded to the commission a greater role in defining the state's telecommunications policy prior to legislative changes found in House Bill 563. Though the sample of cases is small because most commission cases are not appealed, those that are available present a telling pattern. The Ohio Supreme Court has reviewed several cases concerning access charges, complaints as to tariffs, and rate cases involving mixed problems of regulated and deregulated services. In these cases, the court accepted the commission's general approach of maintaining local monopolies, even while the court couched its acceptance in terms of the deregulation and despite statutory limitations which often directed different results.

1. Access Charges and Pooling: The Generic Cases

As noted above,⁴⁶² the commission approved a set of procedures for implementing access charges which locked in local exchange company revenues at 1983 levels. Following the initial order, the commission continued to face questions concerning the distribution of the pool of funds exceeding the revenue requirements.⁴⁶³ In two subsequent decisions, known as *Subfiles A and B* and *Subfile C*, the commission ordered the distribution of the excess funds.⁴⁶⁴ MCI appealed each of these decisions.⁴⁶⁵

The dispersion of the pooled funds collected under the access charge order presented the court with another opportunity to affirm the commission's "broad brush" approach to regulating telecommunications after the divestiture. In the first *MCI* case arising from the commission's *Subfile A and B* decision, MCI challenged the pro rata distribution of the pool excess on the grounds that the commission failed to provide due process and ordered discriminatory rates.⁴⁶⁶ In affirming the commission, the court rejected MCI's due process claim and

⁴⁶¹ *Id.* at 265, 513 N.E.2d at 246.

⁴⁶² See *supra* text accompanying notes 337-40.

⁴⁶³ See *supra* text accompanying notes 341-62.

⁴⁶⁴ *Id.*

⁴⁶⁵ *MCI Telecom. Corp. v. Pub. Util. Comm'n of Ohio*, 32 Ohio St. 3d 306, 513 N.E.2d 337 (1987) (hereinafter as *MCI I*); *MCI Telecom. Corp. v. Public Util. Comm'n of Ohio*, 38 Ohio St. 3d 266, 527 N.E.2d 777 (1988) (hereinafter as *MCI II*).

⁴⁶⁶ *MCI I*, 32 Ohio St. 3d at 309, 513 N.E.2d at 341.

upheld the commission's authority to alter rates and direct refunds through a notice and comment procedure. Despite a statutory complaint process and the requirements the rate making statutes impose on hearings, the court rejected the company's demand for a hearing on the theory that "ratepayers" had no constitutional right to a hearing absent a concomitant statutory right.⁴⁶⁷ The court further held that the use of notice and comment satisfied a statutory requirement that the decisions of the commission be supported by evidence of record.⁴⁶⁸

Second, the court concluded that the rate reduction did not present a case for the application of the antidiscrimination statutes.⁴⁶⁹ In addressing this argument, the court accepted the finding that the source of funds contained in the pool was not limited to the interexchange carriers, thus eliminating the possibility that the rate reduction resulted in a form of cross-subsidy which unfairly allowed the local exchange companies to use competitors' funds to lower their rates for competing long distance service.⁴⁷⁰ The court could thus conclude that the commission had acted properly within its broad discretion in allowing the refund to be passed through in the form of the toll rate reduction.⁴⁷¹

In *MCI II*, the court completed the reasoning it began in the prior case. Again MCI challenged the procedures for setting access charges and the distribution of funds that had accumulated in the access charge pool.⁴⁷² In affirming the commission's decision, the court relied on its prior opinion, and found that the commission's broad discretion permitted it to enter into "a generic rate-making process" through notice and comment.⁴⁷³ The court also found that the requirement that a decision be on the record was satisfied by the commission's review of its own prior decisions, and its assertion that sufficient company-specific cost information was not available to set access charges for individual companies.⁴⁷⁴ Finally, the court failed to address in any further detail the allegations that the rate reductions would result in discrimination against the interexchange carriers.⁴⁷⁵

⁴⁶⁷ *Id.* at 310, 513 N.E.2d at 342. See OHIO REV. CODE §§ 4905.26 and 4909.19 (Anderson 1977 and Supp. 1990).

⁴⁶⁸ *MCI I*, 32 Ohio St. 3d at 311-12, 513 N.E.2d at 343.

⁴⁶⁹ See *supra* text accompanying notes 290-93.

⁴⁷⁰ *MCI I*, 32 Ohio St. 3d at 313, 513 N.E.2d at 344-45.

⁴⁷¹ *Id.* 513 N.E.2d at 345.

⁴⁷² *MCI II*, 38 Ohio St. 3d at 268, 527 N.E.2d at 779.

⁴⁷³ *Id.* at 270, 527 N.E.2d at 781.

⁴⁷⁴ *Id.* 527 N.E.2d at 781.

2. Access Charges: Complaint Proceedings

As an alternative to directly attacking the commission on its orders setting up particular procedures, other parties sought to attack the commission's policy (and more directly, local exchange practices adopted pursuant to those policies) through the complaint process provided by section 4905.26.⁴⁷⁶ The results of these cases have been mixed at best.

One of the early challenges to the mirroring of access rates through a complaint case appears in the 1987 *Allnet* case (*Allnet I*).⁴⁷⁷ As a result of the mirroring requirement, Ohio Bell raised its state access tariffs to the federally-approved levels.⁴⁷⁸ Allnet complained to the commission that the increase violated the statutory requirement of a full rate case for a rate increase.⁴⁷⁹ The commission dismissed the complaint on the ground that it amounted to an untimely attempt to rehear the original generic case setting access charges.⁴⁸⁰ In reversing the commission, the Ohio Supreme Court found that Allnet had stated sufficient grounds for a complaint under section 4905.26.⁴⁸¹ In particular, the court was concerned that Allnet have an opportunity to present its claim that the increases authorized by the mirroring order were unreasonably large.⁴⁸² Moreover, the commission had indicated its intent to monitor access charges and adjust them if necessary to prevent unreasonable rates in its original access charge order.⁴⁸³ As a result, the court concluded that the commission should perform the review that it said it would perform when it established the mirroring requirements.⁴⁸⁴

In *Allnet II*,⁴⁸⁵ the commission again dismissed a complaint challenging the Ohio Bell access tariffs for intraLATA access, and the Ohio Supreme Court reversed. Following its decision in *Allnet I*, the court concluded that the appellant had stated sufficient grounds under section 4905.26 by alleging that it was paying premium access rates for less than premium service.⁴⁸⁶ Again, the commission probably assisted the court in its decision by stating that it recognized that there was a problem, but would delay the resolution of it until it could hold a generic

⁴⁷⁶ See *supra* text accompanying note 286.

⁴⁷⁷ *Allnet Comm. Serv., Inc. v. Pub. Util. Comm'n of Ohio*, 32 Ohio St. 3d 115, 512 N.E.2d 350 (1987).

⁴⁷⁸ *Id.* at 115, 512 N.E.2d at 351.

⁴⁷⁹ *Id.* at 115-16, 512 N.E.2d at 351.

⁴⁸⁰ *Id.* at 116, 512 N. E.2d at 351.

⁴⁸¹ *Id.* at 117, 512 N.E.2d at 352.

⁴⁸² *Id.* at 117, 512 N.E.2d at 353.

⁴⁸³ *Id.* at 117-18, 512 N.E.2d at 353.

⁴⁸⁴ *Id.* at 118, 512 N.E.2d at 353.

⁴⁸⁵ *Allnet Comm. Serv., Inc. v. Pub. Util. Comm'n of Ohio*, 38 Ohio St. 3d 195, 527 N.E.2d 840 (1988).

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⁴⁸⁶ *Id.* at 196, 527 N.E.2d at 842.

hearing concerning the matter.⁴⁸⁷

The effect of these decisions is substantially more than might be suggested by the narrow legal lines the decision sought to draw. The court has repeatedly stated that the complaint process is not available to competitors to challenge utility rates.⁴⁸⁸ In stark contrast to the decisions based on the discrimination statutes in which the court refused to address the competitive questions raised by the complaints, the court in *Allnet I* and *II* permitted a downstream competitor to challenge a rate for its reasonableness without meeting the narrow requirements found in sections 4905.33 or 4905.35. In essence, the court opened a new avenue for competitors to shore up their competitive position.

Justice Douglas' dissent in *Allnet II* suggests the problem with the court's approach to the complaint process in the access charge area. In essence, the distinction between competitors and customers is blurred. Despite specific provisions concerning anticompetitive behavior contained in the code, "customers" of access could now use section 4905.26 to sidestep the narrow constraints. Thus, the customer could seek a competitive advantage through this procedure, thereby casting the commission into the role of competitive arbitrator.⁴⁸⁹

A second, thornier, issue presented by the *Allnet* cases is the curious contrast between those cases and the *MCI* decisions. On the one hand, the court permitted the commission to set rates through a generic proceeding. On the other, it directed the commission to hold detailed hearings if a challenge is presented. In the latter, the challenger carries the burden of demonstrating that the rates are unreasonable. Yet the utility is never required to demonstrate that the rates are initially reasonable. Thus, a complete shift of responsibilities occurs. In essence, the customer is required to demonstrate what reasonable rates are for that utility. That result is hardly indicated by the rate making statutes.

3. Rate Cases

The third potential avenue remaining for stake holders wanting to address the competitive policies of the commission is the traditional rate case. Once again, however, the court has demonstrated a remarkable ability to treat the competitive issues in a way which permits the commission to perpetuate the hold of the local exchange company over potential competitors, while arguing competitive necessity.

⁴⁸⁷ *Id.*

⁴⁸⁸ See, e.g., *Armco, Inc. v. Pub. Util. Comm'n of Ohio*, 69 Ohio St. 2d 401, 433 N.E.2d 923 (1982).

⁴⁸⁹ *Allnet Comm. Serv. Inc. v. Pub. Util. Comm'n of Ohio*, 38 Ohio St. 3d at 197-98, 527 N.E.2d at 843 (Douglas, J., dissenting).

In *Armco*,⁴⁹⁰ the commission's first attempt to argue competitive necessity for unusual forms of rate regulation was successful. In this case, the commission approved an Ohio Bell request for flexible rate schedules for the provision of some of its business equipment systems.⁴⁹¹ The commission based its approval of the rates on the increased competition in the market and the inability of Ohio Bell to respond to that competition under fixed rate schedules.⁴⁹² Importantly, the commission's decision came on the heels of the FCC's approval of detariffing customer equipment in the *Computer II* inquiry.⁴⁹³ The rate schedule set a minimum rate and permitted increases up to two times the minimum rate.⁴⁹⁴ Despite the failure to set a single rate, the court noted that the minimum rates were set under normal ratemaking procedures so as to provide a return to the utility.⁴⁹⁵ The court did not indicate how the costing of the service occurred.

A customer and a group of competitors challenged the commission's approval.⁴⁹⁶ The first challenge to the rates asserted that increases permitted under the flexible tariffs were not permitted under the provisions for rate changes contained in the Revised Code.⁴⁹⁷ Second, the appellants argued that the commission lacked the authority to approve flexible rates.⁴⁹⁸ Addressing the first two challenges, the court agreed with the commission that section 4905.31, concerning special arrangements for utility service, permitted the commission to approve a flexible schedule.⁴⁹⁹ The court seemed greatly influenced by the ongoing efforts in the divestiture case, and by the FCC, to accomplish some of the competitive goals contained in the challenged order.⁵⁰⁰ These changes at the federal level necessitated a different approach to regulation at the state level.⁵⁰¹ As the court concluded, "[w]hat is clear is that the radical transformation of the formerly monopolistic, regulated telecommunications market is proceeding apace and that this transformation is of such magnitude as to require a thorough reexamination of these regulatory practices and procedures which have become inapplicable or obsolescent in the face of non-monopolistic market condi-

⁴⁹⁰ *Armco, Inc. v. Pub. Util. Comm'n of Ohio*, 69 Ohio St. 2d 401, 433 N.E.2d 923 (1982).

⁴⁹¹ *Id.* at 401, 433 N.E.2d at 924.

⁴⁹² *Id.* at 402, 433 N.E.2d at 924.

⁴⁹³ *Id.* at 402-03, 433 N.E.2d at 925.

⁴⁹⁴ *Id.* at 403, 433 N.E.2d at 925.

⁴⁹⁵ *Id.*

⁴⁹⁶ *Id.* at 404, 433 N.E.2d 925.

⁴⁹⁷ *Id.* at 405-07, 433 N.E.2d at 926-27.

⁴⁹⁸ *Id.* at 407, 433 N.E.2d at 927.

⁴⁹⁹ *Id.* at 409, 433 N.E.2d at 928.

⁵⁰⁰ *Id.* at 409-10, 433 N.E.2d at 928-29.

⁵⁰¹ *Id.* at 411, 433 N.E.2d at 929.

tions."⁵⁰²

Several equipment vendors that competed against the Bell companies also complained of the strategy adopted by Bell to encourage its customers to move to new equipment on long term contracts.⁵⁰³ They alleged that Bell had adopted rates on new and old equipment which encouraged customers to sign long term contracts which precluded competition.⁵⁰⁴ However, the narrowness of the applicable statute concerning discrimination, section 4905.33, prevented the commission from entering the fray, because there was no evidence that the company was offering the new services for free or below "actual cost."⁵⁰⁵ The court approved the commission's view that it was "without jurisdiction to entertain allegations of anti-competitive practices unless the statutory conditions . . . obtain."⁵⁰⁶

Once again, the effect of the decision was to permit the regulated monopoly an opportunity to compete on a better playing field. It could provide competitive services from within the structure of a protected monopoly and its practices could not be challenged as being anticompetitive within the regulatory framework.

In an apparent departure from the favorable treatment of the local exchange companies, the commission refused to adopt accelerated depreciation schedules after the FCC attempted to preempt state regulation in a *Cincinnati Bell* case.⁵⁰⁷ The Ohio Supreme Court agreed, and held that the FCC action did not estop the commission from making a different finding, despite the commission's participation in the FCC docket.⁵⁰⁸ The court went on to reject Bell's argument that the FCC order preempted the state from setting different depreciation rates than those prescribed for interstate rates by the FCC. The court concluded that the FCC lacked the authority to prescribe intrastate depreciation rates, even under the FCC's assertion that the approach was necessary to promote the interstate system.⁵⁰⁹ Again, however, the slower depreciation schedules had the effect of slowing competitive pressures. Ironically, this time the effect potentially favored

⁵⁰² *Id.*

⁵⁰³ *Id.* at 412, 433 N.E.2d at 929-30.

⁵⁰⁴ *Id.*, 433 N.E.2d at 930.

⁵⁰⁵ *Id.*

⁵⁰⁶ *Id.* at 412-13, 433 N.E.2d at 930.

⁵⁰⁷ *Cincinnati Bell Tel. Co. v. Pub. Util. Comm'n of Ohio*, 12 Ohio St. 3d 280, 466 N.E.2d 848 (1984), *appeal dismissed*, 476 U.S. 1166 (1986). The commission's authority to set intrastate depreciation schedules was affirmed by the Supreme Court in *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355 (1986).

⁵⁰⁸ *Cincinnati Bell Tel. Co. v. Pub. Util. Comm'n of Ohio*, 12 Ohio St. 3d at 283, 466 N.E.2d at 852.

⁵⁰⁹ *Id.* at 284, 466 N.E.2d at 852-53.

the local exchange companies because their rates would appear more competitive than the effect of the obsolescence of their equipment might actually permit. In other words, the local exchange companies' rates were being maintained at artificially low levels compared to unregulated entities, which could more accurately write off the cost of plant for economic depreciation. In the short run, at least, the local exchange companies benefited from lower perceived costs due to the commission's action and the court's approval. Once the customer was drawn into the Bell system by its lower rates, he had an additional incentive to stay, even if the rates were later increased, as the real depreciation costs were recognized.

Summary

There is a certain irony in the court's growing deference to commission actions in telecommunications regulation. The state goal of adapting to the competitive environment created by divestiture is dramatically different from the effect of the decisions issued by the commission and approved by the court. Indeed, the effect of the decisions is to strengthen the competitive position of the local exchange companies in their relations to potential competitors. Thus, the competitors of the local exchange companies could be financing the lower rates of their competitors in the intraexchange long distance market.

This problem was partially mitigated by the court's apparent approval of the complaint process by competitors seeking to lower access tariffs. However, the irony is further reinforced by requiring the competitors to demonstrate that the tariffs are unreasonable under the standards of section 4905.26. Thus, the burden of ascertaining the appropriate cost information is placed on the wrong party: the one with the greatest competitive pressure to keep costs low and avoid additional administrative wrangling and the expenses associated with it.

A second and even more fundamental effect of the court's decisions is the continuing deterioration of the legislative rein over the PUCO. While the General Assembly has apparently endorsed much of the commission's agenda with the adoption of House Bill 563,⁵¹⁰ the court's acquiescence is still more remarkable in light of the statutory standards it has claimed to apply.⁵¹¹ Quite simply, there was nothing in Chapter 49 which would permit the court to endorse "generic rate making", as it did in *MCI II*. Very specific procedures are set out in the code for setting rates through the determination of the costs of providing service.⁵¹²

⁵¹⁰ See *infra* text accompanying notes 517-76.

⁵¹¹ See *supra* text accompanying notes 456-61.

⁵¹² See *supra* text accompanying notes 302-11.

While the rates for a particular service need not be based purely on cost,⁵¹³ the overall revenue of the utility is limited by a very specific formula. To approach an industry as if it were a single company to set "generic rates" does not meet the requirements of the statute.

Third, the court permitted the commission to substitute notice and comment proceedings for actual factual hearings. In some cases involving policy making this may make sense. There is also a recognition that some form of rate making can occur through notice and comment without offending notions of due process.⁵¹⁴ However, the commission, with the court's approval, has taken this procedure to new levels. Inherently, the powers of the commission then moved beyond those of an agency entrusted with certain powers to one with its own set of predilections that could be exercised at will.

OHIO'S LEGISLATIVE RESPONSE TO DEREGULATION

Despite its success in administratively redefining its legal authority, the Ohio commission, in its second *Regulatory Framework* decision, recognized the potential limits of the existing statutes in its decisions concerning deregulation.⁵¹⁵ (Thus a weak argument can be made that the decisions of the commission reflected the statutory limitations.) One might also point to the court's approval to question the need for additional authority when it acceded to nearly all of the commission's assertions of authority to set rates in novel and apparently extra-statutory ways.⁵¹⁶ Nonetheless, the Ohio legislature moved forward on a much broader agenda to offer telephone companies a new regulatory environment. House Bill 563 served as the conduit for that change.

Legislative History of House Bill 563

As introduced, House Bill 563⁵¹⁷ was a curious laundry list of provisions. Its primary provisions suggested a general goal of deregulation.⁵¹⁸ The

⁵¹³ *Townships of Mahoning County v. Pub. Util. Comm'n of Ohio*, 58 Ohio St. 2d 40, 388 N.E.2d 739 (1979).

⁵¹⁴ *United States v. Florida East Coast Rwy. Co.*, 410 U.S. 224, 235 (1973).

⁵¹⁵ *Regulatory Framework*, *supra* note 328, at 4.

⁵¹⁶ See *supra* text accompanying notes 472-75.

⁵¹⁷ Ohio H.B. 563, 117th General Assembly, 1st Sess. (1987).

⁵¹⁸ In an interesting departure from traditional Ohio practice, the bill contained a statement of legislative purpose. *Id.* § 4927.02. The proposed findings suggested that current regulation was inappropriate and that future universal service required continued reasonable charges. *Id.* § 4927.02(A)(2)-(3). The bill then declared the policy of the state to be the encouragement of innovation in telecommunications, the promotion of diversity, the maintenance of reasonable rates for basic local exchange service, to both maintain regulation and detariff, and to establish Lifeline rates. *Id.* § 4927.02(B). The General Assembly retained much of this language in the final enacted version of the bill. See *infra* text accompanying notes

major goals of the bill were a provision concerning reduced barriers to entry⁵¹⁹ and a provision for price caps which would permit increases for local service rates based on increases in the Consumer Price Index.⁵²⁰ The bill also provided for automatic rate reductions,⁵²¹ and it partially modified the standards for the introduction of new services. Finally, it expanded the complaint process to recognize claims by parties seeking access to the local exchange.⁵²²

On the other hand, the bill retained many traditional features of regulation and monopoly rights. Most significantly, the local exchange companies kept their sole franchises.⁵²³ Additionally, the utilities retained the power to exercise eminent domain and their exemption from zoning requirements.⁵²⁴ The bill contained numerous reporting requirements as well.⁵²⁵ It also retained requirements for abandonment and for the establishment of services.⁵²⁶ Finally, the bill mandated the provision of some lifeline rates.⁵²⁷

Early committee testimony on the bill was essentially supportive of the need for change. Industry spokesmen such as the presidents of the major Ohio telephone companies stressed the need to recognize increased competition in the form of cellular, private microwave, and two-way cable that existed.⁵²⁸ There was less agreement over the effect of the bill and its pricing provisions on the cost of telephone service. Ohio Bell's president suggested that it provided a means of protecting local customer subsidies.⁵²⁹ However, United Telephone's president stated that the competitive market would force out subsidies and rate averaging which had existed under monopoly regulation.⁵³⁰

The commission's early position was not specific. The commission felt it appropriate to allow market forces to operate, and noted the generic proceedings it had undertaken to accomplish this on a limited basis.⁵³¹ The commission also

⁵¹⁹ Ohio H.B. 563, § 4927.03 (as introduced).

⁵²⁰ *Id.* § 4927.04.

⁵²¹ *Id.* § 4927.04(E).

⁵²² *Id.* § 4927.07(B).

⁵²³ *Id.* § 4927.09(B).

⁵²⁴ *Id.* § 4927.09(A).

⁵²⁵ *Id.* §§ 4927.06 (annual reports) and 4927.08 (triennial review by the Public Utilities Commission to the legislature and governor).

⁵²⁶ *Id.* §§ 4927.05 and 4927.07(A).

⁵²⁷ *Id.* § 4927.10.

⁵²⁸ Testimony of Edward Bell, President of Ohio Bell Telephone Co. (Sept. 29, 1987) at 7; Testimony of J. Darrell Kelly, President of United Telephone Co. of Ohio (Sept. 9, 1987) at 7.

⁵²⁹ Testimony of Edward Bell, *supra* note 528, at 4.

⁵³⁰ Testimony of J. Darrell Kelly, *supra* note 528, at 10-11.

⁵³¹ Testimony of Thomas Cherna, Chairman of the Public Utilities Commission of Ohio, undated, at 3.

took the position that regulatory flexibility should be encouraged.⁵³² Nonetheless, the commission remained neutral on the original version of H.B. 563.⁵³³

On the other hand, the Office of Consumers' Counsel took an early position setting out its opposition to the bill.⁵³⁴ In particular, the Consumers' Counsel felt that the claims concerning competition and consumer desire for varied services were overstated.⁵³⁵ The testimony also contained a strong endorsement of rate regulation, as then required by the Revised Code and implemented by the commission, and warned of increased rates if greater freedom were given to the companies to set them.⁵³⁶

Following initial hearings in September and October 1987, the bill stalled for more than a year. The delay was caused in part by disagreement among the local exchange companies over the use of a price cap approach to setting rates.⁵³⁷ The local companies were further split on the need to proceed with full rate cases to implement a new rate structure.⁵³⁸ During the delay, extensive negotiations apparently took place to revise the bill to meet commission, Consumers' Counsel, and industry concerns.⁵³⁹

On October 14, 1988, the chairman of the Public Utilities Commission provided a substitute bill to the House Public Utilities Committee.⁵⁴⁰ The chairman's draft bill placed substantial discretion in the commission to detariff and deregulate services as well as to adopt alternative methods of regulation.⁵⁴¹ According to the chairman, it attempted to "balance the needs of the telecommunications industry in an information-hungry society with the need for regulatory protection in those circumstances in which it is appropriate."⁵⁴² Underlying this approach was the conclusion that the premise of natural monopoly did not apply in some circumstances.⁵⁴³ Thus, the commission sought the ability to respond

⁵³² *Id.* at 4.

⁵³³ *Id.* at 5.

⁵³⁴ Testimony of William Spratley, Office of Consumers' Counsel (Oct. 29, 1987) at 1.

⁵³⁵ *Id.*, *passim*.

⁵³⁶ *Id.* at 1.

⁵³⁷ Interview of John Duffy, Legislative Director of the Public Utilities Commission of Ohio (Feb. 23, 1990).

⁵³⁸ *Id.*

⁵³⁹ The statement is based on interviews with several participants in the process by the author.

⁵⁴⁰ Testimony of Thomas Cherna, Chairman, Public Utilities Commission of Ohio (Oct. 14, 1988); Letter of Jacqueline Bracken, State Legislative Director for the Office of Consumers' Counsel, to State Rep. Frank Sawyer (Nov. 1, 1988), at 1.

⁵⁴¹ Sub. H.B. 563, 117th General Assembly, 2d Sess. (1988).

⁵⁴² Testimony of Thomas Cherna, *supra* note 540, at 1.

to varying conditions in a flexible manner. As the chairman further suggested in his testimony, "We need to put in place a system that will permit us to recognize where effective competition exists and allow us [to] respond to it by relaxing the regulation of that segment. At the same time, the system must permit us to maintain regulatory control where monopoly characteristics continue."⁵⁴⁴ The bill was not directed at creating lifeline rates or local measured service, or affecting extended area service.⁵⁴⁵

Opposition to the substitute bill came from two sources. MCI objected to the bill because it feared that the local exchange companies would attempt to take advantage of additional flexibility to assign costs to access, a monopoly service.⁵⁴⁶ Its testimony concluded, "MCI cannot ... endorse this bill so long as serious questions remain regarding the provision of monopoly access, the potential for cross-subsidization and the effect of deregulation without public participation in a formal hearing process."⁵⁴⁷

Consumer groups also objected to the bill.⁵⁴⁸ In addition to the concerns he raised in the bill's initial hearings,⁵⁴⁹ the Consumers' Counsel also objected to the wide latitude given to the commission to adopt various regulatory approaches, and the freedom of the companies to avoid reregulation.⁵⁵⁰ He also urged additional consumer input into the bill's language prior to its adoption.⁵⁵¹ The legislative director of the Office of Consumers' Counsel further noted that the bill did not prevent unfavorable cross-subsidies, did not adequately provide for maintenance of service standards, permitted costs to be shifted to the least price sensitive customers, and failed to identify who should pay the costs of increased innovation.⁵⁵² The Ohio Association of Realtors also voiced opposition to the bill because its members feared that the phone companies would use it as a means of mandating local measured service.⁵⁵³

⁵⁴⁴ *Id.*

⁵⁴⁵ *Id.* at 3.

⁵⁴⁶ Testimony of MCI Telecommunications Corp., undated, at 3.

⁵⁴⁷ *Id.*

⁵⁴⁸ In addition to the objections of the Office of Consumers' Counsel, the American Association for Retired Persons and the City of Cleveland testified against the bill in hearings before the Ohio Senate. Memorandum of Laura Skiby to the Ohio Senate Ways and Means Committee, Nov. 10, 1988 (detailing the testimony concerning House Bill 563 and Senate Bill 443).

⁵⁴⁹ See *supra* text accompanying notes 534-36.

⁵⁵⁰ Testimony of William Spratley, Office of Consumers' Counsel, Nov. 10, 1988, at 3-4.

⁵⁵¹ *Id.* at 2.

⁵⁵² Letter of Jacqueline Bracken, State Legislative Director for the Office of Consumers' Counsel, to State Rep. Frank Sawyer, Nov. 1, 1988, at 1-2.

⁵⁵³ Interview of John Duffy, Legislative Director for the Public Utilities Commission of Ohio (Feb. 23, 1990).

These and other similar arguments presented to the Ohio Senate did not succeed in slowing the bill's progress.⁵⁵⁴ The substitute bill containing the basic element of the final version emerged from the House of Representatives on November 17, 1988, and passed the Ohio Senate on November 18. The House concurred in Senate amendments to the bill on December 8. The Governor approved the bill on December 15, 1988, and the effective date for the operative provisions of the bill was March 17, 1989.

Provisions of House Bill 563

The significant portions of the bill are contained in five new sections of the Revised Code.⁵⁵⁵ First, several significant definitions are set out in section 4927.01. Subsection (A) defines "basic local exchange service" as the provision of access and usage of telephone facilities to complete non-long distance calls.⁵⁵⁶ Subsection (C) then defines "public telecommunications service" as everything except the physical plant that provides the service, the provision of telephone equipment, and broadcast or cable services.⁵⁵⁷ These definitions interplay among the remainder of the sections in defining the scope of deregulation which the commission is authorized to address.

Section 4927.02 sets out the policy behind the enactment of the bill. Like the original bill, the resulting law contains a variety of goals no one is likely to oppose. In addressing deregulation, the commission is directed to consider the policy of the state to maintain basic service,⁵⁵⁸ maintain just and reasonable rates,⁵⁵⁹ encourage innovation,⁵⁶⁰ promote diversity of options,⁵⁶¹ and "recognize the continuing emergence of a competitive telecommunications environment through flexible regulatory treatment of public telecommunications services where appropriate."⁵⁶² The law fails to offer any weights to be assigned to the various interests, other than their rank order.

To achieve these stated goals, the General Assembly gave the commission broad authority to implement alternative rate making and other deregulatory

⁵⁵⁴ Memorandum of Laura Skiby to the Ohio Senate Ways and Means Committee, Nov. 10, 1988 (detailing the testimony concerning House Bill 563 and Senate Bill 443).

⁵⁵⁵ The bill also provided for limitations on mergers through the enactment of OHIO REV. CODE ANN. § 4905.402 (Anderson Supp. 1990).

⁵⁵⁶ *Id.* § 4927.01(A).

⁵⁵⁷ *Id.* § 4927.01(D).

⁵⁵⁸ *Id.* § 4927.02(A)(1).

⁵⁵⁹ *Id.* § 4927.02(A)(2).

⁵⁶⁰ *Id.* § 4927.02(A)(3).

⁵⁶¹ *Id.* § 4927.02(A)(4).

⁵⁶² *Id.* § 4927.02(A)(5).

actions in section 4927.03 and 4927.04. Section 4927.03(A) provides that the commission, on its own initiative or the application of a telephone company and after notice and comment (and a hearing if the commission deems it necessary), may exempt a telephone company from the general requirements of Chapter 4905⁵⁶³ and the rate making requirements of Chapter 4909, or apply alternative regulatory requirements on a service.⁵⁶⁴ There are three limitations on this general power. First, the commission must find that the change in regulation or exemption is in the public interest.⁵⁶⁵ Second, the commission must find that the telephone company is subject to competition with respect to the service or that customers have reasonably available alternatives.⁵⁶⁶ Third, the provision does not apply to the provision of basic local service if it would result in an exemption or "impair the exclusive right of any telephone company ... to provide basic local exchange service in the local service areas in which such service is provided by the company on the effective date of this section."⁵⁶⁷

The bill then sets out several criteria for determining if the service for which alternative regulation or an exemption is sought is competitive.⁵⁶⁸ The factors include the number and size of alternative producers, the availability of services for alternative providers, the availability of functional equivalents or substitutes, and other indicators of market power such as market share, growth of market share, ease of entry, and affiliations of producers.⁵⁶⁹

Once the commission has approved an exemption or change in regulation from that provided by the other sections of the Revised Code, it may rescind or modify that change upon notice and hearing if it finds that the conditions for approval no longer exist, or if the change is in the public interest.⁵⁷⁰ However, if a service has been deregulated for more than eight years, the affected company must consent to a return to regulation.⁵⁷¹

Section 4927.04 provides the commission with the authority to adopt alternative methods of rate making. In any rate making proceeding for which an exemption or alternative procedure has not been established under section 4927.03, the commission may use an alternative if it is in the public interest and,

⁵⁶³ See *supra* text accompanying notes 263-92.

⁵⁶⁴ OHIO REV. CODE ANN. § 4927.03(A)(1) (Anderson Supp. 1990).

⁵⁶⁵ *Id.*

⁵⁶⁶ *Id.* § 4927.03(A)(1)(a)-(b).

⁵⁶⁷ *Id.* § 4927.03(B).

⁵⁶⁸ *Id.* § 4927.03(A)(2).

⁵⁶⁹ *Id.* § 4927.03(A)(2)(a)-(d).

⁵⁷⁰ *Id.* § 4927.03(D).

⁵⁷¹ *Id.* Published by IdeaExchange@Uakron, 1991

if proposed by the commission, the company consents.⁵⁷² The statute then provides another laundry list of alternative considerations to guide the commission:

Alternative methods include, but are not limited to, methods that maintain universal telephone service in the state; minimize the costs and time expended in the regulatory process; tend to assess the cost of any telecommunications service to the entity or service that causes such costs to be incurred; afford rate stability; promote and reward efficiency, quality of service, or cost containment by telephone companies; or provide sufficient flexibility and incentives to the telecommunications industry to achieve high quality, technologically advanced and universally available telecommunications services at just and reasonable rates and charges.⁵⁷³

As in the case of the provision concerning alternative regulation and exemptions, one can only guess at the relative importance of each of the factors, other than to note their rank order. The statute offers no assistance in resolving the inherent conflicts between the various goals. Once again, the Legislature apparently left that determination to the commission.

Another interesting and unusual proviso in both sections 4927.03 and 4927.04 is that companies need not be treated consistently. That is, the commission need not permit all companies to adopt the same kinds of exemptions, alternative regulatory structures, or rate making methods.⁵⁷⁴ Thus, the commission could base regulation on the amount of dominance that a particular party has within a market.

Finally, the General Assembly provided for the creation of a Telecommunications Advisory Council. Made up of political, industry, and general public representatives, the council was directed to report to the Governor and the General Assembly on the state of the telecommunications industry in Ohio, and to evaluate whether the actions of the Public Utilities Commission were consistent with the policies contained in the statement of purpose of the legislation.⁵⁷⁵

⁵⁷² *Id.* § 4927.04(A).

⁵⁷³ *Id.*

⁵⁷⁴ *Id.* §§ 4927.03(C) and 4927.04(C).

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⁵⁷⁵ *Id.* § 4927.05. The stated goals of the legislation are contained in *id.* § 4927.02.

Summary

This legal change was remarkable in several respects. First was the speed with which the legislature acted once the commission joined the legislative sponsors of the bill. Second was the striking amount of discretion provided to the commission by the General Assembly. With few exceptions, there is no direction contained in House Bill 563. Instead of the formulaic process which is inherent in traditional ratemaking,⁵⁷⁶ the commission was directed to adopt whatever procedures appeared appropriate in light of the public interest and the competitive exigencies of the particular situation. Thus, it fell to the commission to give operational meaning to the legislation, and this time court review would prove an even less effective check on the commission's choices. In substance, then, the General Assembly made a political choice to hand off the policy making process associated with telecommunications to the executive branch and its commissioners.

In this regard, House Bill 563 continues the tradition of placing a great deal of discretion in the hands of the commission for the process of dealing with changes in the telecommunications market and changing federal regulation. That tradition started with the commission's assertion of expanded authority in the early 1980s to address the changes in federal regulation.⁵⁷⁷ It continued with the judiciary's acquiescence in the *MCI* cases.⁵⁷⁸ It was reinforced in House Bill 563 by the General Assembly's assignment to the commission the tasks of deciding the very nature of regulation for competitive services and of devising alternative rate making approaches for basic exchange service.⁵⁷⁹ House Bill 563 thus confirms the commission's initial actions.

Despite the rhetorical nod to deregulation, there is nothing in the bill which requires change. The bill is designed around a standard of public interest protection which has essentially no intrinsic meaning.⁵⁸⁰ It places a great deal

⁵⁷⁶ See *supra* text accompanying notes 294-311.

⁵⁷⁷ See *supra* text accompanying notes 327-454.

⁵⁷⁸ See *supra* text accompanying notes 462-75.

⁵⁷⁹ See *supra* text accompanying notes 555-75.

⁵⁸⁰ Pierce, *The Role of Constitutional and Political Theory in Administrative Law*, 64 TEX. L. REV. 469, 478-79 (1985):

[T]he characterization of ... traditional standards a empty means that they impose no limit on the substantive agency discretion. The agency's decision-making process is affected by judicial review, in the sense that it must follow specified procedures, support findings with evidence, and state its reasons for acting. If the agency takes those steps, however, its decision-making process can produce virtually any substantive result that lies on the broad spectrum of results that are consistent with any political view held by a significant portion of the population.

of discretion in the hands of the commission, and further frees the commission from the requirement of holding hearings to determine the factual basis for its decisions to exempt, or otherwise deregulate, a particular service offering.⁵⁸¹ While this flexibility could be used to avoid the effects of current regulation, this need not be the case, for the commission is just as free not to act or to use the authority to freeze existing problems associated with regulation into the "competitive" system.

Thus, there is a strange twist of logic inherent in the General Assembly's action. As the legislative director of the commission remarked in an interview, House Bill 563 is not a deregulation bill.⁵⁸² Rather, it permits the commission to act in any manner it sees is in the public interest.⁵⁸³ To the extent that the commission has sought to maintain past payments from long distance companies to local exchange companies on a noncost basis, those may continue if they are deemed in the public interest. Moreover, the legislative changes reinforce this position with the requirement that any change be free of adverse effects on local exchange service.⁵⁸⁴ Likewise, the commission could choose to retain those oversight and tariff structures that it feels are necessary as a result of complaints (as it did in the case of alternative operator services regulation⁵⁸⁵), despite the lack of any sound economic argument that consumers are faced with a monopoly provider or that the complaints are not the ordinary effects of competition and the process of working out poor providers. Fundamentally, therefore, House Bill 563 represents an imprecise political accommodation rather than an economic response by the Legislature.

LESSONS TO BE APPLIED

The movement away from old ways of doing things has been difficult, and likely will continue to be so.⁵⁸⁶ Although the statutory mandate gives the commission the authority to adopt more competitive solutions, however, neither the commission nor the legislature demonstrated in any meaningful way how change will be accomplished. The comments of the players in the commission's

⁵⁸¹ OHIO REV. CODE ANN. § 4927.03(A) (Anderson Supp. 1990).

⁵⁸² Interview of John Duffy, Legislative Director of the Public Utilities Commission of Ohio (Feb. 23, 1990).

⁵⁸³ OHIO REV. CODE ANN. §§ 4927.03 & 4927.04 (Anderson Supp. 1990).

⁵⁸⁴ OHIO REV. CODE ANN. § 4927.03(B) (Anderson Supp. 1990).

⁵⁸⁵ See *supra* text accompanying notes 436-53.

⁵⁸⁶ A more recent example is the commission's treatment of company-specific access charges. The process was marked by another admission of the commission that the separation of costs is essentially a matter of guess work. The commission thus adopted in a recent *General Telephone* case an arbitrary split of the nontraffic sensitive costs and rejected the recommendations of all litigants including its own staff recommendation. Opinion and Order, GTE North Inc., No. 87-1307-TP-AIR, slip op. at 41-50 (Pub. Util. Comm'n of Ohio, Oct. 28, 1988), *aff'd sub nom.*, *American Tel. & Tel. Co. v. Public Util. Comm'n of Ohio*, 51 Ohio St. 3d 150, 555 N.E.2d 282 (1990).

third inquiry into the emerging competitive environment likewise do not demonstrate any planned approach to deregulation, apart from the expected competitive positioning (or posturing). Nonetheless, the form of the statute and, often explicitly, the players suggest that the commission must address the new environment with some sort of partial regulation. If the lessons of deregulation, at the federal level are meaningful, careful planning and new approaches will be the key to adjusting the competing interests which will emerge as the forms of subsidy continue to break down in the competitive environment.

Issues in the "563" Investigation

Following the adoption of House Bill 563, the commission initiated an investigation to define the issues raised by the Ohio legislature's new instructions and grant of discretion.⁵⁸⁷ The original list of issues identified by the commission for review⁵⁸⁸ reflected many of the same concerns discussed in the earlier regulatory framework dockets.⁵⁸⁹ The commission divided the inquiry into four industry segments and asked for comments directed at each segment.

As expected, the interexchange carriers suggested that they deserved additional freedom for themselves but argued that other parties should not fare so well. AT&T took the position that there was extensive competition, but feared the local exchange bottleneck.⁵⁹⁰ The other interexchange carriers that filed comments, MCI, U.S. Sprint, and Litel, not only feared the bottleneck, but also AT&T.⁵⁹¹ All then voiced a desire for greater freedom from current regulation of rates, rate changes, certification, and notification procedures in the "competi-

⁵⁸⁷ Entry, Implementation of Sections 4927.01 through 4927.05, Revised Code, as They Relate to Competitive Telecommunications Services, No. 89-563-TP-COI (June 13, 1989) (hereinafter *Competitive Telecommunications Services*).

⁵⁸⁸ *Id.*, Attachment A (Aug. 15, 1989). Each segment of the industry was presented with essentially the same questions concerning its operation in a competitive market. For example, the first section was addressed to the concerns of the interexchange carriers. *Id.* at 1-4. First, the commission asked what level of regulation should be applied. *Id.*, Attachment A at 1. Second, the commission raised again the issue of different levels of regulation for carriers based on market dominance. *Id.* Third, the commission asked whether regulation of interexchange carriers affiliated with local exchange companies should be different. *Id.* Fourth, the commission asked for comments on whether specific criteria needed to be developed to define whether a company was subject to competition. *Id.*, Attachment A at 2. Fifth, the commission inquired as to the parts of current streamlined regulation that needed change. *Id.*, Attachment A at 2-3. Sixth, the commission raised the question of what information should be kept confidential. *Id.*, Attachment A at 3. Seventh, the commission questioned what service standards should apply to the interexchange companies. *Id.* Eighth, the commission raised the issue of what continuing reporting requirements should be maintained. *Id.*, Attachment A at 4. Finally, the commission requested comments on the types of measures it should consider to prevent anticompetitive behavior and what future monitoring it should establish to assure that the new regulatory process was operating in the public interest. *Id.*

⁵⁸⁹ See *supra* text accompanying notes 363-95.

⁵⁹⁰ AT&T Comments, *Competitive Telephone Services*, *supra* note 587, at 4-5.

⁵⁹¹ Comments of MCI Telecommunications Corp., *id.* at 2; Comments of U.S. Sprint, *id.* at 1; Comments of Litel, *id.* at 1; Comments of Cable and Wireless Co., *id.* at 2-3.

tion" portions of the market for long distance service.⁵⁹² For those less competitive portions of the market, however, the commenters favored the retention of dominant carrier or monopoly regulation of the bottleneck.⁵⁹³

Responses to the commission inquiry concerning regulation of the local exchange companies were fairly similar. The local exchange companies agreed that additional streamlining was necessary.⁵⁹⁴ Many noted the advantages of detariffing prices for competitive services.⁵⁹⁵ Two companies suggested levels of regulation based on the amount of existing competition.⁵⁹⁶ In general, the commenters suggested that the commission not attempt to be overly precise in defining what constituted competition.⁵⁹⁷ One commenter went so far as to suggest that the commission establish a special group to monitor the marketplace for competitive changes as a basis for making proposals as to what services deserved varying regulation.⁵⁹⁸ The parties also agreed that the commission lacked the authority to intervene in competitive disputes.⁵⁹⁹ Finally, two commenters suggested that the commission adopt some form of price cap policy.⁶⁰⁰

As previously noted, the interexchange companies did not agree with the local exchange companies sanguine appraisal of their own position. Uniformly, the interexchange companies noted the local exchange bottleneck and suggested the need for accounting separations for competitive and noncompetitive

⁵⁹² See, e.g., Comments of AT&T, *id.*, *passim*.

⁵⁹³ Comments of AT&T, *id.* at 36-45; Comments of U.S. Sprint, *id.* at 12; Comments of MCI Telecommunications Corp., *id.* at 8. The dichotomy of interests was also reflected in the reply comments of the parties in which they continued to debate the dominant status of AT&T. See, e.g., Reply Comments of MCI Telecommunications Corp., *id.*

⁵⁹⁴ Initial Comments of the Ohio Bell Telephone Co., *id.* at 9-11 (Dec. 4, 1989) (hereinafter as Ohio Bell Comments); Initial Comments of Cincinnati Bell Telephone Co., *id.* at 11-13 (hereinafter as Cincinnati Bell Comments); Initial Comments of GTE North Incorporated, *id.* at 9 (hereinafter as GTE Comments); Initial Comments of United Telephone Co. of Ohio, *id.* at 6 (hereinafter as United Comments); Comments of Central Telephone Co. of Ohio, *id.* at 10 (hereinafter as Central Comments); Joint Comments of Alltel Ohio, Inc., The Elyria Telephone Co. and the Western Reserve Telephone Co. regarding Local Exchange Carriers, and Request for Service of Comments regarding Interexchange Carriers, Radio Common Carriers and Cellular Carriers, *id.* at 2 (hereinafter as Alltel Comments).

⁵⁹⁵ Ohio Bell Comments, *id.* at 12, 16; United Comments, *id.* at 7; Alltel Comments, *id.* at 4; Cincinnati Bell Comments, *id.* at 10.

⁵⁹⁶ United Comments, *id.* at 7-8; GTE Comments, *id.* at 5.

⁵⁹⁷ Ohio Bell Comments, *id.* at 14; Alltel Comments, *id.* at 5; United Comments, *id.* at 10; Central Comments, *id.* at 14 (competition not defined by market share). General Telephone urged that the commission consider contestability of markets. GTE Comments, *id.* at 11.

⁵⁹⁸ Cincinnati Bell Comments, *id.* at 6-7.

⁵⁹⁹ See, e.g., Ohio Bell Comments, *id.* at 21.

services.⁶⁰¹

The third and fourth areas of inquiry addressed the regulation of radio common carriers and cellular telephone companies. They agreed that reduced regulation was appropriate. In this case, however, there were much stronger arguments concerning competition over quality, substitution of other products, and price competition.⁶⁰² The need for regulation was further reduced by the nonessential nature of cellular⁶⁰³ and paging services offered by these companies and the free movement of customers among providers.⁶⁰⁴ Not surprisingly, however, these companies were also concerned about connections with local telephone systems necessary to complete connections for their services.⁶⁰⁵

Consistent with their opposition to House Bill 563,⁶⁰⁶ several consumer representatives also filed comments and opposed reduced regulation.⁶⁰⁷ In addition to the general concern that consumers should not bear the costs of service changes and the effects of competition that could shift costs,⁶⁰⁸ they also tended to agree on the need for full hearings when deregulation was sought.⁶⁰⁹ There were further suggestions regarding full or accounting separations of competitive and noncompetitive services⁶¹⁰ and the protection of basic service.⁶¹¹

A Theory of Partial Regulation Revisited

Posturing aside, the comments in the 563 investigation point to basic problems with partial deregulation. In a nearly perfect world, competition would operate in those markets that are competitive, regulation would operate in those

⁶⁰¹ See, e.g., Comments of AT&T, *id.* at 36, 45-46; Comments of MCI Telecommunications Corp., *id.* at 6.

⁶⁰² See, e.g., Comments of Ameritech Mobile, *id.* at 1-3.

⁶⁰³ *Id.* at 8.

⁶⁰⁴ Comments of Cincinnati SMSA Limited Partnership, *id.* at 5.

⁶⁰⁵ Comments of GTE Mobilnet, *id.* at 9.

⁶⁰⁶ See *supra* text accompanying notes 534-36 and 546-54.

⁶⁰⁷ The exception was the representative of the Federal Government which felt that some deregulation assisted the government in its obligation for competitive bidding. Comments of the Dept. of the Army, *Competitive Telecommunications Services*, *supra* note 587.

⁶⁰⁸ Comments of the Office of Consumers' Counsel, *id.* at 4; Comments of the Ohio Ass'n of Realtors, *id.* at 1.

⁶⁰⁹ Comments of the City of Cleveland, *id.* at 4; Comments of the Office of Consumers' Counsel, *id.* at 2.

⁶¹⁰ Comments of the Office of Consumers' Counsel, *id.* at 7.

⁶¹¹ Comments of the Greater Cleveland Welfare Rights Organization, *id.* at 1. The realtor association further voiced its concern over local measured service as a mandatory rate structure. Comments of the Ohio Ass'n of Realtors, *id.* at 1-2.

that are not, and effective pricing policies based on accurate assessments of costs would determine the cost of access to monopoly on terms that neither discriminate nor subsidize any particular group.⁶¹² Regulation would be designed to address particular forms of market failure which might exist (e.g. informational failures or the existence of natural monopoly service or bottlenecks⁶¹³). Protection for universal service would arise with full recognition of its costs, plus some allowance for protecting low income individuals.⁶¹⁴

The real world, however, differs in important respects from the economic model of mixed markets. First, the industry does not operate in nice, clean segments.⁶¹⁵ Second, the informational needs to support such a system are tremendous.⁶¹⁶ Third, one must accept at the beginning one fundamental principle: the decision to deregulate, detariff, or maintain current or higher levels of regulation remains essentially political. Economic perfection is not possible because the conflicting policies inherent in the system would not permit it. (In that sense, the criticisms of the PUCO, the courts, and the FCC are unfair.) Indeed, economists recognize as much:

What these differences signify is that the problems addressed are difficult and, in a sense, insoluble, more political than scientific. Our ablest economists are much like the seven blind men given the task of describing the elephant by sense of touch. . . . [T]he wise synthesizer will have to do more than simply add the reports together, or count majorities on disputed issues; he or she will have to achieve and rely on a gestalt impression rather than any table of measurements. . . . It remains for politicians, threading an uncertain path through the half-lighted murk, to reconcile the conflicting interests that are the reality behind the rhetoric.⁶¹⁷

That conclusion certainly is consistent with what has happened in the last ten years at both the federal and state levels.

⁶¹² See *supra* text accompanying notes 46-48. For an interesting discussion of the need to maintain regulation in those residual pockets of monopoly left by divestiture, see Brennan, *supra* note 121, and Gabel, *supra* note 48.

⁶¹³ See *supra* text accompanying notes 73-77.

⁶¹⁴ Kahn & Shew, *supra* note 50, at 253-54.

⁶¹⁵ See *supra* text accompanying notes 8-72.

⁶¹⁶ See *infra* text accompanying note 689.

⁶¹⁷ Schwartz, *The Art of Telecommunications Regulation*, J. COMM. 180, 184-85 (Aug. 1984)

To address the multiple concerns facing regulators, there are some modest sensible proposals. First, regulators should consider some careful planning. Second, the commission should consider adopting some of the tools of antitrust law as a means for determining the scope of its regulatory efforts. Third, the commission should consider applying some of the tools developed at the federal level and by other states, in modifying existing interim regulation in ways which are consistent with the perceived market failures it may identify and with the theoretical model of regulation in the mixed market place of telecommunications.

Planning

Several years ago, Professor Trebing correctly noted that regulation will have to respond at a more sophisticated level to address the changing environment.⁶¹⁸ First, he proposed improved regulatory planning to address the need for new facilities and their mix.⁶¹⁹ Second, he suggested that consideration of equity and distributional issues become a part of the planning.⁶²⁰ "These issues include the obvious problems of assuring service to low-income consumers and thin markets, but they also include more sophisticated issues, such as the secondary effects of deaveraging, the impact of telecommunications modernization plans on the average of service to all classes of customers, and the intergenerational impact of phase-in plans and accelerated cost recovery."⁶²¹ Third, he noted the need for adequate determinations of the cost of service for residual monopoly markets. Fourth, he concluded that regulators will have to acquire a sensitivity for market structure in making decisions, both in terms of determining which markets to deregulate and identifying those industry practices which are restrictive and thus frustrate consumer welfare enhancing results.⁶²²

The planning process would address two questions in particular. First, the commission needs to develop a clearer picture of the players and their relative market power. Indeed, House Bill 563 requires the commission to premise its decision-making on the ability of the players to exercise control over price and quantity. Second, the commission must determine the extent to which it wants to create markets which may infringe on the past monopoly structure (without infringing on basic local exchange). In this regard, the role of the past subsidies and the concerns over who should pay for improvements to the system will raise the kinds of fundamental political questions the commission has avoided or sought to ignore. If the commission plans to encourage greater competition in the telecommunications market, it will have to devise the appropriate tools for the

⁶¹⁸ Trebing, *supra* note 16, at 627-28.

⁶¹⁹ *Id.* at 628.

⁶²⁰ *Id.*

⁶²¹ *Id.*

particular niches in the marketplace which are likely to emerge. To the extent that the power exists, the role of regulation is greater. To the extent that it does not exist, however, the role of regulation is doubtful.

Antitrust Tools

If the legislative premise for House Bill 563 is taken seriously, the focus of the regulation will necessarily change from regulating a monopoly to overseeing a mixture of competitive and noncompetitive services. In this regard, the commission may seek to draw from another body of literature, antitrust law, to guide its decision making. This approach to regulation may at first seem somewhat contradictory, but the use of antitrust theory is merely the appropriate counterpart of regulation in those sections of the market that can operate competitively.⁶²³ Antitrust seeks to achieve the benefits of competition indirectly by seeking to eliminate various forms of anticompetitive behavior.⁶²⁴ Given the requirement that the commission determine that competition exists when making the decision to deregulate, it is readily apparent that the commission must use the tools of antitrust to address these questions.

The first application of antitrust approaches would be in the identification of companies with some market power. At the heart of this issue is a determination of whether a company can raise prices or limit output successfully. In many sectors of the telecommunications market, there should be no special problems which are not common to all such determinations. In other instances in which the dominant carrier can potentially exhibit leverage, additional care must naturally be used.

While the determination of monopoly status is in itself no small task,⁶²⁵ the regulation of telecommunications is marked with a growing body of literature and decisions which can serve as guides for the determination. In particular, the commission might use determinations of essential facilities control as a method to determine potential points in the system for applying greater regulatory muscle.

1. *The Essential Facilities Doctrine*

Despite the lack of Supreme Court⁶²⁶ or academic⁶²⁷ endorsement, the

⁶²³ See generally, Breyer, *supra* note 55.

⁶²⁴ *Id.* at 1006.

⁶²⁵ See *infra* note 633 for materials containing the relevant discussion.

⁶²⁶ The U.S. Supreme Court has never expressly recognized the doctrine as a basis for liability under the Sherman Act. It had a chance to do so in *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973), *reh'g denied*, 411 U.S. 910 (1973), and *Aspen Highland Skiing Corp. v. Aspen Skiing Co.*, 472 U.S. 585 (1985), in which the lower courts based their decisions on essential facility grounds, but the Court found liability under different theories.

courts continue to explore the application of the essential facilities doctrine as a means of addressing monopoly power questions. Importantly, the courts have looked to the essential facilities doctrine as a basis for addressing the rights of regulated monopolies to effect the actions of their competitors by restricting access.⁶²⁸ Thus, the analysis in this area reflects the same fundamental concerns raised by actions to deregulate the vertical activities of local exchange companies which control the access to the network through their monopoly grant of basic exchange service. To the extent that the legal analysis is applicable, a commission could look to this antitrust doctrine as a tool to identify those players who can exert market power, and thus require additional regulatory scrutiny.

2. *The Legal Analysis*

The rationale for applying the doctrine in the case of a regulated utility is consistent with many of the same concerns raised in the context of rate regulation of an industry operating in both the competitive and noncompetitive arenas:

If a [Bell Operating Company] or a Regional Holding Company were permitted to charge different customers different rates for exchange access or local exchange facilities, depending upon whether those customers purchased other products or services sold by the BOC or Regional Holding Company, then it could ... exploit its "bottleneck" monopoly over exchange access and local exchange facilities to the detriment of its competitors and ultimately of consumers of telecommunications services. The difference between charging a competitor a markedly higher price for access and denying access altogether is, after all, a difference of degree, not of kind. ... It is clearly reasonable to read the MFJ's nondiscrimination provisions in light of its fundamental purpose to stymie efforts by a local monopoly to use its stranglehold on essential facilities and services to thwart effective competition in areas where its monopoly position was not protected

⁶²⁷ See, e.g., Reiffen & Kleit, *Terminal Railroad Revisited: Foreclosure of an Essential Facility or Simple Horizontal Monopoly?*, 33 J.L. & ECON. 419 (1990).

by the MFJ.⁶²⁹

Simply put, the rationale for the court's action is to prevent the monopoly from exercising control of its critical facility as a means of preventing competition or extorting monopoly rents from downstream competitors.

In the context of antitrust, the essential facilities doctrine consists of the application of four factual assertions to reach the conclusion that an unfair use of monopoly power is being applied to a competitor.⁶³⁰ First, the monopolist must control an essential facility.⁶³¹ A careful review of this requirement reveals that two fundamental issues are presented. First, there must be a monopolist. Second, the facility must be essential. Neither term is self-defining and the recent case law demonstrates the importance of each requirement.

To be liable, the actor must be a monopolist who can exercise market power.⁶³² Though one of the more difficult problems in antitrust law is the determination of market power,⁶³³ the courts historically have reasoned that a substantial share of the market carries with it market power. For example, in the *Otter Tail* case,⁶³⁴ the court inferred that Otter Tail had market power based on the estimates of its market share, which ranged from 75 to 91 percent.⁶³⁵ The

⁶²⁹ *United States v. Western Elec. Co.*, 846 F.2d 1422, 1428 (D.C. Cir. 1988), *cert. denied*, 488 U.S. 424 (1988).

⁶³⁰ There is a violation of Sections 1 or 2 of the Sherman Act when a firm or group of firms denies a competitor access to something considered essential to competition in a market. The leading case applying the essential facilities doctrine is *MCI Communications Corp. v. Am. Tel. & Tel.*, 708 F.2d 1081 (7th Cir. 1983), *cert. denied*, 464 U.S. 891 (1983). In that case, the Seventh Circuit listed four elements necessary to a finding of liability under the doctrine:

(1) control of the essential facility by a monopolist; (2) a competitor's inability practically or reasonably to duplicate the essential facility; (3) denial of the use of the facility to a competitor; and (4) the feasibility of providing the facility.

Id. at 1132-33. In *United States v. Am. Tel. & Tel.*, 524 F. Supp. 1336 (D.C. Cir. 1981), Judge Greene stated the doctrine this way: "[A]ny company which controls an 'essential facility' or a 'strategic bottleneck' in the market violates the antitrust laws if it fails to make access to that facility available to its competitors on fair and reasonable terms that do not disadvantage them." *Id.* at 1352-53. Judge Greene found this to be the "applicable legal standard" in the case and thus denied A.T.&T.'s motion for summary judgment in concluding that A.T.&T. had monopolized the intercity services (long distance) market by not permitting its long distance competitors to interconnect with local exchanges.

⁶³¹ See *infra* text accompanying notes 651-57.

⁶³² *Flip Side Productions v. Jam Productions*, 843 F.2d 1024, 1032 (7th Cir. 1988), *cert. denied*, 488 U.S. 909 (1988).

⁶³³ See P. AREEDA & L. KAPLOW, *ANTITRUST ANALYSIS: PROBLEMS, TEXT, AND CASES* 567-82 (4th ed. 1988); 2 P. AREEDA AND D. TURNER, *ANTITRUST LAW* chs. 5 and 8 (1977 & Supp. 1987); E. GELHORN, *ANTITRUST LAW AND ECONOMICS* 113-35 (1986); Symposium, *Empirical Approaches to Market Power*, 32 J. L. & ECON. S1-S275 (1989); Landes & Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937 (1981).

⁶³⁴ *United States v. Otter Tail Power Co.*, 331 F. Supp. 54 (D. Minn. 1971), *aff'd in part and remanded in part*, 410 U.S. 366 (1973).

difficulty of this approach is two fold. First, it is difficult to define the proper geographic and product markets. "We try to include in the relevant market only those suppliers--of the same or related product in the same or related geographic area--whose existence significantly restrains the defendant's power."⁶³⁶ As the complexity of the market increases due to product differentiation and substitution, so to do the difficulties of measurement.⁶³⁷ Second, factors other than market share may affect the ability of the firm to engage in monopoly behavior.⁶³⁸ Thus, the process of determining monopoly power is, by definition, flexible.

While these problems would seemingly be reduced in the case of a utility with a regulated franchise, such is not the case. On the one hand, the utility is clearly granted a tremendous share of the market. In the case of a local telephone company, it may be the exclusive provider of some telecommunications service. On the other hand, the utility is subject to commission regulation based on the premise that regulation will prohibit the use of monopoly power, either in the form of higher prices or less efficient service. The courts addressing the issue of the monopoly power of a utility have thus faced an additional question of whether the utility can successfully use its monopoly status.⁶³⁹ The issue is whether the company can effectively avoid the regulatory structure,⁶⁴⁰ or use (and abuse) it as a barrier to entry to other competitors.⁶⁴¹

Additionally, the monopolist must control an essential facility. Facilities are deemed essential by the apparent lack of reasonable substitutes available to competitors. In the *Otter Tail* case, for example, there was no effective substitute for the transmission facilities sought by competing municipal power systems.⁶⁴² In *Flip Side Productions, Inc. v. Jam Productions*,⁶⁴³ however, evidence of available alternatives demonstrated that the facility was not essential to competition. The plaintiff was a concert promoter. It alleged that the defendants exclusively controlled the Rosemont Horizon, a concert hall, in violation of section 2 of the Sherman Act. The plaintiff also alleged that the Horizon was an essential facility for the booking and promotion of concerts in the Chicago area. Other sizable concert facilities, however, were available and had in fact been used

⁶³⁶ P. AREEDA & L. KAPLOW, *supra* note 633, at 572.

⁶³⁷ *See id.* at 575-80.

⁶³⁸ *See, e.g.,* Scheffman & Spiller, *Introduction: Empirical Approaches to Market Power*, 32 J. L. & ECON. S3, S9 (1989).

⁶³⁹ Generally, the courts have refused to conclude that the utility is free of antitrust review because it is regulated. *Otter Tail Power Co. v. United States*, 410 U.S. 366, 372-75 (1973). *See generally*, Note, *The Application of Antitrust Laws to Telecommunications*, 69 Cal. L. Rev. 497, 505-14 (1981).

⁶⁴⁰ *United States v. American Tel. & Tel. Co.*, 524 F. Supp. 1336, 1347-48 (D.D.C. 1981).

⁶⁴¹ *Southern Pacific Comm. Corp. v. American Tel. & Tel. Co.*, 740 F.2d 980, 1001 (D.C. App. 1984), *cert. denied*, 470 U.S. 1005 (1985).

⁶⁴² *Otter Tail Power Co.*, 331 F. Supp. at 59.

⁶⁴³ 843 F.2d 1024 (7th Cir. 1988).

by the plaintiff for large concerts in the Chicago area.⁶⁴⁴ The court said that the plaintiff would lose even if it had been foreclosed from using any of these facilities, because there was still competition for the concert-going consumer among those who controlled the facilities.⁶⁴⁵

Likewise, several activities by Ohio Bell in the distribution and production of Yellow Pages directories have been held to be outside the essential facilities doctrine. In *Directory Sales Management v. Ohio Bell Telephone Co.*,⁶⁴⁶ the court concluded that the codelivery of the Yellow Pages with the White Pages, billing and collections for classified advertising in the Yellow Pages, and the provision of business classifications were not essential facilities to competitors of Bell seeking to enter directory services, because alternatives were reasonably available and the information was already available to competitors. (In the case of the business classifications sought by the plaintiff, the court further concluded that the information was unreliable and, therefore, rejected the claim of necessity.⁶⁴⁷)

Second, the competitor must be practically unable to duplicate the facility.⁶⁴⁸ By this, the courts have determined that the competitor would find it economically infeasible to reproduce the facility to which it is seeking access.⁶⁴⁹ Existing alternatives, or ones that can be reasonably developed by the competitor, will frustrate the claim.⁶⁵⁰

Third, the monopolist must deny access of the facility to the competitor.⁶⁵¹ There are two implied requirements. First, the alleged monopolist must control access to the essential facility.⁶⁵² Second, the denial must be directed at a potential or actual competitor.⁶⁵³ Absent either of these factors, there is no competitive disadvantage associated with the denial.

⁶⁴⁴ *Flip Side Productions*, 843 F.2d at 1034.

⁶⁴⁵ *Id.*

⁶⁴⁶ 833 F.2d 606 (6th Cir. 1987).

⁶⁴⁷ *Id.* at 613.

⁶⁴⁸ See *supra* note 630.

⁶⁴⁹ *Hecht v. Pro-Football, Inc.*, 570 F.2d 982, 992 (D.C. Cir. 1977), *cert. denied*, 436 U.S. 956 (1978).

⁶⁵⁰ *City of Malden v. Union Elec. Co.*, 887 F.2d 157, 161-62 (8th Cir. 1989); *Twin Laboratories, Inc. v. Weider Health and Fitness*, 720 F. Supp. 31 (S.D.N.Y. 1989), *aff'd*, 900 F.2d 566 2d Cir. (1990).

⁶⁵¹ See *supra* note 630.

⁶⁵² *United States Football League v. National Football League*, 842 F.2d 1335, 1368 (2d Cir. 1988)(NFL did not control access to network television).

⁶⁵³ *Ferguson v. Greater Pocatello Chamber of Commerce*, 848 F.2d 976 (9th Cir. 1988)(no claim stated against owner of facility that did not compete with the plaintiff in the provision of trade shows); *Interface Group v. Massachusetts Port Authority*, 816 F.2d 9 (1st Cir. 1987)(no claim stated against owner of facility who did not compete with plaintiff in providing airline services).

Fourth, it must be feasible for the monopolist to provide the facility.⁶⁵⁴ In *Otter Tail*, it was apparently feasible for the utility to provide the transmission because it had provided transmission services in its own sales to the municipalities previously, and it regularly wheeled power for other entities.⁶⁵⁵ In contrast, a utility is not required to provide its facilities under circumstances in which it will lose money on the transaction.⁶⁵⁶

3. Application to State Utility Regulation

In the case of utilities regulation, the commission is not interested in determining antitrust liability. Rather, it may use a modified standard to establish those instances in which regulatory intervention is necessary. In essence, the commission would seek to determine if the owner of the facility currently has monopoly power over an essential facility that others could not reasonably duplicate, and which could be used by competitors without injury to the owner's interest or to the integrity of the facility. Obviously, this standard raises a host of complicated factual questions. But these questions appear especially amenable to a process of administrative regulation with its expertise and resources.

Dealing with the Residual Monopoly

Once the commission has identified a company with a bottleneck control of an essential facility, its plan would dictate a series of decisions. Foremost would be the determination of access and its cost to the facility. Fundamentally, the commission would determine that the owner could not deny access to others except under limited conditions, and would set a rate and technical standards for that access on a nondiscriminatory basis. Other continuing problems would

⁶⁵⁴ See *supra* note 630.

⁶⁵⁵ *Otter Tail Power Co.*, 331 F. Supp. at 57, 60-61.

⁶⁵⁶ *City of Malden v. Union Elec. Co.*, 887 F.2d 157, 162 (8th Cir. 1989). This element of reasonableness gives rise in the telecommunications area to a rather odd defense that permits the utility in the first instance to determine if it is proper to provide an interconnection. Under the Federal Communications Act, a common carrier may refuse to provide an interconnection if it determines that the connection is not in the public interest. 47 U.S.C. § 201(a) (1982) provides:

It shall be the duty of every common carrier engaged in interstate or foreign communication by wire or radio to furnish such communication service upon reasonable request therefor, and, in accordance with the orders of the Commission, in cases where the Commission, after opportunity for hearing, finds such action necessary or desirable in the public interest, to establish physical connections with other carriers, to establish through routes and charges applicable thereto and the divisions of such charges, and to establish and provide facilities and regulations for operating such through routes.

The decisions apparently assume that the competitor will seek an agreement from the common carrier prior to seeking a decision from the FCC approving the interconnection. For this defense to operate, however, the carrier must reach a good faith conclusion that the denial is in the public interest. *Southern Pacific Comm. Corp. v. American Tel. & Tel. Co.*, 740 F.2d 980, 1009-10 (D.C. Cir. 1984); *MCI Comm. Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1138 (7th Cir.), *cert. denied*, 464 U.S. 891 (1983).

remain, however, because the monopolist could theoretically operate in both the monopoly and competitive markets. At this point, the commission would have to apply other tools to regulate the mixed market.

1. Rate of Return and Incentive Regulation

Continued price regulation is an obvious approach to the portions of the utility services which will likely remain noncompetitive, such as local exchange service. Aggregate rate of return regulation, however, poses a problem of allowing too high a return for some services, with the subsidization of others. In fact, some services already suffer from these concerns, as various cost of service studies suggest.⁶⁵⁷ Solutions to the problem exist. In particular, Selwyn suggests a more liberal view of rate of return regulation which uses it as an incentive for the utility to expand markets and introduce technology.⁶⁵⁸ Thus, incentives such as the retention of a part or all of the income over some set rate of return would encourage the utility to market its services and cut costs more aggressively.

In addition, with greater incentives comes the need for a commission to observe behavior in at least two areas. Incentive regulation may result in lower service quality and pricing increases over the inelastic portions of the utility market.⁶⁵⁹ The commission may be required to demand much more detailed information concerning pricing and costs of particular service offerings.⁶⁶⁰

Price caps⁶⁶¹ may also be an alternative to cost of service regulation. However, these present difficult allocation and political problems which the commission may not want to address. First, price caps may be very difficult to adopt. As the FCC learned, price caps without substantial consumer protections are difficult to sell to the public and other political actors.⁶⁶² Ohio's recent experience with price cap legislation likewise demonstrates the political pitfalls of the approach.⁶⁶³

Second, price caps tend to be experiments in practice. Historically, they have not survived for very long periods of time, even when adopted due to

⁶⁵⁷ Selwyn, *supra* note 46, at 218-19.

⁶⁵⁸ *Id.* at 225.

⁶⁵⁹ *Id.* at 225-26.

⁶⁶⁰ *Id.* at 226.

⁶⁶¹ See *supra* text accompanying notes 214-37.

⁶⁶² Peter Shields, *The Politics of the Telecommunications Process: The Example of the FCC's Price Cap Initiative*, Center for the Advanced Study of Telecommunications Working File 1989-009, Sept. 1989.

⁶⁶³ See *supra* text accompanying notes 317-36.

changes in the economy or political reaction.⁶⁶⁴

Third, price caps present some real tradeoffs. The selling point for a price cap is that it can reduce real cost by increasing the efficiency of the utility. The utility has an incentive to produce at higher levels because it retains any efficiency gains.⁶⁶⁵ Further, the cap is intended to frustrate cross subsidies because cost transfers are limited by the caps on prices for particular services.⁶⁶⁶ Finally, there are likely to be reduced rate case expenses because rates are allowed to move with inflation.⁶⁶⁷

On the other hand, several problems exist with price caps. Initially, price caps are fundamentally based on rate case determinations of prices.⁶⁶⁸ To the extent there were problems in the calculation of rates or the distribution of costs in the original rates, these problems are continued and potentially amplified. This concern may add to the need for careful ongoing review of rates, thus offsetting the benefits of reduced rate case expense. Moreover, this review is likely to be more difficult conceptually because it is further removed from the rate base information which drove traditional rate regulation. Moreover, price caps do not address the concern of technical barriers which might be used as barriers to entry.⁶⁶⁹

Finally, the use of price caps assumes a high degree of faith in the commission's ability to set the appropriate productivity level. To the extent that the commission misses in either direction, the very problems sought to be solved are aggravated because the possibility of gouging and subsidies is once again brought to the fore. To the extent that the offset is too low, the company is offered a windfall. To the extent it is too high, the company is injured. Yet, there is no apparent method to make the calculation. The FCC, for example, sought to allay fears of price caps by adding a half percent to their calculation "[t]o ensure that ratepayers benefit from price cap regulation",⁶⁷⁰ while the California commission concluded that an even higher offset was appropriate because "recent productivity trends should continue and even increase somewhat as a result of continued technological improvements and adoption of an incentive-based

⁶⁶⁴ Raymond Lawton, *Price Caps: Precedents and Predictions*, Center for the Advanced Study of Telecommunications Working File 1989-002, June 1989.

⁶⁶⁵ Norris, *Price Caps: An Alternative Regulatory Framework for Telecommunications Carriers*, PUB. UTIL. FORT. 44 (Jan. 18, 1990).

⁶⁶⁶ *Id.*

⁶⁶⁷ *Id.*

⁶⁶⁸ *Id.* at 44-45.

⁶⁶⁹ J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 88.

⁶⁷⁰ Published by IdeaExchange@UAkron, 1991
FCC Price Cap, 54 Fed. Reg. 19,837.

regulatory framework."⁶⁷¹ It is not particularly clear why there is an effective two and a half percent difference between the federal and California calculations for essentially the same factor in the formula. Yet, that factor is the driver of all the rest of the benefits that are to arise from price caps. It appears in this light as a rather thin thread.

2. Structural Separations

The related problem of separating competitive and noncompetitive services offered by a monopoly also has several potential solutions. Because the incentive exists to misallocate the costs of local service, one solution to avoid this result is to require a separation of the regulated and nonregulated revenues and costs:⁶⁷²

[Structural separations] force some telephone companies to compete in certain offerings only through organizations separate from their telephone operations--separate in personnel, facilities equipment, marketing, operations, and capitalization. In addition, these regulations and decrees restrict information flows between some telephone operations and the separate subsidiaries, and limit some subsidiaries' revenues.⁶⁷³

Alternatively, the commission could use less aggressive forms of separations. Among the nonstructural safeguards which the FCC has used are accounting measures to prohibit cost shifting, network information disclosure, prohibition of discrimination in favor of customers to access, and limits on the information available to AT&T from the use of its system.⁶⁷⁴ Ohio has addressed this concern through regulatory separations to date.⁶⁷⁵ However, it may want to take a much closer look at the problem.

Full structural separation may be inappropriate, as the FCC and Ohio apparently have concluded, because one of the benefits of the network is its operating efficiency.⁶⁷⁶ Just as one of the difficulties of divestiture is the loss of economies of scope associated with common plant,⁶⁷⁷ separations may have

⁶⁷¹ California Price Cap, 107 Pub. Util. Rep. 4th at 91.

⁶⁷² Kahn and Shew, *supra* note 50, at 199.

⁶⁷³ Lavey, *Ending Structural Separation for Telephone Companies*, 18 CONN. L. REV. 81 (1985).

⁶⁷⁴ Fowler, Halprin, and Schlichting, *supra* note 104, at 189-90.

⁶⁷⁵ See *supra* text accompanying notes 363-65.

⁶⁷⁶ Selwyn, *supra* note 46, at 224.

⁶⁷⁷ <http://ideaexchange.uakron.edu/akronlawreview/vol24/iss2/2>

J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 86.⁸⁸

the untoward effect of creating greater costs than an integration of competitive and noncompetitive activities of the utility.⁶⁷⁸ (Economies of scope refers to the ability of a single firm to produce several related services at a lower cost than the separate production of each service.⁶⁷⁹)

A partial solution to the potential for cross subsidization when structural separation is not used is the creation of a set of cost allocators.⁶⁸⁰ Commissions could use prior cost information to form a base line for determining the proper allocation of revenues for regulated activities.⁶⁸¹ Cost allocation, however, is notoriously difficult in telecommunications, due to the common plant used in operations.⁶⁸² An additional weakness of accounting separations is that it requires a high degree of administrative vigilance.⁶⁸³

There are several other common problems with a requirement that separate subsidiaries or accounting separation be used to prevent cross-subsidization. First, the regulatory commission may have difficulty tracking the activities of the subsidiaries as their numbers grow and activities become more complex. Second, it is difficult to value the spin-off facility so that a transfer of value does not occur. Finally, there is a likelihood that the cost of capital will result in some form of subsidization. "Perhaps the only feasible solution is to require that the regulated and nonregulated activities each issue equity capital that would be traded in the market."⁶⁸⁴ Nonetheless, no one seems to have a better idea as to how to separate competitive and noncompetitive portions of a utility.

3. Technical Standards

A related problem associated with the issue of access to the bottleneck facility is that of technical standards. Several difficulties are associated with the requirement of technical standards. First, the antitrust court has retained jurisdiction over many of the standards. Second, standards do not address the cross subsidy concern. Third, a multiplicity of standards could emerge and effectively create barriers.⁶⁸⁵ The chairman of the FCC indicated that federal policy would emphasize opening access to competitive technologies through open network architecture, a reduction on the restrictions on the holding companies,

⁶⁷⁸ Lavey, *supra* note 673, at 105.

⁶⁷⁹ *Id.* at 120.

⁶⁸⁰ *Id.* at 105.

⁶⁸¹ *Id.* at 106.

⁶⁸² See P. HUBER, *supra* note 33, at 3.53 to 3.54.

⁶⁸³ J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 87.

⁶⁸⁴ Trebing, *A Critique of Structure Regulation in Common Carrier Regulation*, in TELECOMMUNICATION REGULATION TODAY AND TOMORROW 121, 165 (E. Noam, ed. 1983).

⁶⁸⁵ J. HORNING, R. LAWTON, J. RACSTER, W. POLLARD, D. JONES & V. DAVIS, *supra* note 11, at 86.

and faster capital recovery. In particular, the chairman stressed increasing the technological factors which would reduce costs, while increasing demand for telecommunications services.⁶⁸⁶ A decision of a federal court of appeals concerning the preemptive effect of the FCC's ONA requirements,⁶⁸⁷ however, may mandate increased state activity.⁶⁸⁸

4. Administrative Commitment

One of the ironies of "deregulation" is that the administrative commitment may actually increase, and there will be little assistance from the relevant federal agency. (A Government Accounting Office report noted that the FCC enforcement is likely to be minimal, because it has fewer than twenty auditors to devote to the task, with the result that the agency could conduct a full audit once each 16 years.⁶⁸⁹) States are likewise limited in the resources which can be brought to bear, and these must be spread among many different areas of regulation other than telecommunications.

It is also important to remember that the decision to adjust regulation is not purely commercial. There is a highly political element to it as well. As noted previously, deregulation carries with it significant impacts on labor and consumer expectations.⁶⁹⁰ As part of its administrative commitment, the commission might do well to open the process to hearings and the record which can be made by that process. The political response is likely to be less reactive if the process itself is one which is perceived as fair, open, and grounded on a substantial record.

CONCLUSION

The model of partial regulation offers some insights to the method of regulating, but does not answer the basic questions of who must win and lose. That decision will essentially be political. Nor does the model provide an answer as to what the best approach to regulation in its many facets might be. Only experience will show whether incentive rate making or price caps will prove more effective in efficient and adequate service, or if informational tariffs are effective in the provision of alternative operator services. The strength of House Bill 563 is that it does not bind the commission to a single experiment. The commission

⁶⁸⁶ Address of Alfred Sikes, Chairman, Federal Communications Commission, Telecommunications 1989: Policy and Regulation in the New Administration, Washington, D.C. (Nov. 30, 1989).

⁶⁸⁷ *California v. FCC*, 905 F.2d 1217 (9th Cir. 1990).

⁶⁸⁸ Sikes, *After Computer III: Picking Up the Pieces at the FCC*, 126 PUB. UTIL. FORT. 31, 32 (Aug. 16, 1990).

⁶⁸⁹ Wilke and Carnevale, *Nynex Overcharged Phone Units for Years, an FCC Audit Finds*, Wall St. J., Jan. 9, 1990, at A6, col. 4.

can fit the solution to the perceived problem. In that regard, at least, the lack of direction in the bill is positive. It remains for the commission, however, to demonstrate the ability to experiment with changing circumstances and political realities.

In any case, change will continue to occur in the telecommunications market.⁶⁹¹ New entities and unusual contractual relationships will be the norm.⁶⁹² "Segmentation and specialization will be critical factors, and the transition of productivity to price will border on the furious, injecting more fluidity and change in an environment already beset by rampant change."⁶⁹³ The commission will have to change with the environment it is attempting to regulate if the rhetorical goals are to be met.

⁶⁹¹ M. IRWIN, *supra* note 112, at 6.

⁶⁹² "As adjacent boundary lines dissolve, firms whose relationship in the past was distant or even unrelated now confront each other as direct competitors and rivals." *Id.* at 9.

