COMPETITION IN A REGULATORY ENVIRONMENT

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Abstract

This paper examines the difficulty which exists in allowing competition in a regulatory environment. We examine how AT&T formerly was able to use the regulatory process as a barrier to entry in the long distance and terminal equipment market but how presently the regulatory process is putting AT&T at a competitive disadvantage in the long distance market.

Introduction

In this paper, we examine how AT&T used the lag in the regulatory and judicial processes to its advantage to successfully thwart competition in the terminal equipment and long distance markets and contrast that with the present situation in which AT&T is being hurt by the regulatory lag in the long distance market.

The lag in the regulatory process was the largest barrier to entry which the potential competitors of AT&T faced. However, with the recent divestiture of AT&T and the move towards deregulation, the regulatory process is now making it more difficult for AT&T to compete in the long distance market. Thus, the regulatory lag which historically has worked to AT&T's advantage in forestalling competition is now decreasing AT&T's ability to compete.

Entry into the Long Distance Market¹

The FCC in 1956 examined the issue of whether it should allow private users to construct their own long-distance microwave systems. After nearly three years of studying this issue the FCC announced the Above 890 decision which allowed for private construction of microwave systems. After a request by AT&T, the FCC reviewed its decision but did not change its initial decision and the decision took effect in 1960.

This decision did not authorize new companies to enter the business in competition with AT&T but only allowed individual users to build systems

for their own use. It was similar to the Interstate Commerce Commission's provision for corporations to use their own trucks without common carrier regulations or authorization.²

In 1963, Microwave Communications, Inc. (MCI) applied for status as a common carrier so that it could compete directly with AT&T in the long distance market. After much discussion and debate the FCC in 1969 granted MCI common carrier status. In 1972, MCI began to provide long distance service. After nearly 9 years and \$10 million spent in the regulatory process, MCI was able to compete with AT&T in the long distance market. However, the issue was still not resolved. MCI claimed that it was not given full interconnection rights, i.e. interconnection with the local Bell operating companies. After thirteen years this issue was finally resolved in MCI's favor in July 1976.

Also, there was debate over what services MCI could offer. Before 1975, MCI offered only private line service. However, in 1975 MCI decided to enter the switched long distance market and filed a tariff with the FCC for Execunet. AT&T filed a complaint with the FCC concerning this tariff claiming that MCI was not legally allowed to provide switched long distance service. In 1976 the FCC ordered MCI to discontinue Execunet service. MCI went to court and was allowed to provide Execunet while the Appeals Court decided the issue. The Appeal's Court decision in favor of MCI was appealed to the Supreme Court. Finally,

in 1978 the Supreme Court allowed the Appeal's Court decision to become effective by refusing to hear the case. Thus, a delay of three years ensued before MCI was allowed to compete in the switched long distance market.

This brief history of the long distance market shows that the regulatory process can take many years before entry is allowed. The original microwave issue began in 1956; after nearly 22 years, it was affirmed that entry in the long distance switched market was permitted.

Also, it must be remembered that the FCC was considered by many to be a pro-competitive regulatory body, unlike the state regulatory bodies which for the most part were against competition. The use of the regulatory process to inhibit competitive entry is not unique to the long distance market.

Entry in the Terminal Equipment Market³

Before 1956, the telephone companies' "foreign attachment" tariffs foreclosed competition in the terminal equipment market. It was illegal for a customer to use other than telephone company provided terminal equipment. The telephone companies presented their customers with a tying agreement, that is to receive telephone service one had to lease telephone company provided terminal equipment. However, several companies who wanted to compete in the terminal equipment took this foreign attachment tariff issue before the FCC and the courts.

In 1948 Hush-A-Phone asked the FCC over the objections of AT&T for permission to market its cup-like device. After 7 years, the FCC decided against Hush-A-Phone. Hush-A-Phone took the issue to court and in 1956 the court decided in its favor. After 8 years, the company was able to market and sell its device.

In response to the Hush-A-Phone decision, Thomas Carter, in 1960 began to market his device, the Carterfone. AT&T claimed that the Carterfone violated its tariff. Mr. Carter went to the FCC and also filed an antitrust suit; in 1968 the FCC decided in favor of Mr. Carter and told AT&T to revise its foreign attachment tariff.

However, AT&T's new tariff required all non-telephone terminal equipment to be attached

to the network by means of a telephone company provided connecting arrangement. AT&T claimed that the connecting arrangement was needed to protect the integrity of the system. The connecting arrangement's price, which was controlled by the states, virtually foreclosed competition in the residential and small key market and increased considerably the cost of interconnection in the PBX market. In 1975, the FCC did away with the connecting arrangement requirement and allowed for certification of terminal equipment. However, the issue was taken to the courts and after the Supreme Court refused to hear the case certification became effective in October 1977.

Also, jurisdictional rights became an issue in the terminal equipment market. The same terminal equipment can be used for both intrastate and interstate telephone calls. The FCC claimed that it had jurisdictional control over the terminal equipment market. However, the states claimed that they had jurisdictional rights. The states of Oklahoma, Nebraska and North Carolina attempted to ban competition in the terminal equipment market.

In 1976 Telerent held that the FCC had jurisdiction over the terminal equipment market. However, this decision did not finalize the jurisdictional question. The telephone companies asked Congress to give the states authority over terminal equipment. This bill never made it through Congress.

Thus, after nearly 30 years competition began to take place in the terminal equipment market. The issue of jurisdiction over terminal equipment exemplifies the problems which new entrants face in their attempt to compete with the telephone companies: the same issue has to be answered repeatedly at different forums.

This leads to uncertainty for the entrants and their customers or potential entrants. This uncertainty makes entry riskier, probably sufficiently so to discourage at least some entry. Also, the cost of doing business is greater due to constant appearances before state and federal regulatory commissions as well as the courts and Congress. For example, MCI, the new entrant spent around seven years and \$10 million in the regulatory process. The estimated cost of the facilities was around \$2 million and was built in 7 months. Thus, it is clear that there are no quick regulatory

solutions in deciding whether competition should be allowed in the markets that are regulated monopolies. The regulatory process is a real barrier to entry. Also, any cost incurred in removing this regulatory barrier is a sunk cost and unlike assets in the company can not be sold. Finally, the first firm which attempts to remove these barriers incurs all the cost. Once the barriers are removed, other companies can enter.

The Long Distance Market Today

Presently, the situation is reversed in the long distance market. AT&T is now the victim and not the benefactor of the regulatory lag. AT&T is considered a dominant carrier by the FCC and thus AT&T rates are still regulated whereas its competitors' rates are not. To change its rates, AT&T must get approval from the FCC and, unlike its competitors, these rates cannot be adjusted immediately. AT&T must fulfill notification requirements and show that its proposed rates are cost justified. AT&T is required to notify the FCC not less than 45 days before a rate increase and not less than 35 days before a rate decrease. AT&T's competitors have 15 days to petition against the rate change. If the FCC does not make a decision in the allotted time periods then the FCC can postpone the decision at most 45 days in terms of a rate increase and at most 55 days for a rate decrease. Thus, the FCC must make a decision within 90 days to either reject, accept the request or suspend the decision for 5 months. After this 5 month period the FCC must either accept or reject the rate request. Thus, the maximum time period for an FCC decision is 8 months. It is rare for AT&T to have a rate decrease approved in less than 35 days.

Also, any AT&T rate changes must be cost justified. AT&T must submit a cost of service study for a 12 month period before the proposed rate change and a 12 month forecast of traffic and revenues. Thus, AT&T is at a competitive disadvantage; if a competitor of AT&T cuts its rates AT&T cannot respond immediately to this price change. However, a competitor of AT&T can respond to AT&T proposed price changes before these price changes actually occur. For example, AT&T originally filed its Pro-America tariff on February 12, 1985. It was declared unlawful by the FCC on September 18, 1985. AT&T revised the tariff and it finally took effect on May 13, 1986. Thus, it took AT&T over 19 months to

change its rates.

Also, AT&T filed a petition to revise its Software Defined Network on March 6, 1985. On May 31, 1985 the FCC suspended the tariff revisions pending an investigation. On October 31, 1985 the tariff took effect. In this case it took AT&T over 7 months to change its rates. To alleviate this problem AT&T proposed that its rates be deregulated, but there is considerable opposition to deregulation from AT&T competitors and AT&T is currently fighting a battle similar to that of its competitors when they tried to enter the market.

This paper shows the difficulty of trying to achieve competition in a regulatory environment. Originally AT&T benefitted from the use of the regulatory process but now AT&T is at a competitive disadvantage because of regulation.

Footnotes

1. For a more detailed analysis of the long distance market see Gerald Brock *"The Telecommunications Industry"*, Harvard University Press, Cambridge, Mass., 1981.
2. *Ibid.*, p. 206.
3. For a more detailed analysis of the terminal equipment market see Joseph P. Fuhr "Competition in the Terminal Equipment Market After Carterfone" *The Antitrust Bulletin*, Vol. 28, No. 3, pp. 669-698.

References

1. Brock, Gerald, *The Telecommunications Industry*, Harvard University Press, Cambridge, Mass., 1981.
2. Fuhr, Joseph P., "Competition in the Terminal Equipment Market After Carterfone" *The Antitrust Bulletin*, Vol. 28, No. 3, pp. 669-698.