

Losing By Judicial Policymaking: The First Year of the AT&T Divestiture

Paul W. MacAvoy†
Kenneth Robinson††

Ten years ago, in the midst of the political flux engendered by President Nixon's resignation and pardon, the Antitrust Division of the U.S. Department of Justice (DOJ) filed suit under Section Two of the Sherman Act challenging American Telephone and Telegraph Company's (AT&T) regulated monopoly. The Division's complaint contended, essentially, that through manipulation of interrelated "bottlenecks," AT&T had unlawfully monopolized the provision of telephone equipment and long-distance services.¹ This extraordinary antitrust litigation against a regulated company advanced inexorably, spanning four Congresses, three Presidents, and two U.S. district court judges.

On January 1, 1984, AT&T formally divested its local Bell Operating Companies (BOCs), pursuant to a consent decree ending the government antitrust suit.² At the time of divestiture most antitrust and telephone industry experts predicted that divestiture would prove to be in the "public interest,"³ but few would now claim that divestiture has benefited the public thus far.⁴

† Dean and Professor of Business Administration in the Graduate School of Management, and Professor of Economics, University of Rochester.

†† Policy Advisor to the Assistant Secretary, National Telecommunications and Information Administration, U.S. Department of Commerce. The views expressed are neither those of the Department of Commerce nor of any other government agency.

1. See MacAvoy & Robinson, *Winning by Losing: The AT&T Settlement and Its Impact on Telecommunications*, 1 YALE J. ON REG. 1, 14 (1983) [hereinafter cited as *MacAvoy & Robinson I*].

2. The two principal published court rulings regarding the AT&T settlement are: *United States v. AT&T Co.*, 552 F. Supp. 131 (D.D.C. 1982) (text of the decree), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983); and *United States v. Western Elec. Co.*, 569 F. Supp. 1057 (D.D.C. 1983) (approving the plan of reorganization). In addition, there are a number of supplemental rulings in *Western Electric* by the judgment court published at 578 F. Supp. 662 (foreign exchange offerings), 578 F. Supp. 643 (mobile radio services), 578 F. Supp. 653 (tariff filings), 578 F. Supp. 668 (routing), 578 F. Supp. 677 (third party intervention), and 578 F. Supp. 680 (federal contracting).

3. See, e.g., Grant, *Through a Glass Brightly: Consumers and the New Tomorrow*, in DISCONNECTING BELL: THE IMPACT OF THE AT&T DIVESTITURE 132 (H. Shooshan ed. 1984) [hereinafter cited as DISCONNECTING BELL].

4. According to a November 1984 national survey conducted by Louis Harris & Assoc., Inc., 64% of the 1247 adults surveyed thought the AT&T breakup was a bad idea, compared to 25% of those surveyed who thought it was a good idea. Jackson, *Business Week/Harris Poll: The Public Sees the Little Guy as the Loser*, BUS. WK., Dec. 3, 1984, at 89.

On the eve of divestiture, we published an article which assessed the principal legal and economic rationales for the AT&T settlement and advanced several predictions about the state of the post-divestiture telephone industry.⁵ We predicted that the new AT&T, through its substantial scale economies, would gain unregulated monopoly power over the supposedly competitive long-distance service market—at least if the company's principal reason for accepting divestiture was to be realized. We also predicted that without profit transfers ("settlements") from Long Lines, local telephone rates would increase and service quality would decline as the local companies struggled to cover their costs. In effect, we viewed the settlement as a "win" for AT&T, if it enabled AT&T to escape the increasing burden of financing the over-regulated local exchange system while retaining its highly profitable long-distance service and equipment operations. Consumers, we argued, would not benefit from divestiture, because they would end up paying both higher prices for local service and the same or higher prices for long-distance service.

More than a year into divestiture, it appears that both consumers and AT&T are worse off. In this article we explain why some of the predictions made in our first article have not come to pass. We argue that divestiture has not turned out as initially expected because of limitations inherent in the judicial process through which the settlement and its underlying policies were determined. The settlement was a private agreement between the Justice Department and AT&T. Public proceedings followed the announcement of the settlement, and with limited revisions the district court approved the divestiture plan.⁶ Thus, a radical restructuring of the telecommunications industry was achieved⁷ without the full participation of all parties concerned with the outcome. No one group, and certainly not the judgment court, had the power to control all aspects of the telecommunications industry and to ensure that its goals of divestiture were achieved. Since neither the legislative nor executive branch of the federal government fully participated in the formulation of the divestiture plan, institutional support for the goals of divestiture has been weak.

Even had the process of divestiture worked smoothly, the goals of divestiture could not easily have been accomplished. AT&T and the Justice Department hoped to achieve two related goals through divestiture: the

5. See *MacAvoy & Robinson I*, *supra* note 1.

6. See *supra* note 2.

7. For descriptions of the restructured industry, see Besen & Woodbury, *Regulation, Deregulation, and Antitrust in the Telecommunications Industry*, 28 ANTITRUST BULL. 39 (1983); Lavey & Carlton, *Economic Goals and Remedies of the AT&T Modified Final Judgment*, 71 GEO. L.J. 1497 (1983); Trienens, *Vertical Integration: Should the AT&T Doctrine Be Extended?—The Telecommunications Industry*, 52 ANTITRUST L.J. 259 (1983).

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development of marginal cost-based pricing,⁸ and the creation of effective competition in long-distance (toll) markets, thus facilitating reduced regulation of AT&T's long-distance operations.⁹ Achieving these goals would require pricing local telephone service at much higher levels, to cover operating and common capital costs, a result which neither regulators nor Congress has been willing to permit.¹⁰ Instead, local rates continue to be subsidized while BOC revenue requirements are supplemented by non-cost-based access charges levied on AT&T and the Other Common Carriers (OCCs).¹¹ The carrier access charges do not represent a stable solution to the BOCs' revenue needs because AT&T and the OCCs can "bypass" the local exchange networks and avoid these charges.¹² AT&T has particularly strong incentives to seek cheaper alternatives to the BOC networks because it pays significantly higher charges for interconnection than the OCCs. Furthermore, in the market for long-distance service effective competition has not developed. The continued regulation of AT&T and restrictions which prevent the BOCs from entering this market have sheltered the OCCs from competition. Thus, the price reductions and technological innovations that should accompany increased competition for long-distance service have yet to materialize.

In Section I of the article we discuss the revenue transfers among telephone services which existed prior to divestiture and outline the terms of the settlement between AT&T and the government. Section II discusses developments in the first year of divestiture, and describes those areas in which the settlement has failed to satisfy the objectives of interested parties. Section III identifies a set of goals which we argue should be the focus of the post-divestiture telecommunications policy. Although it is perhaps premature to judge the success or failure of divestiture just one year into the process, we believe corrections are necessary to prevent a bad situation from further deteriorating.

8. On the efficiency of marginal cost pricing, see P. SAMUELSON, *ECONOMICS* 435-36 (10th ed. 1976). See also Kahn, *The Road to More Intelligent Telephone Pricing*, 1 *YALE J. ON REG.* 139, 140-41 (1984) (discussing cost-based pricing for telephone services).

9. See, e.g., *The AT&T Settlement: Hearings Before the Senate Comm. on Commerce, Science, and Transportation*, 97th Cong., 2d Sess., pt. 1, at 59 (1982) (testimony of William F. Baxter, Assistant Attorney General for Antitrust) [hereinafter cited as *Hearings*]; AMERICAN TELEPHONE & TELEGRAPH CO., 1983 ANNUAL REP. 12-13 (1984).

10. See *infra* text accompanying notes 62-66 & 88.

11. The OCCs include MCI, GTE/Sprint, ITT Longer Distance, US Tel/All America, and ALLNET. See R. Davidson, *Telecommunications in Transition* 31 (1984) (Harvard Bus. School Case Study no. 0-384-207).

12. See *infra* note 83.

I. Traditional Telephone Industry Pricing and the AT&T Settlement

A. Pricing

Prior to divestiture AT&T and the telephone industry functioned under a regulated pricing scheme which did not reflect marginal cost.¹³ Long-distance service was priced substantially above cost in order to subsidize local rates.¹⁴ Since the 1950's, regulators have divided the U.S. telephone system into two spheres of operation: (1) long-distance toll operations, for decades dominated by AT&T—and more recently joined by a fringe of specialized or competitive common carriers; and (2) local exchange operations, dominated by the monopoly franchise of the AT&T operating companies.¹⁵ Long-distance operations have long been characterized by cost-reducing technology, leading to substantial profitability when rates are held constant.¹⁶ Local exchange operations, on the other hand, have been characterized by cost increases, due in part to the labor intensiveness of the operations and a relatively stable technology.¹⁷ These cost increases coupled with price controls have led to low, indeed, often nonexistent profitability. One of the primary roles of regulation was to direct increasing cash flows from toll service to the local operating companies to cover the joint and common capital costs of both toll and basic exchange services. By supplementing local revenues in this manner it was possible to sustain low local rates.

The effects of this system of revenue shifting were substantial. Thirty years ago long-distance operations bore a share of common capital costs roughly comparable to their relative use of local telephone plant. Interstate telephone calling then covered three percent of common costs and accounted for about three percent of total message traffic.¹⁸ In more recent years, the long-distance cost assessment has escalated in order to provide

13. The telephone industry recovered much of the cost of providing access to the telephone network through charges based on use, even though connection costs remain independent of the amount of use and additional use entails low marginal costs. Marginal cost pricing would charge subscribers a two-part tariff separating the incremental costs of providing access to the network for one additional subscriber from the marginal cost of additional use by that subscriber. See Kahn, *supra* note 8, at 140-41.

14. Under the settlements process, transfers of net income from Long Lines were used to cover local and joint local-long-distance costs, thereby keeping local rates low.

15. See CONGRESSIONAL BUDGET OFFICE, *THE CHANGING TELEPHONE INDUSTRY: ACCESS CHARGES, UNIVERSAL SERVICE AND LOCAL RATES* 9 (1984) [hereinafter cited as CBO STUDY].

16. See generally Wiley, *The End of Monopoly: Regulatory Change and the Promotion of Competition*, in *DISCONNECTING BELL*, *supra* note 3, at 23, 25 (discussing technological advances in telecommunications service).

17. See CBO STUDY, *supra* note 15, at 6 ("The local loop . . . retains much the same technology as it has for 100 years—copper wire physically connecting customer equipment with the central office").

18. *Id.* at 10 (numbers estimated from chart).

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cash flows necessary to keep local telephone rates low.¹⁹ In 1983, the average monthly price charged for local residential telephone service was approximately eleven dollars.²⁰ The average monthly cost, including joint and common capital costs, of providing this service was about twenty-six dollars.²¹ The revenues needed to defray the fifteen dollar per month shortfall came from profits on inter- and intrastate tolls, business services such as private lines, equipment leasing, and other activities.²² The prime beneficiaries of this pricing policy were residential telephone customers who made few toll calls.²³ In addition to these inter-service and inter-personal transfers, substantial inter-regional transfers also occurred. Phone customers in the Northeastern states, for example, contributed substantial amounts through their relatively high toll bills to maintain relatively low local rates in both high-cost rural and fast-growing "Sunbelt" communities.²⁴

Long-distance rates, particularly interstate rates regulated by the Federal Communications Commission (FCC),²⁵ have remained almost constant while the cost of providing long-distance service has declined significantly.²⁶ Not only did the FCC and state regulators allow toll rates to remain constant as costs declined, so that profit margins widened, but these agencies also blocked competitive entry into the long-distance field

19. In 1981 interstate telephone calling covered 26% of subscriber plant costs but accounted for only 8% of total message traffic. *Id.* at 9.

20. COMMON CARRIER BUREAU, FEDERAL COMMUNICATIONS COMMISSION, ANALYSIS OF THE EFFECTS OF FEDERAL DECISIONS ON LOCAL TELEPHONE SERVICE, attachment 14 (Dec. 9, 1983).

21. CBO STUDY, *supra* note 15, at 13 (the \$26 figure represents an FCC estimate of the 1981 monthly average fixed cost per subscriber).

22. See, e.g., H.R. REP. NO. 479, 98th Cong., 1st Sess. 19 (1983).

23. Residential long-distance usage is quite concentrated. According to one published study, 83.9% of total residential customers in 1977 had monthly interstate long distance bills of \$10 or less. See STAFF OF HOUSE SUBCOMM. ON TELECOM, CONSUMER PROTECTION, AND FINANCE, 97TH CONG., 1ST SESS., TELECOMMUNICATIONS IN TRANSITION: THE STATUS OF COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY 89 (Comm. Print 1981).

24.

Substantial interregional revenue transfers result . . . from mismatches between separations-based cost allocations to the interstate revenue requirement and subscriber toll contributions to the revenue pool. . . . [I]n 1982 for every dollar contributed to the [interstate] toll pool, Connecticut, [the] District of Columbia, Massachusetts, Rhode Island, Tennessee, New Jersey, Delaware, Ohio, Pennsylvania, and Hawaii received about \$0.75 (plus or minus \$0.10). Georgia, New Hampshire, Wisconsin, and New York roughly broke even. Alaska, Arizona, Arkansas, California, Florida, Idaho, Montana, Oregon, South Dakota, Vermont, and Wyoming all drew in excess of \$1.25.

LEHMAN BROTHERS, THE BELL EXCHANGE 9 (1984). See also H.R. REP. NO. 479, *supra* note 22, at 113-14 (minority views) (discussing the amount of interstate subsidy); 129 CONG. REC. H9265 (daily ed. Nov. 7, 1983) (remarks of Rep. Corcoran); Baseman, *Open Entry and Cross-Subsidization in Regulated Markets*, in STUDIES IN PUBLIC REGULATION 357 (G. Fromm ed. 1981).

25. Under the Communications Act of 1934, 47 U.S.C. §§ 201-205 (1982), the FCC is charged with setting interstate rates. Intrastate rates remain the province of state regulatory agencies. See 47 U.S.C. § 152(b) (1982).

26. See *MacAvoy & Robinson I*, *supra* note 1, at 6, 8.

until 1977. As a result, market forces could not operate to lower toll charges to levels approximating marginal costs.²⁷ During this period, state regulators limited increases in local telephone rates to small annual percentages. Because the cost of providing local service was rising faster than the rates charged for the service, the profitability of local operations dwindled, so that the long-distance revenue transfers became essential.

Keeping local telephone rates at artificially low levels benefited both AT&T and the state regulatory agencies. Because the settlements that the local companies received were tied to the amount of local investment, these companies were provided with an incentive for capital investment. With increased local investments, AT&T was able to justify increases in long-distance profit margins, due to formulas used to calculate AT&T's revenue contributions to local operations.²⁸ Low local telephone rates maximized telephone penetration and increased the volume and profitability of long-distance calls.²⁹ Regulators were able to demonstrate to their political constituencies the positive consequences of regulation, namely, low prices and universal service.

Permissive, if not explicitly mandated, monopoly pricing of long-distance service was a critical factor in maintaining this pricing system. When confronted with local revenue shortfalls, regulators allowed AT&T to cover such shortfalls with cash flows generated from monopoly-level profit margins on toll and related services.

This pricing system began to crack under substantial economic and political pressure.³⁰ The demonstrated high profit margin on toll service at-

27. See S. BREYER, REGULATION AND ITS REFORM 296-98 (1982); Knieps & Spiller, *Regulation by Partial Deregulation: The Case of Telecommunications*, 35 AD. L. REV. 391, 395 (1983).

28. Local operating companies divided their costs between interstate and intrastate jurisdictions under a system of "separations and settlements." The allocation of costs was made in accordance with the FCC Separations Manual (Part 67 of the FCC rules). A Subscriber Plant Factor (SPF) was used on a state-by-state basis to allocate plant costs. The SPFs represented multiples of the factors measuring the relative interstate use of local plant. Costs allocated to the interstate jurisdiction were recoverable through tolls on interstate services. See *The Federal-State Joint Board and the Jurisdictional Separations Proceeding*, FCC NEWS, Apr. 15, 1983, at 1, 4. See also CBO STUDY, *supra* note 15, at 9-10.

29. In 1934, telephone service was available only in one out of every three households. By 1970, 91% of U.S. households had service and, by 1984, about 98% of households had at least one telephone. R. Salaman, *The Price of Residential Telephone Service 1* (May 25, 1984) (National Telecommunications and Information Administration Staff Paper on file with the *Yale Journal on Regulation*).

For discussions of the benefits of traditional telephone industry pricing policies, see Trebing, *Common Carrier Regulation—The Silent Crisis*, 1969 LAW & CONTEMP. PROBS. 299; Gabel, *The Early Competitive Era in Telephone Communication, 1893-1920*, 1969 LAW & CONTEMP. PROBS. 340.

30. For the history of competitive entry into the long-distance and equipment fields, see Note, *Resale and Sharing of Private Line Communications Services: AT&T Restrictions and FCC Regulations*, 61 VA. L. REV. 679 (1975); Note, *Competition in the Telephone Equipment Industry: Beyond Telerent*, 86 YALE L.J. 538 (1977) [hereinafter cited as Note, *Competition*]; Comment, *Intercity Telecommunications Competition After Execunet*, 31 FED. COM. L.J. 117 (1978); Wiley, *The End of Monopoly: Regulatory Change and the Promotion of Competition*, in DISCONNECTING BELL, *supra* note 3, at 23.

tracted competitors, first on the fringe (private lines only) and then at the core of the long-distance market. The FCC tried to keep competitors out by issuing only limited service licenses. This regulatory policy gave way when the courts subsequently overturned these administrative limits on licensing.³¹ The OCCs, when freed from regulatory restrictions, offered services at prices low enough to capture market share from AT&T,³² thus inviting a competitive response from AT&T. Contemporaneously, the FCC authorized competition in the telephone equipment market; this also undermined the industry's traditional pricing system.³³

AT&T resisted these competitive inroads not only by seeking to cut long-distance rates,³⁴ but also by refusing to provide equal local exchange interconnections to the OCCs.³⁵ AT&T also sought to contain competition in the equipment markets.³⁶ The Antitrust Division assumed that the problems encountered by the new vendors of service and equipment were the inevitable consequence of AT&T's dominant position in the inter-related long-distance, local service, and equipment markets, coupled with the firm's incentive and ability to manipulate these markets to exclude or limit competition.³⁷ The Antitrust Division failed to recognize that opposition to competitive entry was not limited to AT&T. For example, local telephone companies owned by GTE Service Corp. and others, which had virtually no toll operations, refused to provide local interconnections in much the same fashion.³⁸ Almost all of the 1500 very small independent

31. See *MCI Telecommunications Corp. v. FCC*, 561 F.2d 365 (1977), *cert. denied*, 434 U.S. 1040 (1978). This is not to suggest, however, that the pre-divestiture price structure maximized profit for AT&T. Indeed, because downward elasticities were lower on local service, the maximum profit on the price-cost margins should have been larger on local service than on long-distance service.

32. See *infra* text accompanying note 98.

33. See *In re* Proposals for New or Revised Classes of Interstate and Foreign Message Toll Telephone Service (MTS) and Wide Area Telephone Service (WATS), 56 F.C.C.2d 593 (1975), *modified*, 58 F.C.C.2d 736 (1976). See generally Fuhr, *Competition in the Terminal Equipment Market After Carterfone*, 28 ANTITRUST BULL. 669 (1983); Note, *Competition*, *supra* note 30.

34. See *MacAvoy & Robinson I*, *supra* note 1, at 6 (chart indicating that the price charged by AT&T for a long-distance call decreased in 1975 and 1977). AT&T reacted to OCC competition in the private line market by seeking lower de-averaged tariffs for high-density areas. *Id.* at 15-16 (discussing AT&T's Hi/Low tariff proposal). See also Wiley, *supra* note 30, at 33-34.

AT&T's proposed and implemented price reductions prompted significant private antitrust litigation. See, e.g., *Southern Pacific Com. Co. v. AT&T*, 556 F. Supp. 968, 968-69 (D.D.C. 1983), *aff'd*, 740 F.2d 1081, 1105 (7th Cir. 1983), *cert. denied*, 440 U.S. 971 (1984).

35. For example, Bell had a "customer premises" requirement that allowed the hook-up of a long distance competitor only if the hook-up occurred within the confines of the customer's premises, thereby preventing competitors from using local networks in the operation of their systems. *United States v. AT&T*, 552 F. Supp. at 1354-57. In general, according to the DOJ, intercity competitors experienced delays, poor service, and poor maintenance in obtaining interconnection from local operating companies.

36. See *MacAvoy & Robinson I*, *supra* note 1, at 14-15.

37. *Id.*

38. See, e.g., *United States v. GTE Corp.*, 1985-1 Trade Cas. (CCH) ¶ 66,354 at 64,756 n.23 (D.D.C. 1984) (alleged denial of equal access); *Illinois Bell Tel. Co. v. FCC*, 740 F.2d 465, 476 (7th Cir. 1984) (alleged hobbling of equipment competitors)

telephone companies similarly resisted long-distance competition, although they had neither equipment manufacturing nor toll operations.³⁹

Financial incentives, rather than anti-competitive schemes, explain this resistance. In response to the diminished cash transfer to local companies resulting from long-distance competition, the regulatory authorities imposed "access" charges on the OCCs for connections to Bell's local exchange system. But by regulatory fiat, the access charges paid by the OCCs were only a fraction of the settlements paid by AT&T Long Lines. Until 1984, the leading competitive carrier, MCI, paid only about \$235 per local line per month; AT&T paid settlements on average of \$600 per line per month.⁴⁰ Understandably, local telephone companies preferred to deal with AT&T because they received more money to cover local revenue shortfalls.

Competition in long-distance service posed a serious threat to the traditional pricing of telephone services. New entrants, with an increasing market share, did not have the same regulatory obligation to help subsidize local rates. AT&T's declining market share meant that the subsidy available to local companies would decline. While the traditional regulatory apparatus remained, the cash transfers on which it was based were in jeopardy.

By 1980, a strictly regulated AT&T, confronted with competitive pressures, responsible under regulation for subsidizing local service, and besieged by a hostile Justice Department, was prepared to accept the risks of the open market without the operating companies and their regulatory baggage. The company apparently believed that its future under divestiture would be much brighter than under the traditional, but crumbling, system of regulation.

B. *The Settlement*

After protracted negotiations, AT&T and the Department of Justice reached a settlement on January 8, 1982.⁴¹ Under its terms, AT&T retained much of its nationwide long-distance telephone network; its equip-

39. See, e.g., *Telecommunications Act of 1982: Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 97th Cong., 2d Sess., pt. 1 at 768 (1982) (testimony of Richard A. Lumpkin, U.S. Independent Telephone Association) [hereinafter cited as *House Hearings*]; *Amendments to Communications Act of 1934: Hearings on S.611 and S.622 Before the Subcomm. on Communications of the Senate Comm. on Commerce, Science, and Transportation*, 96th Cong., 1st Sess., pt. 1 at 425 (1979) (statement of Carlton Appelo, Organization for the Protection and Advancement of Small Telephone Companies).

40. See *National Ass'n of Regulatory Util. Comm'rs v. FCC*, 737 F.2d 1095, 1144-45 (D.C. Cir. 1984); *MCI Telecommunications Corp. v. FCC*, 712 F.2d 517, 527 (D.C. Cir. 1983). See also R. Davidson, *AT&T and the Access Charge 7-8* (1984) (Harvard Bus. School Study No. 0-384-208).

41. *N.Y. Times*, Jan. 9, 1982, at A1, col. 1.

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ment manufacturing and supply arm, the Western Electric Co.; and its world-renowned research affiliate, Bell Laboratories.⁴² The agreement lifted the limits on the scope of AT&T's retail operations imposed by a 1956 consent decree.⁴³ The company thus was free to diversify into data processing and other new fields.⁴⁴ AT&T was required, however, to divest itself of its local telephone exchange companies, the BOCs, which accounted for about three-quarters of AT&T's assets, but contributed less than half the unified company's profits.⁴⁵ The BOCs were directed to commence a costly plant modernization and upgrading program which was to be completed by 1986.⁴⁶ The goal of this program was to ensure that all long-distance carriers would enjoy what came to be known as "equal interconnection," i.e., physically equivalent connection to local telephone company subscribers.⁴⁷ The decree also restricted BOC operations, by permitting them to provide only local exchange telephone services.⁴⁸

Prior to approving the agreement between AT&T and the Justice Department, the trial court conducted review proceedings on the proposed settlement under the Tunney Act.⁴⁹ U.S. District Judge Harold H. Greene, the judge of record throughout the latter stages of the litigation, entertained comments from a myriad of concerned parties.⁵⁰ The testimony of these parties and the judge's own concerns led him to consider possible changes to the proposed settlement.

Judge Greene ultimately ordered four significant modifications in the proposed settlement. First, over the objections of both AT&T and Justice, the court approved BOC participation in the business of marketing and

42. United States v. AT&T, 552 F. Supp. at 173-74, 222-25.

43. See United States v. Western Electric Co., 1956 Trade Cas. (CCH) ¶ 68,246 (D.N.J. 1956). See, e.g., IBM v. FCC, 570 F.2d 452, 454 n.3 (2d Cir. 1978) (noting that 1956 decree apparently does not permit AT&T to offer data processing services through its subsidiaries); National Ass'n of Regulatory Util. Comm'rs v. FCC, 525 F.2d 630, 637 n.31 (D.C. Cir. 1976); GTE Serv. Corp. v. FCC, 474 F.2d 724, 730 n.7 (2d Cir. 1973). See also Wiegner, *Prometheus Unbound and Seeking His Footing: AT&T's Move Into Computers*, FORBES, Mar. 12, 1984, at 141 (discussing the challenge the new AT&T presents to IBM); Chu, *Corporation Planning: From Shadow to Substance*, 1983 BELL TELEPHONE MAG., No. 2, at 14 (1983).

44. AT&T, 552 F. Supp. at 179-80.

45. MacAvoy & Robinson I, *supra* note 1, at 19-21.

46. AT&T, 552 F. Supp. at 141-43, 160.

47. *Id.* at 228. See also Bell System Tariff Offerings of Local Distribution Facilities for Use by Other Common Carriers, 46 F.C.C.2d 413, 48 F.C.C.2d 676 (1974), *aff'd sub nom.* Bell Tel. Co. v. FCC, 503 F.2d 1250 (3d Cir. 1974), *cert. denied*, 442 U.S. 1026 (1975).

48. AT&T, 552 F. Supp. at 188-89.

49. This act requires an affirmative finding of "public interest" before entering a consent decree in a government antitrust case. Antitrust Procedures and Penalties (Tunney) Act, 15 U.S.C. §§ 16b-16h (1980). See also Carr, *Some Observations on the Tunney Act*, 52 ANTITRUST L.J. 953, 958 (1983).

50. The parties who were represented before Judge Greene, in addition to the plaintiff and defendants, are listed in AT&T, 552 F. Supp. at 134.

installing telephone equipment.⁵¹ Second, the court ordered AT&T to relinquish the lucrative Yellow Pages operation to the BOCs.⁵² Third, the court adjusted the lines of demarcation initially drawn between "natural monopoly" local functions and ostensibly competitive long-distance operations. Through this realignment, the court shifted to the BOCs about one-fourth of the long-distance operations and associated revenues originally slated to remain with AT&T.⁵³ Fourth, the court imposed a seven-year ban on AT&T's participation in the "electronic publishing" field, and barred the BOCs from entering this field altogether.⁵⁴ A revised plan of reorganization embodying these changes was developed by Justice and AT&T and approved by the court in August 1983.⁵⁵

It is still too early to determine the full impact of Judge Greene's revisions. Three of his four modifications were aimed at increasing BOC revenues by expanding their permissible activities within the traditional boundaries of basic exchange service. The fourth revision was narrowly focused on protecting the nascent electronic publishing industry from competition. Judge Greene's prescriptions imply that the supposedly monopolized local exchange operations require additional revenue sources to make up for lost revenue transfers from the long-distance market. However, substantial restrictions on the permissible activities of the BOCs remain

51. The BOCs are still not permitted to manufacture telephone equipment. *Id.* at 190-93.

52. *Id.* at 188-91, 193-94. In contemporaneous congressional hearings, a number of state regulatory commissioners testified that Yellow Pages profits contributed \$73M, \$57M, \$62M, \$35M, and \$21.4 million to support local rates in New York, New Jersey, Missouri, Massachusetts, and Vermont, respectively. One study estimates that Yellow Pages contributed \$2 billion annually nationwide in revenues generally used to defray the joint and common costs of basic exchange service. See *House Hearings, supra* note 39, pt. 1, at 126 (testimony of Edward Burke, President, National Ass'n of Regulatory Util. Comm'rs); *id.* at 855-57 (testimony of state commissioners Gioia, Barbour, Dority, and McCarren).

53. See *MacAvoy & Robinson I, supra* note 1, at 31-33. AT&T's pre- and post-divestiture market share can be computed in a variety of ways. Domestic toll telephone revenues totalled \$43.5 billion in 1982, of which \$26.7 billion (61%) is attributable to AT&T on a post-divestiture basis, declining from 75% pre-divestiture. Domestic toll revenues include revenues from inter- and intrastate MTS, WATS, and private line services provided to the public by common carriers and the revenue equivalent of the use of private microwave systems. This figure also includes 1982 toll revenues of the independent telephone companies (\$7.6 billion), the Bell Operating Companies (\$6.1 billion), the competitive carriers (\$2.4 billion), and the value of private microwave services (\$660 million). AT&T's post-divestiture share of minutes of use of public switched network services has been calculated at about 58%. See Comments of AT&T at 51-53, *In re Long-Run Regulation of AT&T's Basic Domestic Interstate Services*, FCC Docket No. 83-1147 (filed Apr. 2, 1984). AT&T in 1982 estimated that "approximately half of the intra-state long-distance traffic will remain with the BOCs." *Department of Justice Oversight: U.S. v. AT&T (The Effect on Local Rates): Hearings Before the Senate Comm. on the Judiciary, 97th Cong., 2d Sess., pt. 2, at 177 (1982)* (written responses of AT&T to committee inquiries). Traditionally, inter- and intrastate toll revenues have been roughly equal. Our estimate, therefore, is that about one-fourth of pre-divestiture AT&T's long-distance traffic was transferred to the BOCs as a result of divestiture.

54. *AT&T*, 552 F. Supp. at 180-86. See generally Robinson, *Public Information and 'Electronic Publishing' Services*, 32 ANNENBERG J. COM. 103 (1982).

55. *United States v. Western Elec. Co.*, 569 F. Supp. at 990, 1057.

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after divestiture. In Section III we argue that such restrictions should be lifted so that BOCs can develop the additional sources of revenue necessary to stabilize local rates.

II. Divestiture and Its Immediate Aftermath

The AT&T break-up brought with it a host of undesirable consequences. In this section we examine the effects of the divestiture on the price and quality of service provided to telephone customers. We then examine the present condition of four major actors⁵⁶—AT&T, the BOCs, the Justice Department, and the public—and compare their fortunes to those predicted at the outset had divestiture worked as AT&T and Justice designed it.

A. *Effects on Price and Service*

Divestiture yielded not only a scaled down AT&T, with some 370,000 employees and approximately \$33 billion in 1984 revenues, but also seven regional holding companies (the BOCs), each with about 100,000 employees and about \$10 billion in projected revenues.⁵⁷ The BOCs were vested with ownership of twenty-two telephone operating companies, which provide local telephone service to about eighty-five percent of American residents.⁵⁸ In addition, a new “central services organization,” subsequently named Bell Communications Research, was created and charged with providing the regional companies with a variety of technical and defense-related services.⁵⁹

Proponents of divestiture claimed that it would eliminate “bottlenecks” previously manipulated by AT&T to reduce toll competition and would produce more efficient long-distance pricing and maintain low local telephone rates.⁶⁰ Ensuing efficiency gains were supposed to ensure that long-

56. Obviously, other groups, such as the FCC and the state regulatory agencies, are also major actors. We do not discuss these groups here, however, because their interests in the decree, while substantial, are secondary to those of the groups we examine.

57. AT&T Press Release, Jan. 28, 1985 (AT&T employees and revenues); *MacAvoy & Robinson I*, *supra* note 1, at 20 (BOC employees); STANDARD & POOR'S STOCK REPORTS: NEW YORK STOCK EXCHANGE, Jan. 1985, at 184T, 311, 314, 1706T, 1744T, 2077U, 2362 (BOC revenues).

58. See *MacAvoy & Robinson I*, *supra* note 1, at 3 n.7.

59. *Id.* at 20. See also U.S. DEPT OF COMMERCE, 1984 U.S. INDUSTRIAL OUTLOOK 46-3; 1985 U.S. INDUSTRIAL OUTLOOK 31-4 (AT&T will also provide some of these services until 1987).

60. See *Department of Justice Oversight: U.S. v. AT&T: Hearings Before the Senate Comm. on the Judiciary*, 97th Cong., 1st & 2d Sess., pt. 1, at 68, 133-34 (1982) (testimony of William F. Baxter, Assistant Attorney General for Antitrust, and testimony of Morris Tanenbaum, AT&T Executive Vice-President); *The Proposed Antitrust Settlement of U.S. v. AT&T: Joint Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, and the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 97th Cong., 2d Sess. 13 (1982) (testimony of Charles L. Brown, AT&T Chairman) [hereinafter cited as *Joint Hearings*]; *Hearings*, *supra* note 9, pt. 1, at 7 (testimony of

distance rates would be more closely aligned with the economically optimal marginal cost of providing such service. The discriminatorily high charges AT&T must pay for local access have inhibited the development of competition in the long-distance market. Virtually the only price reduction in long-distance service in the first year of divestiture—a 6.1% across the board cut in interstate rates—came about as a result of FCC, not market, action.⁶¹ Furthermore, any major reduction in the price of toll service would mean a significant loss of revenues that had been diverted toward covering joint toll and local exchange costs. This loss would have required local service price increases for a large number of residential and rural telephone subscribers.

Pending court approval of the reorganization plan, the BOCs filed an unprecedented \$10.8 billion in local rate increase requests with state public utility commissions nationwide (see Table 1). The companies rationalized these requests as necessary to lower revenue shortfalls caused by divestiture.⁶² In fact, the companies had other reasons for the requests, such as the adoption of accelerated depreciation practices authorized earlier by the FCC.⁶³ Divestiture, however, provided the BOCs with a pretext for phasing in these changes and justifying them to the regulators and the public. As a consequence of this approach, the public and most Congressmen came to believe all subsequent price increases for local telephone services were caused by divestiture.⁶⁴

Charles L. Brown, AT&T Chairman).

61. Investigation of Access and Divestiture Related Tariffs, Phase I, FCC Docket No. 83-1145 (Nov. 8, 1984); MTS and WATS Market Structure, Phase I, FCC Docket No. 78-72 (Aug. 22, 1983).

62. See K. GORDON & J. HARING, THE EFFECTS OF HIGHER TELEPHONE PRICES ON UNIVERSAL SERVICE 61 (1984) (FCC Office of Plans and Policy Working Paper).

63. See Amendment of Part 31, 89 F.C.C.2d 1094 (1982), *reconsid.*, 92 F.C.C.2d 864 (1983), *aff'd sub nom.* Virginia State Corp. Comm'n v. FCC, 737 F.2d 388 (4th Cir. 1984); Effects of Federal Decisions on Local Telephone Service, 55 RAD. REG. 2D (P & F) ¶ 295 (1983); K. GORDON & J. HARING, *supra* note 62, at 22-23.

64. Cf. Schwartz, *It's a Bird, It's a Plane—No, a Phone Bill*, N.Y. Times, Jan. 31, 1985, at A23.

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Table 1
Pending Telephone Rate Cases in Ten Populous States

State	Amount Requested (Billions of \$)	Local Share (%)	To be paid from Carrier Access Charges (%)	To be paid from Local Customer Acc. Charges (%)
California	2.915	26.90*	39.40	11.40
New York	1.299	39.15	n/a	n/a
Texas	1.371	n/a	49.20	12.30
Pennsylvania	.379	62.10*	51.60	0.00
Illinois	.312	69.14*	n/a	n/a
Ohio	.305	80.89*	0.00	41.30
Florida	.259	n/a	74.20	25.80
Michigan	.212	76.42*	86.00	14.00
New Jersey	.090	60.00	n/a	n/a
North Carolina	.126	53.22	79.90	20.10
Ten states	7.268	41.03*	44.94	13.58
All states	10.776	45.35*	41.73	12.13

* The revenues used to calculate this figure include only the flat rate portion of basic residential service.

n/a not available

Source: COMMON CARRIER BUREAU, FEDERAL COMMUNICATIONS COMMISSION, ANALYSIS OF THE EFFECTS OF FEDERAL DECISIONS ON LOCAL TELEPHONE SERVICE — (A REPORT AFTER INQUIRY IN CC DOCKET 83-788) Attachment 7 (1983).

The local telephone companies sought to recover a majority of these revenues by imposing new access charges on the long-distance carriers and individual subscribers for use of the basic exchange system. As Table 1 shows, about \$7.3 billion in rate increases were sought in the largest states. Of this amount, forty-one percent was to come from higher local telephone rates, and fifty-nine percent was to be derived from access charges, levied both on toll carriers and on individual phone customers.

In many states, regulators added to the companies' proposed increases in carrier access charges. The states analyzed in Table 2 granted on average 103.9% of the original rate increase requests. The same regulators who approved increased carrier access charges totally rejected all nine requests for the imposition of local end-user access charges. Table 3 shows, moreover, that state regulatory commissions granted only slightly more than half of the requests for higher local telephone rates, allowing on average fifty-three percent of the requested rate increase.

Table 2
Telephone Company Requests for Increases in Access Charges

State	Date	Carrier	End User
percentage of requests granted			
Alabama	10/83	125.00	0.00
Arkansas	3/83	123.29	0.00
California	6/83	98.69	n/r
Colorado	11/83	100.00	n/r
Florida	6/83	103.22[129.11] ^a	n/r[0.00] ^a
Illinois	6/83	105.88	n/r
Massachusetts	10/83	100.00	n/r
Michigan	9/83	101.37	0.00
Nevada	10/83	100.00	n/r
(PUC)	12/83	100.00 ^b	n/r
New York			
(RHC)		82.68n/r	
North Carolina	9/83	128.72	0.00
	3/83	n/r	0.00
Ohio	9/83	89.33	0.00
Tennessee	10.83	n/r[117.82] ^a	n/r
Texas	6/83	108.80	0.00
Virginia	8.83	100.00	n/r
Washington	9.83	107.19	0.00 ^c
West Virginia	8/83	100.00n/r	
Wisconsin	8/83	100.00	n/r
Wyoming	11/83	100.00	n/r
Average		103.90[105.61] ^d	0.00[0.00] ^d

^anumbers in brackets are amended requests.

^bpending permanent approval.

^coriginally granted 100.00%, then rescinded entirely.

^dincluding amended requests

n/r not requested

PUC = Public Utility Commission

RHC = Regional Holding Company

Source: OFFICE OF POLICY ANALYSIS, NATIONAL TELECOMMUNICATIONS INFORMATION AGENCY, U.S. DEPT. OF COMMERCE, SUMMARY OF STATE TELEPHONE REGULATORY DATA table B (1984).

Table 3
General Rate Requests, as Submitted to State Regulatory Agencies

State	Date	Percentage of initial request awarded	Percentage of amended request awarded
Alabama	10/83	64.95	n/amd
	1/84	18.69	25.64
Arkansas	3/83	41.84 ^a	53.28 ^{a,b}
California	7/83	67.42	n/amd
Colorado	11/83	16.56	39.24
Florida	11/82	34.72	40.23
Illinois	8/83	37.34	48.23
Massachusetts	none	n/r	n/r
Michigan	11/82	40.32	n/amd
Nevada	1/84	pndg.	n/amd
New York	8/83	36.13	48.10
North Carolina	1/84	pndg.	n/amd
(PUC)		63.12	41.75 ^c
Ohio	3/83	62.85	63.27
(RHC)			
Tennessee	7/83	14.02	29.92
Texas	6/83	47.87*	61.87*
Vermont	1/84	pndg.	n/amd
Virginia	8/83	85.31*	93.60*
Washington	5/82	50.42	n/amd
West Virginia	8/83	63.44*	68.00*
Wisconsin	8/83	54.32 ^d	54.65 ^d
Wyoming	2/84	pndg.	n/amd
Average		47.02*	51.37*
Average without identifiable access charges and awards		46.55*	53.38*
Average including original unamended requests			52.41*
Above without access charges and awards			53.94*

*includes some access charges.

^aincludes \$11 million the U.S. Court of Appeals ordered the PSC to award for depreciation expenses (otherwise, the award would have been 33.87%).

^bincludes the \$11 million in a above.

^cincludes \$125.7 million request for end user access charges.

^dinterim award

n/r not requested

PUC = Public Utilities Commission

n/amd not amended

RHC = Regional Holding Company

pndg. case still pending.

Source: OFFICE OF POLICY ANALYSIS, NATIONAL TELECOMMUNICATIONS INFORMATION AGENCY, U.S. DEPARTMENT OF COMMERCE, SUMMARY OF STATE TELEPHONE REGULATORY DATA, table A (1984).

In ten of the largest states, residential monthly rates for unlimited local calling service increased an average of thirteen percent for urban customers and twenty-one percent for rural customers (see Table 4). Business customers faced slightly larger rate increases on the same class of service

in both urban and rural areas (see Table 5). Increases of this magnitude, however, were inadequate to cover both the direct costs of local service and the common costs of local and long-distance service previously paid by transfer payments from long-distance revenues in the integrated Bell System. Basic telephone service rates would have had to increase by up to twenty-five percent over the three years following divestiture to compensate for the loss of the long-distance subsidy caused by divestiture.⁶⁵

65. The Office of Policy Analysis and Development of the U.S. Department of Commerce National Telecommunications and Information Administration developed a model on which the following analysis was performed. The difference between two scenarios depicting the post-divestiture and pre-divestiture structures was simulated by phasing out the Subscriber Plant Factor (SPF) method of non-traffic sensitive cost allocation (which was approximately 24% of these costs) in place before divestiture and by not replacing that payment to local companies, causing them to raise local rates. The results were as follows:

Year	Increase in the 1981 Revenue Requirement per local subscribers	
1982	Exchange (%)	5.80
	Exchange (\$/month)	1.35
	Interexchange Non-traffic Sensitive (\$/month)	-1.35
1983	Exchange (%)	18.50
	Exchange (\$/month)	4.31
	Interexchange Non-traffic Sensitive (\$/month)	-4.31
1984	Exchange (%)	32.20
	Exchange (\$/month)	7.48
	Interexchange Non-traffic Sensitive (\$/month)	-7.47
1985	Exchange (%)	47.30
	Exchange (\$/month)	10.98
	Interexchange Non-traffic Sensitive (\$/month)	-10.97
1986	Exchange (%)	64.40
	Exchange (\$/month)	14.93
	Interexchange Non-traffic Sensitive (\$/month)	-14.93

Dollars are current dollars.

1981-1986 Annual Growth in Exchange Revenue Requirement per Local Subscriber due to Divestiture (%/year)	7.90
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Source: OFFICE OF POLICY ANALYSIS AND DEVELOPMENT, NATIONAL TELECOMMUNICATIONS INFORMATION AGENCY, U.S. DEPARTMENT OF COMMERCE, PRELIMINARY ANALYSIS OF BELL SYSTEM REVENUE REQUIREMENTS, scenarios 2.1 and 6.1 (1982)

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Table 4
Changes in Residential Monthly Rates in Ten Populous States

	Urban			Rural		
	1982/83 (\$ per month)	1984/85	Percentage Change	1982/83 (\$ per month)	1984/85	Percentage Change
California	7.72	8.25	6.87	7.72	8.25	6.87
New York	15.65	17.65	12.78	7.75	8.74	12.77
Texas	10.75	11.05	2.79	7.84	8.15	3.82
Illinois	31.84	33.75	6.00	6.78	9.85	45.28
Ohio	12.95	14.95	15.44	12.95	14.95	15.44
Florida	12.30	12.20	-0.81	8.60	8.55	-0.58
Michigan	10.65	11.86	11.36	7.87	8.80	11.82
North Carolina	12.48	18.43	47.68	10.02	15.77	57.39
Massachusetts	10.60	n/a	0.00	7.30	n/a	0.00
Virginia	12.55	16.48	31.31	6.19	9.57	54.60
Average			13.34			20.74

Source: OFFICE OF POLICY ANALYSIS AND DEVELOPMENT, NATIONAL TELECOMMUNICATIONS INFORMATION AGENCY, U.S. DEPARTMENT OF COMMERCE, SUMMARY OF STATE TELEPHONE REGULATORY DATA, Tables D and E (1984).

Table 5
Changes in Business Monthly Rates in Ten Populous States

	Urban			Rural		
	1982/83 (\$ per month)	1984/85	Percentage Change	1982/83 (\$ per month)	1984/85	Percentage Change
California	16.05	17.15	6.85	16.05	17.15	6.85
New York	34.09	38.44	12.76	17.73	19.54	10.21
Texas	27.05	28.25	2.73	18.40	19.75	7.34
Illinois	None	None	—	16.86	21.93	30.07
Ohio	22.85	26.35	15.32	22.85	26.35	15.32
Florida	20.40	20.35	-0.25	20.40	20.35	-0.25
Michigan	None	None	—	17.29	19.34	11.86
North Carolina	33.03	42.98	30.12	26.26	6.21	32.89
Massachusetts	34.20	n/a	0.00	20.30	n/a	0.00
Virginia	36.37	51.43	41.41	14.67	28.25	92.57
Average			13.62			21.19

Source: OFFICE OF POLICY ANALYSIS AND DEVELOPMENT, NATIONAL TELECOMMUNICATIONS INFORMATION AGENCY, U.S. DEPARTMENT OF COMMERCE, SUMMARY OF STATE TELEPHONE REGULATORY DATA, Tables F and G (1984).

Not surprisingly, state regulators, who administered pre-divestiture policy, strongly resisted the local rate increases initiated by the newly divested companies. This resistance reflected the unwillingness of consumers to accept the large and abrupt local price increases associated with divestiture. This grassroots resistance has undercut the new pricing policy.

The impact of the rate increases following divestiture is reflected in

changes in producer price indices for both local and long-distance service (see Table 6). Local service prices increased by substantially more than the rate of inflation. Interstate long-distance rates decreased slightly as a result of FCC regulatory action following divestiture.⁶⁶

Table 6
Producer Price Indices — Selected Telephone Services

	October 1983	January 1984	October 1984
Local Service	164.7	166.9	178.2
Residential*	170.5	173.3	184.4
Business	174.0	176.7	187.5
Toll Service	149.4	149.6	147.3
Intrastate MTS	152.3	152.9	158.9
Interstate MTS	153.4	153.4	145.6
Intrastate WATS	151.2	151.1	148.7
Interstate WATS	127.1	127.1	119.6
Private Lines			
Interstate	156.9	158.4	158.4
Producer Price Index**	245.4	247.0	248.8

(1972 = 100)

* The Producer Price Index for residential local service is a measure of the first transaction between the provider or service and the consumer. Telephone services contained in the Consumer Price Index cover not only local residential service, but also parts of toll service, equipment leasing (such as extension phones), and non-recurring charges (such as installation).

** For total finished goods.

Source: BUREAU OF LABOR STATISTICS, U.S. DEPARTMENT OF LABOR, PRODUCER PRICES AND PRICE INDEXES, Oct. 1983, Jan. 1984, Oct. 1984.

Although telephone rates generally did not fall as predicted, the quality of service manifestly deteriorated, especially in the putatively competitive long-distance market. AT&T reported to the FCC in late January 1984 that orders for private line service were backing up. The normal monthly carry-over swelled from 3,000 to 11,500 unfilled orders, and the wait required to obtain Wide-Area Telephone Service (WATS) lines rose from eleven to twenty-two days.⁶⁷ By August, backlog and delay problems had worsened, with more than 40,000 private line orders in the month-to-month carry-over.⁶⁸ AT&T subsequently explained that rapid intracorporate procedures before divestiture had necessarily been supplanted "by a more formal method" between AT&T and the now independent BOCs,

66. See *supra* note 61.

67. Letter from D.J. Culkin, Corporate Vice-President, AT&T, to Jack D. Smith, Chief, FCC Common Carrier Bureau (Jan. 27, 1984).

68. FEDERAL COMMUNICATIONS COMMISSION, AT&T COMMUNICATIONS 1984 SERVICE ORDER PROVISIONING (Sept. 1984).

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and that service quality consequently suffered.⁶⁹ Moreover, consumer satisfaction with service declined as uncertainty about who was responsible for service quality grew.⁷⁰ Disruption of expanded AT&T offerings subjected the long-distance service market to the shock of zero growth in the face of rising demand.⁷¹ The FCC-mandated decrease in AT&T long-distance prices, when adjusted for service delays and zero growth, probably left the long-distance consumer no better off than before divestiture.

B. *The Impact of Divestiture on Key Participants*

Regulators, politicians, and the public recoiled from divestiture, which, in the name of fostering "competition" and "efficiency," caused prices to increase and seemingly intractable operating and pricing problems to materialize in an industry previously famous for rendering the world's finest telephone service. These developments, while not totally unexpected, went considerably beyond adjustments that divestiture proponents had acknowledged were likely to occur. None of the four major actors involved in the divestiture secured quite as much as expected, while some got considerably less.

AT&T was among the losers. It had relatively clear goals it hoped to achieve through divestiture: freedom from the revenue transfer claims of the BOCs, and the promise of partial, if not total, deregulation of its long-distance service offerings. A year after divestiture, however, AT&T found itself still financially obligated to the BOCs for revenue transfers constituting sixty percent of AT&T's operating expenses, with no indication that it will be able to relinquish its role as the principal financial supporter of local telephone service.⁷² Furthermore, AT&T remains as subject to FCC review processes today as it had been during the previous ten years; virtually none of the structural constraints on AT&T, imposed by the FCC based on the need to regulate monopoly, have been removed.

The mixed results for AT&T are reflected in the modest gains of its shareholders since divestiture. Under the divestiture plan, each ten shares of the old AT&T was converted into ten shares of the new AT&T plus

69. Stuart, *AT&T Sees Backlog Till Early '85*, N.Y. Times, Aug. 22, 1984, at D1, col. 3.

70. See, e.g., Maremont, *Did It Make Sense To Break Up AT&T?*, BUS. WK., Dec. 3, 1984, at 86, 88; Baker, *Wired for Slumber*, N.Y. Times, Oct. 3, 1984, at A27 ("the [telephone] bill has recently become so complicated that you need a doctorate in telephone-bill interpretation to make any sense of it").

71. Romano, *Telecommunications Regulation and the Realities of a Competitive Marketplace*, PUB. UTIL. FORT., Nov. 22, 1984, at 41, 44. See generally O'Reilly, *AT&T: What Was It We Were Trying to Fix?*, FORTUNE, June 11, 1984, at 30; Maremont, *supra* note 70, at 88.

72. See AT&T Emergency Petition, FCC Docket No. 78-72 (filed Feb. 27, 1984). See also C. Brown, Remarks before the New York Society of Security Analysts 7 (Dec. 11, 1984) (on file with the *Yale Journal on Regulation*).

one share in each of the seven regional holding companies.⁷³ A share of the new AT&T stock traded for \$17.88 immediately upon divestiture and traded for \$19.50 one year later.⁷⁴ As shown in Table 7, the total return, including dividends and capital appreciation, on shares of the new AT&T was significantly lower than that on the Dow Jones Utilities Index.

Likewise, the BOCs have not reaped the benefits of divestiture that their managements might have expected. Because court-imposed restrictions on the scope of BOC activity persist, the companies, far from being independent of AT&T, remain heavily dependent on it as the source of revenues needed to maintain local rate subsidies.⁷⁵ Even so, shares of the new regional holding companies fared better than new AT&T shares. These shares returned thirty-two percent at a time when the average return on Dow Jones Utilities was twenty-four percent (see Table 7). Investors evidently perceived the BOCs as possessing sufficient short-term income-generating opportunities to secure coverage of their local service costs.⁷⁶

73. *What Happens to AT&T Stockholders*, U.S. NEWS & WORLD REP., Nov. 28, 1983, at 70.

74. DAILY STOCK PRICE RECORD, NEW YORK STOCK EXCHANGE, Oct.-Dec. 1983, at 24; Oct.-Dec. 1984, at 25.

The stock price of AT&T during the period prior to and after divestiture reflected gains caused by several events: the initial settlement of the DOJ's antitrust suit, the MCI decision, MCI Telecommunications Corp. v. American Telephone & Telegraph Co., 708 F.2d 1081 (7th Cir. 1983), and release of the final divestiture plan and the *Access Charges* decision. In August 1982, when the settlement of the AT&T case was approved by the court, AT&T's stock had a total return of 11.0%. Based on our calculations using the "market model", with a value-weighted index of all the stocks on the NYSE as the market portfolio, we would have expected AT&T to have had a return of only 6.0% at that time. The MCI antitrust case decision was overturned in January 1983, a month with a return of 16.6% in contrast with an expected return of 1.6%. The settlement of the final divestiture plan and the FCC *Access Charges* ruling in August 1983 resulted in a return of 7.8% when the expected return was 0.6%. The announcement of the consent decree was also viewed as good news; the five day return of AT&T around the announcement date was 3.0%, which is significantly larger than the expected return of -1.5%. These significant positive returns suggest that analysts viewed the divestiture-related events which provoked them as favorable to the company.

After divestiture, the total return on new AT&T shares over 1984 was 15.8%. This return includes gains due to events unrelated to the company's performance. In May 1984, AT&T had a return of 10.5% (expected return = -2.5%), which coincided with the FCC decision to allow AT&T to pay lower rates for local hook-ups and AT&T's decision to buy back \$100 million of its own shares. In July 1984, when Judge Greene issued his ruling barring the BOCs from offering long-distance services, AT&T had a return of 4.4% (expected return = .3%).

For a discussion of the "market model", see E. FAMA & M. MILLER, *THE THEORY OF FINANCE* 267-320 (1972).

75. Prior to divestiture, some \$12.5 billion of interstate long-distance revenues were distributed to the nation's 1500 local telephone companies, H.R. REP. NO. 479, 98th Cong., 1st Sess. 21 (1983). The traditional division of revenue arrangements continued for some time after divestiture, but was converted late in 1984 to contracts between AT&T and the BOCs. For a discussion of some of the plans intended to replace this revenue stream, see *infra* text accompanying notes 84-96.

76. The higher than average return was a result of the increased stock prices of the regional holding companies; the actual 1984 dividend returns of these companies fell short of those of the Dow Jones Utilities, as shown in Table 7.

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Table 7
1984 Telephone Company Stock Performance
(per share rate of return)

	Dividend Yield (%)	Price Change (%)	Total Return (%)
AT&T	6.71	9.09	15.80
Regional Holding Companies			
Ameritech	9.30	18.99	28.29
Bell Atlantic	9.81	23.18	32.99
Bellsouth	9.26	21.07	30.33
NYNEX	9.76	20.73	30.49
Pacific Telesis	9.73	24.10	33.83
Southwestern Bell Corp.	9.51	20.17	29.68
USWest	9.71	26.74	36.45
Dow Jones Utilities	10.48	13.41	23.89

Source: DAILY STOCK PRICE RECORD, NEW YORK STOCK EXCHANGE, Oct.-Dec. 1983, at 1, 21, 24, 53, 54, 320, 335, 409, 456; Oct.-Dec. 1984, at 1, 22, 25, 53, 54, 319, 335, 410, 457.

The strong stock market performance of the BOCs and the concomitant weak performance of AT&T is not consistent with some earlier forecasts: most analysts, including the authors, saw a new, leaner AT&T surging forward as a major growth company while the BOCs languished as wire and cable connection providers with typical or below average public utility returns.⁷⁷ These forecasts were based on the assumption that revenue transfers from long-distance to local service would be eliminated, a development regulators have been unwilling to permit.

It is unclear whether the Department of Justice has achieved its original goals through divestiture. The DOJ, in proposing divestiture, said that it was seeking to accelerate competition and deregulation throughout the telecommunications industry. Neither has occurred to date. Although it is difficult to evaluate whether the antitrust policies pursued by the DOJ will in the long run produce a competitive, healthy telephone industry, the first year of divestiture showed remarkably little progress toward this end. In fact, the Antitrust Division has found itself serving increasingly as a regulator of the BOCs, and together with the judgment court, as ultimate arbiter of developments in the telecommunications industry.⁷⁸

The public was promised more efficient pricing and expanded choice of telephone services from divestiture. It has instead received price increases across the board, with the exception of the FCC-mandated cut in AT&T

77. See *MacAvoy & Robinson I*, *supra* note 1, at 31-39; see also Schwartz, *Stacked Competition and Phony Deregulation for AT&T: The Proposed Telecommunications Competition and Deregulation Act of 1981*, 3 COMM/ENT 411 (1981).

78. See *infra* text accompanying note 126; see also *United States v. Western Electric Co.*, 592 F. Supp. 846 (D.D.C. 1984).

prices, and considerable service disruption. Consumers who rarely, if ever, gave any thought to telephone matters have, as a result, brought increased pressure to bear on the Congress and, in the process, heightened the level of direct government intervention in the telecommunications market.⁷⁹

C. *Understanding What Went Wrong*

Divestiture, which was supposed to benefit both consumers and AT&T, has in the short run benefited neither. This failure is the result of miscalculations by the judgment court, AT&T, and the DOJ regarding pricing in the telephone industry. These parties failed to realize that simply altering ownership by divestiture, without addressing the fundamentals of pricing policy, was almost certain not to yield effective competition in the long-distance telephone market. Focusing solely on ownership, they ignored the strong commitment of state regulators to maintaining low local rates with revenues received from long-distance service.

In the first year the decree was in effect, state regulators, and the public they served, resisted the local rate increases required by the new structure of the telecommunications industry. These regulators, still working for the pre-divestiture policy of low local rates, continued to divert AT&T's long-distance revenues to cover costs that otherwise would have required rate increases. Such diversion prevented long-distance rates from falling and thus to some extent prevented AT&T from operating as an effective competitor in the rapidly developing long-distance market.

The DOJ misapprehended the reasons why local telephone companies discriminated between AT&T and the OCCs when providing local exchange access and call distribution. That discrimination resulted from straightforward revenue considerations—the higher charges that AT&T paid to the operating companies—rather than any invidious anti-competitive scheme. Having incorrectly labeled the discriminatory conduct as predatory, the DOJ failed to recognize the conflict between the resulting revenue flows implied by the restructuring of AT&T and those required by the industry's traditional regulatory pricing goals.

The goals of AT&T, Justice, and the judgment court were blocked by too narrow a view of the relevant factors. Opening long-distance markets to competitive entry destroyed the old regulatory framework in which long-distance operations supported local service prior to the decree. Divestiture served to balkanize the telephone industry at a time when the forces of technology and competition were blurring traditional product and service lines. Following divestiture the telecommunications industry

79. See *infra* text accompanying notes 88-89.

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has required almost constant regulatory oversight by the judgment court. This oversight is itself a form of government intervention, and is inimical to the sought-after "competitive" and "deregulated" telephone industry which divestiture was supposed to allow.

III. Necessary Steps to Improve Local and Long-Distance Telephone Operations

Breaking up AT&T was a mistake. To undertake such a disruptive reformation of market structure without fully addressing industry pricing policies was a failure of process. But that mistake cannot be undone. It is unrealistic at this point to contemplate reconstitution of a single, integrated Bell Telephone System. The focus, therefore, must be on rectifying the more egregious problems resulting from divestiture.

Many of the problems resulting from divestiture are amenable to improvement, which can be achieved by focusing on a set of consistent policy goals. These goals should include: (1) stabilizing local telephone rates while sustaining the local operating companies, (2) removing inefficient constraints on the activities of the operating companies, (3) establishing competition for local service where economically justified, and (4) deregulating the new AT&T. But these are stopgap measures; in the long-run, Congressional action is needed in order to implement a comprehensive telecommunications plan. Only through the legislative process can a workable compromise among competing institutional objectives be achieved.

A. *Seeking to Stabilize Local Telephone Rates*

The price of local residential telephone service remains a topic of overriding political sensitivity. Any attempt to alleviate the problems resulting from divestiture must therefore take into account the possibility of congressional intervention. Two parallel initiatives are needed in order to stabilize local rates while sustaining the revenue generating capacities of the BOCs. First, access charges paid by AT&T and the OCCs must be equalized to reduce AT&T's incentive to bypass local networks. Second, the BOCs should be permitted to develop non-local revenue sources independent of AT&T and the OCCs.

Divestiture jeopardized the flow of funds which had sustained local operations while local companies charged artificially low local rates. Immediately prior to divestiture, the Bell System had assets in the range of \$130 billion.⁸⁰ Between two-thirds and three-quarters of those assets were

80. This number represents telephone plant assets net of accumulated depreciation. AMERICAN TELEPHONE & TELEGRAPH CO., 1983 ANNUAL REPORT, Financial Section, 8, 26-28 (1984); see also *MacAvoy & Robinson I*, *supra* note 1, at 20.

sunk in local telephone plant, but local service prices generated less than half of the annual revenue requirement associated with that local investment.⁸¹ The balance of the annual revenue requirement was recovered through "contributions" from inter- and intrastate toll operations.⁸² After divestiture these contributions continued in the form of differential access charges paid by AT&T and the OCCs to the BOCs. However, such access charges represent an unstable source of revenues because common carriers can bypass local networks and avoid the charges.⁸³

The FCC's first *Access Charges* decision contained a proposal for replacing the potential revenue shortfall confronting the BOCs.⁸⁴ Under this plan, a four dollar to six dollar end-user access charge (per line per month) was to be levied on all telephone subscribers.⁸⁵ The FCC plan would have shifted much of the burden for covering common costs away from the long distance carriers (and major business users who constitute their principal customers) to local subscribers. This plan was not intended to be a source of widespread price increases.⁸⁶ But coming on the heels of the substantial local rate increase requests already filed by the BOCs, end-user access charges were seen by the public as simply another effort to increase consumer telephone prices.⁸⁷

The House of Representatives responded to public pressure by passing legislation prohibiting such end-user access charges; the Senate nearly passed a similar measure, delaying the imposition of such charges, in early

81. See *MacAvoy & Robinson I*, *supra* note 1 at 19-21; AMERICAN TELEPHONE & TELEGRAPH, *supra* note 80, Financial Section, at 2, 26.

82. See, e.g., *United States v. Western Elec. Co.*, 569 F. Supp. at 1091.

83. Bypass is a process through which a telephone user connects directly to a long-distance company or to the location being called (via a private line) without going through the BOC. This practice is only economical for very heavy long-distance users, so the BOC is deprived of a significant amount of revenue which it would have received by transporting the call from its network to the network of the long-distance carrier. Examples of bypass technologies include roof-top antennae, fiber-optic two-way cable and cellular mobile radio link-ups to the inter-exchange facilities of a common carrier. See N.Y. Times, Mar. 11, 1985, at D1; Ordovery & Willig, *Local Telephone Pricing in a Competitive Environment*, in TELECOMMUNICATIONS REGULATION TODAY AND TOMORROW 267, 270 (E. Noam ed. 1983). See also Weber, *AT&T is Shaping Local Bypass Aid*, BUS. WK., Jan. 9, 1985, at 1, col. 3.

84. *In re MTS and WATS Market Structure (Access Charge Order)*, 93 F.C.C.2d 241 (1983), 53 RAD. REG. 2D (P & F) 479, *modified on reconsid.*, 48 Fed. Reg. 42,984, 54 RAD. REG. 2D (P & F) 615 (1983), *further modified on reconsid.* 49 Fed. Reg. 7810, 55 RAD. REG. 2D (P & F) 785 (1984), *aff'd in part, remanded in part sub nom.* National Ass'n of Regulatory Utility Comm'rs v. FCC, 737 F.2d 1095 (D.C. Cir. 1984), *cert. denied*, 53 U.S.L.W. 3599 (U.S. Feb. 19, 1985).

85. 48 Fed. Reg. at 42,986-90, 53 RAD. REG. 2D (P & F) at 516-17, 560; 54 RAD. REG. 2D (P & F) at 619-26.

86. *Cf.* Memorandum Opinion and Order, 48 Fed. Reg. 42,984, 42,986; 54 RAD. REG. 2D (P & F) 615, 619-20 (1983); *Universal Telephone Service Preservation Act of 1983: Joint Hearings Before the Senate Comm. on Commerce, Science, and Transportation and the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 63 (1983) (testimony of FCC Chairman Mark Fowler).

87. See, e.g., 129 CONG. REC. H9662 (daily ed. Nov. 10, 1983) (remarks of Rep. Gore).

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1984.⁸⁸ Faced with this congressional reaction, the FCC adopted a revised access plan calling for a maximum end-user charge of \$2.35 phased in over a two-year period commencing in June 1985.⁸⁹ Each dollar in end-user charges yields approximately \$1 billion annually.⁹⁰ The revised FCC plan will produce \$2.40 billion in annual revenues for local telephone companies while reducing the amount paid to them by toll carriers by a like amount. Because the annual revenue required to cover joint and common costs is between \$10 and \$13 billion,⁹¹ local exchange companies will still require substantial subsidy payments.

The settlement decree required that common carrier access charges be "nondiscriminatory" and "cost-based."⁹² However, under the present system, AT&T continues to pay charges that are more than twice as large as those paid by the OCCs.⁹³ While it is true that AT&T receives premium "Feature Group D" service, while its competitors receive inferior "Feature Group B" service,⁹⁴ the superior service it currently receives does not justify the substantial and disproportionate cost burden AT&T must bear.⁹⁵ In addition, it is unclear whether the deep discount now enjoyed by the OCCs will disappear once "equal interconnection," as defined by the consent decree, is achieved. The OCCs may argue that an access charge differential should be maintained until full, universal interconnection is established. The decree explicitly provides for waivers in the case of small central exchange offices, so that universal interconnection may not be achieved before the turn of the century.⁹⁶

88. H.R. 4102, 98th Cong., 1st Sess., 129 CONG. REC. H9686 (daily ed. Nov. 10, 1983), which would have prohibited end-user access charges, passed the House on Nov. 10, 1983. See 129 CONG. REC. H9701 (daily ed.). In view of the House action, the FCC on Jan., 25, 1984, voted to postpone and reconsider its *Access Charges* decision. Memorandum Opinion & Order on Further Reconsideration, 49 Fed. Reg. 7810 (1984). The following day, the Senate narrowly (44 to 40) passed a resolution tabling legislation similar to the House measure then pending. 130 CONG. REC. S211 (daily ed. Jan. 26, 1984).

89. See Recommended Decision & Order by the Federal-State Joint Board, MTS and WATS Market Structure, FCC Docket No. 78-72 (Nov. 23, 1982), *adopted*, FCC Mimeo No. 84-637, 50 Fed. Reg. 940 (1985).

90. Authors' estimate.

91. Authors' estimate.

92. See *United States v. AT&T*, 552 F. Supp. at 233. See also *United States v. Western Elec. Co.*, 569 F. Supp. at 1067.

93. The actual discount for OCCs is now 55%. CBO STUDY, *supra* note 15, at 54.

94. For a description of the different types of "Feature Group" services, see TELEFOCUS, Jan. 1985, at 7.

95. AT&T has maintained, for example, that simply because it purchases one category of local exchange service at one end of a circuit, it need not necessarily purchase the same category at the other end of the circuit. In other words, it can use the costly "Feature Group D" service at an originating end and the less expensive "Feature Group B" service at the terminating end. As the firm argued in 1984 to the FCC, "The [BOCs] cannot rely on claimed differences in originating access as justification for charging AT&T over twice what other carriers are charged for the distinct, and concededly identical, terminating access element." See TELECOM. REP., Sept. 10, 1984, at 4.

96. The decree ostensibly covers all BOC central offices, but provides for waivers in the case of

If such discrimination in access charges continues, AT&T is likely to seek less costly alternatives to continued use of BOC local exchange systems.⁹⁷ The advantages enjoyed by the OCCs under the prevailing system are largely responsible for the loss in AT&T's market share and their rapid growth. Between 1982 and 1983, AT&T revenues increased from \$24.98 billion to \$26.13 billion, but its competitors, with their share of the market expanding from 4.8% to 8.4%, increased revenues from \$2.4 billion to \$3.82 billion.⁹⁸ AT&T can stabilize its market share only by pricing toll offerings closer to cost. This pricing change cannot occur if AT&T continues to bear the major burden of supporting local rates.

A major threat to BOC revenues exists because AT&T and the OCCs can avoid access charges by establishing direct links to customers.⁹⁹ The concentration of demand for toll calling in a few large business users

offices without stored program switches or serving fewer than 10,000 access lines. *United States v. AT&T*, 552 F. Supp. at 233. It is estimated that about 60% of central offices (serving about 40% of subscribers) fall into this category. The recent GTE-Sprint antitrust consent decree applies an equal interconnection obligation on GTE telephone companies. See *United States v. GTE Corp.*, 1984-2 Trade Cas. (CCH) ¶ 66,355 (D.D.C. Jan. 11, 1985). No such obligation applies to other telephone companies.

97. One option open to AT&T is to select the cheaper "Feature Group B" interconnection service which its competitors use. On Aug. 15, 1984, AT&T petitioned the Texas Public Utility Commission requesting that it order Southwestern Bell to provide AT&T with this service, which AT&T maintained was identical to the "Feature Group D" AT&T currently employs. AT&T maintained the swap would save it about \$180 million annually in reduced local exchange costs. TELECOM. REP., Aug. 20, 1984, at 1. Southwestern Bell countered by seeking an FCC order directing AT&T to continue to subscribe to the premium local interconnection service. TELECOM. REP., Aug. 27, 1984, at 3. AT&T ultimately withdrew the proposal. This controversy indicates the increasing tension between AT&T and the BOCs, and the growing reluctance of the former to serve as the chief financial support for the latter.

98. Reply Comments of AT&T, Appendix B, Schedule 1 at 182, *In re Long Run Regulation of AT&T's Basic Domestic Interstate Services*, FCC Docket No. 83-1147 (filed June 4, 1984).

99. Two types of bypass may raise problems: bypass of the interexchange system and bypass of related services, such as billing. At present, AT&T is exploring alternative billing arrangements, evidently because the charges of the BOCs are considered excessive. AT&T, for example, has undertaken a direct billing experiment in Minnesota and may follow the same tack in other states. See TELECOM. REP., Nov. 26, 1984, at 8-9. Initially, parties complained that permitting AT&T and the BOCs to engage in joint billing was anticompetitive and would afford AT&T a cost advantage. See *United States v. Western Elec. Co.*, 569 F. Supp. at 198-99. Billing costs are a major AT&T cost factor, particularly given the large volume of low volume toll customers the firm now serves. As AT&T has stated:

This can be illustrated by the economics of a customer who makes one interstate long distance call in a month. Such a customer typically speaks for seven minutes and generates about \$1.70 in revenues. AT&T, however, incurs \$2.80 in costs as a result of that one call. Fully 85 percent of these costs are the externally imposed costs of billing and access charges. An average of 85 cents of the costs reflect costs of bill rendering and account administration, fixed costs that are incurred whether the customer makes one or many calls. AT&T is able to recover these fixed costs only from higher-volume customers who generate sufficient revenues to cover these 'up front' costs.

Comments of AT&T at 47 & n.1, *In re Long-Run Regulation of AT&T's Basic Domestic Interstate Services*, FCC Docket No. 83-1147 (Apr. 2, 1984). The establishment of local distribution facilities independent of the BOCs is another means by which AT&T could potentially reduce its operating costs.

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makes bypass of local distribution facilities profitable on an individual basis when access charges are high.¹⁰⁰ Given the disproportionately large contributions to local rates associated with AT&T's toll traffic, even relatively limited bypass by AT&T could mean a substantial reduction in local telephone revenues. A major reduction in BOC revenues would force state regulators to approve local subscriber price increases if the BOCs are to remain viable over the long-run.

The FCC, with the support of the Justice Department, should direct that the present access charge discount enjoyed by the OCCs be eliminated once equal interconnection, as defined by the consent decree, is achieved. Furthermore, as soon as each BOC central office is converted to equal access, the carrier access charges associated with that office should be the same for all toll carriers.

The FCC should also take steps to ensure that the superior categories of interconnection which the decree requires are, in fact, used by the competitive carriers. The decree explicitly gives the OCCs the option of continuing to use inferior grades of interconnection and paying lower access charges.¹⁰¹ These carriers have demonstrated that it is possible to make considerable profits without equal interconnection, because after adjusting for quality differentials their prices are still lower than those of AT&T. Given that the decree requires the BOCs to make substantial, costly alterations in their plant to accommodate equal interconnection,¹⁰² access charges should be set at levels which reflect only the added costs of higher quality connections. If they are not set at this level, and the OCCs are free not to purchase the expanded interconnection services, an obvious potential for underutilized local plant exists which would exacerbate the BOC's already poor prospects for generating revenue. If equal interconnection is the means of ensuring effective competition in the long-distance communications market, either price differentials among carriers must be cost-based or the option to purchase inferior local interconnection services must be eliminated.

It is essential that both the access charge differentials and the base levels be set correctly. A rational pricing system, involving cost-based access charges for the use of local exchange networks, is necessary to remove

100. See G. BROCK, *BYPASS OF THE LOCAL EXCHANGE: A QUANTITATIVE ASSESSMENT* 37 (1984) (FCC Office of Plans & Policy Working Paper Series No. 12).

101. See *United States v. AT&T*, 552 F. Supp. at 233.

102. In July 1983, AT&T estimated that it would cost the BOCs \$73 million to reconfigure their networks and \$2.47 billion to provide equal access. See *United States v. Western Elec.*, 569 F. Supp. at 1066. The decree provides that AT&T must reimburse the BOCs for whatever costs the BOCs cannot otherwise recover, but the preliminary accounting in this regard is not to take place until January 1, 1989. Equal access, however, is to be provided in virtually all offices by September 1986. See *United States v. AT&T*, 552 F. Supp. at 233.

the incentive for common carriers to bypass these networks. But the charges that will be imposed on common carriers under the FCC's revised access charge plan are not cost-based. For example, the FCC plan envisions that a portion of the charges paid by toll carriers will be distributed as subsidy payments to rural telephone companies in order to minimize local rate shocks.¹⁰³ Such subsidy payments may effectuate a regulatory policy to keep prices low, but they do not qualify as costs under the "cost-based" requirement contained in the consent decree.¹⁰⁴

Access charges which are not cost-based represent an unstable source of revenues, except in areas where scale economies are so great as to prohibit bypass. High access charges will encourage economically inefficient investments by the common carriers. Carriers will establish bypass connections because of high access charges even when local networks could provide connections at a lower marginal cost.

103. Under the FCC's "High Cost Fund" proposal, long-distance carriers would pay, in effect, a surcharge on the local exchange access charges they pay. The funds would be pooled and then disbursed to telephone companies whose costs exceed designated limits. See MTS-WATS Market Structure, FCC Docket No. 78-72; Joint Board Recommendations, 49 Fed. Reg. 48,325, 57 RAD. REG. 2D (P & F) 267, 284 (released Nov. 23, 1984) (to be codified at 47 C.F.R. pt. 67). Under this latest plan about \$427 million would have been collected from the long-distance carriers, and disbursed almost exclusively to small, independent telephone companies. 49 Fed. Reg. at 48,335. The FCC adopted the Joint Board's November recommendations in December. FCC Mimeo 84-637, 50 Fed. Reg. 939 (1985) (to be codified at 47 C.F.R. pts. 67, 69).

104. What constitutes "cost-based" pricing under the antitrust laws and under FCC regulation is not the same. Simply because the charges placed on toll carriers are approved by the FCC under the 1934 Communications Act does not make those charges "cost-based" for the purpose of enforcing the consent decree. There is, of course, an elaborate literature regarding "cost" which has developed under the Robinson-Patman Act and related laws. See, e.g., ANTITRUST DEVELOPMENTS 1955-1968, 1968 A.B.A. SEC. ANTITRUST L. REP. 131; P. AREEDA, 1982 ANTITRUST LAW 153 (Supp. 1982). The judgment court has stated it does not wish to "precipitate a conflict between the agency's [FCC's] responsibilities and a court judgment." *United States v. Western Elec. Co.*, 569 F. Supp. at 656.

What cost standard will apply remains unclear. See Lavey & Carlton, *supra* note 7, at 1507 & n.58. The possibility of some conflict was raised in correspondence early in 1983 between Justice and the FCC. TELECOM. REP., Jan. 24, 1983, at 3. Recently, the FCC stated on this issue that:

Simply put, the tension that is poised between the Commission's existing access charge rules for Dedicated and Common Transport and the provisions of the *MFJ* with respect to equal charges per unit of traffic delivered or received, is whether the Commission should impose its cost based pricing requirements upon interexchange carriers that access the Bell Operating Companies prior to the expiration date of the equal charges per unit of traffic delivered or received provision of the *Modification of Final Judgment* (552 F. Supp. at 233-34).

Although we believe that our Dedicated and Common Transport access charges rules are probably the correct long term solution we also recognize that the "equal charges" provision of the *MFJ* is an integral component of the provisions that were contemplated by the parties thereto, as well as by the reviewing Court. While the applicable provision of the Communications Act are not, as a matter of law, displaced either by the *MFJ* or the U.S. District Court's determinations with respect thereto, we believe that it is desirable to afford parties an opportunity to submit comments.

MTS-WATS Market Structure, Phase I, FCC Docket No. 78-72, FCC Mimeo 84-604, 8-9, 50 Fed. Reg. 939 (1985).

The issue of which regime governs—that of the FCC or the consent decree—most likely will arise when toll carriers, such as AT&T, challenge local carrier charges, such as AT&T has already tentatively done in Texas. See *supra* note 97.

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While cost-based access charges are being established, additional sources of BOC revenue should be developed to help stabilize local rates. As discussed in the next section, the BOCs can develop alternative revenue sources if they are permitted to diversify into other markets, including the long-distance services market. Until cost-based pricing is established, limited restrictions on common carrier bypass of local networks may be required.¹⁰⁵

B. *Removing Constraints on the Permissible Activities of the Operating Companies*

The judgment court has asserted that the BOCs are most properly confined to providing local telephone services. Under the decree, the BOCs were excluded from the interstate long-distance communications market and from most other competitive markets.¹⁰⁶ The court rejected recent proposals by the BOCs to offer new, unregulated services domestically and to market products overseas.¹⁰⁷ It has defended its "containment" policies by arguing that BOC diversification could lead to predatory pricing and cross-subsidization, place burdens on basic service, and distract BOC management from fulfilling its obligation to provide equal interconnection as required by the court decree.¹⁰⁸

The decree provided that the BOCs may diversify into new geographic areas and product lines upon a showing that there will be no anticompetitive effect on the "target market" involved.¹⁰⁹ However, the July 1984 decision of the judgment court established an elaborate waiver review process for approval of new BOC activities.¹¹⁰ One BOC has appealed this

105. One alternative to restricting bypass while retaining non-cost-based access charges would be to set access charges closer to cost for interconnections to high volume end-users. See Ordovery & Willig, *supra* note 83, at 281 (suggesting that it might be feasible to design access charges that declined per unit as customer usage increases).

106. *United States v. AT&T*, 552 F.Supp. at 188-89.

107. See *United States v. Western Elec. Co.*, 592 F. Supp. 846, 870-72 (D.D.C. 1984).

108. As the Department of Justice contended in comments before Judge Greene:

The existence of more profitable ventures within the holding company family also could result in a rational holding company taking increased earnings out of the BOCs and investing in the more profitable unregulated ventures. In such a case, the existence of businesses established under Section VIII (C) waivers could result in reduced investment in the BOCs as they became "cash cows" to be milked in order to support unrelated activities. At the same time, new business ventures have the potential to divert the attention of senior regional management from the provision of regulated telephone service. The quality of regulated service could thus diminish.

Memorandum of the United States Concerning Removal of Line of Business Restrictions Pursuant to Section VIII(C) and Response to Motions of Bell Atlantic and BellSouth at 10, *United States v. AT&T*, No. 82-0192, (D.D.C. filed Feb. 21, 1984). See also *Western Elec. Co.*, 1984-2 Trade Cas. (CCH) ¶ 66,121 at 66,275.

109. *United States v. AT&T*, 552 F. Supp. at 225.

110. See *Western Elec. Co.*, 592 F. Supp. 846, 873-74 (D.D.C. 1984).

decision on the grounds that it is tantamount to a unilateral modification of the decree. The company contends that the court's speculations regarding cross-subsidies, ratepayer burdens, delays, and the like are without factual foundation.¹¹¹

The practical effect of the court's protectionist approach is to shield interstate telecommunications companies, including AT&T, from their most likely potential competitors, the BOCs. Although the judgment court, after many months of delay, ultimately approved several diversification proposals filed by the BOCs,¹¹² the burdensome regulatory process has prevented the BOCs from responding rapidly to changing market conditions and new customer demands.¹¹³

The court-imposed restrictions on the permissible activities of the BOCs are difficult to reconcile with the consent decree's stated purpose of accelerating competition. Once equal interconnection is accomplished, existing constraints on further diversification of the BOCs into toll markets should be eliminated. The most lucrative telecommunications market today is the long-distance services market, in which the BOCs already have a substantial presence because they provide about half of total intrastate toll service.¹¹⁴ Of course, the profitability of the toll market could decline, given the substantial amount of new capacity now being added by AT&T and the OCCs. It could also fall if AT&T were permitted to price its services more in line with its costs. Despite these possibilities, the BOCs should be allowed to enter the long distance market. Any profits the BOCs derive from such services will help maintain low local rates.

Even prior to equal interconnection, there is no sound public policy reason for prohibiting the BOCs from providing toll services between local markets in which they do not also have local telephone operations. For example, Pacific Telesis (which provides local service in California and Nevada) could compete in the New York-to-Washington toll market. Indeed, prohibiting such competition in noncontiguous markets has a dis-

111. See Brief of Appellant US West, Inc., at 40, *United States v. Western Elec. Co.*, No. 84-5687 (D.C. Cir. filed Dec. 23, 1984).

112. The diversification proposals were referred to the DOJ with "safeguards and conditions". See *United States v. AT&T*, 592 F. Supp. 846, 868, 873 (D.D.C. 1984).

113. See Letter from Secretary of Commerce Malcolm Baldrige to Solicitor General H. Rex Lee (Apr. 2, 1984); Letter from Assistant Commerce Secretary David J. Markey to Assistant Attorney General for Antitrust J. Paul McGrath (Oct. 1, 1984) (letters on file with the *Yale Journal on Regulation*).

114. See *supra* note 53. Under the consent decree, the BOCs are permitted to transport telephone traffic only between telephones located within a Local Access and Transport Area (LATA). BOCs also provide access to inter-LATA long-distance carriers for telephone customers within a LATA. The local Bell System is divided into 161 LATAs of varying size. The definition of a long-distance call is determined by state regulatory agencies. Thus, intra-LATA calls handled by the BOCs include both local and long-distance calls. *United States v. Western Elec. Co.*, 569 F. Supp. 990, 993-95 (D.D.C. 1983) (approving LATAs). See also *MacAvoy & Robinson I*, *supra* note 1, at 17-18.

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tinctly anti-competitive effect, because it shields AT&T and the other toll carriers from both actual and potential competition.

The arguments which have been used to support regulatory constraints on BOC activities make little sense. The notion that local telephone exchange operations somehow enable BOCs to establish illicit cross-subsidies or engage in predatory pricing is difficult, perhaps impossible, to support with facts. There is little evidence that basic exchange telephone rates in the United States have been excessive by any measure. Precisely the opposite is demonstrated by a study discussed in our first article.¹¹⁵ Local telephone operations, standing alone, are by no reasonable measure a prime potential source of funds for cross-subsidies; we suspect that few BOCs today are even earning their allowed rates of return on their local investments.

Constraining BOC activities can only lessen the likelihood that the AT&T divestiture will yield tangible public dividends. One plausible, if not anticipated, rationale for divestiture was that it created seven new potential competitors to AT&T. If this potential is now suppressed, policy-makers may find it increasingly difficult to explain to a skeptical public why divestiture was necessary. If competition is desirable, all actual and potential competitors should be afforded an opportunity to compete. The geographic and product line constraints on the BOCs, therefore, should be eliminated.

C. *Establishing Competition for Local Service Where Economically Justified*

Underlying the consent decree was a misconception about the competitive natures of the long-distance and local service markets. The long-distance market was viewed as competitive, while it was assumed that scale economies associated with the local service market rendered it a "natural monopoly." In fact, at the time of the settlement, the long-distance service sector hardly conformed with most notions of a competitive marketplace, and local telephone service did not constitute a "natural monopoly."¹¹⁶ Competition existed at the local level between the BOCs and

115. *MacAvoy & Robinson I*, *supra* note 1, at 9 n.21 (study suggests that an unregulated telephone company would have charged local rates that were twice those charged by AT&T in order to compensate for rising operating costs).

116. *Wash. Post*, July 17, 1984, at 20, col. 3. See also Eldor & Sudit, *Alternative Specifications of Returns to Scale and Joint Estimation of Factor Demand and Production Functions in Telecommunications*, 18 *REV. BUS. & ECON. RESEARCH* 15 (1982); Raj & Vinod, *Bell System Scale Economies Estimated from a Random Coefficients Model*, 34 *J. ECON. & BUS.* 247 (1982).

other service providers. This competition, on the fringe of the traditional switched-voice telephone business, has continued to grow.¹¹⁷

The level and intensity of competition among local distribution systems are a function of the services demanded by major business users. Due to substantial concentration in the demand for both long-distance and local private line service at many business locations, new service offerings which bypass local distribution networks are economically feasible.¹¹⁸ Although the consent decree prohibited the BOCs from entering the long-distance market, it placed no constraints on AT&T entering the local traffic distribution field.¹¹⁹ The decree also did not limit the ability of firms, such as cable television companies, to provide local facilities for certain specialized purposes such as high-speed data communications.¹²⁰

In general, competition in local service markets should be encouraged. The present Bell local telephone plant cannot efficiently handle certain classes of message traffic, including some classes of data communications. Local telephone plant, for example, is typically engineered to handle messages averaging two minutes in duration. Data communications, however, usually involve very short messages averaging a few seconds, such as those associated with credit card verifications, or very long messages, such as those associated with remote access data processing and the retrieval of information from computerized data banks. Accommodating such traffic on local telephone plant requires additional switches, because switches are used more often or are tied up for longer periods of time. Switching costs ordinarily constitute about seventy percent of overall circuit costs; channeling such classes of data traffic across the conventional local plant could significantly increase operating costs.

Inefficient duplication of local exchange functions can be avoided if local telephone companies are permitted to price their distribution services in line with marginal costs. Marginal cost pricing would eliminate the incentive for firms to enter select local exchange markets to skim away profits which the BOCs currently generate to subsidize local telephone

117. See Pepper, *Competition in Local Distribution: The Cable Television Industry*, in UNDERSTANDING NEW MEDIA: TRENDS AND ISSUES IN ELECTRONIC DISTRIBUTION OF INFORMATION 147 (B. Compaine ed. 1984).

118. See, e.g., G. BROCK, BYPASS OF THE LOCAL EXCHANGE: A QUANTITATIVE ASSESSMENT, *supra* note 100.

119. *United States v. AT&T*, 552 F. Supp. 131, 171-73 (D.D.C. 1982).

120. The matter of actual and potential cable television competition with the telephone industry arose recently in conjunction with passage of the Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (to be codified at 47 U.S.C. §§ 601-639). The bill did not resolve all of the disputes regarding cable television competition with traditional telephone offerings, though it did address certain regulatory jurisdictional issues. See H.R. REP. NO. 934, 98th Cong., 2d Sess. 27-29 (1984), *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 4655, 4664-65.

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rates. The FCC's revised access charge plan, however, fails to facilitate such cost-based pricing.

Once marginal cost pricing is established, even limited constraints on the development of local distribution options should be unnecessary. If competitive distribution systems can provide certain services at a lower cost than that associated with conventional telephone plant, such systems should be developed. Neither the BOCs nor the state regulatory agencies, however, is likely to acquiesce in the expansion of local service options absent some assurance that such an action will not jeopardize the primary source of BOC revenues. The most promising way to alter the views of BOC management and state regulators is to reduce the line-of-business restrictions on diversification by the BOCs contemporaneously with the expansion of local service competition. If the BOCs can generate revenues from new business ventures they will have less need for protection from competition in local markets.

D. *Deregulating the "New" AT&T*

Speaking after the announcement of the AT&T settlement, William F. Baxter, the principal government architect of the consent decree, stated that divestiture would permit total deregulation of a very important portion of the telecommunications industry: namely, the long-distance operations of the new AT&T.¹²¹ He made the same argument in defending the settlement before a congressional committee, when he declared that "I foresee in the near future the potential for substantial deregulation of the Long Lines function."¹²²

There is little doubt that the promise of government support for future deregulation played a major role in inducing AT&T to agree to divestiture. For several years prior to divestiture AT&T had actively sought passage of legislation that would sanction deregulation of the firm's "effectively competitive" enterprises.¹²³ In fact, such legislation, supported by the Reagan Administration, passed the U.S. Senate overwhelmingly in the fall preceding the announcement of the AT&T settlement.¹²⁴

The post-divestiture experience reveals major political resistance to such deregulation. AT&T's long-distance services remain as subject to FCC and state rate-of-return regulation as they were prior to divestiture. In

121. *Joint Hearings*, *supra* note 60, at 81 (testimony of William F. Baxter, Assistant Attorney General).

122. *Hearings*, *supra* note 9, pt. 1, at 59 (testimony of William F. Baxter, Assistant Attorney General).

123. *See, e.g.*, Schwartz, *supra* note 77.

124. Trienens, *Deregulation in the Telecommunications Industry: A Status Report*, 50 ANTI-TRUST L.J. 409, 423 (1982).

addition, other AT&T operations, although not subject to rate regulation, must be provided through a separate subsidiary under requirements imposed by the FCC's 1980 *Second Computer Inquiry* decision (*Computer II*).¹²⁵

Policy-makers have been reluctant to make commitments concerning the possible relaxation of regulatory restrictions on AT&T. The Justice Department, in FCC proceedings following divestiture, actually argued against AT&T deregulation, stating:

Total immediate deregulation, . . . is not appropriate. AT&T continues to provide a variety of monopoly services, such as international and certain intrastate toll services and, therefore, there is a potential risk of inefficient cross-subsidization of interstate services if AT&T is fully deregulated in interstate exchange services. Moreover, the need for the competitive interexchange carriers to install capacity and the unavailability of equal access on a universal basis gives AT&T continuing market power. The Commission should take account of AT&T's continuing market power in fashioning its 1984-1990 transition toward the removal of rate and facilities regulation.¹²⁶

The FCC has indicated that an essential precondition to deregulation of AT&T's long-distance services is the achievement of equal interconnection. The FCC believes that competition can exist in interexchange services, but only upon a "level playing field."¹²⁷ Under this view AT&T must be handicapped through rate regulation and unequal access charges until equality of access to basic exchange hardware is achieved. Otherwise, AT&T could price services at or below cost, driving its competitors out of business.

However, continued regulation of AT&T's long-distance services has tangible ill effects. It subsidizes the growth of the OCCs and thus creates an artificial and unstable market structure. Current regulations have sustained AT&T prices at higher than competitive levels and have inhibited innovations in customer services.¹²⁸ The OCCs have benefited from these regulations, which enable them to price their services just below the price

125. See Final Decision, Amendment of Section 64.702 of the Commission's Rules and Regulations, 77 F.C.C.2d 384 [hereinafter cited as *Computer II*]; *reconsid.*, 84 F.C.C.2d 50 (1980), *further reconsid.*, 88 F.C.C.2d 512 (1981), *aff'd sub nom.* Computer and Communications Indus. Ass'n v. FCC, 693 F.2d 1982 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983).

126. See Comments of the U.S. Dept. of Justice at 2, *In re Long Run Regulation of AT&T's Basic Domestic Interstate Services*, FCC Docket No. 83-1147 (filed Apr. 2, 1984).

127. See Patrick, *On the Road to Telephone Deregulation*, PUB. UTIL. FORT., Dec. 6, 1984, at 19. The author, Dennis R. Patrick, is a Commissioner of the FCC.

128. See Romano, *supra* note 71 at 41.

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umbrella which AT&T must set.¹²⁹ Once equal interconnection is achieved the traditional rate-of-return regulation governing AT&T's conventional services should be removed and access charges should be equalized. Deregulation of certain interstate services that already are competitive, such as interstate private line services or interstate television transmission services, should not await equal access.

If the regulatory restraints on AT&T are removed, the prices of telephone services will move toward cost, forcing the OCCs to increase productivity in order to compete with AT&T's scale economies. In the short-run consumers will benefit from lower prices, a wider range of services, and a higher level of technological innovation. In the long-run there is a risk that the OCCs will be unable to survive and that AT&T will regain its monopoly position in long-distance service.¹³⁰ Even so, reentry opportunities would limit monopoly pricing; the prospects of sustained competition can be enhanced by permitting the BOCs to enter the long-distance market.

In addition to regulations governing AT&T's basic telephone services, the company remains subject to the constraints of *Computer II*. This FCC decision deregulated the provision of both customer-premises telephone equipment and computerized telecommunications services. AT&T can only participate in these deregulated activities, however, through a "fully separate" or "arm's length" subsidiary, a condition ostensibly designed to minimize cross-subsidies flowing from regulated to unregulated endeavors.

The FCC adopted these restrictions before divestiture, when AT&T was dominant in both toll and local telephone operations. Despite the fact that divestiture shrunk AT&T to about the same size as IBM, and removed its local exchange functions, the FCC rules persist.¹³¹ The elaborate "separate subsidiary" requirements contained in the FCC rules impose significant costs on AT&T, estimated to be more than \$1 billion a year.¹³² These costs impose an unwarranted burden upon AT&T's operations and reduce the level of innovation and price reductions that AT&T might otherwise achieve.

If the FCC restrictions are lifted, AT&T's ability to subsidize its

129. Romano, *supra* note 71, at 43. See also G. STIGLER, *THE ORGANIZATION OF INDUSTRY* 108-09 (1968) (discussing the theory of umbrella pricing and the dominant firm).

130. *MacAvoy & Robinson I*, *supra* note 1, at 41.

131. The FCC has proposed ending the separate subsidiary requirements for the sale of telephone equipment but has not indicated whether the restrictions on AT&T's computerized services should remain. See *Wall St. J.*, Feb. 1, 1985, at 2, col. 2.

132. See Reply Comments of American Telephone & Telegraph, app. B at 3, *In re AT&T Company Petition for Relief from Computer II Structural Separation Requirements*, FCC File No. ENF 84-17 (Aug. 8, 1984). See also *Equipment, Enhanced Services, and Cellular Communications Services by the Bell Operating Companies*, 49 Fed. Reg. 1190 (1984) (to be codified at 47 C.F.R. § 64.702), *aff'd sub nom.* *Illinois Bell Tel. Co. v. FCC*, 740 F.2d 465 (7th Cir. 1984).

equipment and computer operations would be no greater than that of several of its competitors. For example, the *Computer II* rules are inapplicable to GTE Service Corporation, despite that firm's extensive involvement in local and long-distance operations as well as equipment manufacturing.¹³³ In fact, the FCC recently declared GTE's long-distance affiliate to be "nondominant" and deregulated it.¹³⁴ The restrictions are also inapplicable to IBM which, in addition to its strong basic position in the computer business, recently acquired a leading U.S. supplier of telephone equipment.¹³⁵ IBM also owns a controlling interest in a long distance carrier which was recently deregulated along with GTE-Sprint.¹³⁶ AT&T should be allowed to compete against these companies in both basic telephone and enhanced services. Any resulting AT&T "dominance" through lower prices would result from its scale advantages; there should be little fear regarding the "predatory" expulsion of GTE or IBM.

The continued regulation of AT&T in both long-distance and data processing markets acts as a form of institutionalized cartel management by which the government calls for "competition" while simultaneously handicapping the most able competitor. Under this mixed system, neither the full scale economies of natural monopoly nor the efficient pricing mechanisms of market competition are achieved. AT&T has cost advantages that would lead to lower prices and larger volumes of service if put to use in making service offerings. If these advantages are constrained by regulation, such market effects cannot occur.

The difficulty of achieving any significant deregulation of AT&T has been largely due to the realities of the political process. The net result of the settlement was not to facilitate deregulation, but rather to reduce AT&T to more politically manageable dimensions.¹³⁷ Through divestiture

133. The decision and order requiring enhanced services to be provided through separate corporate entities originally applied to AT&T and GTE. *Computer II*, 77 F.C.C.2d 384, 389, 474, *reconsidered*, 84 F.C.C.2d 50 (1980). GTE, however, was exempted from these requirements on reconsideration. 84 F.C.C.2d at 72.

134. In its *Competitive Carriers* ruling, the FCC removed most rate, service, and entry controls from interstate carriers such as GTE Sprint. *In re Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, 85 F.C.C.2d 1 (1980). See Baker & Baker, *Antitrust and Communications Deregulation*, 28 ANTITRUST BULL 1, 4 (1983).

135. This deregulation occurred contemporaneous with IBM's acquisition of Rolm Corp., the leading noncarrier-affiliated U.S. telephone equipment supplier. See Schrage, *IBM Seeks to Acquire Rolm Corp.*, Wash. Post, Sept. 26, 1984, at 71, col. 3.

136. Until recently, the FCC placed limitations on IBM's transactions with the Satellite Business Systems consortium in which it had a one-third interest. See *Satellite Business Systems*, 62 F.C.C.2d 997, 1046 (1977), *reh'g denied*, 64 F.C.C.2d 872, 873 (1977). Recently, however, the FCC permitted IBM to assume majority control of this enterprise, which provides "Skyline" and other interstate communications services, and also effectively removed the restrictions on IBM's dealings with SBS. *Changes in Satellite Business Systems Structure*, FCC Mimeo 84-589 (Nov. 28, 1984).

137. Critics of U.S. policy suggest that divestiture was sought to reduce the concentration of private power that had characterized the integrated Bell System. In the words of one of the attorneys

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AT&T lost the substantial state-by-state regulatory agency support that it had previously enjoyed in its dealings with the FCC. This support had stemmed from AT&T's policy of transferring revenue from long-distance to local companies. Unable to marshal the regional telephone companies on its behalf, the new AT&T has been unable to obtain significant support for company policies in Washington.

Equally important, AT&T overestimated the degree of general Congressional and executive office support that would be available for deregulation in the post-divestiture environment. The company apparently believed that there was a substantial probability of ensuing rapid deregulation. But not even the Department of Justice stepped forward to advance this policy. Even if the DOJ had been willing to press consistently for relaxation or elimination of regulatory constraints, such action was not possible within the Department's limited jurisdiction. Having been pervasively regulated for generations, AT&T was unable to move into the open market, given the diversity and inconsistency of federal actions that have followed divestiture.

Conclusions

The AT&T settlement represents an overly ambitious effort by the federal judiciary to restructure a complex regulated industry. The courts do not always constitute the optimal forum for addressing, much less soundly resolving, complex regulatory issues. In the case of the AT&T settlement, turning matters over to the court has created as many problems as it was supposed to resolve. The court 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.

Given the results of the first year of divestiture, comprehensive action by Congress is necessary to strike a workable balance between competitive

who filed the government case, "U.S. v. AT&T is as much about political control as economic power." BRITISH TELECOMMUNICATIONS UNION COMMITTEE, THE AMERICAN EXPERIENCE: A REPORT ON THE DILEMMA OF TELECOMMUNICATIONS IN THE U.S.A. 32 (1983). These sentiments are echoed in the court opinion approving the settlement:

The legislators who enacted the [antitrust laws] voiced concerns beyond the effects of anticompetitive activity on the economy: they also greatly feared the impact of the large trusts on the nation's political system, and they regarded the power of these trusts as an evil to be eradicated . . . The telecommunications industry plays a key role in modern economic, social, and political life . . . [I]t is antithetical to our political and economic system for this key industry to be within the control of one company.

United States v. AT&T, 552 F. Supp. at 164-65.

and regulatory goals. The legislative process has the virtue of involving all parties, and, by so doing, producing a resolution that commands broader acceptability. It should be a matter of indifference to Congress whether necessary changes are consistent with, or contradict, the consent decree which was, after all, a private agreement imposed on the industry by a federal district court judge. New legislation should accomplish three things: ensure stable local telephone rates; free the BOCs from artificial agency and court constraints on their commercial opportunities, including the ability to enter the long-distance telephone business once equal access is accomplished; and, remove restrictions on AT&T's ability to compete. There is no guarantee that such a package of changes would necessarily make the reconstituted American telecommunications industry work better. However, it would minimize the likelihood that, by simply continuing the present *ad hoc* course of court and commission regulation, things will get significantly worse.