> input. Because local exchange service was subject to rate-of-return regulation that limited the revenue yields of monopoly power, and because the local exchange was a necessary input for other offerings, the BOCs had an incentive to leverage their power in regulated exchange service markets so as to foreclose competition in the dependent markets. Revenue "lost" to vigorous and politically popular low local telephone rates could often be captured in these associated markets where regulation was usually either less vigorous or non-existent.[59]

Or was that the theory? As the Justice Department said in 1982, when Baxter ran the Antitrust Division, Bell supposedly used the monopoly rents from its local services to support predatory pricing in long-distance markets:

> [Divestiture] will remove the incentives and abilities that have existed within the Bell System to subsidize competitive activities with supra-competitive earnings from monopoly activities.[60]

The Bell System, it would seem, leveraged *in both directions at the same time* by using its local monopoly earnings to price below its competition in long-distance markets while also using monopoly long-distance earnings to subsidize shortfalls in local exchange markets. These apparently contradictory statements on strategies can be partly reconciled if one accepts the Justice Department's view that AT&T kept prices in some segments of the long-distance markets high, while dropping them in high-volume markets where entry of specialized carriers was taking place. But the Department's theory that AT&T had raised local service rates when regulators

59. Hearing Before the Subcomm. on Antitrust, Monopoly and Business Rights of the Sen. Comm. on the Judiciary, 103rd Cong., 2d Sess. (Sept. 20, 1994) (testimony of William F. Baxter) [hereinafter *1994 Senate Telecom. Hearings*].

60. Response to Public Comments on Proposed Modification of Final Judgement, 47 FED. REG. 23,320 (May 27, 1982) (statement of Department of Justice).

had required subsidies to run from long-distance to local,[61] and that AT&T had also restricted long-distance carriers' access to local switching facilities, necessarily could not both hold. Thus, the Department's "multiple bottleneck" theory was, at face value, only partly inconsistent within itself.

Yet the Commission adopted the Justice Department's view of the bottleneck sources of Bell's exclusionary strategies.[62] So also did Judge Greene, who pointed out that "the key to the Bell System's power to impede competition has been its control of local telephone service . . . . With the loss of control over the local network, AT&T will be unable to disadvantage its competitors."[63]

Based on its theory the Justice Department expected the divestiture to achieve two goals. First, it would create effective competition in long-distance markets; second, as that was achieved, divestiture would permit reduced regulation of AT&T's long-distance operations.[64] In fact, the Department believed that long-distance markets were on the edge of becoming competitive, a belief supported by some economists[65] and by Baxter himself.[66]

61. *See* MacAvoy & Robinson, *Winning by Losing*, *supra* note 1, at 2–9.

62. Competition in the Interstate Interexchange Marketplace, Notice of Proposed Rulemaking, CC Dkt. No. 90-132, 5 F.C.C. Rcd. 2627 (1990) [hereinafter *Competition in Interstate*]. The FCC stated:

> As a result of . . . divestiture, AT&T lost any ability to discriminate against its long-distance competitors through its control of bottleneck local interconnection facilities . . . . AT&T also lost any ability either to subsidize the prices of its interexchange service with revenues from local exchange services or to shift costs from competitive interexchange services.

Id. at 2631 ¶ 39 (quotations omitted).

63. United States *v.* American Tel. & Tel. Co., 552 F. Supp. at 223.

64. *See, e.g.*, Hearing Before the Sen. Comm. on Commerce, Science, and Transportation, 97th Cong., 2d Sess. 59 (1982) (testimony of William F. Baxter, Assistant Attorney General for Antitrust) [hereinafter *1982 Senate Commerce Hearings*]; Hearing Before the Sen. Comm. on the Judiciary, 97th Cong., 1st & 2d Sess. 68, 133–34 (1982) (testimony of William F. Baxter and testimony of Morris Tanenbaum, AT&T Executive Vice-President).

65. BROCK, *supra* note 7 at 303, 307.

66. *See* Hearing Before the Subcomm. on Antitrust, Monopoly and Business Rights of the Sen. Comm. on the Judiciary, and Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 97th Cong., 2d Sess. 76 (Jan. 28, 1982) (testimony of William F.

Baxter predicted that, despite AT&T's large market share in long-distance service, there would rapidly be "significant entry on trunk routes" upon divestiture.[67] Baxter said, "[W]e can have a very large market share without having a significant degree of market power."[68] and "[L]ong Lines will effectively be checked on many of its routes relatively soon."[69] Baxter also stated that divestiture would "substantially accelerate the development of competitive markets for interexchange services, customer premises equipment and telecommunications equipment generally."[70]

With the achievement of full and effective competition, the Justice Department expected that long-distance rates would be closely aligned with the marginal costs of providing such service.[71] Judge Greene similarly predicted, "[W]ith the removal of those barriers to competition, AT&T should be unable to engage in monopoly pricing in any market."[72] At that point in time, divestiture would bring about deregulation throughout long-distance telecommunications. Speaking after the announcement of the AT&T settlement, Baxter 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.[73] He made the same argument in defending the settlement before the Senate Commerce Committee, when he declared, "I foresee in the near future the potential for substantial deregulation of the Long Lines function."[74] By 1991, however, Baxter acknowledged: "I absolutely did not foresee, and would have been horrified had I

Baxter) [hereinafter *1982 Joint Hearings*].

67. *Justice Settles AT&T Case; Bell System Agrees to Divest Local Operating Companies*, 42 ANTITRUST & TRADE REG. REP. (BNA) (No. 1047) 82 (Jan. 14, 1982).

68. *Id.*

69. *Id.*

70. *Justice Department Publishes Competitive Impact Statement on Settlement with AT&T*, 42 ANTITRUST & TRADE REG. REP. (BNA) (No. 1052) 371 (Feb. 18, 1982).

71. *Justice Settles AT&T Case, supra* note 73, at 82.

72. United States v. American Tel. & Tel. Co., 552 F. Supp. at 172.

73. *1982 Joint Hearings, supra* note 72, at 81 (testimony of William F. Baxter).

74. *1982 Senate Commerce Hearings, supra* note 70, at 59 (testimony of William F. Baxter).

been able to foresee, the extent to which regulation has continued."[75]

AT&T's Purpose for Making the Settlement

Why did AT&T agree to the draconian structural reorganization it had spent almost a decade and millions of dollars resisting?[76] Perhaps AT&T was discouraged by the prospect of further litigation and what was perceived as Judge Greene's hostility.[77] AT&T chairman Charles Brown thought that Judge Greene's ruling on AT&T's motion to dismiss signalled that he would ultimately decide against AT&T on the merits.[78] In 1991, however, Judge Greene repudiated the "general assumption I had decided to find against AT&T because of the denial of the company's motions to dismiss and the explanations I gave at the time."[79]

But the prospect of losing and having to appeal to the higher courts was daunting. Even with a strong case before the Supreme Court on the economics of regulation and predatory pricing, the company would be held in suspension for many years. Management perceived that it had to fall behind the new entrants in long-distance markets.

And there was another reason that AT&T was inclined to settle. AT&T's earnings from long-distance service, required by regulators for covering the common costs in both long-distance and local service, were being eroded by the price initiatives of the new independent long-distance carriers upon whom regulators had imposed lesser requirements for the use of their earnings. Consequently, AT&T let the Department of Justice do what the regulators would never have let the company do on its own: divest

75. William F. Baxter, Charles L. Brown, Stanley M. Besen & Henry Geller, *Questions and Answers with the Three Major Figures of Divestiture*, *in* AFTER THE BREAKUP: ASSESSING THE NEW POST-AT&T DIVESTITURE ERA 21, 23 (Barry G. Cole ed., Columbia University Press 1991) (statement of William F. Baxter) [hereinafter AFTER THE BREAKUP]

76. AFTER THE BREAKUP, *supra* note 82, at 40 (statement of Barry G. Cole).

77. *See* David Pauly, *Ma Bell's Big Breakup*, NEWSWEEK, Jan. 18, 1982, at 58.

78. AFTER THE BREAKUP, *supra* note 82, at 38 (statement of Charles L. Brown).

79. *Id.* at 41 (statement of Judge Harold Greene).

its low-profit local exchange operations, so that it would be free to focus on profit-enhancing strategies in the long-distance and equipment markets. AT&T, by capitulating to the Justice Department (and thus "losing" the antitrust suit) won a reprieve from local service subsidy obligations that it could not otherwise have avoided. Charles Brown explained in 1984:

> It had become clear that to gain access to new markets—and, in fact, to retain access to our existing markets—the Bell System would have to agree to some form of structural change . . . . [W]e concluded that getting rid of the terrible uncertainty and capitalizing on future market opportunities were more important than vindicating our past behavior in a marketplace that no longer existed.[80]

An AT&T focused on long-distance transport and switching could expand with high prospective returns while the operating companies languished as wire and cable connection providers with average public utility returns.[81] But such results were, as always, contingent on basic changes in regulation—for one, that earnings - transfers from long-distance to local service would be eliminated, a development regulators were unwilling to permit before AT&T's divestiture.

At divestiture, AT&T shared the Justice Department's expectations that settlement would result in opening up long-distance markets. AT&T even appeared to welcome competition in these markets. In commenting on the appropriate size of the "local access and transport areas" (LATAs) that the decree would create, beyond the boundaries of which the operating companies would not be permitted to carry telephone calls, AT&T argued that LATAs should be big enough to "present an attractive market for potential

80. Charles L. Brown, *A Personal Introduction*, *in* DISCONNECTING BELL, *supra* note 7, at 4.

81. *See* MacAvoy & Robinson, *Winning by Losing*, *supra* note 1, at 31–39; *see also* Louis B. Schwartz, *Stacked Competition and Phony Deregulation for AT&T: The Proposed Telecommunications Competition and Deregulation Act of 1981*, 3 COMM./ENT. 411 (1983).

new entrants" and to "assure that there [would] be multiple interexchange carriers actually or potentially able to serve all telephone subscribers in the area."[82] Shortly after divestiture, Brown contended, "[I]t's obvious to the most zealous of competitors that we don't have market power in long-distance business."[83] He also asserted that AT&T's loss of market power was likely to be permanent, that AT&T would like to cut rates 30 to 40 percent, but that even reductions of those magnitudes would not restore its predivestiture market share.[84]

The promise of Justice Department support for future deregulation must have played a role as well.[85] For several years before divestiture, AT&T had sought legislation that would sanction deregulation of the firm's "effectively competitive" enterprises.[86] In fact, such legislation, supported by the Reagan administration, passed the Senate in the fall of 1981, months before the announcement of the AT&T settlement.[87] At that point in time, AT&T underestimated the strength of political opposition to deregulation; ultimately, the legislation failed in the House of Representatives. The road to deregulation through federal antitrust litigation and the Federal Communications Commission administrative rulings must have looked more promising. And subsequently, AT&T was freed from important aspects of Commission and state "cost of service" rate regulation.

Yet deregulation did not materialize in the first decade after divestiture. Brown subsequently explained in 1991, "I did think more deregulation would take place, that regulatory bodies would back off a lot faster than has actually occurred."[88] Those unmet

82. AT&T Response to Comments and Objections Relating to the Proposed LATA Boundaries at 7, United States v. Western Elec. Co., No. 82-0192 (D.D.C. Nov. 23, 1982).

83. *AT&T "More Vulnerable" Than BOC's: AT&T Chairman Brown Charges Bias By FCC, Congress & Courts*, COMM. DAILY, Sept. 11, 1984, at 3.

84. *Id.*

85. AMERICAN TEL. & TEL. CO., 1983 ANNUAL REP. 12–13 (1984); *1982 Joint Hearings*, *supra* note 72, at 13 (testimony of Charles L. Brown); *1982 Senate Commerce Hearings*, *supra* note 70, at 7 (testimony of Charles L. Brown).

86. *See, e.g.*, Schwartz, *supra* note 88, at 411.

87. Howard J. Trienens, *Deregulation in the Telecommunications Industry: A Status Report*, 50 ANTITRUST L.J. 409, 423 (1982).

88. AFTER THE BREAKUP, *supra* note 82, at 26 (statement of Charles L.

expectations in turn spoke to the inefficacy of the divestiture. "As far as my expectations being realized," Brown observed, "I think the relatively slow pace at which federal and state regulation is decreasing is a disappointment and a major factor in why the divestiture setup has not worked as well as it might."[89]

Wishful Assessments Since the Decree

For more than a decade after divestiture, long-distance markets have offered customers a choice of patronage with any one of three large nationwide long-distance service providers and a plethora of resellers or other smaller facilities-based providers. These conditions have allowed the authors of the decree, whose reputations for wisdom and expertise have been at stake, to conclude that long-distance markets are now competitive. Given that they expected the divestiture decree to produce competitive long-distance markets, their observation that competition is now prevalent is not surprising.

In 1982 Judge Greene found long-distance markets "quite competitive."[90] He affirmed that conclusion in 1987 by explaining that "competition now exists in the interexchange market, and that the entry of the Regional Companies into that market is not necessary to give it vitality."[91] In 1989 he again found that interexchange competition since the divestiture had, in fact, dissipated the monopoly power that AT&T had at the time of the divestiture:

> The basic fact of life . . . is that . . . several large and effective interexchange carriers other than AT&T exist in all areas of the country, and the monopoly or quasi-monopoly situation that gave

Brown).

89. *Id.* at 21.

90. United States *v.* American Tel. & Tel. Co., 552 F. Supp. 131, 189 n.234. At that time, Judge Greene briefly contemplated BOC entry into interexchange but concluded that "the resulting increase in competition would not be substantial." *Id.* at 189.

91. United States *v.* Western Elec. Co., 673 F. Supp. 525, 550 (D.D.C. 1987).

> life and reason to the electronic publishing prohibition on AT&T no longer exists.[92]

Further, in 1991, Judge Greene numbered among the greatest successes of the decree "the emergence of real competition in long-distance and the resulting substantial reductions in rates."[93]

The Justice Department saw competition in long-distance markets through a lens that expanded the coverage of Adam Smith's supply and demand very broadly indeed. In 1995 Assistant Attorney General Anne Bingaman said:

> The MFJ [Modification of Final Judgement] has benefitted the country spectacularly. Separating the long-distance market from the local monopoly has increased competition dramatically, as MCI, Sprint and hundreds of smaller carriers have vied with AT&T to provide long-distance service to businesses and residences. The *New York Times* recently reported that in 1994 more than 25 million residential customers changed long-distance carriers—spotlighting the MFJ's incredible success in bringing real choice to consumers. Residential long-distance rates have fallen some 50 percent since the break-up. Because of these lower prices, Americans are communicating with each other, by phone, fax and computer, more than ever before. We are closer to each other and in better touch with each other, for business and pleasure, because of the MFJ and its benefits. The impact of this change cannot be measured, but it unquestionably is profound and has changed the nation for the better.[94]

92. *See* United States *v.* Western Elec., Co., Civil Action No. 82-0192 (D.D.C. July 28, 1989).

93. AFTER THE BREAKUP, *supra* note 82, at 49 (statement of Judge Harold Greene).

94. Promoting Competition in Telecommunications (speech by Assistant Attorney General Anne K. Bingaman before the National Press Club, Washington, D.C.

William Baxter has held to that enlarged view. He testified to Congress in 1994:

> [A]s soon as the long-distance and the local service monopoly were separated by divestiture, competition in long-distance became more vigorous. Every consumer in America has a choice of long-distance carriers—a choice that tens of thousands exercise daily. Business and consumers have benefitted from this competition. There are now four nationwide fiber optic networks for handling long-distance calls. Over the last 10 years, long-distance rates have been reduced by more than 60% in real dollar terms. And new services have expanded dramatically as long-distance competitors vie with each other to provide the newest technology.[95]

The Commission has generally subscribed to the Justice Department's position that divestiture should and therefore did lead to more competitive long-distance markets.[96] The Justice Department has stated that the decree would make regulation easier for the Commission because it would reduce AT&T to more manageable dimensions.[97] Divestiture would facilitate regulatory changes

(Feb. 28, 1995) (available in 68 ANTITRUST AND TRADE REG. REP. (No. 1702) 312 (Mar. 2, 1995).

95. *1994 Senate Telecom Hearings*, *supra* note 65 (testimony of William F. Baxter).

96. *See* Response to Public Comments on Proposed Modification of Final Judgment, 47 FED. REG. 23,320 (May 27, 1982) (statement of Department of Justice).

97. In the words of one of the attorneys 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). Those sentiments are echoed in Judge Greene's 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

that the Commission thought were necessary to advance further the scale of competitors while keeping a "level playing field."[98] And as the Commission embraced this rhetoric, it has stated that it found that long-distance markets had become competitive in reality. In 1986 the Commission found that AT&T's ability to shift costs from unregulated to regulated activities was then limited by the competition that had developed in long-distance markets.[99] In 1990 the Commission found that long-distance markets generally enjoyed "vigorous" competition,[100] and so the agency proposed to streamline regulation of AT&T's business services.[101] "Since the MFJ," the Commission confidently asserted, "the long-distance industry has changed dramatically, becoming much more competitive."[102]

In an assessment of markets for business services, the Commission found in 1991 that "while AT&T may have certain first-in advantages, no one has shown that those advantages preclude the effective functioning of the business services market. On the contrary, we believe . . . that competition in business services is thriving, that AT&T's competitors are growing, and that consumers are benefitting from these occurrences."[103] The passage of time did not dampen this enthusiasm for its finding on competition in commercial services. In 1993 the Commission concluded "that with the implementation of 800 number portability, AT&T's 800 services are now subject to substantial competition."[104] In 1994

> 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 Co., 552 F. Supp. at 164–65.

98. *See* D. Patrick, *On the Road to Telephone Deregulation*, PUB. UTIL. FORT., Dec. 6, 1984, at 19.

99. Amendment of § 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), 104 F.C.C.2d 958 ¶¶ 84–85 (1986).

100. *Competition in Interstate*, 5 F.C.C. Rcd at 2638 ¶ 94.

101. *Id.* at 2640 ¶ 95.

102. *Id.* at 2632 ¶ 46.

103. Competition in the Interstate Interexchange Marketplace, Report and Order, CC Dkt. No. 90-132, 6 F.C.C. Rcd. 5880, 5892 ¶ 61 (1991).

104. Competition in the Interstate Interexchange Marketplace, Second Report and Order, CC Dkt. No. 90-132, 8 F.C.C. Rcd. 3668, 3669 ¶ 10 (1993).

the Commission found that "[a]t this point in time . . . interexchange competition is increasingly robust."[105] In 1995 the Commission again found "that AT&T lacks the ability to exercise unilateral market power in the provision of [commercial] services and that there is sufficient competition among providers to justify moving AT&T's commercial services from price caps to streamlined regulation."[106]

CONCLUSION

Maintaining the illusion of competition serves the interests of all those still taking part in the largest divestiture in history. Competition was better for AT&T because divestiture would free it from the shackles of earnings diversion to subsidize the local exchange and, eventually, from long-distance regulation. It has not been freed, but chances are greater that it will still gain from further deregulation if there is agreement that the long-distance markets are competitive. At the same time, the current regulatory system works to the advantage of MCI and Sprint. Holding to the position that they are competitive helps them to preserve a status quo in which they set their prices outside the regulatory process. Thus it is easy to see that the large three players in long-distance would find describing the current markets as "competitive" is to their advantage.

But what about the regulators? The Commission, the Justice Department, and Judge Greene have some stake in finding competition where there is none. Of course, it is possible that the Commission, Justice, and Judge Greene view the extent of competition in long-distance markets in a way that is simply mistaken. Yet a simpler explanation is that expecting to find competition, given their premise that there should be competition, these parties assume that the pattern of behavior that they observe in long-

105. Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, Notice of Inquiry, CC Dkt. No. 80-286, 9 F.C.C. Rcd. 7404, 7408 ¶ 5 (1994).

106. Revisions to Price Cap Rules for AT&T Corp, Report and Order, CC Dkt. No. 93-197, 10 F.C.C. Rcd. 3009, 3014 ¶ 16 (1995) [hereinafter *Price Cap Revisions*].

distance markets is indeed competitive. In assessing the state of competition in long-distance markets, the Justice Department, the Commission, and Judge Greene have not made expert, objective observations about the competitiveness of the important markets. Instead, they have made assertions that support positive findings as to the wisdom of their own policies, past and present. That theme resonates in the self-congratulatory remarks of one commissioner in 1995:

> Our commitment to competition is pervasive and enduring. We have worked for more than 20 years to develop competition in the provision of long-distance services and customer- premises equipment . . . . The implementation of equal access has been expensive, but it has opened up competition in the long-distance market. [One result] has been that long-distance rates have declined dramatically over the same period.[107]

So long as they all believe that long-distance markets are becoming competitive, they need not admit that divestiture may have been, in some respects, a mistake. The Commission need not admit that its efforts to introduce competition to long-distance markets have come late to the complicated regulated pricing process of the three large service providers.[108] The Commission may also seek to find

107. Fundamental Regulatory Principles for the Information Infrastructure, Remarks of Susan Ness, Commissioner, Federal Communications Commission, OECD Special Session, Paris (Apr. 3-4, 1995) (available in FCC LEXIS 2597 (Apr. 19, 1995)).

108. *See* Remarks by Richard M. Firestone, Chief, Common Carrier Bureau, Federal Communications Commission, 1992 World Communications Seminar (available in 1992 FCC LEXIS 811 (Feb. 11, 1992)):

> Telecommunications regulatory policy in the United States has undergone a fundamental change in course over the last decade, and I am pleased that the U.S. agency charged with the responsibility of regulating communications between our fifty states and internationally—the Federal Communications Commission—has been in the forefront of much that has been accomplished . . . [Since divestiture and equal access] the interstate

conclusions that allow it to postpone the day when it must accept the fact that policies to develop competition (the goal of the antitrust decree) and policies to attain subsidies directed to "universal service" (the goal of public utility regulation) are incompatible. And, staying on the path towards more competition, without quite getting there, the Commission need not accept any diminution in its powers that might come with deregulation.[109] If such a depiction of regulators marshaling their arguments to protect their authority is troublesome, consider the position of the commissioner wanting both success and the regulatory responsibility for continued success:

> One of this agency's proudest achievements is that it has fostered the development of a vibrant, diverse interexchange marketplace. That achievement did not happen without a good deal of work by the Commission to make the experiment in long-distance competition a success. We cannot take for granted that the long-distance competition we are so proud of will survive—or that local competition will grow and prosper—without continued effort on our part.[110]

The conclusion is that everyone in the policy formation process is

> long-distance industry is both more competitive—approximately 500 carrier entrants at last count— and more robust.

109. Statement of Reed E. Hundt, Chairman, Federal Communications Commission, Before the Comm. on Commerce, Science, and Transportation U.S. Senate on S. 1822, the "Communications Act of 1994," and "Telecommunications Equipment Research and Manufacturing Competition Act of 1994." Public Notice, 1994 FCC LEXIS 835 (Feb. 23, 1994):

> [C]ompetition must be managed and supervised by the FCC and state regulators who are charged with ensuring that the rates that consumers pay for service remain just and reasonable . . . . The divestiture of AT&T was the seminal event in the development of a truly competitive long-distance business.

110. Transport Rate Structure and Pricing Petition for Waiver of the Transport Rules filed by GTE Service Corporation, Report and Order and Further Notice of Proposed Rulemaking, CC Dkt. No. 91-213, 7 F.C.C. Rcd. 7006, 7117 (1992) (separate statement of Ervin S. Duggan)

better off espousing and then finding that competition is forthcoming from the application of antitrust and regulatory policies in long-distance markets. Except, of course, those who would still benefit from taking other approaches to actually establishing more competition in these markets. For them, the home and business subscribers to the services of the long-distance carriers, the question of current regulatory effectiveness remains open.

3

Implementing Regulatory and Antitrust Policies on Developing Competition After 1984

REGULATION OF LONG-DISTANCE RATES and services in postdivestiture markets was necessarily going to affect the competitiveness of markets. The question was the nature and extent of this effect. The Department of Justice expected that divestiture would enable the Federal Communications Commission to deregulate interstate long-distance telecommunications. Assistant Attorney General William Baxter seemed to assume that the decree left the Commission with relatively little role to play in long-distance markets and indeed had given it "no opportunity whatsoever" even to comment on the proposed settlement.[1] Baxter did expect that "long lines . . . at present and in the immediate future will continue to be regulated by the Federal Communications Commission," but projected that "AT&T, after the decree is approved and the reorganization occurs, will be, for the most part, an unregulated . . . and, I believe, a very vigorous competitor . . . . There is nothing about the long lines business in most markets in the United States which makes continued regulation inevitable."[2]

1. Hearing Before the Sen. Comm. on Commerce, Science, and Transportation, 97th Cong. 77–83 (1982); *See* GERALD W. BROCK, TELECOMMUNICATION POLICY FOR THE INFORMATION AGE: FROM MONOPOLY TO COMPETITION 164 (Harvard University Press 1994) [hereinafter TELECOMMUNICATION POLICY].

2. Hearing Before the Sen. Comm. on Commerce, Science, and Transportation, 97th Cong. 43 (1982) (testimony of William F. Baxter).

After divestiture the Federal Communications Commission undertook certain initiatives that proved those expectations to be incorrect. The Commission's regulation of access charges on long-distance calls determined the relative size of the three large interexchange carriers. That is, by requiring AT&T to continue to pay access premiums and by setting ceilings and floors on AT&T's prices, its regulation promoted the relative growth of the second and third largest carriers. But rate setting in AT&T tariff submissions allowed the Commission to retain its role as the central arbiter of the competitiveness of interfirm pricing behavior in long-distance markets.

In spite of the expectations of the Department of Justice, what the Commission has done cannot be characterized as "deregulation." The major suppliers in long-distance markets have not submitted tariff prices to the Commission at levels that would be consistent with the actions of the invisible hand of competition. Rather, the Commission has kept a visible thumb under price levels that has reduced price differences. Oddly, despite repeated insistence that divestiture has produced robust competition in long-distance markets, the Commission continued to keep its thumb there over the ten years after divestiture.

ANTITRUST DIVESTITURE AND RESTRICTIONS ON ENTRY INTO LONG-DISTANCE MARKETS

There is a new "virtual" public agency that has played a key role in determining the competitiveness of long-distance markets. Judge Greene's court has set out a regulatory rule that prevented the Bell operating companies from entering interstate long-distance markets. Operating company long-distance service offerings had to remain within local access and transport areas (LATAs); in effect, they were limited to long-distance services in local (intraLATA) toll markets.

The Bell operating companies, however, did apply persistently to the judgment court for waivers of those limits. Their first substantial initiative was for the purpose of entering cellular phone service markets throughout the country. Under the decree, they were required to hand off cellular calls to long-distance companies just as they did landline calls in regular long-distance service. Judge

Greene granted integrated service waiver requests for nine metropolitan complexes of local exchange providers in 1983 that extended beyond LATA boundaries, and in 1987 granted NYNEX a waiver request to provide interLATA cellular services in the Mid-Atlantic region. By 1992, the court had granted over sixty requests, in the name of "competitive parity" or "community of interest," that for the most part made alignments between cellular service areas and LATA territories of local exchange providers.[3]

But those initiatives did not go to testing limits on entry of the Bell operating companies into long-distance wireline service markets beyond local calling region boundaries. The applicable section of the court's modification of final judgment, section VIII, item C, states that the ban on long-distance services "shall be removed upon a showing by the petitioning Bell operating company that there is no substantial possibility that it could use its power to impede competition in the market it seeks to enter." Twice since the judgment a Bell operating company has petitioned the Department of Justice (in 1987 and in 1994) to remove that restriction; neither petition succeeded in convincing Judge Greene to relax the interexchange restriction. In 1986 the Bell operating companies petitioned Judge Greene directly for a general "clarification" of long-distance market entry restrictions; the effort was rebuffed as an attempt to achieve interexchange entry authorization through an underhanded process.

The first petition to enter a specific set of interLATA service markets was initiated in 1986 when certain Bell operating companies requested authority to provide outside their own service territories. Judge Greene rejected that petition in the same year.[4] U S West, Bell Atlantic, and Pacific Telesis appealed to obtain a reversal of the court's decision on grounds that it barred the Bell operating companies from providing extraregional exchange services without prior court approval. In August 1986 the D.C. Circuit Court determined that the companies could offer exchange services

3. *See* PETER HUBER, MICHAEL KELLOGG & JOHN THORNE, THE GEODESIC NETWORK II: 1993 REPORT ON COMPETITION IN THE TELEPHONE INDUSTRY (Geodesic Co. 1992) [hereinafter GEODESIC NETWORK II].

4. United States *v.* Western Elec. Co., 627 F. Supp 1090 (D.D.C. 1986).

outside of their respective regions not connected to their in-region local exchange services. The court held that the modification of final judgment did not impose restraints on the areas in which the Bell operating companies could provide service, nor did the circumstances of divestiture support territorial restrictions imposed on exchange services.[5]

The first test of the ban on interLATA entry within region was undertaken in 1987 as part of Judge Greene's triennial review of the performance of affected companies required under the decree. The Department of Justice petitioned the court to eliminate interexchange restrictions, although it later partially reversed itself by declaring that interexchange services should be approved on a "case-by-case" basis. It was joined by all the operating companies seeking to enter long-distance interexchange markets pursuant to section VIII(C).[6] AT&T objected to the removal of the interexchange services restrictions, Judge Greene denied the petition and the Bell operating companies appealed. The appellate court's opinion affirmed Judge Greene's opinion, finding that the long-distance restriction had been properly determined under section VIII(C).[7] The appellate panel (Abner J. Mikva, Harry T. Edwards, and Lawrence H. Silberman) also said that Judge Greene had to defer to the Justice Department's expert "economic analysis and predictions of market behavior."[8] The court also found that only the Bell operating companies, not the Department of Justice, could seek revisions, and that the Bell operating companies "did not satisfy their burden in this Triennial Review of showing that there was no substantial possibility that they could use their monopoly power to impede competition."[9]

In April 1994, Ameritech submitted a separate petition seeking the relaxation of limits on its entry into long-distance mar-

5. United States *v.* Western Elec. Co., 797 F.2d 1082 (D.C. Cir. 1986); *DC Appeals Court Says Regional Phone Firms May Expand Service,* 166 DAILY REP. FOR EXEC., Aug. 27, 1986, at A9.

6. United States *v.* Western Elec. Co., 673 F. Supp. 525 (D.D.C. 1987).

7. United States *v.* Western Elec. Co., 900 F.2d 283 (D.C. Cir.), *cert. denied*, 498 U.S. 911 (1990).

8. *Id.* at 294.

9. *Id.* at 300

kets across LATAs in its upper midwest service region. That midwestern operating company petitioned the Department of Justice, along with the Federal Communications Commission and the Illinois Commerce Commission, to be allowed to enter interLATA long-distance markets given that it would "unbundle" its local network to all entrants into its local exchange markets including the long-distance carriers. The response of incumbent long-distance carriers was that even with unbundled services Ameritech would still have an advantage because, according to AT&T, it would still have the only local loop to 99 percent of the customers and thus would maintain the local monopoly.[10]

The Department of Justice solicited responses from interested parties in December 1994 and approved a plan for Ameritech entry into long-distance that was filed with Judge Greene in April 1995. Ameritech and the Department proposed that Judge Greene waive the interexchange restriction as local entry became "competitive" in two local markets—Chicago, Illinois, and Grand Rapids, Michigan—which together had four million customers and $3 billion in long-distance revenues.[11] Under the proposal, the Department would monitor the development of competition and ultimately determine its sufficiency. Even with agreement at this stage, the within state operating companies of Ameritech still needed a waiver from the Federal Communications Commission to attain the flexibility in its rate tariffs required for them to meet the prices of entrants. Other required preconditions included dialing parity, number portability, and state regulatory approval for prices for Ameritech to charge entrants seeking to resell its local exchange offerings. In general, as years passed, the proposal was greatly reduced in scope to selling less than facilities-based service in its relevant interLATA markets in order to increase chances for approval.[12]

Ameritech's petition is still under review in April of 1996. In the space of these three years, other operating companies have

10. *Id.* at 297; David Rubenstein, *Ameritech Seeks Entry into Long Distance,* ILLINOIS LEGAL TIMES, Apr. 1994, at 1.

11. Karen Donovan, *Move Over, Ms. Bingaman, New Trustbuster Is in DC,* NAT'L LAW J., Apr. 24, 1995, at B1.

12. *Justice Approves Plan to Allow Bell Company into Long-Distance,* DAILY REP. FOR EXEC., Apr. 4, 1995, at A64.

sought removal of all of the modification of final judgment's restrictions. Four of the seven Bell operating companies (NYNEX, Southwestern Bell, BellSouth, and Bell Atlantic) requested in July 1994 that Judge Greene vacate the agreement's restrictions since its goals "have been fully accomplished."[13] The companies cited new forms of price controls and new regulations ensuring equal access as fundamental changes fostering competition in the interexchange marketplace. That petition, too, is still under consideration.

In addition, Pacific Telesis (initially a party to the July 1994 motion to vacate) chose instead to initiate actions to open entry into long-distance by proposing new state and federal legislation. Its California initiative is of particular interest; the resulting legislation "commands" the California Public Utilities Commission to grant Pacific Telesis entry into intrastate long-distance markets between LATAs. That legislation was in response to a California Public Utilities Commission announcement that it intended to open local toll service to competition. But the California Public Utilities Commission cannot so proceed to open up interLATA markets under the modification of final judgment, so that Pacific Telesis simultaneously had to pursue federal legislation to open entry across LATAs so as to meet these new state statute requirements. To some extent the federal Telecommunications Act of 1996 met those requirements. But if Congress failed to open entry for Pacific Telesis to interLATA markets by January 1995 (which indeed it did) the California Public Utilities Commission was required to order PacTel to seek a waiver from Judge Greene.[14] In February 1995 Pacific Telesis asked the Justice Department for support in seeking a waiver that would allow it to offer long-distance telephone service within California's eleven LATAs.[15] Such a waiver has not been forthcoming.

These initiatives have involved not only local carriers but also the incumbent long-distance carriers and the Justice Department. Their actions have sought to forestall the emergence of new sources of supply of the scale of Ameritech and Nynex into regional

13. "Bell companies ask court to vacate decree in AT&T case," 67 BNA July 14, 1994 at 62.

14. Jennifer Thelen, *Dialing Direct*, THE RECORDER, July 22, 1994, at 1.

15. *Baby Bell Seeks Help on Waiver*, N.Y. TIMES, Feb. 1, 1995, at D4.

long-distance service markets. The incumbent long-distance carriers have been more than wary of attempts of the Bell operating companies to enter the interexchange marketplace. In March 1995 Judge Greene issued an opinion on an MCI motion for an order directing BellSouth and other operating companies to cease development and deployment of a nationwide, linked database network capable of performing interexchange service functions as part of the operating companies' 800 services. In this case, Judge Greene cited a Federal Communications Commission Report and Order of April 21, 1989, that specifically permitted the Bell operating companies to provide the functions alleged to be violations of the modification of final judgment. Accordingly, he denied MCI's motion.[16]

Meanwhile, the Department of Justice has become more partisan on the side of preventing interexchange entry. While it finally supported a narrow version of the Ameritech petition, in March 1995 the Department announced new guidelines that the operating companies should use when seeking a waiver from the modification of final judgment. They include requirements that the petitioner should provide findings that state regulators have removed local barriers to competition, that there be mutual compensation and interconnection arrangements between local and interexchange carriers, that local toll dialing parity, number portability, and access to poles and conduits all exist, and that local exchange carriers have set up separate subsidiaries for long-distance services. Such findings are all subject to controversy; that they would be required at all is indicative of the Department's position that entry should be made difficult.

Last of all is the effort of potential entrants to seek permission by other routings, principally off the face of the planet. In October 1995 a group of Bell operating companies including Ameritech, Bell Atlantic, NYNEX, and Southwestern Bell Corporation submitted a waiver request to offer direct broadcast satellite transmission of video service to customers. That service would use new technology, and provide new services, outside the realm of the divestiture proceeding. That service is considered an "interLATA"

16. United States *v.* Western Elec. Co., Cl No. 82-0192, filed March 5, 1992, 767 F. Supp. 308 (D.D.C. 1991).

service, which the Bell operating companies may not provide without a waiver from the judgment court.[17] Judge Greene has not yet ruled on that waiver request.

REGULATORY POLICY ON ACCESS CHARGES AND SETTLEMENTS

Divestiture required the federal and state regulatory commissions to develop new policy on long-distance contributions to cover local exchange costs. Before divestiture, the Ozark plan of the agencies diverted a substantial part of AT&T long-distance earnings to cover the joint and common costs attributed to local exchange. In fact, the price-cost margins on AT&T long-distance calls had increased to more than 70 percent in the ten years before divestiture,[18] and its share of "contributions" to cover systemwide costs had increased steadily from 6 percent in 1955 to 32 percent in 1978.[19] After divestiture, given the revenue diversions from gains in market shares of other long-distance carriers, the Federal Communications Commission had to develop new transfer payment schemes that extended beyond the AT&T and Bell operating company settlement process

17. *Five Bell Companies Seeking Permission to Offer DBS Service*, DAILY REP. FOR EXEC., Mar. 1, 1995, at A40.

18. *Cf.* The Historical Cost Study, Defendants' Ex. D-T-427, United States *v.* American Tel. & Tel. Co., 552 F. Supp. 131 (D.D.C. 1982). The price-cost margin for long-distance is based on the average price and the incremental direct cost of a long-distance call; the price-cost margin for local service is based on the average price of the major local services and the incremental direct costs of those local services.

19. Paul W. MacAvoy & Kenneth Robinson, *Winning by Losing: The AT&T Settlement and Its Impact on Telecommunications*, 1 YALE J. ON REG. 1, 7 (1983). Roger Noll and Susan Smart also make that point: "Between the late 1960s and 1984, the fraction of non-traffic-sensitive local exchange costs paid from long-distance revenues increased from 10 to 26 percent, at which time the Federal Communications Commission froze the federal share at 25 percent. Had [the Ozark separations plan] not been in place, by the early 1980s nearly another dollar per month of local exchange costs would have been collected somewhere else in the price structure, and most probably in large measure from the basic monthly rate." Roger Noll & Susan Smart, *Pricing of Telephone Services*, *in* AFTER THE BREAK-UP: ASSESSING THE NEW POST-AT&T DIVESTITURE ERA 88 (Barry Cole ed., Columbia University Press 1991).

and that would allow AT&T to respond to entry by reducing its high price-cost margins on long-distance services. The Commission replaced the separations process internal to the Bell system with (1) access charges that all interexchange carriers paid to the local exchange companies and (2) line charges that customers paid to the local exchange companies.

Access Charges

The modification of final judgment directly specified that access charges paid by interexchange carriers to local exchange carriers would replace the separations/settlements system.[20] Ultimately, however, it was the Federal Communication Commission's rulings that provided the steps to be taken in setting new rates for access services provided to the long-distance carriers by the operating companies. In anticipation of entry into long-distance service markets, in 1980 the Commission tried to develop an access charge plan for the new carriers that would preserve the AT&T subsidy from its long-distance services to local exchange.[21] The announcement of pending divestiture in 1982 caused the Commission to reconsider that plan. Staff economists at the Commission, in the Office of Plans and Policy, urged the Commission to develop a new approach that would "rationalize the industry's pricing practices, improve efficiency, and create opportunities for full utilization of market forces."[22] In short, the Commission should shift contributions to access charges that all long-distance carriers would pay equally for local-originating calls at the long-distance point of presence.

But the logic for what to charge whom had to go further. Access is (1) a service of the local exchange provider to interexchange carriers, but ultimately (2) a service to the end user enabling her to reach the interexchange provider. The Commission proposed to impose not only an access charge on the interexchange providers, but also flat-rate fees on end users as a subscriber line charge (SLC). The 1983 plan would recover non-traffic-sensitive

20. TELECOMMUNICATION POLICY, *supra* note 1, at 174
21. *Id.*
22. *Id.* at 185

costs such as the cost of lines through per-line charges, and traffic-sensitive costs such as switching costs by a charge that varied with usage.[23] The Commission explained:

> Provision of telephone services involves two marginal costs. One varies with the traffic level. The other varies with the number of access lines demanded. For this reason, efficient pricing requires both usage sensitive and non-usage sensitive charges for recovery of access costs . . . . Prices based upon the true cost characteristics of telephone company plant are necessary both to make a decision on whether use of the alternative technologies is appropriate and to make a decision on whether to substitute telecommunications for other activities.[24]

Even so, the per-line charge was clearly perceived by all those in the policy formation process to be an increase in local rates, for "[e]ach dollar of SLC removed a little over $1 billion of revenue requirement from the usage-based carrier access charges and required individual customers to pay an additional $1.00 per month to the local telephone company independent of the customer's volume of usage."[25] The Commission's first proposal was to have the Bell operating companies collect line charges on residential subscribers that started at $2.00 per month and increased rapidly; similarly they were to collect line charges on business subscribers that started at $4.00 per month and also increased at a rapid rate over the next few years.[26] That plan, in theory, raised monthly bills for home consumers and reduced costs of long-distance carriers by billions of dollars per year.

These charges met with strong opposition from Congress

23. MICHAEL K. KELLOGG, JOHN THORNE & PETER W. HUBER, FEDERAL TELECOMMUNICATIONS LAW §9.6.3 (Little, Brown & Co. 1992) [hereinafter FEDERAL TELECOMMUNICATIONS LAW].

24. MTS and WATS Market-Structure, Third Report and Order, CC Dkt. No. 78-72, 93 F.C.C.2d 241, 251, 252 ¶¶ 27-28 (1983) [hereinafter *Access Order*].

25. TELECOMMUNICATION POLICY, *supra* note 1, at 189.

26. *Access Order*, *supra* note 23, at 353.

and Judge Greene's divestiture court. The latter "noted with considerable surprise and some dismay that the Federal Communications Commission, far from using the access charge tool as a means for easing the burdens on the users of local telephone service, has opted instead . . . to saddle the local subscribers with the access costs of interexchange carriers . . . . [T]he agency's action runs directly counter to one of the decree's principal assumptions and purposes—that the fostering of competition in the telecommunication field need not and should not be the cause of increases in local telephone rates."[27] Judge Greene, of course, had no authority to prevent the Commission's action. Further, the D.C. Circuit rejected a related state regulators' challenge to the Commission's authority to set sub scriber line charges.[28]

Pressure from Congress and the Senate forced the Commission to partly yield. In further proceedings, the Commission set an initial level of $4.00 per month, later lowered to $3.50 per month, on the subscriber line charge on the premise that the charge would not be increased. The House and the Senate, responding to the complaint of the other long-distance carriers that the access charge plan would drastically increase their costs, had urged the Commission to give them a large discount.[29] Indeed, a discount was justified as long as their customers had to dial more digits to connect at their point of presence. But the Commission decided on a discount of 55 percent to be phased out as equal quality access became available.[30] The AT&T access charge premium should have just compensated for its ability to provide better quality access; but the extra charge for that better access was in fact enough to induce substantial numbers of consumers to shift to MCI's and Sprint's inferior access services.[31]

27. United States *v.* Western Elec. Co., 569 F. Supp. 990, at 997–99.

28. National Ass'n of Regulatory Util. Comm'rs *v.* F.C.C., 737 F.2d 1095 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1227 (1985).

29. TELECOMMUNICATION POLICY, *supra* note 1, at 198–203.

30. MTS and WATS Market Structure, Memorandum Opinion and Order, CC Dkt. No. 78-72, 97 F.C.C.2d 834, 861 ¶¶ 81–85 (1984).

31. *See* Paul W. MacAvoy & Kenneth Robinson, *Losing by Judicial Policymaking: The First Year of the AT&T Divestiture*, 2 YALE J. ON REG. 163, 251

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