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23 Loosening the Ties That Bind: Regulating the Interstate Telecommunications Market for the 1990's

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Loosening the Ties That Bind: Regulating the Interexchange Services Market for the 1990's

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1 The opinions and conclusions expressed in this paper are those of the author. They do not necessarily reflect the views of the Federal Communications Commission or any of its staff other than the author. The author appreciates the comments and suggestions of Peter Pitsch, Tom Spavins, Ken Gordon and Evan Kwerel of the Commission's Office of Plans and Policy. Any errors in this paper are, however, the responsibility of the author alone.

Section I

In a recent paper, Haring and Kwerel have proposed that the Federal Communications Commission ("Commission") replace rate of return regulation of AT&T with a system of price caps on a limited set of "core" services.[1] Under this proposal, the Commission would not only abandon rate of return regulation as the touchstone for determining whether AT&T's interstate earnings overall were reasonable, but also no longer require service-by-service analysis of costs for determining whether individual rates were lawful. It would replace traditional cost-of-service tariff reviews with the "core" concept, directly regulating rate levels for some services, and indirectly regulating these levels for others. It would prescribe no explicit cap on overall earnings, however.

This proposal raises several legal issues, which this paper addresses. The two principal questions that must be answered in the affirmative for this or a similar proposal to withstand legal scrutiny are:

1. whether, consistent with its obligations under the Communications Act of 1934, as amended, the Commission may "abandon" rate-of-return regulation for AT&T; and

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1 J. Haring and E. Kwerel, Competition Policy in the Post-Equal Access Market, OPP Working Paper # 22 (1987)(hereinafter "Competition Policy").

2. whether the alternative form of regulation proposed by Haring and Kwerel complies with the requirements of Title II of the Communications Act and relevant case law.

A review of relevant administrative and case law reveals legal precedent to support a Commission decision to replace its current rate-of-return regulation of AT&T with the "core" proposal developed by Haring and Kwerel.[2] The remaining pages of this paper set forth that precedent and show how it would support such action. Section II reviews the case law and other factors that support a conclusion that the Commission is under no statutory obligation to impose rate-of-return regulation upon AT&T, and may, with the proper attention paid to procedural requirements, replace this form of regulation with one less onerous. Section III of the paper contains a discussion of whether relevant Commission and court decisions would permit a regulatory scheme such as Haring and Kwerel propose. That Section also

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2 The term "rate-of-return regulation", as used in this paper, describes a pervasive form of regulation designed to control not only the level of the regulated firm's profits, but also the contribution each of its services may make to those profits. Under rate-of-return regulation (also called cost-of service regulation) the Commission not only to determines AT&T's allowable rate of return, but also determines whether: 1) the utility's investment is properly calculated and efficiently incurred; 2) the level of cash expenses is honestly, efficiently and economically incurred; 3) the level of noncash expenses such as depreciation and other accruals is properly reflected in the rate calculations; and 4) the rates proposed or in effect actually cover these costs and produce a fair rate of return. _Nader_ v. _FCC_, 520 F. 2d 182, 204 (D.C. Cir. 1975). Through the tariff review process, the Commission controls the extent to which rates for a specific AT&T service may contribute to meeting AT&T's total interstate costs.

describes the criteria that Title II of the Communications Act would require any scheme for regulating common carriers to satisfy and explains how the Haring-Kwerel proposal meets these requirements. Section IV contains a brief summary of the conclusions reached in the preceding two sections, conclusions that support, if not compel, reexamination of how the Commission regulates AT&T.

Section II

A. Federal Regulation of the Telecommunications Industry (1910-1986).

The Federal Communications Commission has a statutory responsibility to ensure that AT&T's rates are just, reasonable and nondiscriminatory.[3] Currently the Commission attempts to meet this responsibility by assuring that AT&T's interstate services' rates are set overall at levels that will cover AT&T's cost of service, including the cost of raising capital. Before the Commission considers turning to any alternative form of regulation, a preliminary question that must first be answered is whether the Commission is under any legal compulsion to use rate of return regulation. To answer this question, one must look to the Communications Act of 1934, as amended,

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3 MCI Telecommunications Corp. v. FCC, 765 F. 2d 1186 (D.C. Cir. 1985) (quoting American Tel. and Tel. Co. v. FCC, 572 F. 2d 17, 25 (2d Cir.), cert. denied, 439 U.S. 875 (1978); Nader v. FCC, 520 F. 2d at 201.

47 U.S.C. Section 151 et seq., and its legislative history. Because that legislative history is so scant, it is also necessary to examine whether the agencies charged with responsibility for regulating interstate telecommunications services have in the past interpreted their statutory mandate as requiring cost of service regulation.[4]

Federal regulation of interstate communications began in 1910,[5] when the Mann-Elkins Act[6] placed interstate telephone and telegraph services under the supervision of the Interstate Commerce Commission. The Act empowered the ICC to investigate rate complaints and, upon reaching a conclusion that rates were "unjust" or "unreasonable," to declare those rates unlawful.

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4 See FCC v. Midwest Video Corp., 440 U.S. 689, 696, 708 (1979); Philadelphia Television Broadcasting Co. v. FCC, 359 F. 2d 282, 284 (D.C. Cir. 1966).

5 But see Loeb, The Communications Act Policy Toward Competition: A Failure to Communicate, 1978 Duke L.J. 1 (1978) . Loeb asserts that through its judiciary, the federal government was, in fact, already "engaged in a roundabout form of regulation" through aggressive application of the fourteenth amendment's "due process" clause to state rate-setting bodies. Id. at n.17; see, e.g., Smyth v. Ames, 169 U.S. 466, modified, 171 U.S. 361 (1898) (setting the standard for reasonableness against which state ratemaking decisions were measured until it was altered by FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944)).

6 Commerce Court (Mann-Elkins) Act, Pub. L. No. 218, ch. 309, Section 7, 36 Stat. 544 (1910) (amending the Interstate Commerce Act of 1887, ch. 104, Section 1, 24 Stat. 379 (1887)) (provisions relating to telegraph, telephone, and cable companies repealed 1934).

Whether its other responsibilities diverted its attention from the telecommunications industry[7] or its powers were inadequate to make it an effective regulator,[8] the record shows that the ICC was less than a vigorous regulator of interstate telephone service.[9] In particular, during the entire twenty-five year period that it had responsibility for

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7 *See* Interdepartmental Committee Study of Communications (Roper Report), 73d Cong., 2d Sess. 6 (Sen. Comm. Print 1934); Loeb, n.5 *supra*, at 17.

8 *See* Loeb, n.5 *supra*, at 17. Loeb asserts that the ICC could neither initiate actions against telephone and telegraph companies on its own nor prescribe rates to replace rates it found unjust or unreasonable. *Id*.

9 The consensus , in fact, seems to be that ICC regulation of the industry was at best nominal. *See* S. Rep. No.781, 73d Cong., 2d Sess. 2 (1934); Loeb, n.5 *supra*, at nn. 82 & 83 and accompanying text; G. Brock, The Telecommunications Industry: The Dynamics of Market Structure 159-60 (1981). The ICC's most lasting contribution to telecommunications regulation seems to have been its prescription of a uniform system of accounts for telephone and telegraph companies, which the FCC subsequently adopted and the Supreme Court upheld in *American Tel. and Tel. Co.* v. *United States* , 299 U.S. 232 (1936). Only recently did the Commission vote to replace this system with a new system of accounts which it expects will better suit today's regulatory environment. *See* Revision of the Uniform System of Accounts and Financial Reporting Requirements, CC Docket No. 78-196, FCC 86-221, released May 15, 1986. Ironically, even the ICC's uniform system of accounts may not have been its own work product but rather an adaptation of an 1894 Bell System accounting circular. *See* Nelson, *Development of the Domestic Communications Industry: Evolution of Its Structure in Consideration of Technological, Political and Economic Influence*, 28 Fed. Com. B.J. 118, 121 (1975).

regulating AT&T, the ICC never investigated the reasonableness of AT&T's long distance rates and earnings nor did it ever order any changes to them.[10]

In 1934, at the suggestion of President Roosevelt,[11] Congress passed the Communications Act of 1934.[12] As the President had recommended, the Act consolidated in a single independent agency, the Federal Communications Commission, responsibility and authority to regulate all facets of interstate telecommunications previously scattered among the ICC, the Federal Radio Commission, and the Postmaster General.[13] Section 1 of the Act created the Commission " [f]or the purpose of regulating interstate and foreign commerce in communication by wire and radio so as to make available so far as possible, to all the people of the United States a rapid, efficient, Nation-wide ... wire and radio communication service with

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10 G. Brock, n.9 _supra_, at 159.

11 Message to Congress, Feb. 26, 1934, _reprinted in_ H.R. Rep. No.1850, 73d Cong., 2d Sess. 1-2 (1934).

12 47 U.S.C. Section 151 _et seq_.

13 The legislative history of the Act would suggest that this consolidation, rather than any great desire to increase agency power to regulate, was the primary motive of Congress in enacting this legislation. _See_ H.R. Rep. 1850, 73d Cong., 2d Sess. 3 (1934); Loeb, n.5 _supra_, at n.128 and accompanying text. The Act, however, not only achieved the desired consolidation, but also substantially increased the powers of the agency regulating the telecommunications industry. _See_ n. 15, _infra_.

adequate facilities at reasonable charges..." and charged it with "execut[ing] and enforc[ing] the provisions of the Act." 47 U.S.C. Section 151. Title II of the Act sets forth the specific provisions relating to regulation of communications common carriers.[14]

Title II of the Act borrows heavily from the regulatory provisions of the Interstate Commerce Act in effect in 1934. Title II incorporates not only the portions of the latter that had explicitly governed telephone and telegraph companies, but also parts that had applied only to regulation of

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14 Title II requires interstate common carriers to "furnish [their] services upon reasonable request" (47 U.S.C. Section 201(a)) and to make "all charges, practices, classifications and regulations for [those] services ... just and reasonable." (47 U.S.C. Section 201(b)). They must also establish physical interconnection with other carriers whenever the Commission finds, after opportunity for hearing, that such interconnection is in the public interest. (47 U.S.C. Section 201(a)). Title II makes unlawful any unjust or unreasonable discrimination or unjust preference in charges, practices, classifications, regulations, facilities or services related to like communications. (47 U.S.C. Section 202(a)). Each carrier must file with the Commission a tariff showing the rates, terms and conditions for each of its interstate services before offering that service (47 U.S.C. Section 203), see MCI Telecommunications Corp. v. FCC, 765 F.2d 1186, as well as copies of all contracts with other carriers relating to traffic covered by the Act. (47 U.S.C. Section 211). Section 214, 47 U.S.C. Section 214, prohibits a carrier from offering new or additional service until the Commission has found that service to be in the public convenience and necessity; it also prohibits a carrier from discontinuing a service before the Commission determines that "neither present nor future public convenience or necessity will be adversely affected by its discontinuance."

transportation common carriers.[15] In contrast, Section 1 of the Act is "not derived from, or even foreshadowed by the [earlier] communications amendments to the Commerce Act or the overall railroad regulation scheme to which the amendments were appended."[16] Lacking virtually any

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15 The result is an agency with substantially more power to achieve its statutory mandate than the ICC ever held over the providers of telecommunications services. For example, Section 203 of the Communications Act, an adaptation of Section 15(7) of the Interstate Commerce Act, required telecommunications common carriers to file tariffs with the Commission for all their interstate services. Section 15(7) of the Interstate Commerce Act had applied only to transportation common carriers. Section 204 of the Communications Act authorized the Commission to use the tariff filings to investigate proposed rates, either at the request of a user or on its own motion, and to suspend proposed rates pending such investigation. This section was also adapted from Section 15(7) of the Interstate Commerce Act, which had given the ICC such investigative and suspension powers over the railroads, but not the telephone companies. For a more detailed comparison of the provisions of the Interstate Commerce Act and the Communications Act, see Hearings on S. 2190 Before the Senate Comm. on Interstate Commerce, 73d Cong., 2d Sess. 200-13 (1934). This incorporation becomes significant when it is necessary to construe such statutorily undefined terms as "just and reasonable." _See_ Hearings on H.R. 8301 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 15 (1934).

16 Loeb, n.5 _supra_, at 21.

legislative history, this section has consistently been interpreted as granting the Commission a "sweeping mandate." 17 To enable the Commission to fulfill this mandate, the Communications Act provided not only specific

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17 Washington Util. and Transp. Comm'n v. FCC, 513 F.2d 1142, 1157 (9th Cir.), cert. denied sub nom. National Ass'n of Regulatory and Util. Comm'rs v. FCC, 423 U.S. 836 (1975); see Loeb, n.5 supra, at 29. A corollary to the granting of its broad mandate is the Commission's assumption of the role of "expert agency." The courts have consistently acknowledged that "[t]he FCC's judgment about the best regulatory tools to employ in a particular situation is ... entitled to considerable deference from the generalist judiciary." Western Union Intern'l v. FCC, No. 84-1202 , slip op. at 25 (D.C. Cir. Oct. 31, 1986) (citing Computer and Communications Indus. Ass'n v. FCC, 693 F.2d 198, 212 (D.C. Cir. 1982), cert. denied, 461 U.S. 938 (1983)); accord, Philadelphia Television Broadcasting Co. v. FCC, 359 F. 2d at 284.

regulatory powers[18] but also the broad regulatory authority of Section

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18 Those powers include the power to require a carrier to interconnect with other carriers and to establish through routes (47 U.S.C. Section 201(a)), to determine whether carriers' rates and conditions of service are just and reasonable (47 U.S.C. Section 201 (b)) and without unreasonable preferences or discriminations (47 U.S.C. Section 202 (a)). Section 204, 47 U.S.C. Section 204, empowers the Commission to suspend and investigate proposed changes in rates on its own initiative, and, should investigation establish their unlawfulness, Section 205, 47 U.S.C. Section 205, authorizes the Commission to prescribe just and reasonable rates. Section 214 enables it to control entry into and exit from the service market. Most germane to this memo, Title II also gives the Commission all the powers and tools it needs to perform cost-of-service regulation. See National Telecommunications and Information Administration, Comprehensive Review of Rate of Return Regulation of United States Telecommunications Industry, 51 Fed. Reg. at 36,838 (Oct. 16, 1986). The Commission can: (1) determine the property to be included in a carrier's rate base (47 U.S.C. Section 213); (2) prescribe depreciation rates (47 U.S.C. Section 220); (3) determine rates of return (47 U.S.C. Section 205); (4) establish criteria for "allowable" operating expenses (47 U.S.C. Section 204); (5) develop accounting and information systems (47 U.S.C Sections 213(f), 218); (6) specify criteria for reviewing tariffs (47 U.S.C. Section 203); and, (7) establish all rules and procedures required to exercise such regulatory control (47 U.S.C. Section 201(b)).

4(i), 47 U.S.C. Section 154(i).[19] The courts have consistently interpreted this statutory scheme as showing congressional intent to give broad discretion to the Commission in choosing how it will regulate the telecommunications industry.[20] This sweeping mandate, broad regulatory authority and broad discretion are essential to justifying any substantial change to the way in which the Commission regulates AT&T.

While the Communications Act of 1934 gave the Commission expansive powers and discretion, it also gave the Commission responsibility to ensure that AT&T's rates are just and reasonable.[21] To meet this responsibility the Commission now seeks to assure that AT&T's charges for its interstate services are set overall at levels that will cover the costs of AT&T's regulated interstate operations, including its cost of raising capital.

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19 See Nader v. FCC, 520 F.2d at 203. Under Section 4(i), the Commission "may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with [the] Act, as may be necessary in the execution of its functions." 47 U.S.C. Section 154(i). There is also a "mini" Section 4(i) within Title II itself. The last sentence of Section 201(b) states that the Commission "may prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this Act." 47 U.S.C. Section 201(b).

20 See, e.g., Western Union Intern'l v. FCC, No. 84-1202, slip op. at 25-26 (D.C. Cir. Oct. 31, 1986); Computer & Communications Indus. Ass'n v. FCC, 693 F.2d at 212 ; American Tel. & Tel. Co. v. FCC, 572 F.2d 17, 26; Note, Recent Federal Actions Affecting Long Distance Telecommunications: A Survey of Issues Concerning the Microwave Specialized Common Carrier Industry, 43 Geo. Wash L.Rev. 878, n.89 and cases cited therein (1975).

21 United States v. FCC, 707 F.2d 610 (D.C. Cir. 1982).

With respect to specific service offerings, the Commission requires that AT&T set the rates to recover the costs properly allocated to that service. AT&T must supply comprehensive cost support data to establish that its proposed rates will meet this requirement. The Commission's reliance on this approach to meeting its statutory obligations is, however, a relatively recent innovation to federal regulation of AT&T. It was not until the mid 1960's that the Commission determined that the rate-of-return model would be its regulatory touchstone.[22] During the period in which AT&T's monopoly power was undisputed and for all practical purposes unchallenged, the Commission did not rely upon rate of return regulation.[23] Instead it used "continuing surveillance" to prevent earnings of the Bell System from reaching unreasonably high levels.[24]

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22 See American Tel.& Tel Co., Docket No. 11645, 34 FCC 217, 231 (1963), aff'd sub nom. Wilson & Co. v. United States, 335 F.2d 788 (7th Cir. 1964), cert. denied, 380 U.S. 951 (1965).

23 See Rollo, Title II of the Communications Act, 18 Fed. Com. B.J. 37 (1963); Blachly, The Role of Smyth v. Ames in Federal Rate Regulation, 33 Va. L.Rev. 141, 159-69 (1947).

24 In the proceeding that led to its first rate of return prescription, the Commission described continuing surveillance as "a process by which many previous interstate rate adjustments have been brought without formal proceedings ... [, in which] either the Commission or [AT&T] would initiate discussions looking toward appropriate rate changes whenever the level of ... total interstate earnings has appeared to warrant such action." American Tel. & Tel. Co., Docket No. 16258, 2 FCC 2d 173, 177 (1965). The Commission characterized continuing surveillance as an often "effective and highly efficient method of regulation," which, under appropriate circumstances, it intended to use again. Id. at 178.

Ironically it was competition that caused the Commission to turn to the rigorous rate-of-return approach upon which it currently relies for controlling AT&T's rate levels and earnings.[25] By the mid-sixties the Commission had become concerned about the likelihood of AT&T's using revenue from its MTS and WATS monopoly services to subsidize its private line services, for which there was at least incipient competition.[26] As an outgrowth of this concern, in 1967, over thirty years after it was created to regulate AT&T's rates, the Commission for the first time prescribed an

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25 D. Kelley, Deregulation after Divestiture: The Effect of AT&T Settlement on Competition, OPP Working Paper # 8, 16-17 (1982).

26 *See* n. 32, *infra*.

allowed rate of return for AT&T's interstate service offerings.[27] Noting that the Communications Act had set no specific standard for computing a

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27 American Tel. & Tel. Co., Docket No. 16258, 9 FCC 2d 30 (1967). Since that time the Commission has acted on four occasions to represcribe the rate of return for AT&T's interstate operations. See American Tel. & Tel. Co., Docket No. 19129, 38 FCC 2d 213 (1972), aff'd sub nom. Nader v. FCC, 520 F2d 183; American Tel. & Tel. Co., Docket No. 20376, 57 FCC 2d 960 (1976); American Tel. & Tel. Co., 86 FCC 2d 221, recon. denied, 87 FCC 2d 34 (1981), aff'd sub nom. United States v. FCC, 707 F.2d 610 (D.C. Cir. 1983); Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Phase III, FCC 86-354, released August 25, 1986. In other phases of Docket No. 84-800, the Commission codified the procedures and methodologies to be used in its future proceedings to represcribe rates of return for both AT&T's interstate services and the interstate access services of local exchange carriers (Phase II) and enforcement mechanisms for handling overearnings (Phase I). Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Phase I,50 Fed. Reg. 41350 (October 10, 1985), recon., 51 Fed. Reg. 1103 (April 1, 1986); Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Carriers, CC Docket No. 84-800, Phase II, FCC 85-645, released December 20, 1985, modified on recon., 104 FCC 2d 1404 (1986). With its codified procedures, the Commission intends to hold biennial proceedings to represcribe these rates of return.

rate of return,[28] the Commission found its standard for judging the reasonableness of a rate of return to lie in the statutory standard of Section 201(b) calling for "just and reasonable" charges and in the stated purpose of the Communications Act, found in Section 1, that there be "adequate facilities at reasonable rates."[29] That first rate of return prescription was followed in 1970 by rules requiring AT&T to submit substantially more economic data as cost support for its tariff filings,[30] and finally in 1981 by the Interim Cost Allocation Manual, which still governs how AT&T must allocate costs among its interstate MTS, WATS, and private line services categories.[31]

Thus examination of the Communications Act and its legislative history reveals no statutory obligation to use rate-of-return regulation to achieve

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28 American Tel. & Tel. Co., 9 FCC 2d at 52.

29 Id.

30 Tariffs - Evidence, 25 FCC 2d 957, recon. denied, 40 FCC 2d 149 (1970). Among the rules adopted in this proceeding were Section 61.38, 47 C.F.R. Section 61.38, which imposed the cost support requirements with which any AT&T tariff filing must now comply, and Section 61.69, 47 C.F.R. Section 61.69, which made failure to comply with the provisions of Part 61 grounds for rejection of a tariff filing.

31 American Tel. & Tel. Co., CC Docket No. 79-245, 84 FCC 2d 384, recon., 86 FCC 2d 677 (1981), aff'd sub nom. MCI Telecommunications Corp. v. FCC, 675 F. 2d 408 (D.C. Cir. 1982), modified, 94 FCC 2d 1118 (1983).

just and reasonable rates. While the Communications Act clearly gives the Commission authority to adopt and the means to apply this form of regulation, the Act does not expressly mandate it. Nor does the legislative history of the Act indicate that Congress intended the Commission to use this form of regulation to assure just and reasonable rates. Review of the regulatory history of the telecommunications industry shows that when AT&T's monopoly power was strongest and least challenged, neither the ICC nor the FCC perceived the public interest to require such regulation. The FCC's decision to turn to this regulatory approach twenty years ago was triggered by its analysis of the interstate telecommunications market at that time,[32] a factual determination, and one reasonably subject to reexamination in the face of a dramatically altered market structure.

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32 See p.13 supra; see generally American Tel. & Tel. Co., Docket No. 16258, 2 FCC 2d 871 (1965) (MO&O opening investigation that led to the first rate of return prescription for AT&T interstate operations), AT&T and Western Union Private Line Cases, 34 FCC 2d 217 (MO&O prescribing an overall private line services' rate of return for both AT&T and Western Union as well as adjustments to interstate private line telelphone and private line telegraph rates. The goal in this proceeding was to enable the carriers to achieve these earnings while limiting AT&T's ability to subsidize rates for its competitive private telegraph line service with revenues from its private line telephone service. See id. at 229-30).

B. Judicial Standards Governing Regulatory Reform.

A decision to replace rate-of-return regulation of AT&T with some other form of regulatory control would almost certainly trigger judicial review. Thus in order to avoid creating unnecessary uncertainty in the telecommunications industry, it is important to determine whether there is legal precedent to support such a decision. Thus examination of judicial opinions reviewing efforts of other federal regulatory agencies to relax their regulation of industries within their jurisdiction becomes essential in making this assessment because these opinions articulate the standards that appellate courts would apply in judging the legality of an FCC decision to replace rate-of-return regulation for AT&T.

In reviewing an agency's decision to change its policies and procedures, the courts appear to apply a two-pronged test. First a court will look to see whether the Commission's decisionmaking is reasoned in light of the record.[33] The courts recognize, however, that "the

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33 Elaborating on this standard, the Supreme Court explained, "Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." Motor Vehicles Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

reevaluation of extant policy is not, standing alone, an indicator of arbitrariness or caprice; to the contrary, it can be evidence of reasoned decisionmaking .... The key is whether the agency [is] chang[ing] its policy only after reasoned consideration of relevant factors."[34] Section III, infra, discusses the sort of relevant factors that a court might expect the Commission to weigh in deciding whether to replace its current method of rate regulation with another approach.

The second question the courts ask when reviewing a change in regulatory policies is whether the revised policies are consistent with the congressional mandate from which the agency derives its authority.[35] If an agency can show that under current circumstances the goals and purposes of its governing statutes can be accomplished through substantially less regulatory oversight, then the courts will find justified its decision to move from heavy to lighthanded regulation within the boundaries of those

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34 Western Union Intern'l v. FCC, No. 84-1202, slip op. at 24 (D.C. Cir. October 31, 1986) (citations omitted); accord, Drummond Coal Co. v. Hodel, 610 F. Supp. 1489, 1502, 1504 (D. D.C. 1985).

35 Farmers Union Cent. Exchange, Inc. v. FERC, 734 F. 2d 1486, 1500 (D.C. Cir.), cert. denied sub nom. Williams Pipeline Co. v. Farmers Union Cent. Exchange, Inc., 469 U.S. 1034 (1984).

statutes.[36] Because the statutory boundaries on an agency's discretion determine in large measure the extent to which that agency can modify its form of regulation, whether an agency operates under a "public interest" standard or some more narrow, less flexible standard becomes especially significant.[37] The degree of freedom or flexibility accorded an agency seeking to change its regulatory direction appears to be closely tied to the breadth of its legislative mandate and the standards governing its execution of that mandate. For this reason, if an agency with a statutory mandate more narrow than that of the FCC had received judicial approval of its efforts to lighten regulation for at least some segments of the industries it regulated, this would seem to augur well for similar FCC efforts. The Federal Power Commission appears to have been such an agency.

The Natural Gas Act, which created the FPC, seems to have vested far less regulatory discretion in that agency than the Communications Act places

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36 _Farmers Union Cent. Exchange, Inc._ v. _FERC_, 734 F. 2d at 1510. The Supreme Court, and following in its footsteps, the federal courts of appeal have upheld regulatory ratesetting approaches that would substitute reliance on market forces for some degree of (but not total) regulatory control. _See, e.g., FPC_ v. _Texaco_, 417 U.S. 380 (1974); _Permian Basin Area Rate Cases_, 390 U.S. 747 (1968); _Advanced Micro Devices_ v. _CAB_, 742 F.2d 1520 (D.C. Cir. 1984). _Compare_ these cases _with Farmers Union Cent. Exchange, Inc._ v. _FERC_, 734 F.2d at 1510.

37 _See Advanced Micro Devices_ v. _CAB_, 742 F.2d at 1541.

in the Federal Communications Commission.[38] The courts have consistently characterized the primary purpose of the FPC to be protecting consumers from being exploited by natural gas companies.[39] In contrast, the FCC's mandate, to make rapid, efficient nationwide communications services available to all at reasonable rates, makes rate levels only one of several factors the Commission must balance in fulfilling its statutory purpose. Moreover, while it must assure that rates are just and reasonable, the Commission is explicitly given the discretion to "prescribe such rules and regulations as may be necessary in the public interest to" achieve this result.[40] And yet, during the 1960's and 1970's, the Supreme Court consistently upheld FPC decisions to replace the individual cost of service method of fixing rates for segments of the natural gas industry with less onerous, albeit less precise methods for setting just and reasonable rates.

In _Wisconsin_ v. _FPC_,[41] the Supreme Court upheld the FPC's decision to abandon the individual cost-of-service method of fixing rates for natural

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38 _See_ Note, _Storming the AT&T Fortress: Can the FCC Deregulate Competitive Carrier Services?_, 32 Fed. Com. L.J. 205, 212-14 (1982).

39 _See_ _FPC_ v. _Hope Natural Gas Co._, 320 U.S. at 610; _Chicago_ v. _FPC_, 458 F. 2d 731, 750 (D.C. Cir. 1971), _cert. denied_, 405 U.S. 1074 (1972); _see generally_ _FPC_ v. _Texaco_, 417 U.S. at 397-400.

40 47 U.S.C. Section 201 (b).

41 373 U.S. 294 (1963).

gas producers and to substitute in its stead area ratemaking. Then in the Permian Basin Area Rate Cases,[42] the Supreme Court approved the FPC's implementation of that decision through a two-tiered rate structure for setting maximum just and reasonable rates for gas produced in the Basin. To derive a maximum charge for "new gas-well gas" produced in the Permian Basin the FPC had relied upon composite cost data intended to reflect the national average costs in 1960 of finding and producing gas-well gas. The maximum just and reasonable rate for all other gas produced in the Basin was derived from cost data intended to show the average historical cost of gas-well gas produced in the Basin. Noting that this two-tier approach would both provide an incentive for exploration, thus protecting the interests of future consumers, and a shield against excessive profits, thus protecting the interests of current consumers, the Court held that this departure from rate-of-return regulation still led to just and reasonable rates because it would "effectively serve the regulatory purpose contemplated by Congress."[43]

Subsequently, in FPC v. Texaco,[44] the Supreme Court held that the Federal Power Commission could, consistent with the Natural Gas Act, "engage

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42 390 U.S. 747 (1968).

43 Id. at 797-98, 800.

44 417 U.S. 380.

in indirect regulation of small [natural gas] producers."[45] The Court concluded that, while the FPC lacked the authority to rely exclusively upon market place forces to determine just and reasonable rates for such producers, or to exempt them from complying with the just and reasonable rate standard,[46] nothing in the Act required the Commission to fix the rates of these producers through orders directly addressed to them.[47]

Farmers Union Central Exchange v. FERC illustrates, however, that even agencies with broad ratemaking authority can exceed their mandate.[48] In that case FERC adopted a methodology for setting ceilings on profits of oil pipeline operators that permitted a range of allowable prices that would have been excessively high "unless competition in the oil pipeline market dr[ove] the actual prices back down [to reasonable levels]. But nothing in the regulatory scheme itself act[ed] as a monitor to see if this [would] occur[] or to check rates if it [did] not."[49] For this reason, the court held the methodology to be fatally flawed and inconsistent with FERC's statutory mandate to assure just and reasonable rates.

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45 Id. at 387.

46 Id. at 394, 400.

47 Id. at 387.

48 734 F. 2d 1486.

49 Id. at 1509.

As noted earlier, the Commission's mandate is exceptionally broad,[50] and the standards by which its actions are judged are equally expansive.[51] Relevant case law strongly suggests that, while not unbounded, the FCC's statutory authority would certainly permit it to replace rate-of-return regulation for AT&T with some less onerous form of regulatory oversight in the face of an increasingly competitive interstate services market.[52]

Section III focuses upon one specific form of less onerous regulation, the Haring-Kwerel proposal, and discusses why under current circumstances this proposal would be a legally acceptable substitute for rate-of-return regulation.

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50 See n. 17 and accompanying text supra.

51 See Advanced Micro Devices v. CAB, 742 F. 2d at 1541; American Tel. & Tel. Co. v. FCC, 572 F. 2d at 25.

52 See cases discussed at 18-20 supra , American Tel. & Tel. Co. v. FCC, 572 F. 2d at 25.

Section III

A. Current Circumstances

Three years have elapsed since the divestiture of AT&T's local operating companies, the Bell Operating Companies, or BOCs, mandated by the terms of the consent decree terminating the government's antitrust suit against AT&T.[53] During that time the BOCs have met the schedule set forth in the MFJ for providing all interexchange carriers with equal access to the local network facilities needed to originate or terminate their

53 See United States v. American Tel.& Tel.Co.(MFJ), 552 F.Supp. 131 (D. D.C. 1982), aff'd sub nom. Maryland v. United States, 460 U.S. 1001 (1983).

interexchange services.[54] The access tariffs that replaced the pre-divestiture crazy quilt of compensation mechanisms, including settlements, division of revenues, ENFIA, and FX tariffs, have undergone

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54 The MFJ required that upon "bona fide request, every [BOC] end office offer [equal] access by September 1, 1986." 552 F. Supp. at 233. It did recognize an exception to this requirement for end offices "employing switches technologically antecedent to electronic, stored program control switches or those offices served by switches that characteristically serve fewer than 10,000 access lines,"upon a showing that "the costs of conversion for such offices outweighed the potential benefits to users." Id. While the conversions of specific end offices required to bring them into compliance with the terms of the MFJ is yet to be completed, as of October 1, 1986, the BOCs had converted over 67 million access lines (as distinguished from end offices) to equal access. See FCC Public News Notice # 1290, released December 31, 1986. The court will shortly determine a framework for defining reasonable conversion schedules for the remaining offices. The Department of Justice has urged that most of these conversions occur by March, 1988. See Memorandum of the United States Regarding BOC Schedules for Equal Access (filed November 21,1986) in United States v. Western Electric Co., Civil Action No. 82-0192 (D. D.C.) . Under the terms of another consent decree, the General Telephone Operating Companies are also required to offer equal access facilities under a schedule calling for complete conversion to equal access no later than 1990. See United States v. GTE Corp., 603 F. Supp. 730 (D. D.C. 1984). Materials filed with its October 3, 1986 interstate access tariff filing indicate that by December 31, 1986, GTE will have converted 51.2% of its access lines to equal access. See FCC Public News Notice # 1291, released December 31, 1986. In the third phase of its access charge docket, the Commission had imposed an equal access requirement upon the remaining local exchange carriers. MTS and WATS Market Structure, CC Docket No. 78-72, Phase III, 100 FCC 2d 860 (1985). For a summary of the percentage of total access lines each of the major independent telephone companies has converted in the past three years and anticipates converting during 1987, see FCC Public News Notice # 1291.

their second full revision, as called for under FCC rules.[55] AT&T's market share has also declined significantly in this period, and its share of "productive capacity" is declining even more rapidly.[56]

Significant facilities-based competition, particularly in intrastate markets, is definitely a post-divestiture phenomenon. Thirty-six of the thirty-eight multi-LATA states have now authorized such competition;[57]

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55 See 47 C.F.R. Section 69.3. The MFJ required that the division of revenues mechanism through which AT&T compensated the BOCs for their provision of origination and termination of interstate traffic be replaced with a system of non-discriminatory access tariffs through which the BOCs would receive compensation from all the interexchange carriers using their facilities to originate or terminate interLATA traffic. 552 F. Supp. at 233-34. Subsequently in December, 1982, and as a consequence of its investigation into the appropriate market structure for the MTS and WATS market the FCC imposed access charges as the industry-wide mechanism for compensating exchange carriers providing facilities to originate and terminate interstate traffic. See MTS and WATS Market Structure, CC Docket No. 78-72, Phase I, 93 FCC 2d 241, modified on reconsideration, 97 FCC 2d 682 (1983), modified on further reconsideration, 97 FCC 2d 834, aff'd in pertinent part sub nom. Nat'l Ass'n of Regulatory Util. Comm'rs v. FCC, 737 F. 2d 1095 (D.C. Cir.), cert. denied, 469 U.S. 1227 (1984), modified on further reconsideration, 99 FCC 2d 708 (1984), modified on further reconsideration, 101 FCC 2d 1222 (1985), appeal pending sub nom. U.S. Telephone v. FCC, Nos. 84-1115, 85-1386 (D.C. Cir., filed March 23, 1984 and June 24, 1985), aff'd on further reconsideration, 102 FCC 2d 849 (1985).

56 See Competition Policy at 14-20.

57 See National Telecommunications and Information Administration, Telephone Competition and Deregulation: A Survey of the States at 6 (1986) [hereinafter cited as "NTIA Report"]. Idaho and North Dakota are the two multi-LATA states yet to authorize facilities-based competition. While Idaho is currently examining this issue, AT&T's competitors have not sought to enter North Dakota's interLATA market. Id.

almost half of these states had never granted certificates of public convenience and necessity to AT&T's facilities-based competitors before mid-1984. Since that time, however, AT&T's control of intrastate interLATA[58] service markets has undergone a marked decline.[59]

All the factors discussed above have acted to erode AT&T's market power,[60] and, with it, the concerns that led the Commission to select rate of return regulation as its tool for achieving just and reasonable rates. Divestiture-related changes in AT&T's corporate structure have also made this form of regulation increasingly ineffective. The restructured AT&T is

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58 LATAs, or Local Access and Transport Areas, are a creation of the MFJ. To effectuate the MFJ requirement that BOCs provide only exchange and exchange access services, the territories they serve were subdivided into 164 LATAs. See generally United States v. Western Electric Co., 569 F. Supp. 990 (D. D.C. 1982). The BOCs may provide exchange and exchange access services within these LATAs; with only two exceptions, in the absence of a waiver of the MFJ, they may not carry telephone calls beyond LATA boundaries.

59 See, e.g., MCI Telecommunications Corporation, 75 P.U.R. 4th 487, 494 (W. Va. Pub. Serv. Comm'n 1986); Interexchange Telephone Carrier Regulation and Proposed Rulemaking, Docket No. 3522-U, slip op. at 7-8 (Ga. Pub. Serv. Comm'n Jan. 8, 1986); AT&T Communications of Nevada, Inc., Docket No. 84-758, slip op. at 13-15 (Nev. Pub Serv. Comm'n April 15, 1985); SouthernTel of Virginia, 62 P.U.R. 4th 245, 255-56 (Va. State Corp. Comm'n 1984).

60 Even AT&T's competitors in the interexchange services market would concede that AT&T's market power had declined markedly in the past three years. See, e.g., MCI's Petition for Reconsideration at 6, Authorized Rate of Return for the Interstate Services of AT&T Communications and Exchange Telephone Companies, CC Docket No. 84-800, Phase III (filed Oct. 17, 1986).

no longer the capital intensive operation it was prior to divestiture. This means that allowed earnings on investment comprise a significantly smaller component of its revenue requirement and consequently have much less effect on service rate levels than they did before divestiture. Small shifts in revenues, however, can translate into dramatic shifts in earnings. Under these circumstances, making efforts to control AT&T's level of profits the principal focus of regulatory energy compels a commitment of substantial administrative resources to a regulatory exercise with relatively insignificant impact on the charges ratepayers pay. Sharing this opinion, the California Public Service Commission intends to consider in its next general rate proceeding involving AT&T new proposals for determining whether AT&T's intrastate earnings are reasonable.[61] Based upon their assessment of current circumstances in their intrastate markets, ten other states have already abandoned rate-of-return regulation for AT&T operations within their state boundaries.[62]

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61 See Pacific Telephone and Telegraph Co., 66 P.U.R. 4th 104, 109 (Cal. Pub. Util. Comm'n 1985).

62 See Interexchange Telephone Carrier Regulation and Proposed Rulemaking, Docket No. 3522-U (Ga. Pub. Serv. Comm'n Jan. 8, 1986); AT&T Communications of Illinois, Inc., 86-0003 (Ill. Commerce Comm'n April 23, 1986); Rates and Charges of AT&T Communications of Maryland, Inc., Case No. 7941 (Md. Pub. Serv. Comm'n Sept. 17, 1986); Adoption of Administrative Rules relating to the Provision of Telecommunications Services, AR 131 (Or. Pub. Util. Comm'r Nov. 14, 1986); MCI Telecommunications Corp., 75 P.U.R. 4th 487 (W. Va. Pub. Serv. Comm'n 1986); AT&T Communications of Nevada, Inc., Docket No. 84-758 (Nev. Pub. Serv. Comm'n April 15, 1985); Regulation of Intrastate InterLATA Carriers, Cause No. 29217 (Okla. Corp. Comm'n July 24, 1985); Intrastate Access Charges, 69 P.U.R. 4th 69 (Pa. Pub. Util. Comm'n

In their paper Haring and Kwerel identify the significant costs that rate-of-return regulation imposes. While describing in some detail the direct and opportunity costs associated with administering this form of regulation,[63] they focus their remarks upon the economic losses that rate-of

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1985); SouthernTel of Virginia, 62 P.U.R. 4th 245 (Va. State Corp. Comm'n 1984). Through legislation enacted last spring, effective January 1, 1987, Nebraska deregulated interLATA toll service, while banning interLATA rate deaveraging until September, 1991. See NTIA Report at 33.

63 See Competition Policy at 5-7.

return regulation imposes on consumers.[64] They identify three important ways that this form of regulation reduces consumer welfare:

(1) it "significantly weakens the economic incentives for a regulated company to minimize costs and to maximize benefits it provides the public;"[65]

(2) it "divert[s] resources away from marketplace competition to competition within the regulatory and political arenas;"[66] and,

(3) it "prevents the Commission from acquiring the information it needs to make a reasoned determination about the long-term viability of competition in the long-distance business."[67]

Haring and Kwerel conclude that the changes to the structure of the interexchange services market described above have made these costs unacceptably high. They propose an alternative method of regulating AT&T

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64 See id. at 7-11.

65 Id. at 8.

66 Id. at 10.

67 Id. at 11.

that they assert will protect consumers fully, but at lower costs to society than the current regulatory scheme. The following subsection presents a legal analysis of their proposal.

B. The Haring-Kwerel Proposal.

The Haring-Kwerel proposal is simply described.[68] It calls for setting a price ceiling for each of a small set of "core services." Each ceiling price would be uniform nationwide. Among the core services would be at least one close substitute for each service over which AT&T has non-trivial market power. The rate for each core service would be capped initially at the tariffed rate in effect immediately prior to the introduction of their plan. The cap would be adjusted to reflect changes in access charges. The cap might also be adjusted to reflect changes in the purchasing power of money as well as the rate of long-term productivity growth in the telecommunications industry. AT&T would be allowed to set the price of non-core services as it chose, subject to continuation of the current nationwide averaging requirements. It would also be permitted to offer any new service without prior FCC tariff review.

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68 See Competition Policy at 27-28.

The proposal might at first blush apppear to be a radical departure from current Commission practice. It can, however, reasonably be viewed as the next logical step in a regulatory process that since divestiture, and arguably even before that event, [69] has reflected the Commission's recognition that the changing face of the interstate telecommunications industry requires a creative and flexible approach if it is to fulfill its statutory mandate.

In a series of decisions predating divestiture, the Commission has relaxed the conditions under which AT&T may enter and participate in

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69 In decisions antedating divestiture by several years, the Commission consistently revealed an intent to impose only the minimum regulation required to assure the public just and reasonable rates. See Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorization Therefor, Notice of Inquiry and Proposed Rulemaking, CC Docket No. 79-252, 77 FCC 2d 308 (1979); First Report and Order (First Report), 85 FCC 2d 1 (1980); Further Notice of Proposed Rulemaking, 84 FCC 2d 445 (1981); Second Report and Order, 91 FCC 2d 59 (1982), recon. denied, 93 FCC 2d 54 (1983); Second Further Notice of Proposed Rulemaking, 47 Fed. Reg. 17308 (1982); Third Report and Order, 48 Fed. Reg. 46791 (1983); Third Further Notice of Proposed Rulemaking, 47 Fed. Reg. 28292 (1983); Fourth Report and Order, 95 FCC 2d 554 (1983); Fourth Further Notice of Proposed Rulemaking, 49 Fed. Reg. 11856 (1984); Fifth Report and Order, 98 FCC 2d 1191 (1985); Sixth Report and Order, 99 FCC 2d 1929 (1985), rev'd and remanded sub nom. MCI Telecommunications Corp. v. FCC, 765 F. 2d 1186 (1985).

competitive, unregulated markets. Through the Second Computer Inquiry,[70] the Commission fashioned a regulatory scheme to enable the Bell System to enter the unregulated data processing services market and still to remain in compliance with the restrictions imposed by the 1956 Consent Decree.[71] In early 1985, the Commission concluded that changed circumstances within both the unregulated customer premises equipment market and the regulated interexchange services market warranted replacing with non-structural safeguards the structural separation requirements that the Second Computer Inquiry had imposed upon AT&T's participation in the CPE market.[72] Most recently, the Commission concluded that changed circumstances in the unregulated enhanced services market and the regulated interexchange services market warranted its replacing structural separation conditions on

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70 Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), Final Decision, 77 FCC 2d 384, modified on reconsideration, 84 FCC 2d 50 (1980), modified on further reconsideration, 88 FCC 2d 512 (1981), aff'd sub nom. Computer and Communications Indus. Ass'n v. FCC, 693 F. 2d 198 , aff'd on second reconsideration, FCC 84-190 (released May 4, 1984).

71 United States v. Western Electric Co., 1956 Trade Cas. (CCH) para. 68,246 (D. N.J. 1956).

72 See Furnishing of Customer Premises Equipment and Enhanced Services by American Telephone and Telegraph Co., CC Docket No. 85-26, 102 FCC 2d 655 (1985), modified on reconsideration, 104 FCC 2d 739 (1986).

AT&T's participation in the former market with less onerous non-structural safeguards.[73]

The Commission has also relaxed the procedural rules governing its review of AT&T's tariff filings. [74] Without conceding any reduction in the degree of power AT&T exerts in interstate service markets, the Commission has modified its standards for reviewing the lawfulness of both private line service discounts and optional MTS calling plans.[75] More recently, the Commission upheld a decision of the Common Carrier Bureau that permitted the AT&T SKYNET Ku-band services tariff to become effective despite the fact that the cost support data demonstrated that the services would not become compensatory in the near future and despite doubt about their long-term profitability.[76] The Bureau's order reflected a decision

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73 See Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), CC Docket No. 85-229, 104 FCC 2d 958 (1986), reconsideration pending.

74 Amendments of Parts 1 and 61 of the Commission's Rules, CC Docket No. 83-992, 98 FCC 2d 855 (1984).

75 See Private Line Rate Structure and Volume Discount Practices, 97 FCC 2d 293 (1984); Guidelines for Dominant Carriers" MTS Rates and Rate Structure Plans, CC Docket No. 84-1235, FCC 85-540 , 50 Fed. Reg. 42, 945 (October 23, 1985), reconsideration pending.

76 See AT&T Communications: Revisions to Tariff F.C.C. No. 7 to Establish Rates and Regulations for SKYNET Ku-Band Service, FCC 87-3, released January 22, 1987 (Memorandum Opinion and Order denying applications for review of Bureau Order allowing tariff revisions to become effective).

to forsake, at least in this limited case, the traditional regulatory response to such doubts, an investigation of the tariff before it can become effective. Instead the Bureau chose to rely on accounting and reporting requirements to monitor directly the actual demand, costs and revenues associated with the services, and, indirectly, the justness and reasonableness of the rates for these services.[77] In a rulemaking proceeding begun subsequent to this decision, the Commission has proposed to apply this regulatory approach more generally to services for which (1) AT&T's market share is not significant and (2) ease of entry into that service market is an established fact.[78]

Segmenting AT&T's services into two categories, those subject to traditional rate of return regulation and those subject to some form of streamlined regulation in which post hoc reporting and accounting requirements replace Part 61 and Part 65 requirements, may be a reasonable reaction to the uneven development of competition in the interstate markets AT&T serves, but it compounds the difficulties and costs the Commission will

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77 See AT&T Communications, Inc. Tariff F.C.C. No. 7, Transmittal No. 518, Mimeo No. 4620 (released May 20, 1986) at 4-5.

78 Decreased Regulation of Certain Basic Telecommunications Services, CC Docket No. 86-421(Notice of Proposed Rulemaking), FCC 86-548 (released Jan. 9, 1987).

have to confront if it continues to apply these rules to AT&T on either a market or submarket basis. The bifurcated approach only enhances the need for regulatory reform of the sort proposed by Haring and Kwerel. The question is whether, consistent with the Communications Act and relevant case law, the Commission can respond to that need by replacing its current form of regulation with either the Haring-Kwerel proposal or some variation on it.

C. Statutory Goals and the Haring-Kwerel Proposal.

In its ratemaking responsibilities, the Commission's immediate goals and purposes are simply stated. It must assure that rates for interstate telecommunications services are just and reasonable,[79] and the rules it adopts to achieve this result must be in the public interest.[80] Examination of federal case law governing rate regulation reveals that there is no single method or formula that must be used to achieve just and reasonable rates.[81]

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79 Nader v. FCC, 520 F. 2d at 201.

80 Section 201(b), 47 U.S.C. Section 201(b); see n. 19 supra.

81 See FERC v. Penzoil Producing Co., 439 U.S. 508, 517 (1979); Wisconsin v. FPC, 373 U.S. at 309; FPC v. Natural Gas Pipeline Co., 315 U.S. 315 U.S. 575, 585-86 (1942); FPC v. Hope Natural Gas Co., 320 U.S. at 600-02 .

Admittedly, the first cases stating the "no single formula" rule were focusing upon the formulas and methodologies that a regulatory agency might properly use in the steps required to set "cost-based" rates. For example, in Federal Power Commission v. Natural Gas Pipeline Company,[82] the Supreme Court was confronted with two issues related to the methodology used by the FPC to define a gas company's rate base and depletion allowance: (1) whether either the Constitution or the Natural Gas Act required the FPC to include "going concern value" in setting the rate base used to compute the gas company's interstate revenue requirement; and (2) whether the amortization period for the business should have started no earlier than the passage of the Natural Gas Act even though the company had operated for six years before the legislation was enacted.[83] In prescribing interim rates pending the outcome of a full rate case, the FPC had answered both questions in the negative. An appellate court disagreed. Holding that the Constitution did not bind ratemaking bodies to following any combination of formulas in determining reasonable rates, the Supreme Court stated that if the Commission's prescription, "as applied to the facts before it and viewed in its entirety, produces no arbitrary result," the court would inquire no further.[84]

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82 315 U.S. 575.

83 Id. at 581.

84 Id. at 586.

Subsequently, in Federal Power Commission v. Hope Natural Gas Co.,[85] the Supreme Court reviewed an FPC order reducing that gas company's rates for natural gas sold in interstate commerce. The rate reduction arose in part because the Commission used "actual legitimate cost" rather than reproduction cost or trended original cost to define Hope's rate base and refused to include in that rate base certain costs previously charged to operating expenses. Finding that the Commission had used the "wrong" formula for computing the gas company's rate base, and, in particular, that it should have included the disallowed operating expenses in that base, the court of appeals held that the prescribed rates were not just and reasonable from the company's perspective. The Supreme Court, however, explained that it was unnecessary to determine the different ways in which the Commission might permissibly define the rate base on which the company's return would be computed because the end result reached by the FPC in this case was neither unjust nor unreasonable from the investor's viewpoint, and "it is the result reached, not the method employed which is controlling."[86]

It was in Wisconsin v. FPC[87] that the Supreme Court first applied the

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85 320 U.S. 591.

86 Id. at 602.

87 373 U.S. 294.

"no single formula" rule to uphold a regulatory commission's decision to set rates on industry average costs rather than an individual company's costs of service, and in the Permian Basin decision,[88] the Court upheld the FPC's execution of that ratemaking methodology. In the latter case, in a further clarification of the "no single formula" rule, the Court found that the Commission ... ha[d] quite appropriately incorporated in its calculations factors other than producers' costs ....[89] Finally in Federal Energy Regulatory Commission v. Pennzoil Producing Co.,[90] the Supreme Court rejected a lower court's conclusion that FERC was obligated to grant Pennzoil special relief from prescribed area rates because the oil company's royalty payments caused its profit margins to decline. Here the Court applied the "no single formula" rule to conclude that FERC was not obligated to adhere "'rigidly to a cost-based determination of rates, much less to one that base[s] each producer's rates on its own costs.'"[91] The Court held that, under either the Constitution or the Natural Gas Act, FERC's obligation to provide rate relief would be triggered only when prescribed rates fell to confiscatory levels or "outside the 'zone of

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88 390 U.S. 747. See discussion supra at pp.20-21.

89 Id. at 814.

90 439 U.S. 508.

91 Id. at 517.

reasonableness.'"[92] Thus the touchstone for determining whether rates are "just and reasonable" is whether they fall within a "zone of reasonableness," not whether they were computed by using a specific methodology or may produce a certain average rate of return.

In the Hugoton-Anadarko Area Rate Case,[93] a federal appellate court discussed the significance of rate of return as a factor in determining whether rates calculated using non-cost based ratemaking principles are just and reasonable. In that post Permian Basin decision, the ninth circuit examined an FPC order setting rates for natural gas produced in the Hugoton-Anadarko geographic area based upon an industry settlement proposal to which consumer interests had not agreed. Consumer interests then appealed the decision because the FPC had failed to make a finding as to the overall rate of return that would result from rates prescribed under the terms of the settlement. They asserted that without knowing the appropriate rate of return, it would be virtually impossible to decide whether the rates fell above the zone of reasonableness. The court observed, however, that once the FPC departed from individual cost-of-service ratemaking principles, the precision and objectivity which a rate-of-return determination appears

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92 Id. at 519.

93 466 F. 2d 974 (9th Cir. 1972).

to give that agency's ratemaking decision becomes somewhat illusory.[94] The court stated that while the average rate of return that may result from rates based at least in part on non-cost factors may be a consideration in determining their reasonableness, it is neither an indispensable nor a controlling factor in this determination.[95] In upholding the FPC's approval of the proposed settlement, the court concluded that the prescribed rates' exceeding rates based on individual cost-of-service ratemaking principles would not necessarily make the former unjust or unreasonable, as long as reliance on non-cost based factors, like the current economic climate, trends in the industry and supply and demand problems, still led to prescribed rates falling within the zone of reasonableness.[96]

Without standards that enable courts and regulators to identify the boundaries of the zone of reasonableness this touchstone would be of little practical use. Again it is case law that provides the necessary guidelines. In _Farmers Union Central Exchange_ v. _FERC_, the court summarized those guidelines:

> [A]n agency may issue, and courts are without authority to invalidate, rate orders that fall within a "zone of

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94 _Id_. at 982.

95 _Id_. at 983.

96 _See generally_, _id_. at 987-89.

reasonableness," where rates are neither 'less than compensatory,' nor 'excessive.' .... The 'zone of reasonableness' is delineated by striking a fair balance between the financial interests of the regulated company and the 'relevant public interests, both existing and foreseeable.'

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The delineation of the 'zone of reasonableness' in a particular case may ... involve a complex inquiry into a myriad of factors. Because the relevant costs, including the cost of capital, often offer the principal points of reference for whether the resulting rate is 'less than compensatory' or 'excessive,' the most useful and reliable starting point for rate regulation is an inquiry into costs. .... At the same time, non-cost factors may legitimate a departure from a rigid cost-based approach. [But] 'each deviation from cost-based pricing [must be] found not to be unreasonable and to be consistent with the Commission's [statutory] responsibility.' 97

The focus of the federal court of appeals in Farmers Union Central Exchange was on the upper bound of the zone of reasonableness. In that case, the court was reviewing FERC's efforts to develop generic ratemaking principles for oil pipeline systems subject to regulation under the Interstate Commerce Act. The ratemaking methodology the commission adopted reflected its view

97 734 F.2d at 1502 (citations omitted).

that rate regulation for oil pipelines should serve only as a cap on egregious price exploitation.[98] By FERC's own admission the methodology was designed to protect against only "'egregious exploitation and gross abuse,' held that rates resulting from this methodology would fall above the zone of reasonableness because "[r]ates that permit exploitation, abuse, overreaching or gouging are _by themselves_ not 'just and reasonable.'[99]

The lower bound for the zone of reasonableness had actually been set much earlier in cases like _National Gas Pipeline_ , in which regulated entities complained that government prescribed rates, because they were unconstitutionally low, were neither just nor reasonable. In _National Gas Pipeline,_ the Supreme Court observed that "[b]y longstanding usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense."[100] Elaborating in _Hope_ on what it

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98 Under the FERC plan oil pipeline companies could choose from among eight alternative measures for setting their cost of equity the measure most advantageous to them. Among the alternatives available to them were: (i) the realized nominal rates of return on shareholders' book equity in American industry generally over either the past year or the past five years; (ii) the particular parent or parents' realized nominal rate of return on total non-pipeline book equity over either the most recent fiscal year or the past five years; and (iii) total returns (dividends plus capital gains) on a diversified common stock portfolio over either the past five years or "the long run -- 25 years, 50 years, or more...." _Id_. at 1522.

99 _Id_. (emphasis in text).

100 315 U.S. at 585 (citations omitted).

considered to be the minimal non-confiscatory rates, the Supreme Court indicated that to avoid being found confiscatory, rates had to be set high enough to enable a regulated company to meet its operating expenses and its capital costs, i.e., at levels developed by traditional cost-of-service ratemaking principles.[101]

The cases discussed above establish that the zone of reasonbleness is "bounded at [the lower] end by investor interest against confiscation and at [the upper] end by the consumer interest against exorbitant rates."[102] An agency may prescribe any ratemaking methodology it pleases as long as "the methodology result[s] in a reasonable balance between consumer and investor interests," that is, the resulting rates fall within that zone of reasonableness.[103]

The issue discussed in this section is whether the Haring-Kwerel proposal would result in lawful rates, that is, rates falling within that zone of reasonableness. To answer that question it is necessary to examine the proposal to see whether it contains mechanisms either capable of driving

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101 320 U.S. at 603.

102 Jersey Central Power & Light v. FERC, 768 F. 2d 1500, 1503 (1985) (citing Washington Gas Light Co. v. Baker, 188 F. 2d 11, 15 (D.C. Cir. 1950), cert. denied, 320 U.S. 952 (1951).)

103 Id. at 1504.

rates into that zone or of detecting and correcting for the failure of market forces to achieve this result.[104]

Under the Haring-Kwerel proposal the Commission would designate certain services as "core services," and would set the maximum charges, or "caps," for each service so designated. Initially the cap for each would be set at the current tariffed rate. The Commission would probably have to make a specific finding that these rates were just and reasonable.[105] Since they are presumably based on costs, and few, if any, rates become effective under the current regulatory scheme without close scrutiny by competitors and the Commission to assure their being cost-based, and therefore just and reasonable, it should be possible to make this finding without much difficulty. Once the initial rates were certified as just and reasonable, the Commission would attach a presumption of lawfulness to rates for core services as long as they did not exceed these caps. The caps could periodically be adjusted to reflect : (1) changes in access costs; (2) inflation; and (3) projected trends in industry productivity. While clearly a departure from traditonal rate-of-return regulation, this methodology still ties the lawfulness of rates to costs, at least on an industry-wide

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104 See Farmers Union Central Exchange v. FERC, 734 F.2d at 1509, and discussion supra at p. 19.

105 See Advanced Micro Devices v. CAB, 742 F.2d at 1540.

basis, because the factors relied upon in adjusting the initially cost-based caps would themselves all clearly be tied either directly to changes in AT&T's costs of operation (e.g., access charges) or to industry-wide costs (e.g. inflation and productivity). For this reason, this approach can fairly be compared to that approved by the courts in the Permian Basin Area Rate Cases[106] and the Hugoton-Anadarko Area Rate Case.[107]

The failure to set a lower bound on rates for core services may at first appear troublesome. There are safeguards built into this ratemaking methodology, however, that should assure that AT&T would be neither compelled nor able to set rates below the zone of reasonableness. The manner in which the initial core service rate caps are set assures that these rates fall within the zone of reasonableness. The factors on which adjustments would be based assure that the caps remain within the zone of reasonableness. Thus the new ratemaking methodology would not compel AT&T to set rates for core services at confiscatory levels. The cap on core service rates should, moreover, eliminate AT&T's incentive to price such services below cost because it prevents AT&T from being able to extract long-run monopoly profits from users of an initially underpriced service.

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106 390 U.S. 347. See discussion at pp.20-21 supra.

107 466 F. 2d 974. See discussion at pp.40-41 supra.

In the short run, the cap on earnings for all the core services should effectively preclude AT&T from being able to offset revenue shortfalls from one service with excess earnings from another core service. Efforts to recoup earnings shortfalls from non-core services would be similarly unsuccessful since for each non-core service there would be a close substitute among the core services. High prices for the non-core service would merely drive customers to the price-capped core service, if not into the arms of AT&T's competitors.

Admittedly, the Haring-Kwerel proposal may permit AT&T to realize profits in excess of its cost of capital. As noted above, however, this does not lead to a result that is necessarily unreasonable per se.[108] The use of a factor reflecting projected trends in industry productivity to adjust core service rate caps assures that even if market forces prove inadequate to protect customers against "unreasonable high profits," AT&T would still share with ratepayers the fruits of any marked increase in efficiencies. The productivity factor could provide the necessary safeguard against "[r]ates that permit exploitation, abuse, overreaching, or gouging,

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108 See discussion at pp.37-44 supra; FPC v. Natural Gas Pipeline Co., 315 U.S. at 585-86; Banton v. Belt Line Ry., 268 U.S. 413, 423-24 (1925); Leventhal, Vitality of the Comparable Earnings Standard for Regulation of Utilities in a Growth Economy, 74 Yale L.J. 989, 1004, 1016-17 (1965).

[which] are by themselves not 'just and reasonable'" and thus should avoid the "fundamental flaw" that led the court to strike down the ratesetting methodology proposed by FERC in Farmers Union Central Exchange.[109]

Under the Haring-Kwerel proposal, rates for non-core services would not be subject to direct regulation by the Commission; they would, however, clearly be subject to indirect regulation that would compel them to fall within the zone of reasonableness defining lawful rates. AT&T would be free to set its rates for these non-core services at non-confiscatory levels.[110] The incentive to set them lower would be absent since the cap on core services substantially limits AT&T's ability either to recapture unrecovered costs from core service customers, or to recover monopoly profits in the future. Setting the charges for other non-core services at offsetting, but extortionate levels would cause customers to migrate either to the services of competitors or to core services, for which rates would be capped at just and reasonable levels. Thus the selection of core services, coupled with the setting of caps for their rate levels that are based upon carefully selected factors tied closely to costs, has the effect of achieving the statutory goal of just and reasonable rates for non-core services. For this reason the Haring-Kwerel proposal appears to be the sort of indirect

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109 734 F. 2d at 1509.

110 But see p. 49 infra.

regulation found by the courts to be a legally acceptable alternative to strict rate-of-return regulation.[111]

Special mention should be made of the proposal's treatment of new services as non-core services. Based on past experience, the Commission can reasonably conclude that a new service, while perhaps based on a more efficient use of existing technology or the application of a new technology, will be evolutionary rather than revolutionary. It would therefore be almost certain to have a close substitute already included among the core services. Thus, like all other non-core services, the presence of its core substitute with capped service rates would control the rate level of the new service, albeit indirectly. If a new service should fall into the "revolutionary" category, however, the proposal would certainly not preclude the Commission from deciding to determine a specific just and reasonable rate for that service or from requiring AT&T to provide cost data to aid the Commission in this effort.

It is important to emphasize that the Haring-Kwerel proposal does not alter or suspend AT&T's obligation to file tariffs pursuant to Section 203 of the Communications Act, 47 U.S.C. Section 203(a). Nor does it eliminate

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111 See FPC v. Texaco, 417 U.S. at 388-89; Pan American Airlines v. CAB, 392 F.2d 483, 396 (D.C. Cir. 1968).

AT&T's obligation to avoid unreasonable discriminations or preferences in its rate levels and structures. In fact, the Haring-Kwerel proposal offers special protection to customers in parts of the country where market forces may be too weak to protect them against unreasonably high rates. Because it prohibits geographic deaveraging for all services, core or non-core, the proposal assures that these customers will pay no more for their telecommunications services than will those customers in areas subject to strong market forces. Thus it carefully protects the Commission's commitment to universal service. Moreover, while it would suspend any obligation to file economic cost support for any proposed rate changes within the zone of reasonableness defined for core services, or for any filing for non-core services, the proposal does not foreclose interested parties from filing petitions to suspend or reject AT&T's tariff revisions, or from invoking the Commission's complaint process.[112] It does, however,

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112 The proposal does not specify the showing that such a petitioner must make to obtain suspension of a tariff under its core/non-core approach. In its Competitive Carrier docket, the Commission required the following showing to justify suspension of a non-dominant carrier's tariff filing:

> (1) that there is a high probability that the tariff would be found to be unlawful after investigation ... ; (2) that any harm alleged to competition (which [the Commission] believed[d] accomplishes public interest benefits) would be more substantial than that to the public arising from the unavailability of the service pursuant to the rates and conditions proposed in the tariff filing ... ; (3) that irreparable injury would be suffered if suspension does not issue; and (4) that the suspension would not otherwise be contrary to the public interest.

Policies and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, CC Docket No. 79-252, First Report, 85 FCC 2d 1, 37 (1980), A similar injunctive relief type standard would appear to be a reasonable addition to the proposal.

create a presumption of lawfulness for any filings associated with non-core services and any filings within the zone of reasonableness for core services.

In summary, Haring and Kwerel offer a proposal to reduce, but not eliminate, the regulatory role assumed by the Commission vis-a-vis AT&T. Grounded in sound economic principles, it appears to be consistent with legal precedent and current Commission initiatives. Adoption of reporting requirements enabling the Commission to monitor the results of the proposal's introduction might satisfy any lingering doubts about the Commission's ability to fulfill its statutory obligations through this proposal. Such additional safeguards could reassure a reviewing court that the Commission was not abdicating its statutory responsibilities. They could also enable the Commission to ascertain that the anticipated benefits of this less onerous form of regulation were, in fact, realized. And, should those anticipated benefits fail to appear, reporting requirements would enable the Commission to take prompt remedial action.

Section IV

Neither the Communications Act, its legislative history, nor legal precedent requires the continued use of rate-of-return regulation to control the earnings of AT&T or to assure its customers just and reasonable rates. Under current circumstances, the Haring-Kwerel proposal appears to offer a less onerous means of assuring just and reasonable rates for all service users. If an approach that would be less costly to society than rate-of-return regulation for AT&T can still achieve the statutory goal of just and reasonable rates, it would be more likely than continued rate-of-return- regulation to maximize consumer welfare. It therefore appears that it would be in the public interest to substitute such an approach for rate-of-return regulation. This suggests that, at a minimum the Commission should seriously explore this option, and that it should do so as soon as possible.

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