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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M.
THURSDAY, SEPTEMBER 24, 1981

STATEMENT OF
HENRY ESCHWEGE, DIRECTOR
COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
AND THE
SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION AND FINANCE
OF THE
COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES
ON
REGULATING DOMESTIC TELECOMMUNICATIONS COMMON CARRIERS



MR. CHAIRMEN AND SUBCOMMITTEE MEMBERS:

WE WELCOME YOUR INVITATION TO BE HERE TO DISCUSS OUR REPORT RELEASED TODAY TO THE CONGRESS ENTITLED "LEGISLATIVE AND REGULATORY ACTIONS NEEDED TO DEAL WITH A CHANGING DOMESTIC TELECOMMUNICATIONS INDUSTRY" (CED-81-136). IN REVIEWING THE FEDERAL COMMUNICATIONS COMMISSION'S REGULATORY PROGRAM, WE HAD TWO OBJECTIVES. FIRST, WE ASSESSED THE METHODS THE COMMISSION USES IN IMPLEMENTING FOR COMMON CARRIERS A SYSTEM OF PRICE/EARNINGS REGULATION. SECOND, WE EXAMINED THE ACTIONS THE COMMISSION HAS TAKEN TO PREVENT ANTICOMPETITIVE BEHAVIOR AGAINST NEW ENTRANTS.

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IN DISCUSSING THIS INDUSTRY IT IS WELL TO KEEP IN MIND THAT IN 1979 OVER 1500 CARRIERS GENERATED ABOUT \$53 BILLION IN SERVICE REVENUES, EMPLOYED OVER ONE MILLION PERSONS AND HAD A GROSS INVESTMENT IN PLANT AND EQUIPMENT OF ABOUT \$155 BILLION. LET ME HIGHLIGHT EACH OF THE AREAS OF OUR REPORT.

THE DEVELOPMENT OF COMPETITION
IN DOMESTIC COMMON CARRIER
TELECOMMUNICATIONS

RAPID TECHNOLOGICAL CHANGE IN COMMON CARRIER TELECOMMUNICATIONS HAS PAVED THE WAY FOR A MORE COMPETITIVE INDUSTRY STRUCTURE. REACTING TO THIS CHANGE, THE FEDERAL COMMUNICATIONS COMMISSION, SUPPORTED BY THE COURTS, HAS OVER THE PAST 20 YEARS ISSUED A NUMBER OF DECISIONS ALLOWING COMPETITION INTO THE MANUFACTURE OF TELECOMMUNICATIONS TERMINAL EQUIPMENT AND INTO THE INTERSTATE PROVISION OF TELECOMMUNICATIONS SERVICES, WHICH HAVE ALTERED THE STRUCTURE OF THE INDUSTRY.

THE EVOLUTION OF THE INDUSTRY FROM A HIGHLY MONOPOLIZED STRUCTURE TO A COMPETITIVE STRUCTURE IS, HOWEVER, NOT COMPLETE. WE ARE RECOMMENDING THAT THE COMMISSION ESTABLISH WITHIN ITS COMMON CARRIER BUREAU AN INDUSTRY ANALYSIS SECTION TO MONITOR INDUSTRY STRUCTURE. THROUGH ITS MONITORING ACTIVITIES, THE SECTION WOULD PROVIDE A BASIS FOR DETERMINING WHICH CARRIERS ARE DOMINANT AND WHICH ARE NONDOMINANT SO THAT THE APPROPRIATE REGULATORY PROGRAMS AND POLICIES CAN BE APPLIED TO THESE CARRIERS. IT WOULD ALSO ENABLE THE COMMISSION TO MEASURE ITS EFFECTIVENESS IN ENCOURAGING COMPETITION.

IF IT WISHES TO ENDORSE THE TREND TOWARD COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY, THE CONGRESS SHOULD AMEND

TITLE I OF THE COMMUNICATIONS ACT OF 1934 TO DIRECT THE COMMISSION TO RELY ON COMPETITION AND THE PRIVATE SECTOR TO THE MAXIMUM EXTENT POSSIBLE TO ACHIEVE THE OVERALL GOALS OF THE ACT.

TO PROMOTE MORE EFFICIENT USE OF THE COMMISSION'S RESOURCES, WE ARE ALSO RECOMMENDING THAT THE CONGRESS AMEND THE ACT TO ALLOW THE COMMISSION TO EXEMPT FROM ANY OR ALL PROVISIONS OF TITLE II CARRIERS, WHO BECAUSE OF THEIR LACK OF MARKET POWER DO NOT REQUIRE THE FULL RANGE OF REGULATIONS. THE COMMISSION COULD THEN FOCUS ITS RESOURCES ON IMPROVING THE REGULATION OF THOSE CARRIERS WHOSE MARKET DOMINANCE REQUIRES CONTINUED REGULATION.

IMPROVING FCC'S APPLICATION
OF PRICE/EARNINGS REGULATION

THE COMMISSION HAS USED A SYSTEM OF PRICE/EARNINGS REGULATION WHICH RELIES ON RATE OF RETURN/RATE BASE REGULATION TO GOVERN PRICES CHARGED BY CARRIERS. TO IMPLEMENT SUCH A PROGRAM, THE COMMISSION MUST ESTABLISH AND MONITOR RATES OF RETURN, REVIEW THE REASONABLENESS OF INVESTMENTS AND EXPENSES, AND APPROVE INDIVIDUAL RATES FOR CARRIERS' SERVICES. THE COMMISSION HAS, HOWEVER, FOCUSED LARGELY ON ESTABLISHING CARRIERS' RATES OF RETURN AND PAID LITTLE ATTENTION TO CARRIER INVESTMENT COSTS AND EXPENSES.

WE RECOGNIZE THAT BECAUSE OF THE NATURE AND MAGNITUDE OF THE TASKS INVOLVED, A SYSTEM OF PRICE/EARNINGS REGULATION CAN NEVER BE EXPECTED TO FULLY SIMULATE A COMPETITIVE OUTCOME. AS WORKABLE COMPETITION DEVELOPS, THE COMMISSION CAN RELAX ITS APPLICATION OF PRICE/EARNINGS REGULATION. UNTIL A COMPETITIVE

ENVIRONMENT EXISTS, HOWEVER, WE ARE RECOMMENDING THAT THE COMMISSION STRENGTHEN ITS REGULATORY APPROACH. FOR EXAMPLE, IT SHOULD INCREASE THE SCOPE OF ITS AUDIT PROGRAM AND IMPROVE ITS COORDINATION WITH STATE PUBLIC UTILITY COMMISSIONS.

THE COMMISSION'S AUTHORITY FOR APPROVING FACILITIES NEEDS TO BE CLARIFIED. WE ARE RECOMMENDING THAT THE CONGRESS AMEND THE COMMUNICATIONS ACT TO SPECIFICALLY AUTHORIZE THE COMMISSION TO REQUIRE CARRIERS TO SUBMIT FOR APPROVAL PLANS FOR THE CONSTRUCTION OF ANY FACILITY SUBJECT TO ITS JURISDICTION AND TO REQUIRE CARRIERS TO FILE LONG TERM FACILITIES CONSTRUCTION PLANS.

THE 20-YEAR STRUGGLE WITH COSTING PRINCIPLES AND METHODOLOGIES

ALLOCATING COSTS APPROPRIATELY AMONG VARIOUS TELECOMMUNICATIONS SERVICES IS A CRITICAL ASPECT IN PREVENTING POTENTIAL CROSS-SUBSIDY BETWEEN MONOPOLY AND COMPETITIVE SERVICES. THE COMMISSION, OVER THE LAST 20 YEARS, HAS ESTABLISHED THE BROAD PRINCIPLE THAT COSTS SHOULD BE FULLY DISTRIBUTED AMONG ALL SERVICES. THE COMMISSION HAS HAD LIMITED SUCCESS IN DEVELOPING A METHOD TO IMPLEMENT THIS PRINCIPLE.

THE COMMISSION INITIALLY DEVELOPED A METHODOLOGY WHOSE DESIGN WAS FLAWED. EFFORTS TO CORRECT IT WERE UNSUCCESSFUL. THE COMMISSION HAS RECENTLY ADOPTED AN INTERIM COSTING APPROACH TO SERVE AS A STOPGAP MEASURE UNTIL A LONG-RANGE SOLUTION CAN BE DEVELOPED.

TO COMPREHENSIVELY ADDRESS THE PROBLEM OF POTENTIAL CROSS-SUBSIDY, THE COMMISSION SHOULD INCLUDE ADDITIONAL SERVICE CATEGORIES AND IMPROVED FACTORS FOR ALLOCATING COSTS IN ITS INTERIM COSTING APPROACH.

TO DEVELOP A LONG-TERM COSTING APPROACH THE COMMISSION NEEDS TO REVISE ITS UNIFORM SYSTEM OF ACCOUNTS TO REFLECT CURRENT TECHNOLOGY AND BUSINESS FUNCTIONS AND TO APPROPRIATELY ALLOCATE COSTS BY SERVICE USING A METHOD WHICH CAN BE AUDITED AND REVIEWED. SINCE 1978 THE COMMISSION HAS BEEN ATTEMPTING TO REVISE THE SYSTEM BUT WITHOUT SUCCESS. IN OUR NOVEMBER 1979 REPORT WE IDENTIFIED MANAGEMENT PROBLEMS WHICH HAVE HAMPERED THE EFFORT AND WHICH REMAIN UNCORRECTED. TO DATE THE COMMISSION ALSO HAS NOT DECIDED ON THE OVERALL DIRECTION OR STRUCTURE FOR THE SYSTEM. WE ARE RECOMMENDING THAT THE COMMISSION ESTABLISH A GROUP CONSISTING OF ACCOUNTANTS, ENGINEERS, ECONOMISTS, AND ATTORNEYS TO COMPLETE A REVISED UNIFORM SYSTEM OF ACCOUNTS.

WITH THE DEVELOPMENT OF COMPETITION THE COMMISSION MUST DETECT AND CORRECT CARRIER RATES WHICH ARE TOO LOW IN ADDITION TO RATES WHICH ARE TOO HIGH. THE COMMISSION HAS HAD DIFFICULTY IN OBTAINING FROM CARRIERS COST DATA FROM WHICH IT CAN PRESCRIBE A LAWFUL TARIFF. WE ARE RECOMMENDING THAT THE CONGRESS AMEND THE COMMUNICATIONS ACT TO PROVIDE THE COMMISSION WITH THE AUTHORITY TO PRESCRIBE INTERIM TARIFFS BASED ON THE COST DATA WHICH THE CARRIER HAS SUBMITTED. IN A COMPETITIVE ENVIRONMENT THIS WOULD PROVIDE THE COMMISSION WITH A TOOL FOR DEALING WITH RATES OF A DOMINANT CARRIER WHICH APPEAR TOO LOW. SHOULD THE COMMISSION PRESCRIBE HIGHER RATES, IT MAY INCREASE THE CARRIER'S INCENTIVE TO SUPPLY COST DATA WHICH MORE CLEARLY SUPPORTS RATES IT WOULD PREFER.

USING SEPARATE SUBSIDIARIES
AS A PROCOMPETITIVE TOOL

IN ITS SO CALLED "COMPUTER II DECISION" THE COMMISSION EMBRACES A SEPARATE SUBSIDIARY DEVICE AS A WAY OF PREVENTING THE POTENTIAL CROSS-SUBSIDIZATION BETWEEN A DOMINANT CARRIERS'S COMPETITIVE OPERATIONS IN CERTAIN EQUIPMENT AND SERVICE MARKETS, AND ITS TRADITIONAL OFFERINGS. THE EFFECTIVENESS OF THE SEPARATE SUBSIDIARY APPROACH, HOWEVER, DEPENDS PRIMARILY ON THE NATURE AND STRINGENCY OF THE CONDITIONS GOVERNING SEPARATION AND THE QUALITY OF REGULATORY OVERSIGHT.

IN OUR VIEW, THE SEPARATE SUBSIDIARY APPROACH PROPOSED BY THE COMMISSION DOES NOT GO FAR ENOUGH TOWARD PROVIDING FOR ORGANIZATIONAL RESTRUCTURING AND SEPARATION CONDITIONS. ALSO, THE COMMISSION HAS MOVED TOO QUICKLY TOWARD IMPLEMENTING THE SEPARATE SUBSIDIARY REGULATORY APPROACH BEFORE MANY ESSENTIAL COSTING, ACCOUNTING, AND DEPRECIATION PROBLEMS HAVE BEEN RESOLVED. FINALLY, THE COMMISSION HAS NOT UNDERTAKEN A SYSTEMATIC AND THOROUGH ASSESSMENT OF WHAT IT WILL REQUIRE--IN THE WAY OF RESOURCES, STAFFING, AND FUNCTIONAL ORGANIZATION--TO GIVE THE APPROACH CREDIBILITY AND A REALISTIC CHANCE OF SUCCESS.

WE ARE RECOMMENDING THAT THE COMMISSION STRENGTHEN THE CONDITIONS GOVERNING SEPARATION ADOPTED IN THE COMPUTER II DECISION AND THAT AS PART OF IMPLEMENTING ANY DEREGULATION APPROACH BASED ON THE USE OF SEPARATE SUBSIDIARIES, IT

--RESOLVE THE OUTSTANDING COSTING, ACCOUNTING AND DEPRECIATION ISSUES WHICH MUST BE IMPLEMENTED PRIOR TO ESTABLISHING SEPARATE SUBSIDIARIES;

- TRAIN AND ORGANIZE A STAFF TO MONITOR AND ENFORCE COMPLIANCE WITH ITS REQUIREMENTS AND CONDITIONS; AND
- PRESCRIBE CONDITIONS FOR CAPITALIZATION AND FINANCING ARRANGEMENTS FOR THE SEPARATE SUBSIDIARIES.

LOOKING BEYOND THE COMPUTER II DECISION, WE ARE ALSO RECOMMENDING THAT THE COMMISSION INITIATE A PROCEEDING TO EVALUATE THE NEED FOR STRUCTURAL SEPARATION OF A DOMINANT CARRIER'S LONG DISTANCE (INTEREXCHANGE) AND LOCAL (INTRAEXCHANGE) OPERATIONS.

DEPRECIATION RATESETTING AND
ITS IMPLICATIONS IN A MORE
COMPETITIVE ENVIRONMENT

DURING 1980 AND 1981, THE COMMISSION MADE CHANGES TO ITS METHODS AND PRACTICES FOR SETTING DEPRECIATION RATES. THESE CHANGES, ALLOWING FASTER CAPITAL RECOVERY, HAVE BEEN LARGELY IN RESPONSE TO THE RAPID CHANGES IN TECHNOLOGY AND REFLECT THE COMMISSION'S OVERALL THRUST FOR A MORE COMPETITIVE ENVIRONMENT.

IN IMPLEMENTING ITS CHANGES, HOWEVER, THE COMMISSION HAS NOT RESOLVED QUESTIONS REGARDING THE METHODS AND PROCEDURES NEEDED TO SET NEW DEPRECIATION RATES. FOR EXAMPLE, THE PROPER METHOD FOR ALLOCATING THE DEPRECIATION RESERVE ACCOUNT TO INDIVIDUAL PLANT ACCOUNTS HAS NOT BEEN DETERMINED AND REQUIREMENTS FOR SETTING DEPRECIATION RATES FOR THAT PART OF THE DEPRECIABLE PLANT FROM THE TELEPHONE POLE TO THE CUSTOMER'S PREMISES HAVE NOT BEEN DEVELOPED.

BEFORE PROCEEDING TO SET REVISED DEPRECIATION RATES, THE COMMISSION SHOULD ADDRESS THESE AND OTHER QUESTIONS. DOING SO SHOULD ALLOW THE COMMISSION TO AVOID ACCEPTING AND APPROVING

DEPRECIATION RATES WITH LESS THAN THE RIGOROUS REVIEW NEEDED.

ENSURING FAIR, NONDISCRIMINATORY
ACCESS TO LOCAL EXCHANGES

SINCE COMPETITION WAS FIRST ALLOWED IN INTERSTATE TELECOMMUNICATIONS SERVICES, THE COMMISSION HAS REQUIRED THAT ALL CARRIERS OFFERING AUTHORIZED INTERSTATE COMMUNICATIONS SERVICES BE GIVEN ACCESS TO LOCAL EXCHANGE FACILITIES ON A NONDISCRIMINATORY BASIS. SUCH ACCESS IS VIRTUALLY THE ONLY MEANS FOR LOCAL DISTRIBUTION OF INTERSTATE TELEPHONE SERVICES. THE COMMISSION AND THE COURTS HAVE CONTINUED, HOWEVER, TO IDENTIFY ACCESS DISCRIMINATION PROBLEMS INVOLVING BOTH THE TYPES OF ACCESS SERVICES PROVIDED AND THE RATES CHARGED FOR SUCH SERVICES.

THE COMMISSION IS ADDRESSING THE PROBLEM OF ACCESS DISCRIMINATION. NEITHER THE COMMISSION'S PAST ACTIONS NOR ITS PRESENT PROPOSALS, HOWEVER, RESOLVE ALL OF THE QUESTIONS NEEDED TO ENSURE NONDISCRIMINATORY ACCESS TO LOCAL EXCHANGE FACILITIES BY ALL CARRIERS. WE ARE RECOMMENDING THAT THE CONGRESS AMEND THE COMMUNICATIONS ACT OF 1934 TO ESTABLISH THE BASIC FRAMEWORK TO CREATE NONDISCRIMINATORY ACCESS CONDITIONS. THIS INCLUDES EXPANDING THE COMMISSION'S AUTHORITY TO ALLOW IT TO REGULATE ALL LONG-DISTANCE TELECOMMUNICATIONS FACILITIES AND SERVICES.

THIS CONCLUDES MY STATEMENT. WE SHALL BE PLEASED TO RESPOND TO QUESTIONS.