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State Regulatory Problems

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I. INTRODUCTION

The telecommunications industry is a hybrid of monopoly and competition. Consequently, every state utilities commission must decide which aspects of telecommunications are competitive and should be free from regulation, and which should remain under regulatory control. As one commentator stated, "The view is surely becoming increasingly widespread, among both regulated companies and impartial observers, that it no longer makes sense to confine regulated companies to their traditional functions."[1] State commissions' main difficulty is identifying which functions should continue to be regulated.

The balancing of competing interests is the central theme of state regulatory decisions. Commissioners must weigh the interests of the regulated companies, which compete with unregulated companies, against the ratepayers' interest in preserving affordable universal telephone service.[2] The differing views on the economic impacts of deregulation aggravate the task of reconciling these interests. In today's volatile regulatory arenas, commissioners, faced with an urgent need to set policies, must ultimately rely on their basic philosophical beliefs regarding the role of regulation and the degree to which it should be exercised. Some commissioners are

† Chairman of the Minnesota Public Utilities Commission.

1. A. KAHN, THE PASSING OF THE PUBLIC UTILITY CONCEPT: A REPRISE 12 (1983).

2. *See* Cornell, Pelcovits & Brenner, *Toward Competition in Phone Service: A Legacy of Regulatory Failure,* REG., July-Aug. 1983, at 37.

concerned about universal service; others favor industry. These broad, general ideologies provide a framework for more detailed regulatory decisions. This Article examines several significant issues facing state regulators: intrastate access charges, how much regulation is required and in which areas, depreciation of telephone property and equipment, local measured service, and commissioners' concerns about federal preemption.

II. INTRASTATE ACCESS CHARGES

Nationally, the Federal Communications Commission (FCC) adopted a series of access charge orders for interstate service.[3] The initial access charge order imposed flat monthly rates for access to local telephone company facilities used to complete interstate calls.[4] Critics of the plan claimed it unduly burdened local ratepayers with escalated phone bills[5] and threatened "universal service."[6] According to Judge Harold Greene:

> [The FCC access charge] undermines one of the assumptions underlying the Court's approval of the [AT&T divestiture] decree—that there would be no impairment of the principal of universal service—that is, that everyone, regardless of income, would have access at least to a minimum of telephone service, in recognition of the fact that this service is a necessity rather than a luxury. The FCC's decision unnecessarily jeopardizes this objective.[7]

Responding to this criticism, the FCC reconsidered its initial order and released a new order in August 1983.[8] To protect universal telephone service, the reconsideration order eases charges on

3. Under the Access Charge Order, the subsidy by long distance is replaced by direct charges on telephone subscribers. *In re* MTS & WATS Market Structure, 93 F.C.C.2d 241 (1983) [hereinafter cited as *Access Charge Order*], *recon. granted,* CC Docket No. 78-72, FCC 83-356 (released Aug. 22, 1983) [hereinafter cited as *Reconsideration Order*].

4. *See Access Charge Order, supra* note 3, app. A, at 15-16 (setting forth maximum charges).

5. *See generally* Wilson, *Telephone Access Costs and Rates,* PUB. UTIL. FORT., Sept. 15, 1983, at 18-25 (criticizing access charge on economic grounds).

6. *See* United States v. Western Elec. Co., 569 F. Supp. 1057, 1091 (D.D.C. 1983); *Vermont—FCC Endangers Universal Service, Says Public Service Board,* PUB. UTIL. FORT., Sept. 15, 1983, at 54.

"Universal Service" is the concept that telephone service should be available to all households. It encompasses the views that telephone service is a basic communications need in every household and should be supplied for a flat fee. *See* Johnson, *Toward Competition in Phone Service: Why Local Rates Are Rising,* REG., July-Aug. 1983, at 33. Johnson states that over 95% of the nation's households have at least one telephone. *Id.* at 36.

7. *Western Elec.,* 569 F. Supp. at 1091 (footnotes omitted).

8. *See Reconsideration Order, supra* note 3.

local subscribers. Subscriber protection is accomplished by imposing limits on flat fees[9] and providing a six-year transition period for phase-in of all assessments.[10] The gradual transition protects subscribers from any sudden major economic repercussions.

State regulators are faced with the issue of intrastate access charges.[11] When AT&T and the Bell companies supplied all long-distance services, local exchange companies'[12] compensation was arranged internally.[13] With the steadily increasing number of companies providing long-distance service, specific charges for providing access to local exchanges had to be established.[14] The Minnesota Public Utilities Commission (MPUC) is charged with determining the appropriate level of compensation required by local exchange companies to provide access to long-distance carriers.

The policy issues that confronted federal regulators in setting charges for interstate access now confront state regulators as they begin to determine intrastate access charges.[15] To facilitate the task, the MPUC has initiated an investigatory procedure in the form, level, and application of intrastate access charges. The procedure entails formal hearings conducted by the Office of Administrative Hearings.[16]

Administrative hearings are producing extensive testimony that will assist the MPUC in making an access charge decision. To acquire further information, the MPUC solicited responses[17] to several questions, including what objectives an access charge should achieve and how an intrastate access charge should be

9. *See id.* at 14-15.

10. *See id.* at 14.

11. For an informative discussion of the issues surrounding the AT&T divestiture, see BREAKING UP BELL: ESSAYS ON INDUSTRIAL ORGANIZATION AND REGULATION (D. Evans ed. 1983).

12. For a further discussion of exchange areas, see *Universal Telephone Service Preservation Act of 1983: Joint Hearings before the Committee on Commerce, Science, and Transportation, United States Senate, and the Committee on Energy and Commerce, House of Representatives,* 98th Cong., 1st Sess. 34-35 (1983).

13. *See* Johnson, *supra* note 6, at 32. In the past, local service has been subsidized. AT&T's prices for long-distance service were set above cost in order to keep local costs down. *Id.* at 31.

14. *See id.* at 31-32.

15. For a general discussion of the issues facing state regulators with respect to access charges, see *id.* at 33-35.

16. *See* MINN. STAT. §§ 237.075, .081, .295 (1982 & Supp. 1983).

17. Notice of Intent to Solicit Outside Opinion Concerning Intrastate Telephone Access Charges for Intrastate Toll Telecommunications, 7 Minn. Admin. Reg. 1242 (Feb. 28, 1983).

structured.[18]

The MPUC's decision on local access charges will affect local ratepayers and telephone companies operating within Minnesota.[19] To reach a fair result, the MPUC must achieve a balance between economic efficiency and customer equity. The local operating companies (Bell and independents) need to recover the costs of providing access to the interexchange network. Heavy assessment of access costs on interexchange carriers could cause carriers to "bypass" the local network, depriving local companies of access revenues.[20] On the other hand, if burdensome access costs are assessed on local ratepayers through flat access charges, excessive rate increases could result making telephone service unaffordable for many subscribers.

III. How Much Regulation—Rate Base Considerations

State regulators must attempt to accomplish a smooth transition in the deregulation of telephone equipment. In 1980, the FCC ordered that all new telephone equipment be deregulated by 1982, although embedded (previously installed) equipment would continue to be regulated.[21] However facile it is to deregulate new equipment,[22] embedded equipment poses many difficulties.

Embedded equipment presents a complex problem because extensive amounts of telephone products and equipment are listed as inventory on the accounting books of regulated telephone companies. This inventory determines, in part, the rate base[23] of these

18. *Id.* at 1244. Other questions solicited included: (1) How should an intrastate access charge plan be administered?; (2) Which telephone companies are legally required to file access charge tariffs?; and (3) Who should pay what? *Id.* at 1244-45.

19. *See* S. Rep. No. 270, 98th Cong., 1st Sess. 42 (1983).

20. *See* Wilson, *supra* note 5.

21. *In re* Amendment of Section 64.702 of the Commission Rules & Regulations (Second Computer Inquiry), 84 F.C.C.2d 50, 66-67 (1980) [hereinafter cited as *Computer Inquiry II*], *recon.*, 88 F.C.C.2d 512, 514 (1981) [hereinafter cited as *Computer Inquiry II Reconsidered*], *aff'd sub nom.* Computer & Communications Indus. Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied,* 103 S. Ct. 2109 (1983).

"New" equipment is defined as equipment not in service as of March 1, 1982 and offered to consumers after that date. *Computer Inquiry II, supra,* at 66-67. "Embedded equipment" is customer premise equipment which is tariffed at the state level and subject to the separations process. *Id.* at 66. The FCC reasoned that this bifurcated system would facilitate a smooth transition from regulation to deregulation of all customer premise telephone equipment. *See id.*

22. Since new equipment has not become entangled in public utility ratemaking and jurisdictional separations, it can easily be deregulated. *See Computer Inquiry II Reconsidered, supra* note 21, at 525.

23. The "rate base" is basically the plant, equipment, and capital investment of a

companies. The calculations required to remove this equipment from the rate base are difficult and complex.[24] Although the FCC has indicated that embedded equipment should be deregulated,[25] many states continue to include it in the regulated rate base.[26]

The MPUC must also determine sale and lease prices for embedded products. An impediment arises since, for example, Northwestern Bell equipment is in the regulated rate base of the company, and yet must compete with outside vendors who are not hampered by regulation. In an attempt to reach a decision, the MPUC has examined filings by Northwestern Bell concerning equipment pricing. In addressing these filings, the MPUC will consider such issues as: Which products are truly competitive and which are not? Should the marketplace alone dictate pricing or should prices be based on cost? What residual effect will pricing decisions have on local service for ratepayers? Should regulatory commissions extricate themselves and let the marketplace environment take over, or should they retain control over the pricing arena?

Consumer groups want stronger regulatory control in the pricing of these products. They argue that rates and prices should be based on cost. The telephone companies contend that prices would reflect results of competition in the marketplace. Representatives of Northwestern Bell believe that pricing of terminal equipment is not a function of cost—except as a floor beneath which prices should not fall. To Bell, pricing is a function of the marketplace, with many determinants. Where are competitive products priced? What is the marketing strategy? What are cus-

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utility. The MPUC may or may not allow a utility to earn a return on this investment. *See* MINN. STAT. § 237.075, subd. 6 (1982). "In the context of public utility regulation, 'rate base' represents the total investment in, or fair value of, the facilities of a utility employed in providing its service." Northwestern Bell Tel. Co. v. State, 253 N.W.2d 815, 818 (Minn. 1977) (construing MINN. STAT. § 237.08 (1976), *repealed by* Act of June 2, 1977, ch. 359, § 8, 1977 Minn. Laws 772, 777). Not all property owned by utilities is necessarily includable in its rate base; the property must be used in providing the utility service to be included in the rate base. *Id.*

24. *See generally* Cornell, Pelcovits & Brenner, *supra* note 2, at 40-41.

25. *Computer Inquiry II, supra* note 21, at 439. The FCC has found that deregulation of embedded equipment would help promote competition, technological development, and reasonable telephone rates. *See id.; In re* Implications of the Tel. Indus. Primary Instrument Concept, 68 F.C.C.2d at 1157, 1175 (1978); *In re* Proposal for New or Reused Classes of Interstate & Foreign Message Toll Tel. Serv. (MTS) & Wide Area Tel. Serv. (WATS), 58 F.C.C.2d 736, 740 (1976); *see also In re* Economic Implications & Interrelationships Arising from Policies & Practices Relating to Customer Interconnection, Jurisdictional Separations & Rate Structures, 61 F.C.C.2d 766, 867 (1976).

26. *See generally* Cornell, Pelcovits & Brenner, *supra* note 2, at 40-41.

tomers' perceptions of the value of the product? What are customers willing to pay for the product? Bell believes these are the important questions which should determine how prices will be set.[27] Two recent decisions reflect the importance of this issue.

In March 1983, Northwestern Bell sought to enter the competitive market by applying to the MPUC for permission to sell telephones, including the well known "Princess," "Standard," and "Trimline" models.[28] Northwestern Bell wanted to sell both new telephones and telephones already installed in customers' homes.[29]

Although Bell faced fierce competition in this market, the MPUC asserted jurisdiction over the sale of this equipment because the equipment was in Bell's regulated rate base.[30] The Minnesota Department of Public Service argued that Bell had a monopoly on in-place equipment and therefore should not be allowed to sell equipment above cost.[31] The MPUC issued an order finding that the sale of telephone equipment was competitive and that Bell did not have a monopoly on telephone equipment.[32] The finding was supported by evidence of numerous suppliers and customers' ability to purchase telephones from the supplier of their choice. The MPUC also established a price floor below which Bell was not allowed to sell equipment but which could be exceeded in response to market conditions.[33] This decision elicited a less than favorable response:

> This is a regulatory interregnum in the telephone industry—a period of transition from regulation to free market. Some confusion of roles and identities is understandable. But if Northwestern Bell must meet market competition in equipment leasing and sales, the state should not require that prices adhere to a 'just' level. Northwestern Bell should be free to charge whatever it can get. Consumers should be free to pay Northwestern Bell's price or to buy from a rapidly growing number of competitors.[34]

27. *See In re* Request By N.W. Bell Tel. Co. for Authority to Offer For Direct Sale Embedded Customer Premises Equip., Specifically the Standard, Trimline, & Princess Tel. Instruments & Volume Control Handset, Nos. P-421/M-83-144, P-421/M-83-167, Order Approving Request at 3 (Minn. Pub. Util. Comm'n June 1, 1983).

28. *Id.* at 1.

29. *Id.*

30. *Id.* at 4.

31. *Id.* at 6.

32. *Id.* at 5, 7.

33. *Id.* at 7.

34. Minneapolis Star & Trib., June 20, 1983, at 6A, col. 2.

The MPUC recently encountered a new rate base issue. In other decisions, the Commission had wrestled with issues dealing with products in the rate base. The new issue, however, involved total deregulation of products and wiring with resultant removal from the rate base. Facing the same issue, the Iowa State Commerce Commission voted to completely deregulate all customer premises equipment and connected services for all companies operating in that state.[35] Following Iowa's lead, the MPUC voted to deregulate the customer premise equipment and wiring.

IV. DEPRECIATION OF TELEPHONE PROPERTY AND EQUIPMENT

Tangentially related to the "competition versus regulation" issue, is how to properly depreciate telephone property and equipment.[36] Telephone companies argue for a change in their depreciation schedules because competition and technological changes induce rapid product equipment obsolescence.[37] Thus, the companies seek to recover their investment over shorter periods of time. They rely on the FCC's mechanisms for accelerated capital recovery to support this position.[38] Telephone companies contend that they should be allowed to recover capital costs consistent with the realities of rapidly changing technology.[39]

Nonetheless, shorter recovery periods produce higher telephone rates for today's consumers. Longer recovery periods amortize costs, placing some of the burden on future consumers. The MPUC has taken the position that today's changing telecommunications climate requires new depreciation mechanisms that respond to technological changes and quicker plant obsolescence. The MPUC has authorized accounting procedures that provide for accelerated capital recovery of telephone plant and equipment.[40] The MPUC has also formally opposed the FCC's preemp-

35. 1983 A.B.A. SEC. PUB. UTIL. L. REP. 209.

36. *See generally* Ragland & Wolfenbarger, *The Capital Recovery Implications of Telecommunications Regulation,* PUB. UTIL. FORT., July 7, 1983, at 25 (1983) (recommendation for capital recovery methods).

37. *See* Johnson, *supra* note 6, at 32 (companies are accelerating write-off of capital assets to reflect current economic value, rather than remaining physical life).

38. *See In re* Amendment of Part 31 (Uniform Sys. Accounts for Class A & Class B Tel. Cos.), 83 F.C.C.2d 267 (1980), *recon. granted,* 87 F.C.C.2d 916 (1981).

39. 83 F.C.C.2d at 277.

40. *See* 4 MINN. CODE AGENCY R. §§ 215-29 (1982) (depreciation certification for telephone regulation).

tion of states' authority to decide capital recovery matters.[41]

V. Local Measured Service

Proposals are being presented to many states' commissions to restructure telephone rate designs. The pricing mechanism to accomplish the restructuring is "local measured service."[42] In effect, local measured service redefines the concept of "universal service" to include only the provision of dial tone to each customer. Thereafter, each customer must pay the costs incurred in individual calling activity.

Telephone companies assert that the concept of "universal service" must be redefined.[43] They believe that prices for services should be based on usage.[44] These companies contend that current rate design should be restructured to recover the costs of providing service to the user, instead of burdening all customers with the average level of costs.[45]

The MPUC has authorized pilot programs to investigate the impact of "measured service" rate designs. Several thousand customers are participating in a program designed by Northwestern Bell. In a June 29, 1983 report to the MPUC, Northwestern Bell presented the results of a survey indicating favorable customer reaction to local measured service.[46] Bell argued that measured service was more equitable and that customers should have the option of selecting a service that will permit them to control costs, similar to present gas and electrical services. Statistics supplied by Bell indicated that residential measured service users average less than two calls per day, at about four minutes per call. Flat rate residential users average about five calls per day and talk for longer periods. Bell concluded that most customers using measured service

41. The MPUC is authorized to determine these issues. Section 237.22 of the Minnesota Statutes states, "The department [of public service] shall fix proper and adequate rates and methods of depreciation and amortization with respect to telephone company property and every telephone company shall conform its depreciation accounts to the rates and methods fixed by the department." MINN. STAT. § 237.22 (1982).

42. "Local measured service" is a method of billing based upon the quantity, time, and distance of calls made by the customer.

43. *See* Nickolai, *Minnesota's Communications Policy Choices: For Whom Will the Bell Toll?*, 10 WM. MITCHELL L. REV. 507, 512-18 (1984).

44. *Id.* at 514.

45. *See generally* Brown, Hershkowitz & Banks, *An Analysis of Current Communications Initiatives in the FCC and Congress*, 10 WM. MITCHELL L. REV. 459 (1984).

46. Bell Report on the Results of Local Measured Service Offering (n.d.).

are saving money.[47]

In a submittal to the MPUC, the Minnesota Department of Public Service disagreed with Bell's report. The Department claimed that Bell has attempted to phase in measured service through the initiation of "experimental" pilot programs. The Department questioned the propriety of allowing these rates without adequate public review and scrutiny and argued for further investigation of a policy issue of this magnitude. To date, the Commission has allowed Northwestern Bell to continue with the authorized pilot program.

As with other telecommunications issues, state regulators must balance conflicting interests. Measured service rates have been introduced in forty-two states.[48] For years, such rate structures have been debated within state regulatory commissions. Advocates of measured service contend that it benefits the public and provides a fair assignment of costs.[49] "The measured service transition is just, as long as it is accompanied by developing economy options for poor people."[50] Although setting prices based on usage is sound policy, rising phone rates and increasing adverse public reaction require that regulators carefully evaluate the bottom-line dollar results of their decisions.

VI. Concerns About Federal Preemption

The central issue arising from the tremendous structural changes occurring in the telephone industry is who will bear the cost of providing service. Ultimately, more responsibility for the cost of telephone service will be placed upon local residential ratepayers.[51] Residential subscribers will, in fact, carry the burden of increased rates.[52] AT&T subsidiaries, for example, requested $4 billion in rate increases from state commissions in 1983, $3.5 billion of which was aimed at residential subscribers.[53] Until recently, most telephone rate increases were assessed to equipment

47. *Id.*
48. Wash. Post, May 15, 1983, at F3, col. 1.
49. *Id.* at F3, cols. 3-4.
50. *Id.*
51. *See* Johnson, *supra* note 6, at 31-33.
52. *See id.* at 36. "If the reasoning behind the FCC's access decision is carried to its logical conclusion, the price of residential subscriber access will end up near its full cost, with the flat charges rising from less than $10 a month to more like $25 (in current dollars)." *Id.*
53. Wash. Post, May 15, 1983, at F1, col. 1.

and business users. Today, state utility commissions face the enormous challenge of maintaining affordable service in an industry that is being altered significantly.

Efforts by state commissions to meet this challenge have been complicated by the uncertainty of their authority and responsibility, which may have been preempted by Congress.[54] Congress has produced a steady flow of legislation addressing telephone issues.[55] Categorized under the general heading of "ratepayer protection" actions, these bills were aimed primarily at softening the financial impact of competition and deregulation on local residental ratepayers. In many cases, the legislation overturns previous FCC or state commissions' decisions. The practical result is a lack of clear public policy to guide future decisions at the state level.[56] Years may pass before these issues are finally settled by the courts, and state commissions can only attempt to exercise their best judgment despite the tenuousness of their decisions.

Some state regulators express greater concern about possible preemption of their decisionmaking authority by the FCC than by Congress.[57] State commissions have appealed FCC decisions that they consider wrongfully preemptive.[58] In addition, the national body representing state commissions' interests[59] is lobbying to protect states' decisionmaking powers. Paul Rodgers, Administrative Director and General Counsel for the National Association of Regulatory Utility Commissioners (NARUC), states:

> The NARUC is dedicated to the principle of federal-state regulatory cooperation, particularly as we find our way to the newly competitive telecommunications environment. At the same time, our role, as advocates of the states' interests frequently dictates that we become the FCC's courtroom adversary. However much we may respect the Commission's national perspec-

54. *See* Computer & Communications Indus. Ass'n v. FCC, 693 F.2d 198, 214-18 (D.C. Cir. 1982); Comment, *An Assessment of State and Federal Jurisdiction to Regulate Access Charges After the AT&T Divestiture,* 1983 B.Y.U. L. REV. 376, 380-81, 403-04.

55. *See, e.g.,* S. 1660, 98th Cong., 1st Sess., *Joint Hearings, supra* note 12, at 5-13 (1983); H.R. 4102, 98th Cong., 1st Sess., H.R. REP. NO. 479, 98th Cong., 1st Sess. 1-13 (1983). *See generally* Brown, Hershkowitz & Banks, *supra* note 45.

56. *See supra* note 55.

57. 1983 A.B.A. SEC. PUB. UTIL. L. REP. 195-96; *see also supra* note 54.

58. *See, e.g.,* Computer & Communications Indus. Ass'n v. FCC, 693 F.2d 198, 215-16 (D.C. Cir. 1982); North Carolina Util. Comm'n v. FCC, 552 F.2d 1036, 1049-50 (4th Cir.), *cert. denied,* 434 U.S. 874 (1977); North Carolina Util. Comm'n v. FCC, 537 F.2d 787 (4th Cir.), *cert. denied,* 429 U.S. 1027 (1976).

59. State commissioners are represented by the National Association of Regulatory Utility Commissioners.

> tive, we believe that the congressional decision to preserve state authority over intrastate communications matters—as embodied in the 1934 Communications Act—was an exceedingly wise one. The FCC is ill-equipped to fully appreciate peculiarly local concerns.[60]

The MPUC is committed to fulfilling its regulatory responsibilities despite these federally created uncertainties.

VII. CONCLUSION

Judge Harold Greene has stated:

> The telecommunications industry as a whole has a bright future for, as the Court previously observed, we are in an age in which information and its transmission are central to the commonwealth and a flourishing economy. No one can predict which company or group of companies will be able best to take advantage of the opportunities which lie ahead. To a larger extent, this will depend upon their own efforts and performance, and to a lesser degree upon the wisdom of those who will exercise regulatory authority over various segments of the industry at the federal and local levels.[61]

The MPUC's role is to attempt to define the regulatory authority to which Judge Greene refers. Each specific decision, such as depreciation, equipment sales, or rate design, involves recurring policy considerations.[62] Whether competition and deregulation of the telephone industry will provide overall benefits is uncertain. Telephone industry representatives claim that technology is changing so rapidly that gauging the impact of deregulation and competition will be impossible.[63]

Operating in this impermanent climate, state regulators often question the import of their decisions. Technological change renders many state commissions' decisions moot or ineffective.[64] Consequently, some commissioners believe the concept of regulation is obsolete and support complete deregulation of telecommunications. In all likelihood, however, public interest groups will disfavor the unbridled, competitive nature of the industry and argue

60. Address by Paul Rodgers to Communications Workers of America (Mar. 22, 1983).

61. *Western Elec.*, 569 F. Supp. at 1122 (footnotes omitted).

62. *See* Johnson, *supra* note 6, at 50-51 (discussing possible alternatives for state regulators).

63. *See* Garfinkle, *Interexchange Telecommunications Markets in Transition,* PUB. UTIL. FORT., July 21, 1983, at 26.

64. *See* Johnson, *supra* note 6, at 31-32.

for more regulatory oversight. Thus the regulatory pendulum, which began swinging one hundred years ago when Alexander Graham Bell was granted the first telephone patent, will swing back again.