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STATEMENT OF
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RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON GOVERNMENT INFORMATION, JUSTICE, AND
AGRICULTURE OF THE COMMITTEE ON GOVERNMENT
OPERATIONS
HOUSE OF REPRESENTATIVES
ON
THE EFFECTS OF CHANGES IN THE
TELECOMMUNICATIONS INDUSTRY
ON FCC'S OPERATIONS

Mr. Chairman and Members of the Subcommittee:

We welcome your invitation to discuss the effects of changes in the telecommunications industry on the operations, workload, and structure of the Federal Communications Commission (FCC). As you are aware, the past decade has been one of explosive growth and change in this industry. Decisions by FCC, the Congress, and the courts have created opportunities to develop many new telecommunications products and services. They have also opened the door to increased competition and deregulation in telecommunications markets. However, the transition to a competitive marketplace is not complete. The role of FCC has, if anything, become increasingly important during this period. Many of its recent decisions and many issues which it is now considering will have major effects on the development of competition in the industry and the availability of telecommunications products and services to the citizens of the United States.

At the request of this subcommittee, we have updated our previous work on FCC's efforts to respond to the changes in the telecommunications industry.[1] As requested, we have focused our attention on issues raised by FCC's recent access charge and Computer II decisions. The access charge decision changes the way in which the costs of providing long distance telephone service are recovered from users, while the Computer II decision allows common carriers to offer customer premises equipment (telephones and other terminal equipment) and enhanced communications services (such as services involving data processing applications) on an unregulated basis.

In general, we have found that FCC has been conscientious in its efforts to carry out its regulatory responsibilities in this dynamic telecommunications environment. For example, during recent years, FCC has made a number of decisions to increase competition in the telecommunications industry and eliminate unnecessary regulation. Further, FCC has made a variety of changes in its organizational structure aimed at improving operational efficiency.

In spite of its efforts, however, FCC has experienced problems in attempting to resolve all of the complex and controversial issues facing it. As discussed below, a number of important issues (including certain issues resulting from its Computer II decision) are still unresolved, and other important regulatory responsibilities (such as the development of a long-term methodology for allocating costs among telephone services) need additional attention. Further, in some instances, such as in its recent access charge decision, FCC has not carried out the analysis needed to fully determine the effects of its actions. This

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[1]A list of these reports is contained in Appendix I.

has increased the risk that FCC's decisions will not achieve their objectives and may instead produce undesirable side effects.

FCC'S ACCESS CHARGE DECISION

For several decades, FCC and State public utility commissions have struggled with how to allocate local exchange telephone plant costs among local and long distance telephone services and how to recover these costs from telephone users. Since 1971, when FCC first allowed competition in interstate telecommunications services, FCC has also been concerned with ensuring that new companies entering the industry are provided nondiscriminatory access to local exchange facilities.

In December, 1982 FCC adopted its access charge decision and reconsidered it in July 1983. The decision, as reconsidered, substantially changes the way in which local telephone exchange plant costs are recovered from telephone users. In making this change, FCC sought to balance several goals--eliminating unreasonable discrimination among rates for interstate long distance services, avoiding widespread customer cancellation of telephone service, encouraging efficient use of the local network, and limiting customers' incentives to bypass the local exchange to avoid certain usage-based charges. FCC, however, did not perform the detailed analysis needed to fully support its determination. As a result, concerns have been expressed by public interest groups and some State public utility commissions, among others, that FCC's decision may not optimally balance its goals and may instead result in many customers cancelling their telephone service.

First, let me address the mechanics of the access charge order. The order divides local telephone plant costs into two categories based on whether or not they are sensitive to telephone use. It is the cost recovery of the common line, one of the non usage-sensitive elements, that has been the central and most controversial issue in the access charge decision.

The common line includes (1) customer premises equipment, (2) the wiring inside a customer's residence or business, and (3) the "local loop" between the customer and the local telephone company's office. Traditionally, the portion of the costs of the common line which are assigned to interstate service has been recovered through usage-sensitive rates charged by long distance carriers. The access charge order will change this cost recovery procedure by requiring each customer to pay a flat monthly charge to cover the interstate costs associated with the local loop portion of this common line. FCC has taken action in other proceedings to gradually remove from carriers' rate bases the costs associated with customer premises equipment and inside wiring. It determined that until these costs are completely removed, they should continue to be recovered through usage-sensitive long distance rates in order to lessen the impact of the flat monthly charges.

The access charge order also provides for a six-year transition to phase in the monthly charge. The charge will begin at a fixed $2 per line per month in 1984 for residential customers and increase annually until all interstate local loop costs (an estimated $6 to $10 per line per month on average) will be recovered directly from customers. To reduce the amount of the flat monthly charges in high cost areas, FCC plans to establish a Universal Service Fund, which will provide financial assistance to local telephone companies whose costs for non usage-sensitive plant are more than 15 percent above the national average.

The FCC believes that the direct recovery of these costs from the customer can work toward achieving its previously stated goals. Further, FCC states that if local loop costs continue to be recovered through usage-sensitive long distance rates, the telephone network may be threatened by the bypass of large customers. As large customers account for a substantial percentage of long distance usage, FCC believes they may bypass the local exchange by building or leasing their own facilities as a way to avoid the usage-sensitive rates. If these large customers abandon the local exchange network, FCC is concerned that remaining customers will have to pay higher rates. Conversely, many critics of FCC's access charge decision contend that the flat monthly charges proposed by FCC will, themselves, considerably increase residential telephone rates and, thus, cause a significant percentage of customers to cancel telephone service.

Before issuing its access charge decision, FCC did not carry out detailed analyses of either (1) the magnitude of bypass which is likely to occur and how it will affect telephone service or (2) to what extent requiring customers to pay the flat monthly charge established in its access charge order will cause customer cancellations of telephone service. As a result, it is unclear whether FCC's decision is the best approach for resolving this difficult and controversial issue.

After issuing its decision, FCC did grant a petition to study the effect of its actions on local telephone rates and will prepare a report on this by December 1, 1983. The FCC will also monitor the impact of the access charge order throughout the transition and, as previously mentioned, will have a Universal Service Fund that will provide financial assistance to telephone companies in high cost areas as a means of reducing customer cancellations.

In addition, it is questionable whether FCC has adequately addressed other aspects of its access charge decision. For example, in its May 1982 supplemental notice in the access charge proceeding, FCC stated that there was no reason to believe that using AT&T's interstate rate of return (the return it may earn on investment) for setting access charges was appropriate. Instead, FCC requested comments from the public on other approaches, including convening a rate of return proceeding on the subject or basing the return on that allowed by the States. FCC did not, however, develop sufficient information to support a different approach and, thus, it chose to use AT&T's authorized interstate rate of return until a new approach can be considered.

COMPUTER II IMPLEMENTATION

In 1980, the Computer II decision allowed telephone companies to offer customer premises equipment and enhanced communications services on an unregulated basis. This decision created the need for FCC to take a variety of actions to ensure that telephone companies did not engage in anticompetitive behavior or cause regulated ratepayers to bear the costs of the companies' unregulated offerings.

In a January 1982, report to this subcommittee[2] we questioned FCC's ability to carry out all necessary Computer II implementation tasks. Since then FCC has established and maintained a task force of approximately 15-17 persons with responsibility for Computer II implementation. The task force, together with other FCC staff, has taken action to address many of the concerns raised in our report; however, a number of important issues remain unresolved.

In its Computer II decision, FCC allowed AT&T to share various administrative services with the subsidiary FCC had required AT&T to establish to provide unregulated products and services. FCC required AT&T to develop costing and accounting procedures to ensure that the costs of these shared services are reasonably allocated. FCC has conditionally approved these

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[2]"Can the Federal Communications Commission Successfully Implement Its Computer II Decision?" (CED-82-38, Jan. 29, 1982).

procedures; however, it is still reviewing whether adjustments in them are needed. At the same time, FCC has done little to examine how other telephone companies are allocating costs between regulated and unregulated activities, even though its Computer II order noted the potential for such companies to engage in cross-subsidy. Even after costing and accounting procedures are approved and in place, FCC will need to monitor compliance with them so long as the potential for anticompetitive behavior exists.

Other issues also remain unresolved. For example, to implement Computer II, it has been necessary for FCC to oversee the capitalization of AT&T's separate subsidiary to ensure that costs were not improperly charged to customers of AT&T's regulated services. While FCC has generally approved AT&T's capitalization plans, a major concern remains undecided, the treatment of $500 million expended by Western Electric by the end of 1982 on research and development for customer premises equipment. FCC has expressed concern that while these research and development activities may primarily benefit AT&T's unregulated operations, some of their costs may have been borne by regulated ratepayers and, if so, ratepayers should be reimbursed. AT&T has stated, however, that it does not believe a reimbursement should be required. Because of the large amount of money involved, FCC has sought additional information from AT&T and solicited public comments on this matter. AT&T and various parties filed statements with the FCC in December 1982 and January 1983, respectively, but according to Computer II task force officials, staffing constraints have prevented them from submitting the issue to the Commission for resolution. They also said limited travel funds may keep the task force from fully carrying out its planned investigation of AT&T's compliance with Computer II computer security requirements. These requirements are aimed at ensuring that AT&T's separate subsidiary cannot access information in AT&T computers which would give it an unfair advantage over its competitors.

In addition, two other major issues relating to Computer II are facing the Commission, both of which need to be resolved by January 1, 1984, when the AT&T divestiture is scheduled to take place. These are deregulation of in-place customer premises equipment and the application of Computer II requirements to the Bell Operating Companies after they are divested from AT&T. In our September 24, 1981, report to the Congress[3] we recommended that FCC establish a framework for deregulating all customer premises equipment; however, FCC has yet to decide on an approach for accomplishing this. Although FCC issued a Notice of Inquiry in April 1982 which laid out the general options for dealing with in-place customer premises equipment, it did not release a Notice of Proposed Rulemaking on that subject until June 1983. AT&T has indicated that unless a plan is approved for transferring in-place equipment to its separate subsidiary by January 1984, it--and, consequently, its customers--will incur additional costs. These costs will be due to the need to establish a temporary organization to retain this equipment in regulated service from the time the equipment is transferred to AT&T from the Bell Operating Companies until it is deregulated.

Before January 1984, FCC also needs to determine how the Bell Operating Companies' offerings of unregulated products and services will be treated under FCC's Computer II requirements. Unless this matter is decided quickly, FCC may not be able to ensure that adequate safeguards are in place to deter or detect possible anti-competitive behavior if the companies are allowed to begin offering unregulated products and services on January 1, 1984.

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[3]"Legislative and Regulatory Actions Needed to Deal With A Changing Domestic Telecommunications Industry," (CED-81-136, Sept. 24, 1981),

OTHER REGULATORY ISSUES

There are also other important domestic common carrier regulatory problems which remain unresolved and which demand additional attention. A number of these were noted in past reports we have issued on FCC activities. For example, in our September 1981 report we highlighted FCC's twenty year struggle to revise its accounting requirements and develop costing principles and methodologies to prevent telephone companies from subsidizing their competitive products and services by overcharging for services in captive monopoly markets. FCC has established a group to revise its Uniform System of Accounts for telephone companies. This project is proceeding toward a January 1, 1986, implementation date, but even after implementation it will not directly provide the data FCC needs to ensure costs are properly allocated among carrier products and services. Instead, FCC has planned to develop a long-term cost allocation methodology which would use financial data recorded in the revised system of accounts to produce cost-of-service information. Currently, FCC relies on an "interim" cost allocation manual adopted in 1980 to provide cost information. In adopting the interim cost manual, FCC noted its limitations and the need to evaluate long-term costing approaches. While FCC stated that it planned to take action on that subject "in the near future," it has yet to do so.

FCC is also faced with other important regulatory tasks, resulting, in part, from the AT&T divestiture. For example, FCC will need to determine how the divestiture will affect telephone rates and service quality--an area which it has already begun to explore. FCC will also need to determine whether and how existing regulatory requirements it has placed on AT&T should be revised after divestiture.

OPPORTUNITIES FOR IMPROVING FCC'S ORGANIZATION AND MANAGEMENT

During the past 6 years we have reviewed how various FCC activities are organized and managed. This has included not only comprehensive analyses of FCC's broadcast and domestic common carrier policies and programs but also an overall review of FCC's organization and management. In these reviews we have made a substantial number of recommendations to the Commission. The Commission has responded positively to many of these. For example, as required under Public Law 97-35, it established a Managing Director and gave him administrative authority over FCC's organizational units. It also developed an improved management system and established an internal program evaluation unit to help assess the effectiveness of its policies and programs. Nevertheless, as we have noted, the Commission continues to experience difficulties.

We believe that these problems result from a variety of factors. In large part they are due to the rapidly changing nature of the telecommunications industry and the complexities of and controversies surrounding many of the issues which the Commission must decide. Further, it should be recognized that the Commission has been attempting to deal with its new and changing responsibilities during a period in which its resources have declined. Given the ongoing nature of many of FCC's current responsibilities and the need for it to address issues which it has not yet considered or is just beginning to consider, we believe FCC may continue to experience problems in attempting to carry out its responsibilities over the next several years.

While we offer no simple solutions for drastically upgrading FCC's ability to handle the issues confronting it, we believe that there are some changes which can improve its performance. In both our September 1981 report on domestic telecommunications regulation and a March 1983 report on international telecommunications,[4] we recommended that to improve its ability to (1) determine the need for changes in regulatory policies and (2) evaluate the effectiveness of its actions, FCC should establish an industry analysis section in its Common Carrier Bureau. We believe the establishment of such a section remains important, particularly in light of the need for FCC to monitor how the AT&T divestiture, its access charge decision, and other recent events affect the structure of the telecommunications industry and the products and services it provides. FCC Common Carrier Bureau staff said FCC is considering the establishment of such a section; however, it has not yet been established.

In our September 1981 report we also recommended that FCC establish a program in its Common Carrier Bureau to improve its coordination with State public utility commissions. We noted that while FCC and the States may frequently be involved in reviewing many of the same aspects of a telephone company's activities, there has often been little coordination between them. In light of the impact which FCC regulatory actions (such as the fixed monthly charge established in its access charge decision and its actions to deregulate customer premises equipment) continue to have on State commissions, we believe that increased FCC efforts to share information and discuss problems and concerns with State commissions are needed. In this regard, we are pleased to note FCC's plans to work with State commissions to monitor the effects of telephone rate increases on universal service.

More generally, we also continue to believe that there is a need for FCC to establish an internal cost accounting system as a way to improve its ability to evaluate the costs involved in

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[4]"FCC Needs to Monitor a Changing International Telecommunications Market," (GAO/RCED-83-92, Mar. 14, 1983).

carrying out its regulatory activities. We recognized the need for such a system in a 1977 report,[5] as a way to both improve FCC's management and form the basis for an FCC user fee schedule. Such a fee schedule would require specific users of FCC services, such as license applicants, to bear the costs of FCC activities from which they receive primary benefit. The need for FCC to establish both an internal cost accounting system and a user fee schedule was also recently noted by the President's Private Sector Survey on Cost Control. FCC has not established such a cost accounting system. FCC has, however, generally supported the establishment of a statutory fee schedule. We also support the establishment of a statutory fee schedule which charges private beneficiaries for the costs incurred by FCC in providing them a product, service, or privilege. However, in light of the uncertainty as to whether such a fee schedule will be enacted, we believe FCC should work toward establishing a cost accounting system which can support user fees under the existing statute.

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That is the end of my prepared statement. I will be happy to answer any questions you may have.

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[5]"Establishing A Proper Fee Schedule Under the Independent Offices Appropriation Act, 1952," (CED-77-70; May 6, 1977).

GAO REPORTS ON THE

FEDERAL COMMUNICATIONS COMMISSION

1977-1983

Report Title	Issue Date	Reference Number
Establishing a proper fee schedule under the Independent Offices Appropriation Act, 1952	05-06-77	CED-77-70
Responsibilities, actions, and coordination of Federal agencies in international telecommunications services	09-29-77	CED-77-132
Greater coordination and a more effective policy needed for international telecommunications facilities	03-31-78	CED-78-87
The role of field operations in the Federal Communications Commission's regulatory structure	08-18-78	CED-78-151
Developing a domestic common carrier telecommunications policy: what are the issues?	01-24-79	CED-79-18
Selected FCC regulatory policies: their purpose and consequences for commercial radio and TV	06-04-79	CED-79-62
Organizing the Federal Communications Commission for greater management and regulatory effectiveness	07-30-79	CED-79-107
Outlook dim for revised accounting system needed for changing telephone industry	11-13-79	FGMSD-80-9
FCC's decision to consolidate licensing division in Gettysburg, Pa. was made without adequate analysis	12-03-79	CED-80-27
FCC did not act in the Government's best interest in acquiring leased space	06-26-81	PLRD-81-39

Report Title	Issue Date	Reference Number
Legislative and regulatory actions needed to deal with a changing domestic telecommunications industry	09-24-81	CED-81-136
Can the Federal Communications Commission successfully implement its computer II decision?	01-29-82	CED-82-38
The Federal Communications Commission's international telecommunications activities	04-19-82	CED-82-77
U.S. preparations for an international conference on broadcast satellites	03/04/83	RCED-83-121
FCC needs to monitor a changing international telecommunications market	03/14/83	RCED-83-92
FCC can further improve its licensing activities	04/26/83	RCED-83-90
Status of Federal Communications Commission efforts to allocate costs between telephone companies' regulated and unregulated activities	09/02/83	RCED-83-235