# 13

# UNIVERSAL SERVICE REINCARNATED

THE UNIFICATION OF TELEPHONE SERVICE by the middle of the 1920s put an end to the first-generation debate over universal service. But the term made a highly visible comeback in the mid-1970s, sparking a debate which is still underway in the 1990s. The return of "universal service" as a policy touchstone gave the term a new meaning. As noted in chapter 2, an entire historical mythology has grown up around the new definition.

Accurate or not, that change in the popular meaning of the term is an important part of the history of telecommunications in the United States. This chapter analyzes that change and shows how it emerged from the debates over the introduction of competition in long-distance markets in the 1970s. The chapter retraces relevant developments in regulation from 1920 to the mid-1970s, including the development of separations by federal and state regulators and the passage of the 1934 Communications Act. In the process, it refutes the historical misconceptions created by the shift in the meaning of the term.

## *The Second-generation Universal Service Concept*

Contemporary readers will have no difficulty recognizing the "new" definition of universal service; it the one that prevails to this day. The new concept defines the goal of universal service as comprehensive household telephone penetration-a "telephone in every home." A related change has occurred in the policy associated with the term. Universal service policy has become synonymous with the manipulation of rate regulation to make telephone service more affordable to consumers. A variety of cross-subsidies are employed to do that; one is to overcharge long-distance users in order to subsidize local service while another is to charge urban consumers higher rates in order to lower charges on rural users.

Whatever their merits as public policy, those concepts represent a departure from the original meaning of the term. As chapter 8 documented with citations from the early dialogue, the

first-generation universal service debate was a response to the conditions created by dual service. The goal of universal service then was technically unified, fully interconnected, geographically ubiquitous service. The policy required to bring it about was consolidation of local exchange service into a monopoly and the interconnection of Bell and independent exchanges. The older policy viewed regulation as a substitute for the price and service incentives of competition. It did not conceive of regulation as a mechanism for effecting cross- subsidies. Nor did government policy focus on household penetration as such.

If that shift in the meaning of the term represented nothing more than a change in government policy (made with full knowledge of the difference between the two alternatives) it would not be so problematical. The change has not been so innocent, however. The newly forged linkage between the term "universal service," household penetration, and regulated monopoly was part of a politically-motivated attempt to salvage the fortunes of the regulated monopoly system in the 1970s. The new definition brought with it a sweeping revision of the history of the telephone system-a revisionism which fabricated the legislative origins of universal service policy and exaggerated the role of regulated monopoly in making telephone service affordable and available to most Americans.

In the historical mythology associated with the new conception, the competitive era's contribution to the development of the infrastructure was ignored, and the earlier universal service debate was forgotten. The origins of universal service policy were instead traced to the 1934 Communications Act, specifically to the wording of the Act's Preamble:

> "…to make available, so far as possible, to all the people of the United States, a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges."[361]

In that view, regulators and telephone monopolies acting together exploited the characteristics of the regulated monopoly system to bring about widespread household access to telephone service. Generally, the separations and settlements process, which allocates part of the revenues generated by the long-distance network to the support of the local network, is identified as the mechanism by which that policy goal was accomplished. In its more romantic formulations, the modern construction of universal service implies that without such measures telephone service would never have been affordable to the bulk of the population.[362]

Of course, Vail was using the term "universal service" almost three decades before the passage of the Communications Act. That did not deter the revision of the term, however. Instead, those who bothered to read Vail's pronouncements simply projected the new meaning into them. Thus, many historians, especially those directly associated with the Bell system, contend that

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[361] 47 U.S.C. s. 151.

[362] See, for example, John Browning, *Universal Service, an idea whose time has past*, 3 WIRED 102 (Sept. 1994): "This is the story of the noblest idea in the history of technology: universal telecommunications service. Universal service brought America into the information age. It put telephones into every home (well, about 94 percent of them) and wove telephone lines through the fabric of American life....Universal service was made a guiding principle of American telecom regulation in 1934."

universal service in the modern sense was an objective of AT&T from the very beginning.[363] They view the gradual but steady increase in household penetration after 1920 as evidence of Bell's commitment to widespread household penetration. Those historians would refuse to recognize any qualitative distinction between the term's usage now and Vail's usage in the early 1900s.

With the new mythology of universal service sketched out, we can now review the post-regulation era developments to assess its historical accuracy. The narrative that follows will make three arguments: 1) that the separations process was not actively used to subsidize local service until the late 1960s and the 1970s, and that its impact on the growth of penetration was minor; 2) that the 1934 Communications Act did not articulate a national universal service policy; and 3) that the redefinition of universal service actually took place in the mid-1970s as part of the regulated monopoly system's attempt to defend itself against long-distance competition.

## *Universal service and the problem of separating the rate base*

The initial application of rate regulation to the telephone industry in the 1920s posed complex problems in economics. Rate base regulation demands that the rates charged by a telephone company for a particular service be based on the book costs of the physical plant used, plus expenses and a reasonable rate of return. It assumes, in other words, that a scientific link between the cost of the facilities used and the price charged can be established. Applying that logic to telephone service is no simple matter. A telephone system supplies millions of possible connections to its users, some local, some to nearby areas, and others to long-distance points. In chapter 3 we argued that each connection is a separate service. But subscribers use the same telephone, local access line, and central office switch for all of those outputs. In the context of rate regulation, how should the costs of those facilities be apportioned among the different services so that regulators can determine what the "proper" rates should be?

The first-generation concept of universal service supported a holistic approach to that problem. It focused on sustaining the telephone network as a system and not as a collection of discrete components. A regional telephone system, it was often observed, covered both "fat" and "lean" territories. Access competition had forced the telephone companies to extend their networks into the "lean" territories in order to preserve the competitive value of their systems. With the pressures of competition gone, regulators wanted to ensure that service would not be withdrawn from less profitable or remote areas. Thus, the application of utility regulation to the telephone companies brought with it "obligation to serve" requirements, or restrictions on the firms' freedom to exit from markets.[364] Naturally, the telephone companies wanted to ensure that the method of rate regulation allowed them to profitably sustain the scope of service regulators required of them. As a result, both regulators and the local telephone companies supported methods that based rates upon sustaining the telephone companies' system as a whole.

[363] A. VON AUW, HERITAGE AND DESTINY: REFLECTIONS ON THE BELL SYSTEM IN TRANSITION (Praeger 1983); PETER TEMIN AND LOUIS GALAMBOS, THE FALL OF THE BELL SYSTEM 16 (Cambridge University Press 1987).

[364] See, for example, some of the cases cited in ALAN STONE, PUBLIC SERVICE UBERALISM 226 (Princeton University Press 1991).

A memorandum written by H. O. Seymour for the Chicago Telephone Company in 1912 (and widely distributed among the Bell operating companies) laid out those problems in a thorough fashion.[365] The memo argued that "with the telephone stations and lines, all do not and cannot…pay their way, yet they must be continued as a necessary part of the whole system and the elimination of one, lessens the service and economic value of the part that remains." The author argued that it was impossible to separate the investment and expenses associated with specific services.[366] Seymour concluded that "in considering rates for any and all classes of service, the operation of the company as a whole must be taken into account, its total investment, total expense, and total revenue; and the reasonableness of a particular rate must depend upon the net earnings of the utility as a whole."

Although the holistic approach to the rate base involved some averaging of costs, those were not perceived as subsidies but as a method of determining reasonable rates in a way that took into account the demand interdependence of telephone service. The principle that users paid rates not simply to recover the cost of the physical facilities they used, but rates which sustained the system as a whole, became known in the industry as "value of service" pricing. Value of service pricing is a logical expression of the first- generation universal service concept, because it attempts to recover the value of the network externality. Indeed, as evidence produced in chapter 6 showed, the pressures of access competition had induced the telephone companies to adopt similar policies on their own, prior to regulation. Seymour's 1912 memo explicitly acknowledged that under competitive conditions, "intelligent selfishness" on the part of the telephone companies would "lead it to so distribute the [cost] load as to bring about the greatest development of the enterprise."

The holistic approach, however, could only be applied uniformly within a single regulatory jurisdiction. Whenever telephone calls crossed state boundaries, the rate base had to be divided into separate parts in order to distinguish between federal and state regulatory authority. That became known as the problem of *jurisdictional separations*.

In the 1920s, debate over jurisdictional separations took the specific form of how to separate the costs and revenue requirements of the *local exchange* service and the *long-distance* service. There were two basic theories about how that should be done. One, the so-called "board-to-board" method, held that the rates for local service should recover all of the costs of the local exchange plant. Long-distance rates should recover only those additional costs required to supply facilities connecting the switchboards of local exchanges. The other principle was known as the "station-to-station" method. The station-to-station method held that because local exchange facilities were used in establishing a long-distance call, some of the costs of the local exchange plant and service should be recovered from long-distance rates. It traced costs from one telephone (station) to the other. That method was more complex in that the costs of the local network had to be divided or allocated among state and interstate services.

[365] B. W. Trafford, Vice President, Chicago Telephone Company, to E.C. Bradley, Vice President, Pacific T&T Co., Jan. 26, 1912. Attached memo by H. 0. Seymour, "A telephone property must be considered as a whole in determining the reasonableness of any rate." In San Francisco Telephone Pioneers Archive.

[366] "If we were asked to provide a subscriber with equipment designed for local service only, we could not serve him, as all equipment used is designed, built up and associated so as to make all classes of service possible." *Id.*

The Bell system supported board-to-board accounting-and for a very good reason. At that time, state regulation of rates was fairly stringent, whereas rate regulation in the federal jurisdiction was practically nonexistent. The long-distance business was increasingly profitable, whereas the Bell system viewed the consolidation of local service as an opportunity to raise what it viewed as the unremunerative rates foisted upon it by fifteen years of competition.[367] Brock has observed that "when there is differential regulation, the monopolist has an incentive to maximize the allocation of costs to the tightly regulated jurisdiction in order to justify higher regulated prices, while minimizing costs to the unregulated jurisdiction in order to capture [unregulated levels of] profit."[368] If AT&T could shift more of the allocated costs to the state jurisdiction, it could justify local rate increases and clear the way for higher long-distance profits. (That fact by itself calls into question the claim that AT&T was interested in promoting universal service in the modern sense at that time.) State regulators, of course, had quite different incentives. Ratifying unpopular local rate increases made them look bad before their constituents. They supported the station-to-station method.

For modern-day observers it is tempting to read a second-generation universal service promotion policy into that debate. Under the board-to-board method, local exchange access rates would be relatively higher and long-distance rates relatively lower. Under the station-to-station method, long-distance users pay more to support the local exchange plant. Station-to-station can thus be seen as a means of using long-distance revenues to make local service more affordable. In fact, the debate over separations principles did take that form starting in the early 1950s. But from the 1920s until the end of World War II, the debate had no such implications.

That is apparent from the Supreme Court decisions which sanctioned the station-to-station principle, *Smith v. Illinois (1930)* and *Smith v. Lindheimer (1933).*[369] The issue before the Court was whether the rates imposed on the Chicago Telephone Company by the Illinois state commission were "confiscatory" under the Fourteenth Amendment. The Bell interests based their argument on board-to-board accounting methods. The Supreme Court rejected their method. It ruled that separation of interstate and intrastate plant "is essential to the appropriate recognition of the competent governmental authority in each field of regulation." Some part of the local exchange plant should be "apportioned" to interstate service, the Court ruled, otherwise "the exchange property…will beat an undue burden." There is no indication that regulators were attempting to keep exchange rates low to stimulate telephone penetration, or that the regulators or the Supreme Court recognized subsidization of exchange access to promote universal service as a valid criterion in ratemaking. In fact, such considerations would definitely have been considered illegal. The "just and reasonable" rates mandated by regulation required establishing a link, as scientific as possible, between actual costs and the rates charged to customers. Rates which did not adequately compensate the telephone companies, or which were designed to transfer wealth from one person to the other, could be challenged as confiscatory.

The courts and regulators were grappling with the issue of how to define the costs of a multiproduct firm, not pursuing a social welfare policy. Even if that had been their intention, the

[367] See chapter 11 for evidence of this.
[368] GERALD BROCK, ___67 (1994); see also TEMIN AND GALAMBOS, *supra* note 3, at 20-22.
[369] Smith et al *v.* Illinois Bell 282 U.S. 133 (1930) and Lindheimer *v.* lllinois Bell 292 u.s. 151 (1933)

impact of separations practices on local rates would have been minimal. According to Gabel, the separations concepts prevailing in the 1920s and early 1930s would have relieved exchange property of only 2 or 3 percent of the investment burden.[370] Even more important, the station-to-station principle, though sanctioned by the Supreme Court in 1930, was not actually implemented on a nationwide basis until 1949. Thus, the growth of telephone penetration from 1920 to 1950 cannot be attributed to the effects of that policy, whatever its motives. (That is discussed in greater detail in the section of this chapter entitled *Cross Subsidies and Local Telephone Service*).

## *The Communications Act of 1934*

The Communications Act of 1934 was passed after the House Committee on Interstate and Foreign Commerce spent more than a year investigating the communications industry. The Congressional committee probed not only AT&T but also independent telephone holding companies, the telegraph industry, RCA, and the new broadcasting networks. There was a suspicion among the committee members that the large holding companies controlling communications were rife with financial abuses. AT&T attracted particular notice because, despite its status as a monopoly, it operated free of effective regulation, particularly at the interstate level. Its ability to move assets and accounts between the federal and state jurisdictions in a way that could manipulate the regulatory process was particularly troublesome to the Congress. "The American Telephone and Telegraph Company," the committee's special counsel wrote, "is more powerful and skilled than any State government with which it has to deal."[371] The Interstate Commerce Commission should be relieved of regulatory authority over telephones, the Committee believed, because it was preoccupied with railroad regulation and lacked the resources to oversee the large and growing communications field at the same time. "Thus far regulation, particularly by the federal government, has been nominal largely because Congress had not made appropriations sufficient to enable the ICC to give effect to existing statutes."[372]

The Committee report accompanying the draft bill described its objectives as follows:

> The bill would accomplish three purposes: (a) codification of existing federal legislation regulating communications; (b) a transfer of jurisdictions from several departments, boards, and commissions to a new communications commission; and, (c), a postponement for further action after further study and observation of some of the more difficult and controversial subjects.[373]

From that it is clear that the Communications Act was essentially a consolidation of federal regulatory authority over the burgeoning new telecommunications field. It was not the starting point of a new policy or a new approach to regulation, but the beginning of real regulation at the

[370] RICHARD GABEL, THE DEVELOPMENT OF SEPARATIONS CONCEPTS IN THE TELEPHONE INDUSTRY 17 (Michigan State University Public Utilities Studies 1967).

[371] 73rd Cong., H.R. No. 1273, PRELIMINARY REPORT ON COMMUNICATION COMPANIES, Submitted by Mr. Rayburn pursuant to H.R. 59, 72nd Cong., and House Joint Resolution 572, 72nd Cong., Apr. 18, 1934, xxx.

[372] *Id.* at xxxi.

[373] *Id.* at xxxi.

federal level. As the report stated, the new law codified existing laws and regulations, and the report emphasized Congress's desire to make existing statutes effective. A new, specialized regulatory agency was perceived as the best means to carry out that task.

*The subject of universal service, in either its modern or classical sense, did not appear in the deliberations.* The records surrounding the passage of the law contain no mention of telephone penetration levels. There is no data in the reports purporting to show that an unacceptable number of people were unreached by the telephone network or unable to afford service. There is not even a discussion of the problem of jurisdictional separations. Instead, Congress amassed thousands of pages of materials analyzing the telephone and telegraph companies' capital structures, shareholders, ownership and voting control, and interlocking directorates.

What, then, are we to make of the Act's preamble, oft-cited as the mandate for the second-generation approach to universal service promotion? A complete citation of the preamble provides the basis for a more realistic understanding of its meaning:

> For 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, and world-wide wire and radio communication service with adequate facilities at reasonable charges, for the purpose of the national defense, for the purpose of promoting safety of life and property through the use of wire and radio communication, and for centralizing authority heretofore granted by law to several agencies and by granting additional authority with respect to interstate and foreign commerce in wire and radio communication, there is hereby created a commission to be known as the "Federal Communications Commission," which shall be constituted as hereinafter provided, and which shall execute and enforce the provisions of the Act.

The preamble contains a grab-bag of extremely broad purposes, such as protecting national security and the safety of life and property, as well as the standard regulatory commission charge to ensure adequate facilities at reasonable charges. The absence of any concern with telephone penetration or separations principles in the record, or of any specific provisions addressing those issues in the statute itself, suggests that that aspect of the law is largely rhetorical-a list of all the good things that come about from telecommunications.

But the most direct refutation of those who see a cryptic universal service policy in those two little lines of the preamble comes from the behavior of the FCC itself. In the first two decades after the creation of the new federal commission, many state regulators opposed involving it in station-to-station separations, because they feared it would lead to encroachment on their regulatory authority.[374] For its part, the FCC did not begin to shift revenues from the federal jurisdiction to the state jurisdiction in order to subsidize local service. On the contrary. Between 1935 and 1945, the FCC succeeded in extracting a series of long-distance rate reductions out of AT&T. The FCC had

[374] GABEL, *supra* note 10, at 39.

no interest in reducing local service rates via separations because that would have jeopardized its ability to deliver rate decreases in its own jurisdiction.

As the FCC was reducing interstate long-distance rates, the Bell system and other telephone companies were asking for, and often receiving, increases in state exchange rates and intra-state long-distance rates. The resulting disparity between state and interstate telephone rate trends was embarrassing to state regulators. Federal regulators were perceived as being more effective, more able to "deliver the goods," than state regulators.

In reaction to the FCC's decreases in AT&T's interstate long-distance rates, state regulators eventually unified in support of the station-to-station principle. The station-to-station method would shift some of the intra-state costs to the federal jurisdiction, thereby preventing another interstate rate decrease and eliminating the pressure for more state rate increases.[375] At that time, AT&T also accepted the station-to-station principle because it could be used to counteract pressure for lower interstate long-distance rates.[376] By 1944, AT&T, state regulators, and the FCC were working together to develop a common approach to separations.

A comprehensive agreement about how to divide up ex- change and toll plant did not come until 1947 with the adoption of the first uniform Separations Manual by the National Association of Regulatory Utility Commissioners and the FCC. The Bell companies did not actually file intrastate tariffs that reflected the new cost separations methods until 1950.[377] Thus, the station-to-station method of separating costs was not fully operational at the national level until thirty years after the end of dual service. Despite the absence of any specific policy to promote or subsidize local service, household penetration grew steadily from 1920 to 1950, faltering only for a few years during the depths of the Great Depression.

### *Cross-subsidies and local telephone service*

After 1950, the formula used by regulators to allocate part of the costs of the local network to the long-distance rate base was based on "subscriber line use" (SLU), or the average proportion of minutes a subscriber's telephone line was used for state and interstate calls. In 1950 interstate SLU was less than 3 percent, so the impact of the station-to-station method on local rates was still minimal. Politicians and state regulators, however, were quick to realize the potential of separations to shift the cost burden among more or less favored constituencies. In 1951, as the FCC began a new inquiry into interstate rates, AT&T, with the support of the National Association of Regulatory Utility Commissioners (NARUC), proposed an alteration of the Separations Manual that would shift more of the local telephone plant into the interstate rate base.[378] The FCC opposed that plan on the grounds that it would lead to a situation in which "services subject to Federal jurisdiction would, in effect, be subsidizing services beyond that jurisdiction."[379] The FCC's resistance was

[375] *Id.*, at 27-45.
[376] TEMIN AND GALAMBOS, *supra* note 3, at 22-25.
[377] See CAROL WEINHAUS & ANTHONY OETINGER, BEHIND THE TELEPHONE DEBATES (Ablex 1988) for a detailed history and description of separations and settlements procedures.
[378] TEMIN AND GALAMBOS, *supra* note 3, at 24.
[379] Paul A. Walker, FCC to Matt L. McWhorter, Oct. 18, 1950.

overcome, however, by the strenuous intervention of Senator Ernest W. McFarland of Arizona, the Chairman of the Senate subcommittee on communications. NARUC, citing the growing disparity between state rate increases and interstate rate reductions, had appealed to the Senator for support. Senator McFarland's correspondence with the FCC on separations raised explicitly the issue of cross-subsidization, scolding the FCC for its willingness to:

> shift the load from the big user to the little user, from the large national corporations which are heavy users of long distance to the average housewife and business and professional man who do not indulge in a great deal of long distance.[380]

Thus in 1952 and 1953 the interstate (long-distance) contribution to local exchange plant increased from 3 percent to 5 percent. The first step towards the use of long-distance revenues to subsidize local service had been taken.

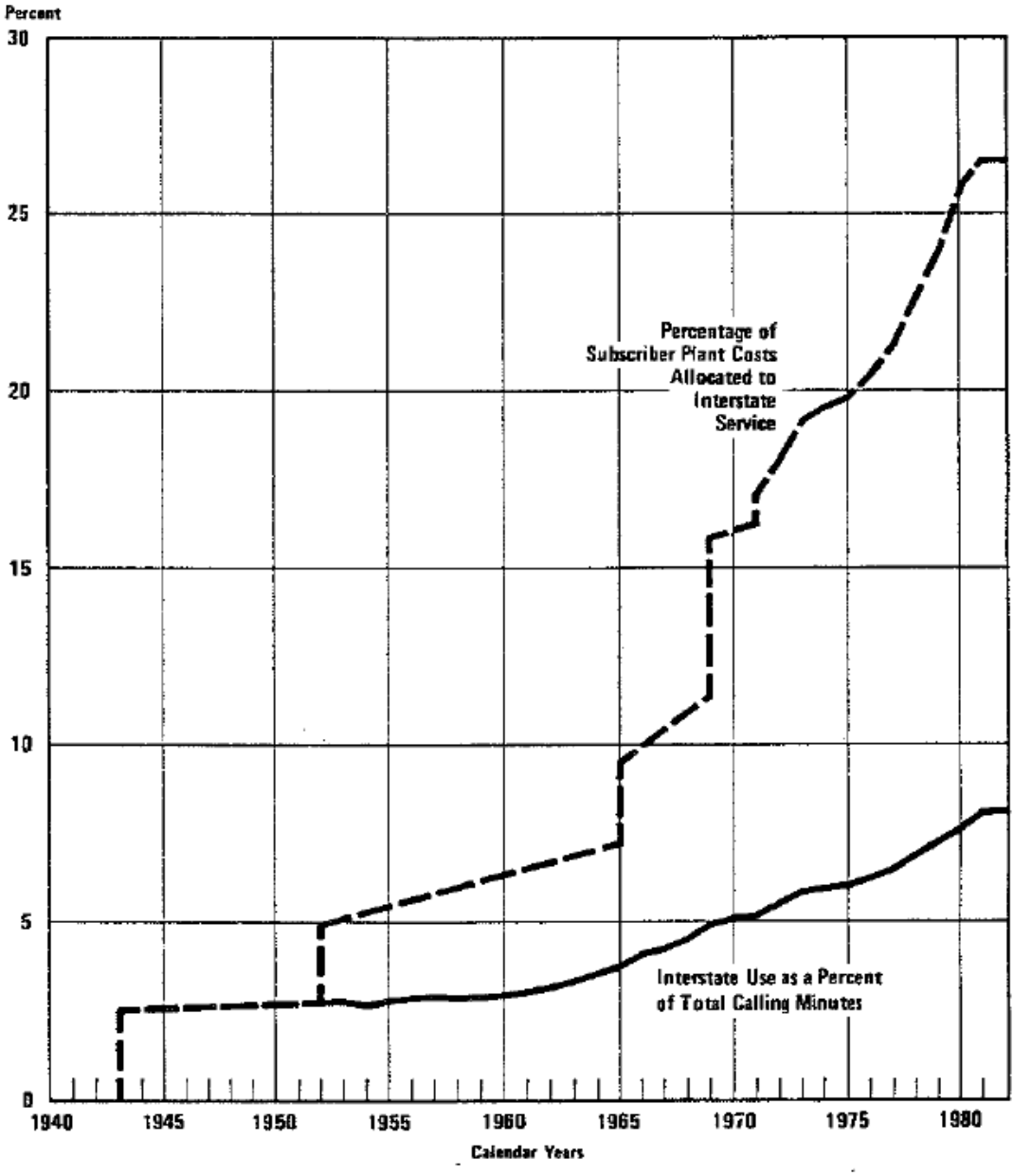
At that juncture, a number of interpretive issues regarding that incident must be underscored. First, the Federal Communications Commission, which had been created by the 1934 Communications Act and charged with its implementation, actively opposed the expansion of cross-subsidization. Second, neither NARUC nor Senator McFarland cited the preamble, or any other section of the Communications Act, in making their case for shifting the burden. Instead, NARUC was concerned about the growing state-interstate rate disparity. For the Senator, it was the obvious political advantage of lowering rates for the many by taxing the few that attracted attention. Indeed, the Senator's political calculus did not even assert that the "average housewife and business or professional man" would be unable to *afford* telephone service unless the burden was shifted. It was, rather, an argument that it would be more fair for large users to carry more of the load. In fact, household penetration was growing rapidly in the postwar period, with or without the departure from SLU.

Indeed, while the precedent was important, the impact of the 1952 separations change on local rates was still small. From 1952 to 1965, the percentage of local plant cost allocated to the interstate jurisdiction grew from 5 percent to 7 percent, while interstate SLU grew from 2.5 percent to 4 percent (see figure 13-1). As that occurred, the average monthly charge for residential telephone service, in constant 1980 dollars, actually increased from $14.25 in 1952 to $15.86 in 1955. In fact, average residential telephone service rates remained higher than their 1952 levels until 1965 (see table 13-1). While one could argue that rates would have gone up faster without the changes, it appears that no drastic subsidy was involved, particularly when compared to post-1970 changes. Despite that, household penetration grew rapidly.

Full-fledged exploitation of the separations process to subsidize local service did not really begin until 1965. From 1952 to 1965 only 3 percent of the costs over and above SLU were shifted from the state to the interstate jurisdiction. During the seventeen years from 1965 to 1982, an

[380] Ernest W. McFarland to Paul A. Walker, Jan. 30, 1951, cited in TEMIN AND GALAMBOS, *supra* note 3, at 25.

FIGURE 13-1
PERCENTAGE OF SUBSCRIBER PLANT COSTS
ALLOCATED TO INTERSTATE SERVICE



additional 20 percent was so shifted.[381] From 1965 to 1969, the real average monthly charge for residential service dropped by $2. By 1982, it was almost half of what it had been in 1965 (see table 13-1). The culmination of that process came with the adoption of the so-called Ozark Plan in 1970.[382] The Ozark plan's separations were still based in part on measures of relative use, but its formulas effectively multiplied interstate minutes by a factor of three in order to establish the amount of local plant to be recovered from the interstate revenues. That led to a continuous and automatic increase in the cross-subsidy from 1971 on.

TABLE 13-1
AVERAGE MONTHLY CHARGE FOR
RESIDENTIAL PHONE SERVICE, 1950-1980

| Year | Current Dollars | Constant 1980 dollars |
|---|---|---|
| 1950 | 4.29 | 14.58 |
| 1951 | 4.48 | 14.11 |
| 1952 | 4.62 | 14.25 |
| 1953 | 4.93 | 15.08 |
| 1954 | 5.10 | 15.53 |
| 1955 | 5.19 | 15.86 |
| 1956 | 5.24 | 15.78 |
| 1957 | 5.28 | 15.35 |
| 1958 | 5.36 | 15.17 |
| 1959 | 5.51 | 15.46 |
| 1960 | 5.55 | 15.33 |
| 1961 | 5.61 | 15.35 |
| 1962 | 5.62 | 15.21 |
| 1963 | 5.65 | 15.11 |
| 1964 | 5.66 | 14.93 |
| 1965 | 5.67 | 14.70 |

[381] In 1965, as part of the so-called "Denver" plan, state and federal regulators increased the interstate allocation by nearly 3 percent. Only four years later, a new separations plan put forth by the FCC increased the interstate allocation by another 5 percent.

[382] See Weinhaus and Oettinger 83-103 (1988) for a description and analysis of the Ozark plan.

TABLE 13-1, CONT'D
AVERAGE MONTHLY CHARGE FOR
RESIDENTIAL PHONE SERVICE, 1950-1980

| Year | Current Dollars | Constant 1980 dollars |
|---|---|---|
| 1966 | 5.64 | 14.22 |
| 1967 | 5.60 | 13.73 |
| 1968 | 5.61 | 13.20 |
| 1969 | 5.68 | 12.68 |
| 1970 | 5.76 | 12.14 |
| 1971 | 6.04 | 12.20 |
| 1972 | 6.38 | 12.48 |
| 1973 | 6.69 | 12.33 |
| 1974 | 7.08 | 11.77 |
| 1975 | 7.32 | 11.14 |
| 1976 | 7.81 | 11.24 |
| 1977 | 8.07 | 10.90 |
| 1978 | 8.31 | 10.43 |
| 1979 | 8.40 | 9.47 |
| 1980 | 8.61 | 8.60 |

Source: Federal Communications Commission, Common Carrier Dkt. No. 80-286, Comments of the National Telecommunications and Information Administration to the Federal-State Joint Board, Appendix B, Aug. 17, 1981, p. 11.

The pressures to do that were simultaneously ideological, political, and regulatory. Consumer groups in the activist 1960s were pressuring utility commissions for lower rates.[383] Regulatory analysts were becoming aware of the social policy possibilities of the separations system. In 1967, for example, economist Richard Gabel published an influential monograph charging that the separations principles used by regulators penalized exchange ratepayers:

Alternative separations treatment could reduce the costs of local exchange service and, eventually, exchange rates, making possible a universal development of exchange services.[384]

Most important, perhaps, was the desire to avoid upheavals. Regulators and telephone companies were faced with a precipitous drop in long-distance costs and a steep increase in the costs of labor-intensive local services. By shifting costs from the state to the interstate jurisdiction, regulators would avoid the kind of rapid price dislocations that would undoubtedly create political headaches.

Ironically, that move to exploit the social policy possibilities of the separations and settlements process carne at a time when the justification for such a subsidy was weak, as at least

[383] Horwitz 235 (1989), notes that state regulators' support for the Ozark plan was partly a response to pressure from public interest groups to keep residential rates low.

[384] GABEL, *supra* note 10, at 5.

85 percent of all American households already had telephone service.[385] Telephones were becoming universal for much the same reason that television sets became universal-Americans wanted them and their increasing affluence made it possible for most of them to get them.

Simple chronology thus defeats any attempt to attribute the growth of household penetration to a universal service policy formulated by the Communications Act and implemented by regulators and telephone companies. The "universal service policy" that is commonly attributed to the 1934 Act was not fully in force until 1965. The use of rate regulation to lower the cost of local access was never part of the law but was a set of practices that evolved out of the debate over the proper way to separate the rate base into different regulatory jurisdictions. And the policy kicked in at a time when the vast majority of American households already had telephone service.

### *The retroactive redefinition of universal service*

It is a deeply entrenched part of telephone industry folklore that the Communications Act of 1934 gave birth to a nationwide universal service policy. That belief is an important part of the history of universal service in the United States not because it is true, but because it is so obviously untrue. Despite the absence of any historical evidence for that notion, it persists. How did that myth take hold?

The answer is that a major redefinition of universal service occurred in the 1970s, when long-distance competition began to threaten the new separations practices adopted by federal and state regulators. By targeting long-distance routes for selective entry, competition struck at the heart of rate regulated monopoly. Long-distance services had been assigned higher costs due to the new separations methodology embodied in the Ozark plan. The alternative long-distance networks of companies such as MCI and Sprint had no requirement to allocate a portion of their costs to local service; they simply ordered local business lines from AT&T at the normal (subsidized) rates to gain access to local users. They therefore had a built-in cost advantage against AT&T. The political challenge that represented forced AT&T and state regulators to develop an explicit rationale for regulated monopoly and its system of separations and settlements. In that struggle, the concept of universal service was redefined in a way that linked it to the practices of regulated monopoly. Regulated monopoly and its separations practices were retroactively credited with making telephone service universally available and affordable.

Three milestones in that reconstruction can be clearly identified. One was a speech before NARUC in late 1973 by AT&T CEO John DeButts. The second was a report submitted to Congress by Eugene V. Rostow on behalf of AT&T in 1975. The third was the Bell system's proposal in 1976 to reform the 1934 Communications Act to preserve regulated monopoly.

[385] The FCC's Statistics of Communications Common Carriers for the year ended Dec. 31, 1965 reported that 85 percent of all American households had telephone service; the Statistics for 1970 reported that 92 percent of all households had telephones. Because the method used to measure household penetration at that time is thought to have overstated the actual amount, I have deducted 5 percent from each estimate, which yields a household penetration percentage of 87 percent for 1970 and 80 percent for 1965. Federal Communications Commission, Statistics of Communications Common Carriers (1970), (1965).

By the early 1970s, the FCC's incremental opening of AT&T's markets to competition had provoked a crisis in telecommunications policy. The Bell system felt itself besieged on many fronts, confronted with an ambiguous and shifting set of rules. One alternative was to gradually accommodate itself to the new order. Another was to stand its ground and fight for the old order. In 1973 AT&T chief executive John B. DeButts chose the latter option. In a speech before the assembled state regulators of the National Association of Regulatory Utility Commissioners (NARUC), DeButts took a public stance against competition and in favor of traditional public service regulation. His speech, entitled "An Unusual Obligation," harked back to the earliest years of regulation in the 1920s and invoked the special social contract between the regulator and the regulated firm.

Debutts' attempt to provoke a public dialogue was next extended into the legislative arena. Bell began to promote congressional action to protect itself from new competition. Eugene V. Rostow was an influential figure in Washington. Having once served as the chair of President Johnson's 1968 Task Force on Communications Policy, he was retained by AT&T to support its legislative efforts. In 1975 he submitted testimony to Congress entitled, "The Case for Congressional Action to Safeguard the Telephone Network as a Universal and Optimized System."[386] It was AT&T, via Rostow, that first aired the specious claim that a monopoly system devoted to universal service was part of the mandate of the 1934 Communications Act.

Bell's actions, however, indicated that it considered the existing Communications Act far too weak a reed on which to base its case. It prepared a new version of the Communications Act, The Consumer Communications Reform Act of 1976. According to Temin and Galambos,

The bill was cast as an amendment to the Communications Act of 1934. It reaffirmed the nation's commitment to universal service and went beyond existing law to state that a unified telephone net- work had been and continued to be essential for the achievement of that goal. The bill bluntly stated that the existing rate structure, by which it meant primarily separations, had promoted universal service.[387]

We have only to look at the context of those events to understand the function of the new universal service ideology. The fateful antitrust suit which eventually led to the breakup of AT&T was filed by the Department of Justice in 1974. MCI had invaded switched long distance with its *Execunet* service in 1975, a development which threatened to subvert the whole station-to-station approach to separations. The Bell company was in the thick of an all-out attempt to persuade Congress to pass a law to preserve the classical monopoly arrangements.

During the battle over the Bell bill and the ensuing years of antitrust proceedings, "universal service" became one of the key rallying cries of AT&T and the other defenders of regulated monopoly, especially state regulators. Just as Vail had used the term to fend off access competition from 1907 to 1920, so AT&T under DeButts attempted to use the same term-albeit with a different

[386] Eugene V. Rostow, "The Case for Congressional Action to Safeguard the Telephone Network as a Universal and Optimized System." Paper based on the memorandum prepared for AT&T for use in the Nov. 1975 hearings before the Subcomm. on Communications of the House Comm. on Interstate and Foreign Commerce.

[387] TEMIN AND GALAMBOS, supra note 3, at 119.

meaning and in a very different context-to renew the nation's commitment to the regulated monopoly structure Vail had helped to establish. The modern reconstruction of universal service, however, was not an accurate description of a historical policy, nor was it really intended to be. It was a political weapon in the battle for the preservation of an institution.[388] Its political appeal-support for lower residential telephone rates and cross-subsidies to rural areas-proved to be remarkably powerful. Even Congressional leaders who opposed most of AT&T's legislative proposals could not resist taking advantage of the political capital to be made by invoking "universal service" in defense of low residential and rural rates. The so-called "Universal Telephone Service Preservation Act of 1983," an opportunistic attempt to maintain local rate subsidies after the divestiture, was drafted by two Senators-Dingell and Wirth-who had refused to support Bell's 1976 legislation.

AT&T's political objectives failed miserably. Its historical revisionism, however, was an overwhelming success. As a revised ideology of "universal service" was pressed into the service of telephone monopolies and other opponents of rate reform in the 1970s and 1980s, its meaning changed in ways that obscured what it had meant when it was coined in 1907. A confusion between its contemporary and historical usage has made it difficult for modem scholars and policymakers to appreciate the significance of the earlier universal service debate. And the universal service claims of regulated monopoly have unfairly eclipsed the earlier contribution of access competition to the development of a ubiquitous telephone infrastructure.

[388] In the case of European PTTs. the retroactive nature of universal service claims is even clearer. European monopolies adopted the same averaging and cross subsidy practices as the American telephone companies without attaining anything near the penetration levels of the United States. but nevertheless made "universality" one of their defenses against the onslaught of new competition in the 1980s. As Gamham (1988) has shown, officially proclaimed universal service goals in Europe often coexist with low penetration and large regional disparities in access to the telephone.