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# How the Bells Stole America's Digital Future

**A NetAction White Paper**

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### **About the Author:**

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### **About NetAction:**

NetAction is a San Francisco-based nonprofit organization that promotes the use of the Internet for grassroots organizing and advocacy.

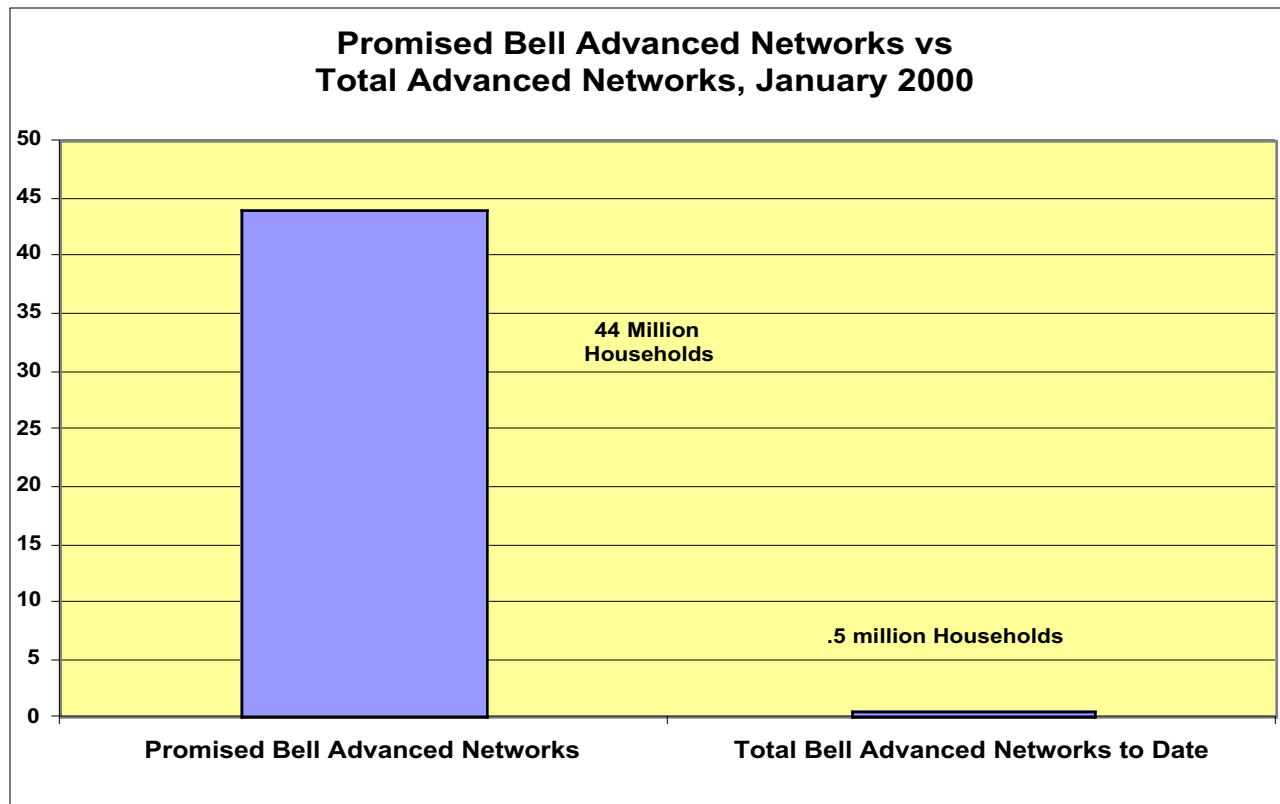
# How the Bells Stole America's Digital Future

## Introduction and Summary

“Bell Atlantic-New Jersey (BA-NJ) has over-earned, under-spent and inequitably deployed advanced telecommunications technology to business customers, while largely neglecting schools and libraries, low-income and residential ratepayers and consumers in Urban Enterprise Zones as well as urban and rural areas.”<sup>1</sup>

The explosive growth of the Internet and the World Wide Web over the last few years has generated increased interest in making sure that these new services are available to all Americans in their homes and schools. The goal is not only to ensure that all Americans have access, but also to ensure the availability of access over advanced high-speed networks. And if the Regional Bell Operating Companies (RBOCs) had delivered on the promises they made in the early 1990s, 44 million households – almost half of America's households – and the vast majority of the nation's schools would already be wired with fiber optic networks. Instead, as of January 2000, only about 500,000 households had access to these advanced networks.

*Source: Bell Annual Reports, New Networks Institute, 1994-2000*



## What Happened to the “Information Superhighway?”

By the year 2000, the information superhighway was to have delivered an incredible array of advanced services over a very high-speed network. A network operating at speeds a hundred times faster than the asynchronous digital subscriber line (ADSL) service that the Bells are finally starting to deploy over the same copper wire network used for voice communication. In fact, by now the full-motion video, 800-channel network was to have changed our lives for the better, and even ushered in a new era of competition in cable television services.

The Bells’ promises were grandiose. For example, California’s Pacific Telesis was supposed to have rewired the state by 2000 with a \$16 billion advanced network:

“In November 1993, Pacific Bell announced a capital investment plan totaling \$16 billion over the next seven years to upgrade core network infrastructure and to begin building California's ‘Communications Superhighway.’ This will be an integrated telecommunications, information and entertainment network providing advanced voice, data and video services. *Using a combination of fiber optics and coaxial cable, Pacific Bell expects to provide broadband services to more than 1.5 million homes by the end of 1996, 5 million homes by the end of the decade.*”<sup>2</sup> (Emphasis added.)

Pacific Telesis wasn’t alone. All of the Bells made similar promises, and in many states they used those promises to convince policymakers to change the way they were regulated. Changes that replaced traditional rate-of-return regulation – intended to protect customers from profit gouging – with alternative regulatory schemes (sometimes called incentive or price cap regulation). These new regulatory frameworks gave the Bells more profits, ostensibly to be used to build advanced networks. However, in most states these advanced networks were never built and the additional revenues were never returned to customers.

All of this has had a serious impact on America’s digital future, which policymakers must address. If the Bells had rolled out the advanced networks that they promised to build – when they promised to build them – the vast majority of Americans would now have access to the Internet over fiber optic networks. The Bells had agreed to wire not just the lucrative high-income neighborhoods, but low-income and rural communities, schools, libraries and health care facilities. By failing to fulfill their promises, the Bells helped create America’s digital divide. In the words of New Jersey Ratepayer Advocate Blossom Peretz:

“...[L]ow income and residential customers have paid for the fiber-optic lines every month but they have not yet benefited.”<sup>3</sup>

Broken promises were the norm throughout America. For example, Ameritech Ohio was supposed to have wired all of the state's public schools with two-way, fully interactive services. And unlike the ADSL service that the Bells have recently started to deploy, the advanced networks that they promised to build offered the same high speed in both directions:

“The Company's infrastructure commitment in this Plan shall consist of the commitment to deploy, within five years of the effective date of the Plan and within the Company's existing service territory, broadband two-way fully interactive high quality distance learning capabilities to all state chartered high schools including vocational, technical schools, colleges and universities; deploy broadband facilities to all hospitals, libraries, county jails and state, county and federal court buildings.”<sup>4</sup>

### **What Happened to All the Money for the “Information Superhighway?”**

New Networks Institute (NNI) estimates that consumers have already paid over \$45 billion in extra telephone charges, and continue to pay over \$8 billion annually.<sup>5</sup> As monopoly providers of local phone service, the Bells are still subject to some regulation, yet they are among the most profitable companies in America today. Bell profit margins are more than double that of the major competitive long distance companies and other regulated utilities and literally 167% above the profit margins of some of America's best-known companies. Much of this excess profit is a result of the financial incentives that were supposed to build the infrastructure for America's digital future.

This report is divided into two parts. Part I, “How the Bells Stole America's Digital Future,” documents the promises that the Bells made to regulators to construct high-speed fiber optic networks, often in exchange for financial incentives. But the promises weren't fulfilled, and the additional revenue generated excess Bell profits. If the Bells had delivered what they promised, low-income urban neighborhoods and rural communities would have been wired by now and the digital divide might have been avoided.

Part II, “Bell Company Profits Are Outrageous,” describes how the Bells profited from these broken promises. Excess earnings, higher rates for services and massive staff cuts have resulted in a significant increase in profits and a significant decline in the quality of customer service.

The digital divide exists today in part because the Bells broke their promises – promises that were often tied to requests for regulatory changes. It's important to remember the Bells' history of broken promises because these companies are once again asking that the rules be changed. This time, the Bells are asking Congress to let them into long distance data markets before their local markets are open to competition as required by the Telecommunications Act of 1996. Given the track record of broken promises documented in this report, granting the Bells' request would be a mistake.

## **Part I**

### **How the Bells Stole America's Digital Future**

#### **1) The Bells Have Repeatedly Failed to Deliver on Promises of Network Upgrades**

Since the mid-1980s, *every* Regional Bell Operating Company (RBOC) has promised massive deployment of advanced interactive networks. First, the widespread availability of ISDN was promised but never delivered. Then, by the early 1990s, the Bell companies had committed to spend billions of dollars to deploy fiber optic networks, replacing the older copper wire network that is still in use today. By now, 44 million households should have access to high-speed advanced networks capable of delivering interactive two-way video and super-fast connections to the Internet. The Bells initiated these plans; regulators did not foist them on the companies. In many cases, the companies made broad and ambitious promises to regulators and consumers in exchange for relief from important pro-consumer regulations. The promises are documented in the Bells' annual reports, press releases and state regulatory filings. These documents show a clear and longstanding pattern of promises made but never fulfilled. Promises that convinced regulators in many states to reduce their regulatory oversight and allow the Bells increased financial incentives. The story starts with ISDN, the Bells' first poster-child of failed deployment.

#### **2) ISDN: It Still Does Nothing**

Integrated Service Digital Networks, commonly referred to as ISDN, was the first example of the Bells' unfulfilled promises. As far back as the mid-1980s, the companies promised to widely promote and deploy ISDN. The basic claim was that this digital technology was, in effect, a revolution in the making. For example, Southwestern Bell claimed in 1986 that:

“At the forefront of new technology is ISDN. Scheduled for commercial availability in 1988, ISDN will revolutionize day-to-day communications by allowing simultaneous transmission of voice, data and images over a single telephone line. With ISDN customers will have the potential to access videotext, (online services) telemetry, alarm services, sophisticated calling features, teleconferencing much more economically than they can today.”<sup>6</sup>

Although the service never materialized, the Bells continued to promise to deploy ISDN well into the 1990s. Ameritech, for example, claimed that ISDN speeds information:

“‘The ISDN link multiplies, by more than 40, the speed with which information can be transmitted,’ says Illinois Bell's Bill Kallmyer, senior marketing operations manager. ‘This results in higher productivity and lower on-line charges for consumers.’ Kallmyer says ISDN is available to single-line customers as well as larger firms.”<sup>7</sup>

These promises, made by all the Bell companies, are legendary. Many involved the wiring of schools and libraries. For example, Pacific Bell’s Education First program was supposed to have wired all of California’s schools with ISDN by 1996:

“Pacific Bell Helps Bring Schools On-line. As part of a continuing commitment to education in California, Pacific Bell has launched ‘Education First,’ a \$100 million program to connect the state's schools to the communications superhighway. By the end of 1996, all of the nearly 7,400 public K-12 schools, libraries, and community colleges in Pacific Bell territory will have access to the company's Integrated Services Digital Network (ISDN), which enables simultaneous transmission of voice, data and video signals over a single telephone line.”<sup>8</sup>

In ISDN, the Bells promised a product they knew they could not deliver. In 1993, NYNEX put forward a vision of telecommunications service that promised ISDN would be there “when business wants it, as much as it wants.”<sup>9</sup> To demonstrate the disparity between myth and reality, compare the NYNEX promise to the real-world experience described by James Gleick, a NYNEX customer who helped start the Pipeline Internet service. NYNEX promised:

“Private-line service as quick as a click: bandwidth where a business wants it, when a business wants it, as much as it wants, for as long as it wants. That's the value of NYNEX Enterprise Services, a set of new networking tools that bring unprecedented flexibility to private-line voice data and video systems.”<sup>10</sup>

But when James Gleick tried to order the service, here is what he experienced:

“I have visited the advanced telecommunication research laboratories and have seen what technology can bring; ISDN, which promises to turn ordinary phone lines into high-bandwidth carriers of pictures and videos. I've also visited the local telephone company and seen what technology can't bring. I've tried to order this very service. I have a 14-page, four-color brochure! ‘NYNEX ISDN Primary Service. For more efficient voice, data, image and video...’ The Pipeline's order has been floating about for months.

Our sales representative says he wrote it up three times, and each time the system bounced it back. I have a phone number for an ISDN specialist inside NYNEX, but he doesn't seem to have voice mail. The Pipeline is not alone. The large, private on-line services, too, rely on more or less the same graying telephone technology, not ISDN.”<sup>11</sup>

The Bells were never particularly enthusiastic about actually deploying and promoting ISDN. Because ISDN is a switched service, the more people use it, the more the Bells would have to invest in switching and, possibly, inter-office transmission facilities. For this reason, over time the Bells’ focus moved away from what ISDN could do for consumers, to the percentage of consumers to whom ISDN was, in some sense “available.” (Based on the placement of some minimal equipment in a central office or the installation of appropriate software.) But the Bells made virtually no practical efforts to promote the use of ISDN, and indeed, by imposing high installation costs and time- and distance-sensitive pricing, actively discouraged its use.

Things were not much different out West, where Southwestern Bell and Pacific Telesis made similar promises in the days before SBC was the holding company for both of those Baby Bells. Southwestern Bell made this promise:

“At the forefront of new technology is ISDN. Scheduled for commercial availability in 1998, ISDN will revolutionize day-to-day communications by allowing simultaneous transmission of voice, data and images over a single telephone line.

...

With ISDN customers will have the potential to access videotext, telemetry, alarm services, sophisticated calling features, teleconferencing much more economically than they can today.”<sup>12</sup>

Two years later, Pacific Telesis boasted that ISDN would help California compete in the 21<sup>st</sup> Century’s global economy:

“To accommodate growing voice and data traffic we’ve nearly completed digitization of Pacific Bell’s interoffice circuits. By testing and implementing advanced technologies like ISDN – which will allow customers to transmit digitized voice, text, video and graphics simultaneously over ordinary Pacific Bell lines – we’re preparing California to compete in the 21<sup>st</sup> Century global economy.”<sup>13</sup>

But these services were never fully rolled out. Instead, in the 1990s, the Bells decided that they would create another revolution – the information superhighway. And once again, some of the



companies tied the promised technology to regulatory concessions. Arguing that they needed to recover their past investments quickly in order to finance the deployment of fiber optic networks, the Bells convinced some state regulators to let them accelerate depreciation of their existing networks. Then they used their increased cash flow to subsidize their unregulated operations.<sup>14</sup> California's experience, described below, is one example.

### 3) California's "Information Superhighway"

Between 1984 and 1992 more than 95 percent of Pacific Telesis' unregulated businesses were funded by local phone monopoly assets.<sup>15</sup> In 1993, Pacific Bell acknowledged that its network needed to be upgraded and announced plans for "California First," an audacious statewide information superhighway.<sup>16</sup> The company boasted that it would spend a whopping \$16 billion dollars to replace the state's existing copper wire network with fiber optic technology. Manufactured from glass rather than copper, fiber optic networks are capable of delivering information at speeds up to 100 times faster than digital subscriber line (DSL) technology, which uses the existing copper wire infrastructure and typically provides high speeds for downloads only. By the year 2000, PacBell planned to have 5 million homes rewired:

"In November 1993, Pacific Bell announced a capital investment plan *totaling \$16 billion over the next seven years* to upgrade core network infrastructure and to begin building California's 'Communications Superhighway.' This will be an integrated telecommunications, information and entertainment network providing advanced voice, data and video services. *Using a combination of fiber optics and coaxial cable, Pacific Bell expects to provide broadband services to more than 1.5 million homes by the end of 1996, 5 million homes by the end of the decade.*"<sup>17</sup>  
(Emphasis added.)

As envisioned by PacBell, "California First" would not just supply regular cable and online services, it would also give customers up to 300 digital channels:

". . . Pacific Bell's proposed platform, consisting of 70 analog channels and between 150 and 300 digital channels, would offer sufficient capacity to serve multiple programmers."<sup>18</sup>

Consumers would receive a cornucopia of services, from "multi-media, virtual reality computer games," to "unlimited programming choices at flexible times for TV watchers."<sup>19</sup>

But along with the hype, there were questions. California Senator Steve Peace (D-El Cajon) worried that PacBell's plan would create a schism between communities that were wired and those that weren't – a portent of today's digital divide:

“You’re going to have two societies out there – one that’s plugged in and one that’s not plugged in,” Peace said. “Pacific Bell has carved out where the wealth is in the county, and it’s going to give those communities a head start. The gap is going to get wide and we’ll never catch up.”<sup>20</sup>

Pacific Bell started construction in May 1994, initially targeting the San Francisco Bay Area in Northern California, and Los Angeles, Orange, Riverside and San Diego counties in Southern California.<sup>21</sup>

In addition to the billions that Pacific Bell would be spending on the California First plan, the company announced plans to spend \$100 million over a three-year period to wire more than 7,400 public schools, community colleges and libraries.

“By the year 2000, phone company officials predicted, every classroom will be wired to handle voice, data and video telecommunications.”<sup>22</sup>

### **An Information Highway to Nowhere**

Today, miles of fiber optic wire line the streets of San Diego, Los Angeles, Orange Country and San Jose. But little of it is being used for its intended purpose; most of it is “dark fiber” now. Most California consumers still don’t have access to two-way, interactive, full-motion, digital video service, and Pacific Bell only recently began widespread deployment of digital subscriber line (DSL) technology over its existing copper wire network. Regulators had expected much more:

“... Pacific's proposals will produce new investment in an advanced telecommunications infrastructure, bring additional competition in the distribution of video services, and give consumers in those areas additional choices in video programming and interactive digital services.”<sup>23</sup>

What happened? Quite simply, Pacific Bell didn’t do what it promised. An examination of Pacific Bell’s construction expenditures through 1996 reveals no major increase in spending for network construction. In fact, the company spent more money on its telecommunications infrastructure in the mid-1980s than it did in the three years after it announced the California First plan.

**Pacific Telesis Capital Expenditures for Construction, 1984-1996**  
(In Billions)

1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
\$2.1	\$2.3	\$2.2	\$2.2	\$1.6	\$1.9	\$2.1	\$1.7	\$1.8	\$1.9	\$1.7	\$2.1	\$1.8

*Source: Pacific Telesis Annual Reports, 1984-1996.*

If the company had implemented the plan to spend \$16 billion on California First, capital expenditures from 1994 on would have been about \$2.3 billion per year above the average spent during the period from 1984-1993. But that didn't happen.<sup>24</sup>

“Pacific and Southwestern Video Curtailment/Purchase Commitments – SBC also announced in 1997 that it was scaling back its limited direct investment in video services in the areas also served by Pacific Bell Telephone Company (PacBell) and Southwestern Bell Telephone Company (SWBell). As a result of this curtailment, SBC halted construction on the Advanced Communications Network (ANC) in California. As part of an agreement with the ACN vendor, SBC paid the liabilities of the ACN trust that owned and financed ACN construction, incurred costs to shut down all construction previously conducted under the trust and received certain consideration from the vendor. In the second quarter of 1997, SBC recognized net expense of \$553 million (\$346 million net of tax) associated with these activities. During the third quarter of 1997, SBC recorded the corresponding short-term debt of \$610 million previously incurred by the ACN trust on its balance sheet.

...

Additionally, SBC curtailed certain other video-related activities including discontinuing its broadband network video trials in Richardson, Texas, and San Jose, California, substantially scaling back its involvement in the Tele-TV joint venture and withdrawing its operations in territory served by SWBell from the Americast venture. During 1999, SBC negotiated a settlement with its Americast partners related to the withdrawal. The settlement did not have a material impact on SBC's financial condition or results of operations. The collective impact of these decisions and actions by SBC resulted in a charge of \$145 million (\$92 million net of tax) in the second quarter of 1997.”<sup>25</sup>

Although Pacific Bell didn't spend the \$16 billion, the company wrote off what it did spend. Customers never benefited from the network or the write-offs.

**Year by Year: A Plan that Failed**  
**(A timeline of Pacific Bell's California First plan.)**

- November 1993: Pacific Bell unveils plans to spend \$16 billion over seven years to upgrade its California network to handle interactive services like home shopping and compete against cable companies with video channels and movies-on-demand.
- May 1994: PacBell begins network construction in Pacific Beach and Mira Mesa in San Diego. Construction also begins in San Jose and in Orange and Los Angeles counties.
- October 1994: City of San Diego considers proposal to require that Pacific Bell pay franchise fees and abide by other requirements imposed on cable companies if it gets into the video business.
- October 1994: Pacific Telesis, Bell Atlantic Corp. and Nynex Corp. form Tele-TV, a joint venture to provide the companies with video programming, entertainment and information to sell to residents.
- January 1995: PacBell and city of San Diego sign "landmark" agreement, with PacBell pledging to give the city 5 percent of gross revenues from voice, video and data services sold over new network. City agrees not to regulate PacBell as a cable company.
- April 1995: PacBell buys Cross Country Wireless Inc. and announces plans to offer "wireless cable" service to 5 million-customer service area covering San Diego, Riverside, Los Angeles and Orange counties.
- September 1995: PacBell slows network construction to save \$1 billion in capital costs over five years for statewide project, but accelerates network construction in the San Francisco Bay Area.
- January 1996: PacBell halts fiber/coaxial network construction in Los Angeles County. Network projects continue in San Diego, San Jose and Orange County (briefly).
- April 1996: SBC Communications of Texas signs deal to buy Pacific Telesis.
- May 1996: Network construction halted in Orange County.
- June 1996: San Jose City Council awards PacBell a cable franchise, giving the company official standing as cable operator.
- September 1996: PacBell begins selling video service in San Jose over its new network.
- April 1997: SBC's purchase of Pacific Telesis becomes final.
- April 1997: Tele-TV, jointly owned by Bell Atlantic Corp., Nynex Corp. and Pacific Telesis Group, cuts staff in half and abandons all joint video projects in favor of individual company efforts.
- May 1997: PacBell launches 'wireless cable' service in Los Angeles and Orange counties.
- June 1997: SBC abandons almost all attempts to compete with cable, announcing immediate ends to Pac Bell's video network project as well as a smaller test in Texas. The decision halts construction in San Diego and pulls the plug on 8,000 PacBell cable customers in San Jose. SBC writes off \$500 million investment in both ventures.
- November 1997: PacBell sends out requests for bids on various components of the partially built video network.

*Source: "PacBell's video bid proving more costly," Elizabeth Douglass, San Diego Union Tribune, Feb. 1, 1998, Page I-1.*

#### **4) Broad-based Incentive Regulation Plans**

Beginning shortly after the divestiture of AT&T created the RBOCs, the Bells began a series of state-level campaigns to obtain relief from traditional, cost-based rate-of-return regulation. Their basic pitch was simple: existing, traditional regulation dampens their incentives to deploy new, advanced, but economically risky technology. Change the way the companies are regulated, and they will deliver America's digital future. Regulators did their part; the Bells did not. The promised technical nirvana never materialized, but the Bells happily accepted the higher earnings that were possible as a result of relaxed regulation.

Nationwide, according to the Bells' annual reports and press releases, there should have been almost 44 million households wired to the fiber optic network by 2000. For example, Bell Atlantic was to have had almost nine million households wired with optical fiber loops by 2000. And that isn't counting the two million households that NYNEX was to have upgraded by 1996.<sup>26</sup>

And U.S. West stated:

"In 1993 the company announced its intentions to build a 'broadband,' interactive telecommunications network . . . U.S. West anticipates converting 100,000 access lines to this technology by the end of 1994, and 500,000 access lines annually beginning in 1995."<sup>27</sup>

Ameritech made similar statements:

"We're building a digital video network capable of delivering multicast and interactive services to six million customers within six years."<sup>28</sup>

As did NYNEX:

"We're prepared to install between 1.5 and 2 million fiber-optic lines through 1996 to begin building our portion of the Information Superhighway."<sup>29</sup>

And Bell Atlantic:

“First, we announced our intention to lead the country in the deployment of the information highway . . . We will spend \$11 billion over the next five years to rapidly build full-service networks capable of providing these (interactive, multi-media communications, entertainment and information) services within the Bell Atlantic Region.

...

We expect Bell Atlantic's enhanced network will be ready to serve 8.75 million homes by the end of the year 2000. By the end of 1998, we plan to wire the top 20 markets. These investments will help establish Bell Atlantic as a world leader in what is clearly the high growth opportunity for the 1990's and beyond.”<sup>30</sup>

The fiber optic networks these companies promised to build were broadband services, capable of transmitting hundreds of times more information for enhanced interactive services. The Internet as it exists today is largely a “narrow band” service, based on existing copper wire phone networks. It’s like the difference between a Ferrari and a skateboard.

## **5) Specific State-Level “Incentive Regulation” Deals**

The Bells engaged in intensive lobbying to win the regulatory changes they desired. Many of these efforts were successful. Some specific examples are described below.

### **Horse Trading in Texas**

Southwestern Bell-Texas was especially good at convincing political and regulatory leaders to grant its wishes. Armed with over 100 lobbyists,<sup>31</sup> Southwestern Bell-Texas held out the vision of a future of wondrous new fiber optic services for schools, libraries, hospitals and even prisons. In testimony before state legislators, Southwestern Bell-Texas President David Cole stated:

“Perhaps the most exciting benefit is, of course, the tremendous potential of this package for our schools, hospitals and criminal justice organizations. Our distance learning, telemedicine and video arraignment pilot projects have demonstrated the incredible good that the infrastructure component of this bill (HB 2128) can lead to for our local communications.”<sup>32</sup>

The Texas Legislature went along with Southwestern Bell’s wishes, declaring that it would raise the standard of living for Texas consumers:

“The legislature further finds that the technological advancements, advanced telecommunications infrastructure, and increased

customer choices for telecommunications generated by a truly competitive market will raise the living standards of all Texans by enhancing economic development, improving the delivery of education, health, and other public and private services and therefore play a critical role in Texas' economic future.”<sup>33</sup>

Texas established an “incentive regulation” plan in place of traditional rate-of-return regulation. This allowed Southwestern Bell-Texas to reclassify as “discretionary” many popular services, including Call Waiting, Call Forwarding and Caller ID.<sup>34</sup> As a result, these services could be priced at market level regardless of cost to the company, earning SBC huge profits.

Not surprisingly, the Texas-style incentive regulation plan earned a “thumbs up” from Merrill Lynch:

“We view the regulation in Texas as positive for SBC – perhaps the best regulatory plan in the country at the state level from the perspective of the local telco incumbent.”<sup>35</sup>

Most of the reclassified services were profitable, and under “incentive regulation” the company was allowed to keep all profits rather than returning them to consumers in the form of lower rates. The resulting over earnings amounted to \$228 million in 1997, according to the Public Utility Commission of Texas.<sup>36</sup>

But if the promised services were actually delivered to any Texas schools, libraries, or health facilities, it is one of the state’s best-kept secrets. Numerous inquires have turned up only a handful of “trials” of high-speed service.

The Texas experience was not unique. Others are described below, and additional examples are included in New Networks Institute’s research.<sup>37</sup>

### **Opportunity New Jersey**

“Opportunity New Jersey” was a state plan that was supposed to bring the information superhighway to Bell Atlantic’s Garden State customers. Using the prominent Deloitte & Touche consulting firm, and heavy state lobbying, Bell Atlantic convinced New Jersey regulators that specific new incentives were needed to ensure Bell Atlantic’s deployment of advanced networks. In fact, the new regulatory structure resulted primarily in excess profits.

Basically, Bell Atlantic promised to deploy a network that would fix nearly everything: Tele-Medicine, Tele-Learning, and even new jobs. Deloitte & Touche’s “New Jersey Telecommunications Infrastructure Study, 1991,” dubbed “Opportunity New Jersey,” proclaimed that the new network:

- "...[I]s essential for New Jersey to achieve the level of employment and job creation expected in the state."
- Would "advance the public agenda for excellence in education."
- Would "improve quality of care and cost reduction in the healthcare industry."

If there had been widespread deployment of various "advanced telecommunications capabilities," a number of public benefits might well have accrued. The question that needs to be asked is: why don't we already have these benefits in light of the deployment promises made by the Bells over the past decade?

In a complaint filed with the New Jersey Board of Public Utilities in April 1997, the New Jersey Public Advocate asserted that Bell Atlantic-New Jersey should have spent approximately \$1.5 billion more than the \$79 million that it did spend to construct fiber optic networks. The Public Advocate concluded that these unexpended funds are largely responsible for some \$1 billion in extra dividends reported by Bell Atlantic-New Jersey's parent company.<sup>38</sup>

Bell Atlantic-New Jersey's broken promises were also documented by Economics and Technology, Inc.:

"In the five years following the Board of Public Utilities' adoption of the ONJ Plan, BA-NJ has enjoyed major financial benefits even though it has not increased its investment as promised and has opposed competition at every turn. The increased pricing and earnings flexibility coupled with reduced investment and continued monopoly pricing practices has enabled BA-NJ's profits to soar under alternative regulation. Consumers clearly have suffered under the ONJ Plan from unnecessarily inflated prices for many services, and have received few benefits in the form of new services and increased competitive choices. Since the adoption of the ONJ Plan in 1993:

- *BA-NJ's actual investment and financial performance under the ONJ Plan indicates that the Board's expectations with respect to infusion of new investment capital have not been realized.*
- BA-NJ's financial return on equity (ROE) jumped from 22% to almost 40%.
- Rather than put those profits back into its telecommunications infrastructure, BA-NJ actually *disinvested* some \$76-million between 1993 and 1995."<sup>39</sup>



## Advantage Ohio

In the case of Advantage Ohio, Ameritech/Ohio did roll out some of the promised fiber optics, but not as part of an advanced telecommunications network. Instead, Ameritech/Ohio used the money that was supposed to pay for an advanced network to deploy fiber to offer traditional cable service.

This shift in strategy is clearly documented in the differences between Ameritech's annual reports for 1993 and 1997. In the earlier annual report, the cover features a picture of two boys doing homework together using enhanced video-conferencing and tele-learning. "Strategy Two," as described in the 1993 report, was all about interactive services:

"We will deliver interactive services to homes and business through our new video network. We've stated our position in interactive services for health care administration, education, government, libraries, travel and commerce, as well as entertainment, games and home shopping."<sup>40</sup>

Ameritech/Ohio also promised to wire schools, libraries, hospitals and county jails with two-way high-speed networks. The DSL service available today typically offers high-speed transmission in only one direction:

"The Company's infrastructure commitment in this Plan shall consist of the commitment to deploy, within five years of the effective date of the Plan and within the Company's existing service territory, broadband two-way fully interactive high quality distance learning capabilities to all state chartered high schools including vocational, technical schools, colleges and universities; deploy broadband facilities to all hospitals, libraries, county jails and state, county and federal court buildings."<sup>41</sup>

By the time the 1997 annual report was published, Ameritech/Ohio wasn't focusing on anything like fiber optics. The company had three basic strategies: 1) roll out voice mail and other calling features; 2) roll out cable services; and 3) focus on international business:

"Actually, Strategy Two is already teeming with success. Take cable TV, for instance. Our Americast cable service is now up and running in more than 20 communities in or around Detroit, Cleveland, Columbus – and right here in suburban Chicago, where young Jordan Kramer has obviously mastered his Red Jr. remote control!"<sup>42</sup>

Ironically, Ameritech has been applauded for creating a market in which “cable competition is driving down prices.” Senator Mike DeWine (R-OH), Chairman of the Senate Judiciary Committee’s Subcommittee on Antitrust, Business Rights and Competition, stated:

“Ameritech has been one of the few telephone companies providing cable competition. We want to encourage that. We want it to expand.”<sup>43</sup>

Cable competition is a positive development, but it is not what telephone customers paid for. Ohio consumers should not be financing a new cable network through higher phone bills.

### **Opportunity Indiana**

A negotiated settlement agreement with the Indiana Utility Regulatory Commission governed Ameritech’s telecommunications services in Indiana from June 30, 1994 through December 31, 1997. Known as “Opportunity Indiana,” the agreement provided for reduced regulation of Ameritech by the Commission. The settlement required Ameritech to reduce its annual revenue by \$57 million per year, and to invest \$120 million over a six-year period to provide digital wiring to every interested school, hospital, and major government center in its service area on a non-discriminatory basis. In addition, Ameritech agreed to invest \$30 million over the same six-year period to pay for information processing and telecommunications equipment.<sup>44</sup>

Shortly before the agreement expired Ameritech petitioned the Commission to establish an alternative regulatory framework, to take effect when the settlement agreement expired. The petition proved to be contentious and the Commission’s ruling eventually wound up before the Court of Appeals of Indiana. One of the issues in dispute was the Commission’s finding that Ameritech had not made the full amount of infrastructure investments agreed to under the “Opportunity Indiana” settlement:

“Ameritech had presented evidence to the Commission that it had been unable to generate sufficient interest in or the required investments among the schools, hospitals and government centers it served. The Commission ruled that if Ameritech was unable to generate sufficient interest to absorb the full amount of the infrastructure investment obligations in Opportunity Indiana, Ameritech should ‘propose some other means for its shareholders to provide infrastructure improvements consistent with [the terms of Opportunity Indiana].’<sup>45</sup>

Ameritech appealed the Commission’s order that it make the promised \$150 million infrastructure investment in compliance with the negotiated settlement. The Appeals Court upheld the Commission’s findings:

“During proceedings on its request for interim relief, Ameritech presented evidence that it had provided only \$15.6 million of the infrastructure investments required by Section 10(b) of Opportunity Indiana. R. at 2730. Ameritech attributed this shortfall to its inability ‘to generate sufficient interest among the schools, hospitals and government centers it serves.’”<sup>46</sup>

The Commission found that Ameritech had failed to live up to its promise and suggested that Ameritech try harder to fulfill its obligation:

“Opportunity Indiana did not state that Ameritech would make investments ‘up to’ a maximum amount. Nor is there anything in Opportunity Indiana which suggests Ameritech’s infrastructure investments were to be optional. It is clear from the language of the Opportunity Indiana settlement agreement that *Ameritech undertook an unconditional commitment to make certain infrastructure investments that would be in effect for the six-year period of 1994 through 1999. Ameritech has not fulfilled that commitment.*<sup>47</sup> [Emphasis added.]

## 6) The Key Flaw in Incentive Regulation Plans

There is a significant flaw in the incentive regulation plans adopted by the various states. When a monopolist is deregulated before competition takes hold, the result is an unregulated monopoly.

One of the concerns that incentive regulation was supposed to address was the absence, in cost-based regulation, of rewards for efficiency. Under traditional regulation, if a less efficient firm had higher costs, regulators authorized higher rates. A firm that used innovation to become a more efficient provider of existing services, or to offer new services, would receive no more or less financial benefit than a firm that was not innovative at all. The key benefit of traditional regulation was that the monopolist had no incentive to reduce customer service, since the cost would always be recovered in rates.

On a purely theoretical level, there is nothing wrong with a regulatory policy that is designed to encourage efficiency and innovation. Nor is there anything wrong with a regulatory strategy intended to produce a substantial upgrade in the quality and capability of the telephone network.

But it was a mistake for regulators to simply trust that competition would develop immediately, bringing better and more efficient service, and multi-billion dollar investments in new networks. Yet that, in essence, is what happened. Profits and prices were subject to much less regulation. Regulators expected the additional revenue that the Bells were able to generate in this relaxed regulatory environment to finance construction of a fiber optic network. But without

competition, the Bells kept the excess revenue, and there was no accountability to ensure that they actually built the networks they had promised to build.

If the Bells were confronted with actual and substantial competition in the local service market, it might have been reasonable to allow issues such as service quality and the pace of deployment of advanced telecommunications capabilities to be determined by the market. But there has not yet been any substantial local exchange competition, particularly for residential customers.

## **7) More Recent Moves to Block the Digital Future: DSL and the Bells**

The Bells' failure to deploy the promised fiber optic networks was a major blow to America's digital future. If the Bells had kept their promises, almost half of America's households and the vast majority of U.S. schools would already have access to a fully interactive high-speed network. Instead, only about 500,000 have been wired to the fiber optic network, less than 5% of the 50 million Internet users in the U.S. subscribe to high-speed Internet service today, and there are four times as many cable modem subscribers as DSL subscribers.<sup>48</sup> In fact, it was the growing demand for cable broadband that finally motivated the Bells to launch aggressive plans to rollout DSL service. And now that they've jumped on the high-bandwidth bandwagon, there is mounting evidence that the Bells are doing everything possible to put competitive DSL providers at a disadvantage.

### **ISPs Have A Litany of Complaints About the Bells**

A recent survey of Internet service providers conducted by New Networks Institute for the Commercial Internet eXchange (CIX) and the United States Internet Service Provider Association (USISPA) found a high degree of dissatisfaction among competitive DSL resellers.

With an estimated 7,000 providers throughout the United States, small and mid-size ISPs serve 46% of all online customers.<sup>49</sup> These companies, not the Bell monopolies, have been the real innovators of America's digital future. But according to the findings of a survey released by NNI on April 12, the Bells and GTE are providing competitive ISPs with substandard customer service and stifling competition. The result is a loss of revenue for ISPs.<sup>50</sup>

Across the board, ISPs rated their customer service experiences with the Bells as substandard in virtually all categories. Only 8% of ISPs surveyed gave the Bells an overall passing grade (above 6.5 out of a possible 10 points). The average grade was 3.7, well below an acceptable standard. The survey also found that 62% of ISPs reported frequent or continual phone line problems, 57% reported instances in which it took months for orders to be fulfilled, and 46% reported being unable to buy a service for resale even when the service was advertised. In addition, 46% of the ISPs reported that it could take several days for repairs to be made to installed phone lines. In the words of one Texas ISP:

“Network switch screw-ups take us down regularly. Inadequate trunking (phone lines) causes circuit busies. Poor equipment causes slow connections. Southwestern Bell lies to our clients when they foul up service and try to take our clients.”<sup>51</sup>

About 40% of the responding ISPs reported that they offered or soon plan to offer DSL service. Those already offering DSL also reported a host of problems in dealing with the Bells:

- 71% of ISPs reported orders being lost by the local phone company.
- 59% of ISPs reported having customers switched to the local Bell’s service without permission – the broadband version of “slamming.”
- 63% of ISPs reported that the local Bell had recommended its own service over the service being provided by the ISP.
- 53% ISPs reported that their customers were told by the local Bell that they could avoid problems by switching to the Bell’s product.

ISPs that purchased DSL from Competitive Local Exchange Carriers (CLECs) for resale to consumers believed the CLECs delivered better service, but felt the CLECs were also being hampered by the Bells. ISPs gave CLECs an approval rating twice that of the average rating for the Bells. Moreover, a majority of small ISPs in secondary markets across America reported that there were no competitive resellers and the Bells were either freezing them out of the market by pricing their own DSL service below the ISP’s cost, or were not providing adequate customer service. Here is what one ISP reported:

“A CLEC must work with Southwestern Bell to gain access to the network, and when SWB screws them, they become another layer of confusion. To coordinate both large companies into a cohesive troubleshooting team in a crisis is impossible.”<sup>52</sup>

## **8) The Impact of the Bells’ Entry In To Long Distance Markets**

In order to promote competition and bring consumers a wide array of new information and communications services, the Telecommunications Act of 1996 requires that local phone markets be open to competitors before the Bells are allowed to sell long distance service within their own markets. But the standards that federal regulators are using to determine if there is sufficient competition are minimal.

Bell Atlantic is to date the only RBOC selling long distance service in its market. The FCC approved Bell Atlantic’s entry into the New York long distance market in December 1999, despite the Justice Department’s finding that 30-40% of all order confirmations to competitors were inaccurate and over 80% of all orders required some form of manual processing. Within

weeks, competitors were complaining about Bell Atlantic's failure to process large numbers of orders for unbundled network elements, and the FCC launched an investigation. On March 9, the FCC entered into a Consent Decree under which Bell Atlantic agreed to make a \$3 million payment to the U.S. Treasury and to file regular performance reports.

The FCC is now considering SBC's application to sell long distance service in Texas. After twice recommending that the FCC reject SBC's application, the Justice Department recently recommended that the FCC approve SBC's application.<sup>53</sup> But in its June 13, 2000 letter to the FCC the Justice Department noted that it still had concerns about SBC's willingness to provide competitors with access to critical information and databases, and acknowledged that SBC had not adequately addressed future competitive issues:

“We emphasize that additional performance measures and ongoing refinement of performance measurement processes are likely to be needed as new services and technologies are implemented. The Texas PUC is already considering these issues, and SBC has committed in this application to promptly institute performance measures regarding the provisioning of line sharing.”<sup>54</sup>

Given the Bells' long history of broken promises, regulators should not be relying on SBC's commitment. If the Bells are permitted to sell long distance service before local markets are sufficiently competitive, America's digital future could again be put at risk.

## **Part II**

### **Bell Company Profits Are Outrageous**

In Part I, we discussed how the Bells in many instances convinced regulators to abandon traditional regulation, which limited monopoly profits, in exchange for their promises to build advanced networks. In Part II, we will show how the Bells' failure to build the promised networks, combined with reduced regulatory oversight, led to excess profits.

#### **1) The Bells' Profits Are Neither “Just” Nor “Reasonable”**

The purpose of the Communications Act of 1934 (as amended in 1996) was:

“... to make available, so far as possible, to all the people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex, a rapid, efficient, Nation-wide, and world-wide wire and radio-communications service with adequate facilities *at reasonable charges*...”<sup>55</sup> [Emphasis added.]

The Act also specifically assigned to the FCC responsibility to investigate and report any overcharges or unreasonable price increases:

“The Commission ... shall report to the Congress whether any such transactions... may result in any undue or unreasonable increase in charges or in the maintenance of undue or unreasonable charges for such service...”<sup>56</sup>

And the more recently enacted Telecommunications Act of 1996 clearly states:

“... Consumer Protection: The Commission and the States should ensure that universal service is available at rates that are just, reasonable, and affordable.”<sup>57</sup>

The “just” and “reasonable” standard has also been imposed on state regulators. For example, in a 1993 decision regarding New Jersey Bell’s application for an alternative form of regulation, the New Jersey Board of Public Utilities wrote:

“[T]he Legislature declared that it is the policy of the State to, among other things, ‘*ensure that customers pay only reasonable charges for local exchange telecommunications service...*’ N.J.S.A.48:2-21.16(a)(2). To this end the Act permits the board to approve a plan for an alternate form of regulation if it finds that the plan, among other things, ‘*will produce just and reasonable rates for telecommunications services.*’”<sup>58</sup> [Emphasis added.]

While the terms “just” and “reasonable” are admittedly imbued with some measure of ambiguity, the sheer magnitude of Bell are unjustifiable.

The Bells are among the richest companies in America. It is clear from all business indicators, including standard measurements of profit margins and return-on-equity (ROE), that the Bells are making double or triple the profits made by companies facing competition. The exhibit below shows the combined average earnings of the Bells and GTE for 1998 and 1999<sup>59</sup> and compares it to the Business Week ScoreBoard for Utilities. In 1998, net margin for the Bells was 110% higher than the net income of the ScoreBoard for Utilities, and ROE was 214% higher than for the utilities. In 1999, the difference was 86% and 154, respectively.

**Business Week's Industry Ranking:  
Bells/GTE Compared to ScoreBoard for Utilities**

	1998		1999 <sup>60</sup>	
	Net Margin	Return-on-Equity	Net Margin	Return-on-Equity
<b>Bells</b>	13.65 %	28%	12.03%	28%
<b>ScoreBoard for Utilities</b>	6.3 %	9%	6.9%	11%
	<b>Difference</b>	<b>Difference</b>	<b>Difference</b>	<b>Difference</b>
<b>Bells Compared to Utilities</b>	110%	214%	86%	154%

*Source: Business Week, March 29, 1998 and March 27, 1999.*

The Bells' profits are also excessive when compared to competitive telecommunications companies. Business Week's Standard & Poor's 500 Annual Report for 1999 shows that the Bells' ROE is much higher than that of the three largest competitive long distance companies and of the "Telecommunications Industry Average." As detailed in the following exhibit, the combined average ROE for AT&T, MCI and Sprint was 163% above that of the three big long distance companies and 130% above that of S&P's telecommunications index.<sup>61</sup>

**Bell Return-on-Equity Compared to Long Distance Companies  
and to the S&P 500 Telecommunications Industry Average**

	Return-on-Equity
<b>AT&amp;T</b>	7.3%
<b>MCI</b>	8.1%
<b>Sprint</b>	16.6%
<b>Combined Long Distance</b>	10.67%
<b>S &amp; P 500 Telecommunications Industry Average</b>	12.2%
<b>Bells</b>	28.1%
	<b>Difference</b>
<b>Bells Compared to Combined Long Distance</b>	163%
<b>Bells Compared to Telecommunications Industry Average</b>	130%

*Source: Business Week's Performance Ranking of the S & P 500, March 27, 2000*

To further put the Bells' profits into perspective, we looked at five icons of American business: McDonalds, the worlds largest restaurant chain; Nike, the largest footwear supplier; Exxon/Mobil, the largest oil company, Disney, one of the largest entertainment companies; and Dow Jones, a major finance company.

The exhibit below compares Bell and GTE profit margins with that of the five identified above. Most businesses are happy if they achieve a 10-20% profit margin. The combined average profit margin for the companies we looked at was only 16%. In contrast, the Bells' profit margin from all services was 42.9%, which is 167% higher than the average for the five businesses combined.



## Bell Profit Margins Compared to Selected Major American Companies

	Profit Margin
<b>Business Group: McDonalds, Nike, Exxon/Mobil, Disney, Dow Jones</b>	16.1%
<b>Bells</b>	42.9%
	Difference
<b>Bells Compared to Business Group</b>	167%

*Source: 4<sup>th</sup> Quarter Year-End 1999 Results, from SEC filings.*

### 2) Some Bell Products Have Profit Margins Approaching 50,000%

The Bells' business model is also revealed through a closer look at the profit margins of specific telephone company product offerings. The exhibit below highlights findings from a Florida Public Service Commission report comparing the actual cost of various calling features to the price paid by subscribers. The Florida Commission found the profit margin on Bell South's Call Waiting feature to be 48,680%. Caller ID, which cost the customer \$7.50 per month, had a 3,264% profit margin.

#### Revenue, Expense and Profit Margin for Selected BellSouth Calling Features

	Price	Cost	Profit	Percentage
<b>Call Waiting</b>	\$4.00	\$0.008 2	\$3.99	48,680%
<b>Call Forwarding</b>	\$4.00	\$0.036 2	\$3.96	10,950%
<b>Caller ID</b>	\$7.50	\$2.223 0	\$7.28	3,263%

*Source: "Report of the Florida Public Service Commission on the Relationships Among the Costs and Charges Associated with providing Basic Local Service, Intrastate Access and other Service by the Local Exchange Companies in Compliance with Chapter 98-277, Section (2) 1 Laws of Florida, February 19, 1999."*

Many states, including New Jersey, Rhode Island and Massachusetts, still charge about \$1 per month for Touch-tone service. But this service costs the Bells absolutely nothing because it was incorporated into network upgrades that were completed in the 1980s in order to provide customers with equal access to long distance companies. In fact, the Bells would incur an expense to offer old-fashioned rotary dialing service.

Excess profits are also common with directory services. The price for a directory listing in the Yellow Pages was traditionally kept above normal returns primarily because revenue was supposed to subsidize other costs of phone service. But many states have freed directory listings from regulation and those revenues no longer subsidize other phone service costs. Prices and profits remain high, however, because there is not enough competition to keep prices in check.<sup>62</sup>

### Business Margins for Directory Publishing in 1999

Company	Operating Income Margin
Bell Atlantic	52.7%
US West	52.9%
SBC	45.4%

Source: 4<sup>th</sup> Quarter 1999 SEC filings.

### 3) Bell Profits Are Still Mainly From Their Core, Local Phone Customer

Despite the expansion of their businesses into new areas, the Bells' overall profits are still coming mainly from captive customers. This isn't surprising, since the incumbents' share of the local phone market is 96% of all lines served.<sup>63</sup> Below is BellSouth's breakout of revenues and profits as presented in the company's 4<sup>th</sup> Quarter 1999 SEC filing. The high percent of revenues and net profits that are derived from traditional telecommunications services is also found in other Bells. Local phone service continues to subsidize most of the Bells' other businesses.

#### BellSouth's Breakout of Revenues and Profits, 4<sup>th</sup> Quarter Year Ending 1999

	Percent of Revenues	Percent of Net Profits
BellSouth International	9%	-0.1%
Wireless	11%	1.5%
Domestic Wireless	12%	6.5%
Telecommunications	68%	92.1%
	100%	100%

Source: 4<sup>th</sup> Quarter 1999 SEC filings.

Historically, the Bells have lost billions of dollars on business ventures beyond their core phone service business. In the 1980s, the Bells collectively lost over \$11 billion in real estate, and by 1999 they had spent approximately \$40 billion overseas, with very large losses.<sup>64</sup> So, although the Bells have continued to talk about being global companies, their profits overwhelmingly come from the local telephone subscriber. And it is the excess profits generated by local service subscribers that have allowed the Bells to become "global" companies. Unfortunately, many of these ventures have just lost money. Here is an example from Bell Atlantic:

"In the third quarter of 1998, we recorded pre-tax charges of \$485 million to adjust the carrying value of two Asian investments – TelecomAsia, a wireline investment in Thailand, and Excelcomindo, a wireless investment in Indonesia. We account for these investments under the cost method.

...

The charges were necessary because we determined that the decline in the estimated fair values of each of these investments was other than temporary. We determined the fair values of these investments by discounting estimated future cash flows.”<sup>65</sup>

BellSouth provides a second example:

“Note F – Devaluation of Brazilian Currency: We hold equity interests in two wireless communications operations in Brazil. During January 1999, the government of Brazil allowed its currency to trade freely against other currencies. As a result, the Brazilian Real experienced a devaluation against the US Dollar. The devaluation resulted in our Brazilian wireless properties recording exchange losses related to their net US Dollar-denominated liabilities. Our share of the foreign exchange rate losses associated with the devaluation recorded during the first quarter was \$280 million.”<sup>66</sup>

#### 4) Prices Should Have Declined, Yet They Haven’t

Determining Bell profits is challenging, since the financial information provided by the Bells is presented in such a way that it is difficult to get a handle on expenses or revenues. But there should be no doubt that prices should have declined significantly. One of the least talked about aspects of the holding company consolidation of the Bells is the massive staff cuts that have effected all service offerings. Since the Bells were created in 1984, over 275,000 workers and managers have been laid off or retired. This has had a significant impact on the companies’ abilities to keep up with new orders, and new competitors. Here is one example:

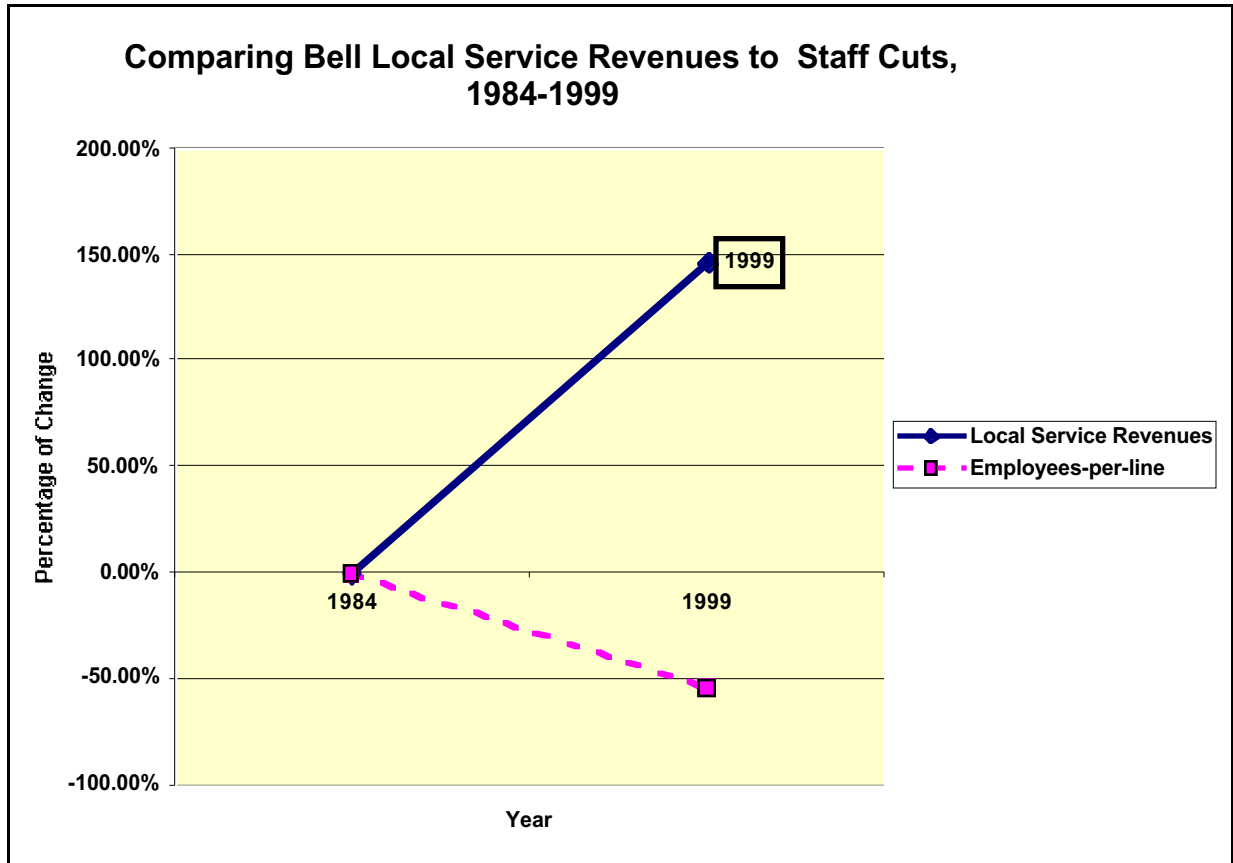
“Employees-per-line” is a standard measurement used to indicate staffing levels in the telephone industry. Between 1984 and 1999, Bell Atlantic (including NYNEX) has cut employees-per-line by 53%. On average, staffing in departments associated with customer phone service have been cut by more than 50%, as indicated in the following exhibit.<sup>67</sup>

#### Bell Staffing Reductions Since Divestiture

Employees-per-line	1984	1999	Percent Reduced
Bell Atlantic/NYNEX	61.0	28.8	53%
Pacific Telesis	63.0	27.0	57%*
US West	61.0	27.3	54%

*Source: Bell Annual Reports and Fact Books.*

The staffing cuts have resulted in huge financial savings for the companies. NYNEX, which is now part of Bell Atlantic, cut nearly 16,200 positions between 1994 and 1997 and anticipated annual savings of a whopping \$1.7 billion once the restructuring was completed.<sup>68</sup> The quote below, from the NYNEX 10Q, 3rd Quarter Report, 1996, clearly shows the savings and staff cuts during 1996. It should also be noted that these savings were not applied to deductions in the price of services to customers:



Source: Bell Annual Reports and Fact Books, 1984-1999, New Networks Institute, 2000.

"Since the inception of process re-engineering and the special pension enhancement program in 1994, approximately 11,900 employees (to date) have accepted the retirement incentives. *On an annualized basis, this will equate to an average reduction in wages and benefits of approximately \$650 million.*"

...

It is anticipated that the restructuring will result in reduced costs during the period of restructuring and *reduced annual operating expenses of approximately \$1.7 billion beginning in 1997*. These savings include approximately \$1.1 billion in reduced wage and benefit expenses due to lower work force levels, and approximately

\$600 million in non-wage savings including reduced rent expense for fewer work locations and lower purchasing costs. Partially offsetting these savings are higher costs due to inflation and growth in the business." [Emphasis added.]<sup>69</sup>

As a result of these staff cuts, there have been definite and documented drops in the quality of service. US West, Ameritech, Bell Atlantic and Pacific Bell have all been investigated and ordered to pay penalties by state regulators. There are also hundreds of complaints from competitors. With fewer people to handle more work, this isn't surprising.

**5) Excess Profits Result From the Bells' Failure to Deliver on Their Promises**

Much of the Bells' excess profits are a result of having misled the public into believing that the companies needed financial incentives to deploy advanced networks. In Massachusetts, for example, Bell Atlantic specifically stated that it would be deploying 330,000 lines of full motion video, 800-channel services to the public by 1995, if only state laws were changed to give the company more money to be used for new construction. Similar promises were made to regulators in other New England states, such as Rhode Island, which subsequently came under Bell Atlantic's control. The state laws were changed, but the advanced networks were never built.

The result, as detailed in the companies' annual earnings reports to the FCC,<sup>70</sup> was that Bell Atlantic greatly benefited from alternative regulation throughout New England. Dividends paid to Bell Atlantic shareholders doubled from \$424 million in 1994 to a whopping \$845 million in 1998. Moreover, Bell Atlantic (New England Telephone) vastly increased its deductions based on the depreciation of its copper wire network, garnering nearly \$90 million more by 1998 in the states formerly served by New England Telephone, including Massachusetts. All of these states were subject to some form of alternative regulation. (Note: The FCC's earnings reports for 1999 have not yet been released.)

**Bell Atlantic-New England Telephone  
Dividends and Depreciation Expenses, 1994 and 1998**

	1994	1998	Change
<b>Bell Atlantic Dividends</b>	\$424 million	\$845 million	Doubled
<b>Depreciation Expenses</b>	\$862 million	\$952 million	\$90 million increase

*Source: Statistics of Common Carriers, FCC: 1994, 1995, 1996, 1997, 1998.*

According to the Massachusetts Alternate Regulation Plan, depreciation expenses of \$100 million per year for five years were supposed to be related to NYNEX's installation and deployment of the fiber optic network. But NYNEX didn't spend the \$500 million, as promised, to deploy fiber. So while revenues increased 15% between 1994 and 1998, expenses only increased by 6%. As a result, Operating Income (revenues minus expenses) rose 56%.

**Bell Atlantic-New England Telephone  
Revenues, Expenses, and Income, 1994 Through 1998**

	1994	1995	1996	1997	1998	Increase
<b>Total Revenues ( in billions)</b>	\$4.1	\$4.2	\$4.6	\$4.5	\$4.7	15%
<b>Operating Expenses (in billions)</b>	\$3.3	\$3.3	\$3.3	\$3.4	\$3.5	6%
<b>Operating Income (in millions)</b>	\$790	\$905	\$1,299	\$1,096	\$1,230	56%

*Source: Statistics of Common Carriers, FCC: 1994, 1995, 1996, 1997, 1998.*

Since the 1980s, the Bells have been working to convince regulators to “cap” the price that the companies can charge for regulated services. Referred to as “price caps” in many states, this type of alternate regulation was touted as a good deal for customers, because it would limit price increases. But it was actually a ruse. Costs have been declining steadily in the telephone industry, so the real effect of “price caps” was to keep prices up while the network costs declined. “Price caps” were also supposed to give the Bells more freedom to invest extra profits in building advanced networks.

## **Conclusion and Recommendations**

The digital divide exists today in part because the Bells broke their promises. The Bells are among the nation’s most profitable companies today because they convinced regulators in many states to adopt alternate regulation plans in exchange for those promises. We can’t change the past, but we can learn from it. And the most important lesson regulators can learn is not to believe the Bells’ promises.

Today, the Bells are asking Congress to lift the restrictions on their entry into the long distance data services market, before the local phone service market is fully competitive.<sup>71</sup> Given their history, this would be a mistake. It would eliminate the last remaining incentive for local competition, enabling the Bells and GTE to retain their monopoly grip on consumers, and further widening the digital divide. The Bells’ claim that they are seeking regulatory relief to fix the digital divide by providing only digital services across LATA boundaries is spurious and an attempt to get the long-distance Trojan Horse inside the regulators’ gates.

In many respects, the Bells represent the absolute worst aspects of traditional monopolies. They are slow, weighed down with bureaucracy and more interested in defending their market share than in providing innovative new technologies and services to their customers. They have

an abysmal record of keeping their promises. Based on this record, we offer the following recommendations to policy makers:

- 1) Congress should hold hearings to look into how much money the Bells collected as a result of promises they subsequently broke.
- 2) Excess profits that are identified as a result of those hearings should be refunded to ratepayers or deposited into a fund to create and support expanded access to information technology in libraries, schools, and community technology centers.
- 3) Until robust competition has emerged in telecommunications and information technology services, Congress should resist RBOC pressure to modify the Telecommunications Act of 1996. In addition, the FCC should refrain from approving any more RBOC applications for entry into long distance markets until there is much stronger evidence of compliance with the Act's 14-point competitive checklist.

## End Notes

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<sup>1</sup> "In the Matter of the Board's Inquiry into Bell Atlantic New Jersey's Progress and Compliance with Opportunity New Jersey, its Network Modernization Program," State of New Jersey Board of Public Utilities, Docket No. TX96100707, Division of the Ratepayer Advocate, March 21, 1997.

<sup>2</sup> Pacific Telesis, 1994 Annual Report, page 5.

<sup>3</sup> Melody Petersen, "New Jersey Telephone Plan Neglects Poor, Critics Say," The New York Times, April 1, 1997.

<sup>4</sup> Ohio Alternate Regulation Plan, "In the Matter of the Application of the Ohio Bell Telephone Company for Approval of an Alternative Form of Regulation, Case No. 93-487-TP-ALT, September 20<sup>th</sup>, 1994, page 68.

<sup>5</sup> In 1992, New Networks Institute started one of the largest research projects ever undertaken to examine the impact that the breakup of AT&T and the creation of the Baby Bells had on telephone customers. Titled "The Future of the Information Age," it consists of 14 volumes, over 1,900 pages, over 910 exhibits, a computer database of telephone prices, and two computer databases containing data from more than 2,000 consumer telephone interviews, (conducted independently through Fairfield Research). The bibliography can be found at: **Error! Bookmark not defined.** This material was updated in "The Unauthorized Bio of the Baby Bells," published in 1999, and once again for this report. The basis of our analysis for Bell overcharging was derived from a series of databases for the years 1980 through 1999 that included Bell revenues, expenses and profit margins (by line of business), number of Bell employees, construction expenditures, "in progress construction expenditures," return-on-equity, dividends, depreciation expenditures, and consumer telecommunications spending. This information was then cross-referenced with changes in state laws, specifically the introduction of Bell incentive regulation plans. A complete discussion of this material can be found in "The Unauthorized Bio of the Baby Bells," pages 169-215, pages 355-367.

<sup>6</sup> Southwestern Bell 1986 Annual Report, page 11.

<sup>7</sup> Ameritech 1991 Annual Report, page 6.

<sup>8</sup> Pacific Bell's "Education First" program, First Quarter Report Summary, March 31, 1994, page 1.

<sup>9</sup> NYNEX 1993 Annual Report.

<sup>10</sup> Ibid.

<sup>11</sup> James Gleick, "The Information Future Out of Control: Hello, Anybody Home?" New York Times Magazine, May 14, 1994, page 17.

<sup>12</sup> Southwestern Bell 1986 Annual Report.

<sup>13</sup> Pacific Telesis 1988 Annual Report.

<sup>14</sup> "Staking Out the Public Interest in the Merger between Pacific Telesis and Southwestern Bell Corporation," by Armando Valdez, Ph.D., Charles Carbone, and Laura Stuchinsky, M.A., 1997.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

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- <sup>17</sup> Pacific Telesis 1994 Annual Report, page 5.
- <sup>18</sup> Summary, FCC Report No. DC 95-40, Common Carrier Action, July 19, 1995, Authorization FCC 95-302, page 1.
- <sup>19</sup> Pacific Bell Press Release, December 21, 1993.
- <sup>20</sup> "Superhighway schedule criticized," Gerry Braun, San Diego Tribune, Jan. 19, 1994, Page C-1.
- <sup>21</sup> Pipeline & Utilities Construction, Dec. 1, 1995, page 21.
- <sup>22</sup> "PacBell to wire schools for high-tech," James W. Crawley, San Diego Union Tribune, Feb. 15, 1994, page C-1.
- <sup>23</sup> Summary, FCC Report No. DC 95-40, Common Carrier Action, July 19, 1995, Authorization FCC 95-302, page 1.
- <sup>24</sup> Pacific Bell's construction expenditures after 1996 are included in SBC's annual reports and are not identified separately.
- <sup>25</sup> SBC 1999 Annual Report, from SEC Edgar Archives.
- <sup>26</sup> NYNEX 1993 Annual Report, page 5, Bell Atlantic 1993 Annual Report, page 4.
- <sup>27</sup> US West 1993 Annual Report, page 19.
- <sup>28</sup> Ameritech Investor Fact Book, March 1994, page 2.
- <sup>29</sup> NYNEX 1993 Annual Report, page 5.
- <sup>30</sup> Bell Atlantic 1993 Annual Report, page 4.
- <sup>31</sup> "Bells Promise of Fiber-Optics Impresses Few," The Wall Street Journal, March 15, 1995, page T1.
- <sup>32</sup> Testimony of David Cole, House State Affairs Committee hearing, March 10, 1995, page 2.
- <sup>33</sup> HB 2128, "An Act relating to the regulation of telecommunications utilities, to the provision of telecommunications and related services, and to the continuation of the Public Utility Commission of Texas," approved by the Texas Legislature in May 1995.
- <sup>34</sup> Ibid.
- <sup>35</sup> "Bush Signs Texas Bill - A Plus for SBC," Merrill Lynch, Global Fundamental Equity Research Dept., June 1, 1995.
- <sup>36</sup> "Project Number 9418: Staff Evaluation of Earnings Reports for Calendar Year 1997," Public Service Commission of Texas, November 10, 1998.
- <sup>37</sup> See: "The Unauthorized Bio of the Baby Bells," published by New Networks Institute, January 1999; "The Bells' Greatest Broadband Failures," **Error! Bookmark not defined.** "On the Need to Investigate Bell Atlantic's Failed Deployment of Advanced Networks and the Impacts on Customers," filed as a Complaint with the Massachusetts Department of Telecommunications and Energy, Oct. 6, 1999, **Error! Bookmark not defined.** "Petition Requesting a Revision of the FCC's Advanced Network Report Findings, and a Request for an Investigation into the Bell Operating Companies' Advanced Network Deployment Failures," filed with the FCC, Dec. 9, 1999. **Error! Bookmark not defined.**
- <sup>38</sup> "In the Matter of the Board's Inquiry into Bell Atlantic New Jersey's Progress and Compliance with Opportunity New Jersey, its Network Modernization Program," State of New Jersey Board of Public Utilities, Docket No. TX96100707, Division of the Ratepayer Advocate, March 21, 1997.
- <sup>39</sup> "A New Opporutnity: Cost Based Pricing of Bell Atlantic Access Charges," Economics and Technology, March, 1996, page i (from web site: **Error! Bookmark not defined.**).
- <sup>40</sup> Ameritech/Ohio 1993 Annual Report.
- <sup>41</sup> Ohio Alternate Regulation Plan, September 20, 1994, "In the Matter of the Application of the Ohio Bell Telephone Company for Approval of an Alternative Form of Regulation," Case No. 93-487-TP-ALT, September 20<sup>th</sup>, 1994, page 68.
- <sup>42</sup> Ameritech/Ohio 1997 Annual Report, (from web site: **Error! Bookmark not defined.**).
- <sup>43</sup> "Consolidation in the Telecommunications Industry: Has It Gone Too Far?" Senate Judiciary Committee's Subcommittee on Antitrust, Business Rights and Competition, S. Hrg. 105-1006, Serial No. J-105-120, September 15, 1998.
- <sup>44</sup> 717 N.E.2d 613, Indiana Bell Telephone Co., Inc. v. Office of Utility Consumer Counselor, (Ind. App. 1999).
- <sup>45</sup> Ibid., page 5.
- <sup>46</sup> Ibid., page 11.
- <sup>47</sup> Ibid.
- <sup>48</sup> "Bandwidth Bandwagon," by David Lake, The Standard, May 15, 2000, (from web site: **Error! Bookmark not defined.**).
- <sup>49</sup> Boardwatch Magazine, Feb. 1, 2000.



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- <sup>50</sup> NNI's ISP survey is at: **Error! Bookmark not defined.**
- <sup>51</sup> Ibid.
- <sup>52</sup> Ibid.
- <sup>53</sup> U.S. Department of Justice, Ex Parte Submission Re: Application by SBC Communications Inc. et al. Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services in Texas, CC Docket No. 00-65, June 13, 2000, (from web site: **Error! Bookmark not defined.**).
- <sup>54</sup> Ibid.
- <sup>55</sup> SEC. 1. [47 U.S.C. 151] Purposes of Act, Creation of Federal Communications Commission, the Communications Act of 1934 (as amended in 1996).
- <sup>56</sup> SEC. 215. [47 U.S.C. 215] Transactions Relating to Services, Equipment, and So Forth, the Communications Act of 1934 (as amended in 1996).
- <sup>57</sup> SEC. 254. Universal Service, the Telecommunications Act of 1996.
- <sup>58</sup> "In the matter of the application of the New Jersey Bell Company Approval for Its Plan For an Alternative Form of Regulation," Decision and Order, Docket No. T092030358, April 14, 1993, page 18.
- <sup>59</sup> We have excluded U.S. West from the 1999 calculation because the company's ROE reported by Business Week was 87.8% and consequently would have biased the results.
- <sup>60</sup> Ibid.
- <sup>61</sup> Ibid.
- <sup>62</sup> 4<sup>th</sup> Quarter Year-End 1999 Results, from SEC filings.
- <sup>63</sup> "Telecommunications @ the Millennium: The Telecom Act Turns Four," Office of Plans and Policy, Federal Communications Commission, February 8, 2000, page 9.
- <sup>64</sup> NNI has been tracking the Bell's revenues, expenditures and profits since 1992, and this includes all major revenue areas. NNI published "Regional Bell Earnings, Expenditures and Profits" in 1994, marketed by Phillips Business Information. These statistics were updated in the NNI publication "The Unauthorized Bio of the Baby Bells," published in 1999. NNI also updated this information using 1999 Bell Annual Reports.
- <sup>65</sup> Bell Atlantic 3<sup>rd</sup> Quarter Report, 1999, Asian Investments.
- <sup>66</sup> BellSouth 10Q 4<sup>th</sup> Quarter, 1999 (from web site, **Error! Bookmark not defined.**).
- <sup>67</sup> Bell Atlantic and NYNEX combined statistics for 1984, (BA was 53, NYNEX was 68), Pacific Telesis was as of 1997, US West from 4<sup>th</sup> Quarter 1999.
- <sup>68</sup> NYNEX 10Q, 3rd Quarter Report, 1996 (from SEC EDGAR Archives).
- <sup>69</sup> Ibid.
- <sup>70</sup> "Statistics of Common Carriers," FCC 1994, 1995, 1996, 1997, 1998.
- <sup>71</sup> H.R. 2420 allows RBOCs to begin offering data services across long distance boundaries. Since technological advances have eliminated the distinction between voice and data traffic, passage of H.R. 2420 would allow voice traffic to be carried over data networks, eliminating the last remaining incentive for local competition and allowing the incumbent carriers to retain their monopoly grip on consumers.