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Louis B. Schwartz

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Diversification and Regulated Industries—
What’s Next for the Telephone Holding Companies?

by LOUIS B. SCHWARTZ*

I
Introduction

Should a telephone company engage in “unrelated” businesses? If telephone company management determines that available funds can be most profitably employed by investing in an airline, a gambling casino, a coal mine, a CATV system, or genetic research, is there any reason why the government should interfere or resist such “diversification”? And if diversification is to be limited, what activities, other than transmitting communications signals, should be regarded as incidental or appropriate to the core task of the telephone company? These issues were addressed in the landmark Antitrust Divestiture Decree that separated American Telephone and Telegraph (AT&T) from the Bell Operating Companies (BOCs) and imposed constraints on BOC diversification.¹

We now stand at the threshold of a decade of litigation and administrative action² relating to the permissible scope of operations that may be undertaken by a regulated public utility or its affiliates. Thus, it is a good time to examine the problem and to articulate principles of decision.

Broadly, the problem is to reconcile antitrust law with regulatory law on the issue of diversification. Antitrust law points towards letting market competition and private management

* Professor of Law, University of California, Hastings College of the Law; Benjamin Franklin Professor of Law and Economics, Emeritus, University of Pennsylvania Law School.


2. See York & Malko, Utility Diversification: A Regulatory Perspective, PUB. UTIL. FORT., Jan. 6, 1983, at 3 (reviewing the Report of the Ad Hoc Committee on Non-utility Investments, Cal. P.U.C. 1184-03-02, investigation into the organizational structure of the state’s telecommunications companies for the provision of competitive and other services, Mar. 21, 1984, and ensuing report to the state legislature transmitted Aug. 6, 1984).
determine the structure and practices of business. Regulatory law, however, recognizes the inability of unfettered competition to protect the public interest in some situations. In the telecommunications business, a “free market” would permit entrepreneurs to put together giant holding companies, affiliating a regulated natural monopoly business with an unlimited range of other operations. A regulatory “public interest” approach, however, points towards a narrower range of permissible activities for telephone companies and their affiliates. This approach attempts to force top management to focus its attention on the utility business and to tie its fate to success in the public service.

Much depends on how one views the operation of public utilities by private management. There are two possibilities: (1) the public utility is carrying out a governmental function, basically for the benefit of ratepayers and citizens who have chosen the private management route because of its advantages for them—greater efficiency, more flexibility in hiring, firing, and paying personnel, and greater responsiveness to the clientele than is generally available from a bureaucracy like the Post Office or the Internal Revenue Service; or (2) the utility corporation is simply a private business subject to specialized controls, principally to limit its profits as required because of the monopoly it enjoys.

On the one hand, if one regards private operation of public utilities as simply an elective form of organization for getting “public work” done, one is unlikely to acquiesce to a holding company structure that subordinates utility management to private powers whose higher priorities are other non-utility businesses. On the other hand, if a utility corporation is conceived as primarily a private business—a distinctive business, to be sure, subject to appropriate regulation, but otherwise free to be acquired and transferred—there seems to be little reason to restrict the lines of business undertaken by the company and its affiliates. Under this view, the utility emerges as simply one of many principalities in a financial empire designed by investment bankers or intracorporate entrepreneurs.

It is the thesis of this article that recent decisions regarding the permissible scope of operations of telephone companies and their affiliates have let the telephone companies go too far afield. Antitrust considerations have been overemphasized at the expense of public regulatory goals. This overemphasis on the putative competitive consequences has led to an underemphasis on customer expectations and convenience, as well as a failure to weigh ade-
quately important considerations of management psychology. These underemphasized psychological considerations relate to the limits of human attention span and competence, and to the diversion of management incentives away from core telephone responsibilities to new, risky, and hence “exciting” ventures in non-regulated businesses. Proper emphasis on these factors provides a rational basis for granting less latitude to large conglomerates than to small telephone enterprises where closer management control of every aspect of the operation is feasible and risk of competitive injury to others is minimal. In this connection, however, “small” should not include AT&T, the Regional Holding Companies (RHCs), or the mid-sized giants among the rivals of the Bell System successors.\(^3\) Moreover, a predominantly psychological criterion of permissible diversification would help to resolve issues as to what activities are properly deemed “incidental” to the core telephone operation. These would be activities within the telephone company’s geographic area that directly respond to subscribers’ needs and to which telephone management expertise is relevant. Activities structured to preserve the benefits of competition, such as publishing directories and providing long-distance service, involve minimal dilution of management’s attention and expertise and minimal distortion of incentives.

Focusing consideration on management competence and incentives will also help to solve the problem of whether profits and losses from the “incidental” excursions into non-core business should be reflected in the regulated rates. It seems reasonable that profits and losses should be reflected in the rates if the excursion has been undertaken and approved as appropriate for telephone management and as ancillary to the provision of telephone service.

Finally, since regulatory agencies, as well as corporate managements, are composed of human beings of presumably limited attention span and expertise, emphasis on management psychology will assure that proper importance is assigned to the administrative difficulties posed for a regulatory agency that must police the “separation” of regulated activities from the unregulated activities of telephone companies.

\(^3\) For example, MCI and GTE Corporation.
The Telephone Decisions

In United States v. Western Electric Co., Judge Harold H. Greene confronted the diversification issues when he considered applications for waiver of the antidiversification provisions of his 1982 Antitrust Divestiture Decree. That decree had been based on the Department of Justice's theory that the competitive operations of AT&T must be separated from the regulated local monopoly operations of the BOCs in order to assure fair competition in long-distance service and in sale of telephone equipment. As to long-distance service, Judge Greene accepted the view that AT&T's competitors might face discrimination in access to the local exchange facilities if those facilities were dominated by AT&T. As to telephone equipment sales, the court believed that divestiture of the BOCs would deprive AT&T of the opportunity to skew BOC purchasing in favor of AT&T's manufacturing arm, Western Electric Company. Furthermore, it seemed logical that the newly liberated BOCs should be restrained from using their local monopolies to favor manufacturing enterprises of their own, and from entering into long-distance operations where they might discriminate against AT&T and other providers of long-distance service. Accordingly, the divestiture decree barred such diversification by the BOCs; it also prohibited the BOCs from entering unregulated, non-monopoly services generally. Section VIII(C) of the decree, however, provided for waiver of these restrictions upon application to the court and "a showing . . . that there is no substantial possibility that [the telephone company] could use its monopoly power to impede competition in the market it seeks to enter."

Shortly thereafter, applications for waiver were made by the RHCs, the seven large groups of operating companies that succeeded AT&T as owners of the BOCs. Among the operations for

6. Id. at 160-66.
7. Id. at 165.
8. Id. at 165-66.
9. Id. at 190-91.
10. Id. at 188-89.
11. Id. at 227-28.
12. Id. at 231.
13. The Regional Holding Companies are Ameritech, Bell Atlantic, Bell South, Nynex, Pacific Telesis Group, Southwestern Bell, and U.S. West.
which waivers were sought were: (1) engaging in data processing; (2) engaging in foreign trade; (3) selling office equipment; (4) selling unregulated communication equipment and services to government agencies; (5) engaging in the real estate business; and (6) providing engineering and construction services to foreign telecommunications agencies. It was evident that a showing might be made that RHC entry into these fields entailed no such threat to competition as was referred to in section VIII(C), either because those fields were being served by powerful competitors or because a monopoly of local telephone service in a region of the United States could hardly provide anticompetitive leverage in providing engineering services in Saudi Arabia or Africa. Judge Greene held, however, that waiver requests must meet an additional requirement: consistency with the "overall purposes of the decree," including "efficient, economical provision of local telephone service."14

Aided by some expansive rhetoric of the RHCs, Judge Greene found that the proposed "wholesale" departures from the line-of-business restraints were indeed a threat to local telephone operations and inconsistent with the general purposes of the decree.15 Judge Greene held that the greater risks inherent in extensive competitive operations would raise the capital costs of the conglomerate enterprise and that this increased cost would be charged in part to telephone subscribers.16 These subscribers would be subsidizing the non-telephone operations, but not sharing in the profits.17

In this same decision, Judge Greene established general standards and procedures to be used in handling applications for waiver of line-of-business restrictions. Applications for waiver will be initially referred to the Department of Justice. If the Department concludes that waiver is appropriate, the court will grant it unless the court or some interested party objects. If the Department disagrees with the request, the court will consider the views of all interested parties in rendering a decision.18 Judge Greene also held that non-telephone operations should be carried on through "separate subsidiaries," and that non-telephone opera-

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15. Id. at 855. See generally id. at 855-67.
16. Id. at 855-67.
17. Id. at 863-64.
18. Id. at 864-66.
19. Id. at 873-74.
tions should be held below ten percent of aggregate revenues.20

In a memorandum opinion handed down December 14, 1984,21 Judge Greene disposed of specific applications that had been approved by the Department of Justice. He authorized Bell Atlantic to engage in financing a customer's acquisition of non-telephone equipment.22 He approved foreign trade activities as "contributing to a more favorable balance of payments."23 He held that real estate operations were sufficiently "remote from the field of telecommunications proper" as to give adequate assurance that monopoly leverage of local telephone service could not be used anticompetitively.24 Despite the potential impact on a smaller competitor, he authorized an off-shore (i.e., non-local) telephone service using the new cellular technology, and, in this case, dispensed with the separate subsidiary requirement. Finally, he permitted entry into the office products business, as well as the computer sales and service industries.25

In United States v. GTE Corp.,26 Judge Greene rendered another important decision regarding the restructuring of the telecommunications industry. He approved a consent decree permitting GTE, a leading provider of local and interexchange telephone service in thirty-one states, to acquire Sprint, the third largest independent interexchange carrier. In addition, GTE may provide information services. Thus, the GTE decree permits what the AT&T decree forbids—the combination of local and long-distance services and the combination of information supply and message carrying.27

Competitive considerations dominate Judge Greene's opinion. He found that GTE does not pose the threat to competition that AT&T does, nor is it as entrenched as the RHCs.28 GTE's entry into the interexchange business is said to be procompetitive inasmuch as GTE's "deep pocket" will bring new financial strength to Sprint.29 Yet, in seeming self-contradiction, he also held that the loss of GTE's potential for independent entry into interexchange

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20. Id. at 870-72.
22. Id. at 8-9.
23. Id. at 9-12.
24. Id. at 14-16.
25. Id. at 20-23.
29. Id. at 12. It is not easy to believe that GTE could be more helpful to Sprint than Southern Pacific, and one wonders why an operation unattractive to Southern Pacific should be desirable for GTE unless GTE is acquiring anticompetitive leverage.
operations was insubstantial, since capital requirements for such entry would be so heavy. The opinion also echoes an earlier theme of the AT&T decisions that agreements negotiated by the Department of Justice with respondent telephone companies will presumptively pass muster with the court.

The December 1984 decisions were a radical retreat from the brave generalizations of the July opinion. The new position is "that the line-of-business restrictions are not intended as barriers to legitimate competition." New significance is given to the theme of the July opinion that "wholesale" and sudden diversification is unacceptable: deliberate and incremental diversification—especially after "equal access" (of competing long distance carriers) is achieved—will not be impeded. The theme of an overextended management with distorted incentives has been submerged.

III
Policy Considerations

From the point of view of the capitalist competitive system, one would think that the management of any firm ought to be free to direct the flow of its resources wherever the promise of profit is highest. High profits are capitalism's signal that additional investment in the relevant field is economically justified, more justified than in other fields offering lower returns. American legislation, however, has typically confined public utilities to fields related to the core utility operation. The Public Utility Holding Company Act of 1935 confined gas and electric systems to businesses "reasonably incidental, or economically necessary or appropriate" to utility operations. Moreover, similar restrictions have been applied to other regulated industries. Under the famous Commodities Clause of the Interstate Commerce Act, a railroad was

30. Id. at 21.
33. 15 U.S.C. § 79k(b)(1). See Michigan Consolidated Gas Co. v. SEC, 444 F.2d 913 (1971) (gas company not permitted to own housing project development company). The statute requires, inter alia, that "necessary or appropriate" be judged according to "public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such systems." 15 U.S.C. § 79k(b)(1). Combination of gas and electric utilities can be justified only by proof of "substantial economies" from joint operation without impairing "the advantages of localized management, efficient operation, or the effectiveness of regulation." Id. See SEC v. New England Elec. Sys., 384 U.S. 176 (1966).
forbidden to haul goods in which it was directly or indirectly interested unless such goods were necessary and intended for use in its common carrier business.\(^{34}\) Railroads were not free to engage in trucking operations except as limited use of trucks might be "auxiliary" to the railroad operation itself.\(^{35}\) Banks and their holding companies are, in principle, confined to bank related operations.\(^{36}\)

A 1956 antitrust decree against AT&T confined the telephone giant's retail activities to regulated "common carrier communications services" and activities "incidental" to the rendering of such service.\(^{37}\) It was primarily to escape that restriction that AT&T struck a deal with the Department of Justice by which it re-claimed the right to diversify in consideration for its divesting the regulated BOCs. The judgment that a regulated public utility should stick to its core business found expression in provisions of the 1982 Divestiture Decree that forbade the BOCs from engaging in activities other than providing "a natural monopoly service actually regulated by tariff."\(^{38}\)

American regulation often allows utility enterprises to be combined with non-utility enterprises provided that the different operations are conducted by distinct, although affiliated,

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34. Section 1(8) of the Interstate Commerce Act, 49 U.S.C. § 10746 (1984 Supp.). Although the Commodities Clause did not bar conglomeration of carrier and manufacturing operations (e.g., where the manufacturing operations were geographically or technologically remote from the railroad's transport system), the impact of the clause was to discourage diversification through vertical integration of shipper and carrier. The Commodities Clause was drastically undercut by U.S. Supreme Court holdings that a wholly-owned railroad subsidiary of a holding company had no interest in goods manufactured by another subsidiary of the same holding company. United States v. South Buffalo Ry. Co., 333 U.S. 771, 772-85 (1948); United States v. Elgin, Joliet & E. Ry. Co., 298 U.S. 492, 501-04 (1936).

35. Section 5(2)(b) of the Interstate Commerce Act, 49 U.S.C. § 1134(e) (1984 Supp.) (whether use "will enable such [railroad or railroad affiliate] carrier to use service by motor vehicle to public advantage in its operations") (emphasis added).

36. 12 U.S.C. §§ 1864, 24(7); cf. Association of Data Processing Orgs. v. Camp, 397 U.S. 150 (1970) (Are data processing services rendered by a bank to other banks and bank customers operations "incident" to banking?). The court in National Courier Ass'n v. Board of Governors of Federal Reserve Sys., 516 F.2d 1229 (D.C. Cir. 1975), rejected a proposal that a bank affiliate be permitted to extend its courier service for bank financial operations to non-financial courier service. But cf. pending proposals to authorize entry into commodity trading advisory services, consumer financial counseling, armored car service, tax planning and preparation of returns, operation of credit bureaus and collection agencies, insurance, real estate, and securities brokerage and underwriting. 46 ANTITRUST & TRADE REG. REP. (BNA) 923.

37. See AT&T, 552 F. Supp. at 178 n.98.

38. See id. at 186. The BOCs were, inter alia, explicitly forbidden to manufacture telephones and other communications equipment, to provide interexchange (long-distance) service, or to provide information services (so-called electronic publishing). Id.
corporations having separate accounting systems. The FCC in its famous Computer II decision authorized AT&T to engage in “enhanced services,” such as data processing, through “fully separated” subsidiaries. Likewise, when the antitrust court came to consider applications for waiver of the antidiversification provisions of the 1982 Divestiture Decree, it required the non-core operations to be carried on through “separate subsidiaries.” This paradoxical result—that utility managers are supposed to stick to the core business of rendering public services, but are allowed to evade that rule by adopting a readily available corporate structure—can be understood only in the light of the underlying public policies.

First of all, there is the traditional fear of monopoly. In the case of public utilities, the public may accept the “natural monopoly” as inevitable, but it jealously guards against extension of that power into adjoining or remote fields that are not natural monopolies. Such an extension can occur if the regulated utility uses revenues derived from its lawfully monopolized utility operation to subsidize operations in a non-utility business. A railroad that goes into the steel business would have an unfair advantage over competing steel companies that have to use the railroad’s freight service. The railroad-affiliated steel enterprise might be given


41. Exemplifying the problems that can arise in this area are Cantor v. Detroit Edison Co., 428 U.S. 579 (1976) (providing lamp bulbs to residential customers of electric power); Peoples Gas Light and Coke Co. v. Slattery, 373 Ill. 31, 64-67, 25 N.E.2d 482, 498-500 (1940) (Are losses incurred in furnishing stoves to gas customers a proper utility expense of promoting gas use or unfair competition in the competitive kitchen appliance business?). See Hovenkamp, Tying Arrangements and Class Actions, 36 Vand. L. Rev. 213, 232-34 (1983), especially note 65, on evasion of regulated rates by linked sale of unregulated goods and services.


Since a utility is guaranteed a limited return upon its public utility business, it may try to allocate the cost of diversified operations to the controlled enterprise and thereby justify rate increases. . . . Independent dealers who compete with the public utility companies in the sale of electric and gas appliances . . . assert that losses incurred in the sale of refrigerators, stoves and the like are recouped by higher rates for utility service . . . .

Pressure from independent merchants has resulted in statutes in some states prohibiting the sale of appliances by public utilities.

Considerations of the foregoing character have suggested that public utility companies should be forbidden to diversify.

Id. at 332-33 (emphasis added).
preferential rates or services, preferential access to capital, or assurance that railroad supplies would be purchased from the affiliate. Likewise, a monopoly telephone company that engaged in supplying data processing services could gain a competitive edge over data processors that have to use telephone lines controlled by a competitor. The fear of unfair preference being given to an affiliated user of the system is especially acute when the affiliated user is a newspaper or other medium of public information. This fear (and the powerful lobbying of press and television interests) was expressed in the provisions of the 1982 Divestiture Decree barring the BOCs and AT&T from engaging in "electronic publishing."

A second policy objective expressed in the antidiversification laws is simplification of the regulatory commission's task by avoiding the necessity of policing accounting controls and revenue flows among enterprises, some of which are rate-regulated, others not. There were decades of litigation over the handling of Western Electric Company (WECO) as a part of the AT&T system. WECO supplied telephones, switchgear, and other equipment to the system. Were its investment and profits part of the regulated telephone business? In that case, the allowable rate of return would be limited and the regulatory agency would be obligated to review the manufacturing operation, excluding "imprudent" expenditures. Or should WECO be treated as an unregulated firm that simply happened to be under common control with the regulated common carrier? In that case, the regulatory agency would have no concern with WECO's profitability, although it might seek to disallow, in the utility's accounting, any "excessive" charge for equipment bought from the affiliated supplier.

A third line of reasoning against unlimited diversification of

44. See AT&T, 552 F. Supp. at 180-86.

In a major policy switch, the California Public Utilities Commission has announced it will support a position with a major impact on rates that long has been advocated by Pacific Telephone & Telegraph Co. Pacific Telephone is about 90%-owned by American Telephone & Telegraph Co.

The decision, by a three-to-two vote, came as the commission rejected the Bell System company's request for an additional $8.4 million a year increase in toll-charging revenue. The company had requested the increase as the commission investigated the prices AT&T's Western Electric Co. charges Pacific Telephone for equipment.

While turning down the immediate rate-increase request, the commission majority said it would, in the future, regard Western Electric as a manufacturer and not as a utility in considering the rate of return it will allow Pacific Telephone.
utility operations into unregulated fields is that executive officers of the utility, like other human beings, have limited attention spans. Running a huge telecommunications system is a staggering responsibility. Presumably, the telecommunications managers can do a better job in communications if they are not simultaneously distracted by problems in the chaotic, high-risk, and competitive businesses of genetic research, gambling casinos, or movie production. Indeed, a leading treatise on effective corporate organization devotes an entire chapter to documenting the "basic principle" that the successful corporation "stick[s] to the knitting—remaining with the business the company knows best." 46

The decision is expected to aid Pacific Telephone in another major rate-increase case here. . . .

Commission member A.W. Gatov, who issued a strong dissent to the majority decision, predicted in an interview that the decision will lead Pacific Telephone to make a $200 million rate-increase application "within four weeks." The decision, he added, "opens the way for AT&T to charge itself through Pacific Telephone whatever it can for its monopoly business."

In the past, the commission has told Pacific Telephone, "We don't care what you pay your big brother (Western Electric)," as Mr. Gatov put it. "We don't consider this an open-market purchase and for purposes of rate-making we are going to price material you get from your big brother at the same percentage of earnings that we allow you." Pacific Telephone has objected vigorously to this treatment and has argued that Western Electric is a manufacturing concern and should be treated as such by the commission.

That, essentially, is the essence of the commission's latest decision, its president, William Symons Jr., agreed yesterday. . . . But he contended that the decision will end "20 years of backhanded, sleight-of-hand treatment to a company which we do not regulate." He said the commission's old formula of treating Western Electric as a utility, and allowing it a rate of return similar to Pacific Telephone, "has placed a penalty on probably the most efficient manufacturing company in this nation."

It was on that point that Mr. Gatov and the commission's staff offered some of their strongest dissent. In his opinion, Mr. Gatov called Western Electric "still largely a phantom company with but one customer"—the Bell System telephone companies.

The commission majority, all of whom were appointed by Gov. Reagan, ruled that Western Electric "has the financial characteristics of a manufacturer" and, as such, its earnings "must be viewed separately and apart from the utility earnings of Pacific . . . ."

The decision was seen here as another move by the commission away from the liberal stance it developed under the administration of Gov. Brown, a Democrat. The latest decision puts the agency's position on Western Electric earnings in line with those of other state's regulatory bodies. "We were the last holdout," Mr. Gatov said. He's the only remaining member of the commission appointed by Mr. Brown, and his term expires Dec. 31.

Id. at cols. 2-3. Cf. O. WILIAMSON, MARKETS AND HIERARCHIES 114 (1975) (integration to evade regulatory restraints); Hovenkamp, supra note 41.

46 T. PETERS & R. WATERMAN, JR., IN SEARCH OF EXCELLENCE: LESSONS FROM AMERICA'S BEST-RUN COMPANIES 292 (1982); see also item 6 of the "Eight Basic Principles"
Judge Greene's opinion of July 26, 1984, recognized the importance of avoiding dilution of management resources and distortion of incentives:

As evidenced both by the pending waiver requests and by reports of their intentions, the Regional Holding Companies are expending significant managerial and other resources to discover and analyze new business opportunities. Moreover, some of these companies candidly state that they regard the telephone business as of limited interest to them and the fate of the rate-payers as of little significance in the context of the decree. Thus, US West proclaims that the “Operating Companies owned by US West are in the telephone business rather than US West” and that “US West does not itself intend to be a telephone company.” Ameritech similarly asserts that, “[w]hile protecting ratepayers may be a worthy goal in the abstract, it is one that should be left to the regulators and the legislators to pursue as they see fit.” And Bell Atlantic argues that its waiver requests must be granted even if diversification into new business will raise the company's cost of capital and divert the attention of its management from providing telephone service, because in its view the effect of diversification on the rate-payers “is extraneous to the Decree” and is therefore not a legitimate criterion for adjudging applications under section VIII(C).

The more the Regional Holding Companies diversify, the less central their telecommunications functions will obviously become to their corporate existence. To the extent that these companies perceive their new, unregulated businesses as more exciting, or more profitable than the provision of local telephone service to the American public—as they obviously do—it is inevitable that, should they be permitted to embark upon such business enterprises on a significant scale, their managerial talent and financial resources will be diverted from the business of providing such service. As a consequence, both the quality and the price of that service are bound to suffer.47

In reiterating this concern at the conclusion of his opinion, Judge Greene further emphasized the peripheral nature of telephone concerns in a conglomerate enterprise, drawing attention to the possibility that

[i]f a Regional Holding Company invested or engaged on a substantial scale in speculative ventures only to become insolvent, it

might turn to the telephone users for the necessary infusions of capital. Moreover, as the experience of the railroads indicates, it is not inconceivable that, should the competitive enterprises of the Regional Holding Companies become profitable while local telephone service becomes a relative liability, they might seek to sell off or otherwise discard their local telephone service affiliates.\textsuperscript{48}

Running a telephone company or a gas company or a hydroelectric company, with mostly captive customers, relatively stable technologies, and legally limited profits, may seem to energetic executives a tame game compared to the excitements of venture capital. Will the telephone operation get second-class consideration and second-rate officers in a holding company structure that is caught up in more glamorous ventures? Are such fears groundless so long as “extracurricular” activities in the aggregate constitute a small percentage of total operations? Can the problem be conveniently controlled by setting a ceiling on the aggregate non-POTS (“plain old telephone service”) activities, so that the tail can never wag the dog?\textsuperscript{49}

As evidenced by a recent newspaper article,\textsuperscript{50} businessmen themselves are becoming more aware of the perils of diversification. Several large oil companies have either shut down or at-

\textsuperscript{48} Id. at 875 n.122.

\textsuperscript{49} Id. at 871-72 (no waiver “for the present” of antidiversification ban where proposed activities are expected to yield the RHC more than 10% of its total net revenues).

\textsuperscript{50} Why Oil Companies Are Now Shying from Diversification, San Francisco Chron., Dec. 3, 1984, at 58. The article reads, in part, as follows:

Exxon Corp. tried to make electronic typewriters, but all it seemed to come up with was red ink.

Atlantic Richfield Co. and Standard Oil Co. of Ohio went into mining and pulled a rock.

And after buying a department store, Mobil Corp. wished it had shopped elsewhere.

To use the industry’s lingo, most of the attempts by oil companies to diversify out of the oil business have come up dry holes.

A decade after the industry, flush with cash from the first mushrooming of oil prices, began to diversify into other fields, most of the diversification efforts have been shut down, closed, or put on the selling block. The oil companies have shifted their focus back to the oilfields, which is just as well, analysts say, because for all the attempts at the diversification, the oil industry never found anything quite so profitable as oil itself.

Last week, Exxon said it was attempting to sell its electronic office equipment business, into which the company has poured more than $1 billion without significantly denting the market dominated by International Business Machines Corp., Xerox Corp., and other giants. A company source said Exxon may be forced to shut down the 2300-employee division and take several hundred million dollars in write-offs.

Exxon’s announcement came on the heels of Ashland Oil Inc.’s writeoff of $270 million to cover the sale of an insurance subsidiary and Atlantic Richfield’s $785
tempted to sell their non-oil concerns as the losses generated by these diversification efforts have continued to mount.\textsuperscript{51} As to the motivations that drive utility managements beyond the realm of their competence, the \textit{Wall Street Journal}, a publication certainly not unsympathetic with the aspirations of businessmen, commented:

Variety may be the spice of life, but does it have any place in the life of a power company?

In the wake of the Penn Central debacle, there have been suggestions that a company performing a vital service should stick to its last. It's argued, for instance, that railroad managers should stick to railroading and not get involved, as the Penn Central management has, \textit{with amusement parks, hockey teams and hotels}. The vital service is bound to suffer, critics claim, \textit{if management's attention is spread across too broad a range} of enterprises, some of which may be considerably more profitable than railroading or whatever.

And now along comes the power industry. . .

\[T\]here has been plenty of railroad-style diversification away from the basic service of providing power. Most power men contend that the trend is all to the good, \textit{allowing profitable sidelines for companies} that, like the railroads, must perform a \textit{basic function} under strict Government regulation. But critics wonder increasingly whether in the long run the service of providing power may not suffer.

Even some power company executives express concern. "I think it's a mistake for a utility to get into a business in which it has no experience," says Donald C. Cook, president of American Electric Power Co., the nation's largest electric utility system, and a former chairman of the Securities and Exchange Commission.

\footnotesize{\textsuperscript{51} Why Oil Companies Are Now Shying from Diversification, supra note 50.}
"It's hard enough to run a utility business without running the risk of spreading your talents too thin."

In fact, just to avoid such a danger, gas and electric utilities that operate in more than one state through holding companies are severely restricted from diversifying by the Public Utility Holding Company Act of 1935. "Congress felt it was not a good policy for such companies to diversify," explains a lawyer at the Securities and Exchange Commission, which administers the act. "It was feared that diversification could drain away assets from the business of supplying power."

The act, however, does not restrict diversification by companies whose utility operations are in only one state or by utilities not set up as part of a holding company. These concerns are normally regulated by state authorities. The vast majority of U.S. power companies are one-state concerns, and since state regulators have so far been most amenable to the idea, diversification abounds in the industry.

Take the case of Elizabethtown Gas Co., Elizabeth, N.J. For 114 years the utility did nothing but provide gas. But in the last 12 months it has formed a holding company with the ambitious name of National Utilities & Industries Corp. Through the holding company, it has started a computer services subsidiary, taken control of a small airline and expressed an interest in acquisitions in modular housing, vacation resorts and appliance manufacturing.

"It's been exhilarating," says John Kean, National Utilities president. He says the company's airline operation, which offers scheduled commuter service in New England and Florida, now has twice as much business as a year ago. "That's certainly something you don't see in the gas business," he declares. . . .

It is axiomatic that the return on an investment depends to a considerable extent on the degree of risk involved. Not surprisingly, therefore, the power companies' search for more lucrative rates of return occasionally comes a cropper. Such was the case when Wisconsin Fuel & Light Co. several years ago purchased radio station WOMT in Manitowoc, Wis. The utility finally sold the station at the end of last year after losing $32,741 in two years on its venture into broadcasting.52

Counter-arguments favoring at least limited diversification into related functions come readily to mind. The utility may be the only enterprise with the interest and ability to furnish a "non-util-

ity” element employed in rendering the utility service. For example, at least in the early days of new utility technologies, only the electric company was in the position to provide electric light bulbs, and the early telephone companies were in a unique position to make and service telephones and other customer-premises equipment. Today, the telephone company may have special incentives, expertise, and facilities for providing directories, such as the Yellow Pages, even though the production of directories is a common non-utility business that could be carried on independently by, for example, the sale of the necessary subscriber information to would-be publishers and advertising firms. Repairing residential phones, whether purchased from the company or from third parties, is another activity which, from the subscriber-convenience point of view, might be open to the BOC despite the potential for competition in repair work.

In United States v. Western Electric Co., the RHCs argued vigorously that diversification would lower risks and thus enable them to obtain capital at lower cost, to the benefit of the telephone ratepayers. The argument was emphatically rejected by Judge Greene on three grounds: (1) There was no evidence that there would be lower capital costs to the telephone company. Any cap-

54. Interesting evidence in support of the RCHs’ position has been furnished by Robinson, 3 TELECOM. POL’Y REV. No. 48, Nov. 30, 1984 (privately circulated), showing much higher returns on equity for the RHCs as compared with AT&T:

Table III: Yield to Date and Return on Equity.
(last nine months)

<table>
<thead>
<tr>
<th>Firm</th>
<th>YTD</th>
<th>Return on Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. West</td>
<td>28.36%</td>
<td>12.92%</td>
</tr>
<tr>
<td>Bell Atlantic</td>
<td>28.20</td>
<td>13.48</td>
</tr>
<tr>
<td>NYNEX</td>
<td>27.85</td>
<td>12.55</td>
</tr>
<tr>
<td>Pacific Telesis</td>
<td>27.75</td>
<td>13.29</td>
</tr>
<tr>
<td>Bell South</td>
<td>23.65</td>
<td>13.37</td>
</tr>
<tr>
<td>Ameritech</td>
<td>22.67</td>
<td>14.39</td>
</tr>
<tr>
<td>Southwestern Bell</td>
<td>20.34</td>
<td>12.97</td>
</tr>
<tr>
<td>AT&amp;T</td>
<td>10.91</td>
<td>10.78</td>
</tr>
</tbody>
</table>

Commenting on another table comparing profit margins of MCI, GTE, and other non-Bell companies, Robinson wrote:

What do these numbers suggest? Well, note, for example, that the second highest margin—net income on sales—is enjoyed by Cincinnati Bell, which is by far the most local of all the firms, with virtually no toll facilities of its own . . . . Notice, too, that while widely diversified GTE has about 30 percent more revenues than Bell South, it yielded almost $100 million less in bottomline cash throw-off during the period. This would tend to suggest, wouldn’t it, that by keeping the BOCs from diversifying, Judge Greene is actually helping the companies get richer.
ital cost-saving to the diversified RHC would result from averaging high capital costs for risky, competitive operations and traditionally lower capital costs for less risky utility financing—i.e., the BOC would be subsidizing the RHC. (2) There was little reason to expect that the diversified RHC enterprise would make supra-competitive profits. (3) Even if such profits materialized, they would not be used to support telephone operations or lower rates, since the RHCs maintained that their shareholders, rather than the telephone ratepayers, were entitled to those profits.55 Judge Greene referred unhappily to the fact that, after he had ruled that the profitable Yellow Page directories should be turned over to the divested operating companies rather than to AT&T (in part to devote those profits to the ratepayers), the RHCs chose, instead, to treat Yellow Page operations as unregulated diversification operations.56

It can be argued, however, that when the telephone company is compelled to engage in some function for its own purposes—for example, data processing connected with switching—the investment required should not remain unused during off-peak periods. Hence the telephone company, to this extent, should be allowed to engage in the business of providing general data processing services. A plausible alternative, however, to this kind of diversification would allow the telephone company to lease to independent unregulated data processors any excess data processing capacity developed for the core telephone operation. These concerns regarding effective use of available resources also arise in connection with proposals of the RHCs to provide telecommunications design and engineering services to other firms, states or nations, especially when such services are to be provided outside the area where the telephone company is franchised to provide regulated message service.

A unique diversification issue is presented when the telephone company proposes to provide a new form of telecommunications service that will compete with the traditional regulated service.

56. Id. at 865-66; cf. AT&T, 552 F. Supp. at 194; 1982 Report of the Ad Hoc Committee on Utility Diversification of the National Association of Regulatory Utility Commissioners (opposing use of unregulated earnings to subsidize rates "except as ratepayers may deserve a share of those earnings to the extent that ratepayers are put at substantial or identifiable additional risk"). In California and some other states, Yellow Pages profits, although unregulated, are applied against revenue requirements and hence reduce regulated rates. CAL. PUB. UTIL. CODE § 728.2.
This was the case when international wireless communication became a feasible alternative to submarine cables. And it may be the case if cable television wiring is used to provide two way telephone connection or if cellular service can replace local wire connection. The new service may not be a “natural monopoly”—it may be both feasible and efficient to allow multiple operators. Protagonists of telephone company entry into such new services will argue that a progressive telecommunications company should be encouraged to be on the forefront of technological advances in the field, whether or not the new technology is inherently competitive. Further, they will argue that the public interest in rapidly advancing technology would best be served by welcoming the existing telephone company into the new technological competition, since this company is preeminently qualified by prior experience and highly motivated to “defend its turf.” Moreover, new competitive entry by others may be a threat to the ideal of “universal service,” since the new outside competition is likely to be directed at the most profitable classes of traditional service. It can be argued that loss of that business would necessitate higher rates to the main body of subscribers.

Opponents of this type of telecommunications diversification argue that frontier research by the telephone company is desirable, indeed mandatory, for prudent management, but that it will occur whether or not the company is free to go into the non-utility businesses that result from the new research. This is so, it is claimed, because it will not be known in advance whether the new discoveries will be primarily applicable to the regulated core business. In any event, the innovating telephone company will be able to exploit its patents by licensing to other communications companies or independent equipment manufacturers. Some economists and antitrust lawyers also argue that dominance of new technologies by old vested interests is more likely to retard than to expe-


58. “Universal service” is the long-time slogan of the Bell System, expressing the idea that everyone benefits from maximizing the number of subscribers on the network. Each additional subscriber serves not only his or her own interest, but expands the number of potential contacts of all other subscribers, facilitates the work of police, fire, and other agencies, etc. See United States v. Western Elec. Co., 569 F. Supp. 1057, 1120 (D.D.C. 1983) (positing as one of the three principal objectives of the decree “protection of the principle of universal telephone service, accessible to all segments of the population, regardless of income”). Needless to say, this is something of an overstatement; only those who can pay for service get it.
dite progress. This was the fear that led Congress to restrain the powerful railroads from entering the trucking business: it was perceived that the railroads would be unlikely to cut their own throats by expanding trucking operations through aggressive rate-cutting or new service. Thus, it must be asked whether non-wire communications would be energetically promoted by firms with vast sunk investments in wire systems.

Perhaps the most controversial policy issue regarding diversification is whether the RHCs should be allowed to engage in interexchange operations in competition with AT&T and other long distance carriers. In examining this question, it is important to keep in mind that the RHCs have been given a very large role in interexchange operations. Local Access and Transport Areas (LATAs) define, for purposes of the Divestiture Decree, the boundary between the service realms of the BOCs and the realm of AT&T and the other interexchange carriers (IECs). The LATAs are quite large, and were made so in order to attract IECs to tie into these comprehensive "local" markets. Thus, LATAs came to embrace hundreds of miles of long distance toll service rendered by the BOCs. The California Public Utilities Commission, for example, has refused to allow IECs to compete with the BOC for this intra-LATA interexchange toll business, preferring instead to use profits from this service to subsidize local residential rates.

The intra-LATA long distance service controversy neatly poses the conflict between competitive considerations and other factors such as management incentives and limited attention span. The AT&T Divestiture Decree seems to make the competitive factors controlling: interexchange service, intra-LATA as well as inter-LATAs, is bound for competition, and combining local and interexchange functions is fraught with potential for internal subsidies, discrimination among IECs, and other anti-competitive practices. However, if we look at the management incentives/expertise side

59. See supra note 34.

60. See Order Instituting Investigation to Determine Whether Competition Should be Allowed in the Provision of Telecommunications and Transmission Within the State, Case 84-06-1113, Cal. P.U.C. (issued June 6, 1984). For other denials of competitive intra-LATA entry, see In re Intrastate Telecommunications Competition, 60 PUB. UTIL. REP. 4th (PUR) 301 (N.J. Bd. of P.U. 1984); In re Inter- and Intra-LATA Interstate Competition, 60 PUB. UTIL. REP. 4th (PUR) 24 (Ky. P.S.C. 1984). The foregoing decisions are reprinted in PRACTICING LAW INSTITUTE, REGULATION AND DEREGULATION AFTER THE AT&T DIVESTITURE (1984), at 538 and 519, respectively.

of the picture, long distance service (like directory service, furnishing phones, and repairing phones) is something that BOC management is quite familiar with and falls squarely within the expectations of local subscribers. Since the intra-LATA toll service has been allotted to the BOCs, there seems little reason to prevent the BOCs from offering complete telephone service. GTE has been authorized to provide it. If the anticompetitive potential can be checked by provisions against discrimination in the case of GTE, why should not that suffice in the case of the BOCs? Why should the BOCs not be free to buy long-distance service from IECs bidding against each other to render service to the BOCs, just as the BOCs are permitted under the Divestiture Decree to buy and resell telephones to subscribers (though the BOCs may not manufacture them), or to provide time and weather information?

Complex as the issues of diversification within the regulated telecommunications industries are, new difficulties are emerging with the diversification of non-telephone companies into telecommunications. Electric companies are awakening to the possible "economies of scope" available to them by virtue of their rights-of-way and ownership of poles that can carry telephone lines as easily as power lines. Comparable economies of scope beckon to data processors whose private line telecommunications capacity might be adapted to at least limited switched message service. Are these "intruders" into telecommunications to be welcomed as portending the end of the "natural monopoly" and the need for regulation? If the intruder is itself a monopoly electric or gas company, must we guard against abusive extension of monopoly or against excessive dilution of management concentration on its core task? How does a percentage-of-revenue "cap" on diversification operate when it is the telecommunications activity itself that is the "distraction" for the management of a regulated gas or electric company?

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62. See supra notes 26-27 and accompanying text.
63. AT&T, 552 F. Supp. at 190-91.
65. See Minnesota P&L Explores Joint Venture to Create Telecommunications Network, Wall St. J., Dec. 13, 1984, at 14. The proposed joint venture is to be with other power companies.
Conclusions—Some Principles on Which to Base Decisions Regarding Diversification

To speak of "conclusions" seems almost presumptuous when dealing with a subject as complex and rapidly changing as the structure of the telecommunications industry. "Reflections" would be more appropriate, for one can reasonably aspire to do no more than modify the intellectual climate in which decisions will be made. The following suggestions are offered in that spirit:

(1) The total preoccupation with "competitive" considerations must give way to a greater concern for management psychology and incentives. Telecommunications executives should stick to what they know best. Priority must be given to the subscribers' demand for efficient, progressive communications service over the shareholders' putative demand for higher returns in non-communications risk enterprises.

(2) The possibility of greater company profits in collateral enterprises is irrelevant to the diversification issue as long as those profits do not accrue to the subscribers. Let ambitious executives and investment bankers who covet these profits organize independent enterprises for those purposes. Let them sell stock in those enterprises to all who can be persuaded of the rosy prospects for a business that does not lean on the public utility. Even if prospective profits (with potential losses) were assigned to ratepayers, it would seem a dubious principle of industrial organization to attempt to finance telephone operations out of profits in gambling casinos, genetic engineering, or personal computers. If the telecommunications industry became nationalized, would anyone think of authorizing the Secretary of Telecommunications to engage in such frolics with a view to covering his or her telecommunications deficits?

(3) The principle that "foreign" operations (geographically or technologically) should be favored by waivers of line-of-business restrictions should be abandoned.66 Foreign operations are the most risky and distracting of possible diversifications. Measuring the "possibility" that competition will be adversely affected by telephone company entry into these markets will be a thoroughly

66. It is worth recalling in this connection that when the Public Utility Holding Company Act of 1935 authorized an exception from its ban against combining several holding company systems, it conditioned that exception upon contiguity of the two systems. 15 U.S.C. § 79k(b)(1)(B).
unrewarding exercise for courts and regulatory agencies—worse than inquiring under Section 7 of the Clayton Act about the "probability" that a merger "may" substantially lessen competition. One may expect imaginative and unconvincing sallies by Department of Justice economists into the effects of the telephone company's "deep pocket," the potential for reciprocal dealing, delineation of the "market" including "close substitutes," and the height of entry barriers.87

(4) If ratepayer interests become the touchstone of diversification policy, expansion into closely related, rather than "foreign," domains will be favored in decisions waiving the line-of-business restrictions. Subscribers want Yellow Pages directories, as well as White Pages directories, for effective use of their phones. Subscribers would generally prefer to get repairs, billing (for long-distance as well as local service88), directory assistance, and other services from a single provider. Concern regarding unfair competition is realistic in the "nearby" diversification setting, and safeguards against cross-subsidization and discrimination may be necessary. Some ventures into new technologies may eventually have to be divorced when the "infant industry" has matured and can offer effective competition to traditional service.89 Incentives would remain in the form of patent royalties and profits from the spin-off of the viable new venture.

(5) The "cap" on diversification adopted by Judge Greene (ten percent of revenues), although laudable in its purpose to limit the distraction of management from a core concern with telephone service, is ill-adapted to that purpose and an invitation to future relaxation of controls. There is little correlation between shares of revenue and demand upon management time and attention. In fact, that demand will be greatest during the period when manage-

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68. We touch here upon a very large issue, the prudence of the basic separation of long-distance and local service. Among the alternatives never seriously considered was to permit the BOCs to buy long-distance service in the competitive long-distance market and to retail that service to subscribers.
ment is planning, making its diversification choices, and arranging for financing—long before any revenues begin to flow. Moreover, under Judge Greene’s approach, the decision to allow diversification is to be made on the basis of “estimated” revenues. Anyone familiar with business forecasting will recognize the impalpable basis proposed here for the diversification “cap.” What will be done when a successful diversification begins to yield “excess” revenues—mandatory divestiture? More likely, self-congratulations all around and an expedited proceeding to lift the cap. What will be done in the case of a failed diversification? Plainly, as revenues go down, management distraction will go up and will be accompanied by preoccupation with alternative new lines of diversification as a means to cover losses. In any event, Judge Greene signalled future lifting of the cap by carefully limiting his constraints on line-of-business waivers with the phrase “for the present.” In the same passage, Judge Greene speaks of requiring that “the bulk of the investments” of RHCs remain in decree-related activities—a statement notable for its use of an investment test, rather than or in conjunction with the revenue test, and for its anticipation of an era when investment in telephone and non-telephone pursuits will be in a ratio not far from fifty-fifty.

In this connection, it is worth noting that as diversification proceeds, the scope of enterprise perceived as normal or incidental to telephone operations will expand. One need only look to the banking industry for an example. Almost no one questions the combination of core banking operations, such as accepting deposits and making commercial loans, with quite unrelated, but traditional, activities such as maintaining trust departments and safe-deposit boxes.

(6) Maintaining a firm line against broad diversification also seems advisable because of the administrative problems necessarily assumed by any agency making the diversification decisions. It will be hard enough for the Federal Communications Commission and the state utility commissions. For a court, the prospect of second-guessing management and maintaining scrutiny over the separation of regulated and “unregulated” businesses is daunting. The function is not one for which a court is equipped. Even so intelligent, experienced, and energetic a judge as Harold Greene

found it necessary to channel most of the decision-making to the Department of Justice, announcing that he will ordinarily accept waivers negotiated by the Department with the telephone company. But one can hardly be comfortable with the conversion of the law enforcement arm of the government into a partner of management in large business decisions. The track record of such partnerships provides little basis for confidence.

Epilogue

With the decisions discussed in this commentary, the “second round restructuring” of the telecommunications industry is well on its way. But this second restructuring may not be the last. The past two years have clearly been the era of strongest resistance to diversification. Judge Greene turned back “for the present” a flood of waiver applications that he saw as undermining the original concept of the Divestiture Decree, especially the primary objective of efficient local telephone operations. But how long is “for the present”?

Two possible terminal points for this second round restructuring are suggested in the opinions. One is the date when “equal access” is achieved—i.e., when the BOCs have adapted their systems to provide all interexchange carriers equivalent facilities for reaching local subscribers. This will occur within two to three years. The second potential terminal point, one that is less precise and predictable, is “when technological and market conditions have changed to a point where the Operating Companies no longer have what, as a practical matter, is a monopoly over local telecommunications service.” Perhaps that monopoly has already begun to crack with the development of cellular radio, a non-wire technology by which subscribers can be interconnected.

Anticipating the date of the “third round” restructuring of the telecommunications industry involves a certain amount of guesswork—both as to what Congress might do and as to the inclinations of the judge who will inevitably succeed Judge Greene as
reluctant Czar of the industry. The range of possibilities is considerable. Congress might adopt as an ultimate goal the reintegration of AT&T, minus the Western Electric manufacturing division and other elements collateral to the core carrier responsibilities, with safeguards to prevent the integrated long distance/local carrier from discriminating against competing providers of long-distance service. That would be close to the original aim of the antitrust suit that led to the Divestiture Decree. Congress might legislate that telephone affiliations should not extend beyond activities directly contributing to service to ratepayers, thus limiting the potential for over-extension of management expertise resulting in dilution of its concentration on basic telephone service. That would be in the spirit of this article, the Public Utility Holding Company Act of 1935, and the legislation confining banks and bank holding companies to bank-related activities. Congress might opt for getting the courts and the Department of Justice out of the anomalous responsibility for ongoing restructuring of the telecommunications industry; plenary power might be restored to the FCC, which in recent years has manifested a large tolerance for diversification so long as non-core activities are separated (by a paper wall, some would say) from basic telephone operations.

Whichever way this “third round” develops, I hope it will be illuminated by some new insights. First, we must recognize that in telecommunications, and other utility operations, competition is both “impossible” and essential. A protected monopoly utility operation, with its inherent system of internal subsidies for socially-favored groups (the poor, the rural, etc.), cannot operate if there is free entry into the most profitable segments of the business. “Cream-skimming” consumes the fat that nourishes the leaner segments of the enterprise. On the other hand, a monopoly protected from all competition forgets to control its costs, is sluggish in technological innovation, tends to co-opt the regulators who are supposed to keep it in line, and can all too easily use its immense resources to invade fields that are ripe for competition. The task must be to permit, even nurture, enough competition to counter these tendencies of monopoly and regulation. The issue is not

77. See Phillips, The Reintegration of Telecommunications (reason to believe “the new structural arrangements will be shortlived”), in ANALYZING THE IMPACT OF REGULATORY CHANGE IN PUBLIC UTILITIES (M. Grew ed. 1984).

"regulated monopoly" or "competition," but rather a prudent meld of these two systems.

The second insight that should guide forthcoming restructuring is that competitive considerations are not the exclusive criterion for decision. There must be renewed awareness of human limitations and management incentives. Let us not restructure the telecommunications industry on the counter-intuitive assumption that the essential telephone service will be managed equally well, regardless of whether the executive officers are simultaneously running a gambling casino, an airline, construction projects in India, or "venture capital" projects in genetic research or computer software.