Alternatives to Rate Base/Rate of Return Regulation of Local Exchange Carriers: An Analysis of Stakeholder Positions

Jeffrey A. Masoner

Program on Information Resources Policy

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Jeffrey A. Masoner is a Manager in External Affairs at Bell Atlantic in Arlington, Virginia.

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EXECUTIVE SUMMARY

- There is little disagreement among telecommunications stakeholders on the historical justifications for local exchange carrier regulation: the existence of a natural monopoly industry structure, the essential nature of the service provided, and the potential for pricing and production abuses. Key goals cited generally comport with those provided in the Communications Act of 1934, and include the universal provision of high-quality service at just and reasonable, non-discriminatory rates, and the balancing of ratepayer and investor interests. Many stakeholders add that regulation should serve as a substitute for competition in markets where competition does not exist.

- Technological, legal, and regulatory changes have radically altered the telecommunications industry since World War II. The result of these changes has been an increasingly blurred distinction between competitive markets and regulated, monopoly-franchised markets reserved to the local exchange carriers. Stakeholders differ in their perceptions about the nature and viability of competition in various markets and consequently about both the ability of rate base/rate of return regulation to meet its goals and the necessity of introducing alternatives to it. Some seek a more efficient form of regulation, in what they view as a need for continued evaluation and adaptation of any form of regulation.

- With barriers crumbling for those who seek entry into selected lucrative markets, local exchange carriers (LECs) are seeking freedom from burdensome regulatory procedures designed for a monopoly industry that they claim no longer exists. LECs assert that the original regulatory "social contract" between regulators and carriers has been violated, as regulators can no longer provide franchise protection and existing regulatory procedures favor competitors' ability to intervene in and delay carrier pricing and service proposals. In response to a more competitive environment, many LECs have proposed or supported alternatives to rate base/rate of return regulation.

- Alternatives to rate base/rate of return regulation of local exchange carriers have been proposed as promoting rate stability and predictability, providing carriers with proper incentives for innovation and efficiency, reducing direct and indirect costs of regulation, and reflecting more accurately the competitive market outcome. The most commonly proposed alternatives -- social contract, price caps, and incentive regulation -- aim at providing some form of basic service rate stability and pricing and earnings freedom for competitive services. Regulatory reform proposals often contain elements of each of these alternatives, in a package designed to most effectively achieve the desired outcome.

- Interexchange carriers (IXCs) have focused on the impact that regulatory alternatives would have on local exchange carrier prices for monopoly inputs, especially where the LEC provides a competitive service utilizing the same inputs. Central to IXC opposition to many regulatory alternatives is their claim that effective competition is lacking for the majority of local exchange carrier services, and that the potential exists for abuses in the limited markets where competition is developing.

- Industry organizations, representing both large users of local exchange services and local exchange carrier competitors, have also focused on what they allege would be possible service and pricing abuses under regulatory alternatives. Like those of the IXCs, industry organizations' concerns in proceedings have centered on the perceived continuation of LEC monopoly power.

- Consumer organizations also consider safeguards, including the public input process, as necessary for protecting monopoly ratepayers from potential service and pricing abuses. They assert the need for stricter cost allocation rules under existing rate of return regulation in order to protect monopoly ratepayers from subsidizing competitive LEC ventures.

- Regulators are concerned with statutory obligations, such as those identified as the historical goals of regulation. Regulators are aware of unique jurisdictional conditions and regulatory proposals, and their final decisions frequently entail a mixture of new regulatory techniques and continued involvement of rate base/rate of return methods.

- Central to many proposals and plans for regulatory alternatives are the definitions of competitive/non-competitive service categories, and the extent to which rate of return is divorced from rate base.

- Stakeholders often see regulatory compromises as temporary transitional measures during the evolution to fully competitive markets. As technological, legal, and regulatory barriers to entry continue to fall, further proposals for regulatory alternatives can be expected.

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PREFACE

Alternatives to Rate Base/Rate of Return Regulation of Local Exchange Carriers: An Analysis of Stakeholder Positions examines the fundamental issues in regulation of local exchange telephone carriers (LEC). What justifies LECs being regulated in the first place? What is new that we should reexamine regulation? What are the major regulatory alternatives? What are their strengths and weaknesses? How does one evaluate the results of any regulatory structure?

These issues are examined from the points of view of major stakeholders, including the companies themselves, governments, users, and competitors.

This report is available in two versions:

- **Full-length version** (this version)
  Formal comments and testimony filed in various state and federal regulatory proceedings are examined in this full-length report. (P-90-3), 356 pages, includes a 25" x 19" fold-out chart, *Overview of Positions*.

- **Summary version**
  This version summarizes the findings of the full-length research report. (P-90-4), 9 pages, includes a 25" x 19" fold-out chart, *Overview of Positions*.

The fold-out chart, *Overview of Positions*, presents the findings of the full-length research report. On the chart, the bracketed numbers in each box are keyed to the text, which provides detail and discussion. For example, [2.3.1.1.] in the upper left-hand cell means that in chapter 2, section 2.3.1.1. expands on the points listed in that cell.

CHAPTER 1

INTRODUCTION

CHAPTER 1

INTRODUCTION

Many telecommunications stakeholders have developed positions on the appropriate level and method of regulation to be applied to LECs. This paper examines stakeholder positions on certain topics critical to evaluating regulatory structures. These include the historical justifications and goals for regulation of the telecommunications industry; changes that have occurred in the telecommunications environment since the introduction of regulation; an evaluation of traditional rate of return regulation of LECs; evaluations of major regulatory alternatives, including social contract, price cap, and incentive regulation; and a framework for evaluating regulatory alternatives.

An examination of stakeholder positions on these topics elucidates stakeholder perspectives on the need to maintain, reform, or replace rate of return regulation. Stakeholders' views of the justifications and goals of regulation (chapter 2) and of the changes that have occurred in the telecommunications environment (chapter 3) are fundamental to their assessment of the strengths and weaknesses of regulatory alternatives. Any evaluation of regulatory alternatives by definition requires an understanding of what regulation is designed to achieve and of the nature of the telecommunications environment as it exists.

The nature and extent of changes in the environment are critical elements in the determination of what, if any, reform of regulatory goals may be necessary, and whether traditional rate of return regulation has been, or will be, able to respond to these changed conditions. Stakeholders' evaluations of rate of return regulation (chapter 4) are the basis for the changes they perceive as needed in the form of regulation and various alternative regulatory structures (chapter 5). Finally, stakeholders' frameworks (chapter 6) for evaluating regulatory alternatives reflect their evaluations of the current telecommunications environment, the goals of regulation in that environment, and the ability of various regulatory alternatives to achieve these goals. These frameworks provide a summary of elements that stakeholders consider critical when evaluating regulatory methods.

1.1. Scope

Formal comments and testimony filed in various state and federal regulatory proceedings provide the source of stakeholder positions reviewed and considered in this research. Therefore, the inclusion of positions is based on active participation in various regulatory proceedings in which alternatives to rate of return regulation have been considered. Since some telecommunications stakeholders have not actively participated in the public input cycles of the regulatory process, their positions have not been considered in the research. Lack of participation may be an indication of no position being taken by the stakeholder, a lack of consensus within the stakeholder group or organization, a lack of knowledge that the process was occurring, or other reasons. However, limiting input to formal comments assures that the author does not attempt to define stakeholders and that stakeholder's positions are the indisputed formal position of the entire stakeholder organization. The focus of this report is limited to regulatory proceedings, since state and federal regulators have primary responsibility for the implementation of regulatory methods (based on interpretations of statutory goals, obligations, and intent), and have been involved in the many specific examinations of LEC regulation. All positions considered in this research were filed prior to August 1, 1988.

Telecommunications stakeholders participating in the regulatory proceedings have been organized into the following categories: LECs, including the divested Bell Operating Companies and large and small independent telephone companies; interexchange carriers (IXCs), who not only are large users of LEC services but also compete with LECs in certain markets; other industry organizations, representing business and industry consumers of LEC services and actual or potential LEC competitors; consumer representatives; and state and federal regulators, who have the responsibility to choose and implement a regulatory structure consistent with their statutory powers and goals.

1.2. Defining Alternatives

This report focuses on stakeholders' evaluations of traditional rate of return regulation and alternatives to it. Traditional rate of return regulation may be considered the original social contract, where the "contract" represented an agreement between the regulators and the LEC, and under which rights and obligations of each were defined. Under this regulatory agreement, the LEC will provide universally available, high quality service, at rates that are just, reasonable, and non-discriminatory, and will be subject to profit constraints through the implementation of rate of return regulation. In return, regulators agreed to provide the LEC with the opportunity for a fair return on investment and franchise protection within their service territory. Under rate of return regulation, profits and prices are fully regulated.

The three alternatives to rate of return regulation examined -- social contract, price cap, and incentive regulation -- represent the most frequently proposed alternatives. While many proposals for service-specific deregulation or relaxed regulation have been approved, these reforms amount to maintaining rate of return regulation with unique treatment of certain products or services. All of the alternative regulatory methods studied are temporary; following a fixed time period, they are subject to review and continuation, modification, or termination.

Social contract and price cap regulation both represent the movement from profit regulation to price regulation. An essential element of each alternative is that regulators and the LEC agree to price commitments for particular categories of services. Varying levels of freedoms may be granted for other categories of services.

Generally, under social contract regulation, price commitments (freezes or limited increases) are provided for basic services, while LECs are granted earnings and pricing freedom for non-basic or competitive services. LEC profits are not monitored under social contract regulation. Variations on the social contract theme involve the definition of basic price regulated services, the nature of price adjustment factors or triggering mechanisms, and the term of the agreement. Another variation is the commitment by the LEC not to initiate an increase in basic service rates, so long as the basic service rate of return does not fall below a threshold rate of return in exchange for earnings and pricing flexibility for non-basic or competitive services. As is the case with all other proposed regulatory alternatives, the LEC may have the opportunity to petition for rate relief if established rates are confiscatory.

Price cap regulation, another variation on the price regulation theme, involves the establishment of "going-in" price caps. Caps may apply to any level of service categories, from a service-specific basis to a company-wide basis, depending on the approved plan. The LEC would have freedom to price below the cap, but would not be permitted to raise prices above the caps without a full rate proceeding. Price floors may be established in order to prevent predatory pricing. Caps would be adjusted periodically, based on agreed upon factors, such as annual inflation increases adjusted for productivity.

Unlike price regulation proposals, incentive regulation plans involve the continued monitoring of rate of return. These plans are also known as "range of rate of return" or "bonus range of return." As with price regulation alternatives, the LEC generally agrees to price commitments for basic services and is granted some level of pricing flexibility for non-basic or competitive services. A range of rate of return is established, and the LEC is entitled to retain any earnings up to a set level, shares with ratepayers earnings up to another set level, and either returns to ratepayers all earnings over a threshold level or is entered into a rate proceeding. As with price regulation, proposed LEC rate increases would be subject to full regulatory scrutiny.

Depending on the perceived need to adapt regulation to a changing environment, stakeholders have evaluated rate of return regulation and many potential alternatives. Most, if not all, currently proposed alternatives are variations on the social contract, price cap, or incentive regulation approach. Therefore, an understanding of stakeholder evaluations of these regulatory methods and of stakeholders' frameworks for evaluating alternatives will provide readers with a general understanding of the issues and positions surrounding the future regulation of LECs.

CHAPTER 2

HISTORICAL JUSTIFICATIONS AND GOALS FOR TELECOMMUNICATIONS REGULATION

Table 1

Regulation of LECs

		Justification	Goals
Local Exchange Carriers (LECs)	**Regional Bell Operating Companies (RBOCs)**	– Natural monopoly nature of industry – Essential service – Utility incentives to overprice or underproduce absent government regulations [2.3.1.1]	– Maintain technologically advanced, efficient network – Establish reasonable and economically efficient pricing structures – Make available services required by the market – Universal service* – Serve as a substitute for competition – Protect ratepayers from firms with market power – Balance ratepayer and investor interests – Prevent duplication of resources by enforcing exclusive local franchises [2.3.1.2]
	Large Independents	– Same as RBOC [2.3.1.1]	
	Small Independents	– Same as RBOC [2.3.2]	– Universal service* – Balance ratepayer and investor interests – Assure just and reasonable rates – Protect LEC from competition within service area [2.3.2] *Many LECs consider universal service a "social" goal of regulation
Interexchange Carriers (IXCs)		– Natural monopoly nature of industry – Essential nature of service – Potential monopoly abuses [2.4]	– Serve as a substitute for competition – Promote just and reasonable rates – Prevent consumer exploitation [2.4]
Other Industry[1]		– Natural monopoly nature of industry – Essential nature of service – Potential monopoly abuses [2.5]	– Emulate competitive pricing characteristics within a natural monopoly market – Prevent consumer exploitation – Promote just and reasonable rates [2.5]
Consumers		– Natural monopoly nature of industry – Essential nature of service – Potential monopoly abuses [2.6]	– Protect ratepayers from real and potential abuses of monopoly power – Promote just and reasonable rates – Promote universal high quality service [2.6]
Regulators	**Federal Communications Commission (FCC)**	– Natural monopoly nature of industry – Essential nature of service – Potential for firms with market power to abuse the public [2..2.1]	– Promote and protect universal high quality service – Foster technological advancement – Protect against carrier's exercise of monopoly power – Promote efficient provision of services at reasonable rates – Balance ratepayer and shareowner interests [2.2.1]
	State Commissions and Commission Staff	– Same as FCC [2.2.2.1]	– Same as FCC – Original social contract between regulators and LECs – Surrogate for competitive market forces [2.2.2.2]

[1] "Other Industry" represents positions of industries which may be large users of LEC services, LEC competitors, or both.

CHAPTER 2

HISTORICAL JUSTIFICATIONS AND GOALS FOR TELECOMMUNICATIONS REGULATION

2.1. Overview

It is frequently argued that unique industry characteristics and market conditions must exist in a free market economy in order to justify the imposition of government regulation. Generally, these conditions include the existence of a natural monopoly industry structure (industries with optimum scales of production so large that only one or a few firms can realize economies of scale and the entire market demand can be met most efficiently by a single firm), the provision of essential services, or the provision of services making up the infrastructure of the economy. According to economic theory, an unregulated monopolist will maximize profits by restricting output and raising prices, resulting in an inefficient allocation of resources and welfare losses to society. English common law, dating to the determination of a ferryman as a common carrier in 1348, imposed a duty to serve all customers on occupations able and likely to abuse the public if no protection were extended.

Following the expiration of the original Bell patents in 1894, the development of the domestic telephone industry entered a period of competition. In larger cities, where the potential customer base was more lucrative, two or more telephone companies competed for subscribers; the result was that to reach all subscribers, it was often necessary to subscribe to service with more than one telephone company. In other cities, independent telephone companies that AT&T refused to interconnect with sometimes found they could not survive in the capital-intensive business. The result was that consumers living in these areas did not have any service available to them.

As the twentieth century began and regulation of the telephone industry began to take hold, many of the classic common law justifications for government intervention existed. Significant start-up investment and the capital-intensive nature of the industry, it was feared, would result in harm to customers in the face of competition. Duplication of facilities would ultimately be at ratepayers' expense, and low variable costs of providing service could lead to ruinous competition and eventually poor, if any, service.

An unregulated natural monopolist, however, would be free to charge excessive rates and engage in other abusive practices, potentially denying access to the network. And in order to continue the expansion of the network to serve all citizens, rights-of-way and the use of public property would be necessary. Regulation of the telecommunications industry was designed to address the concerns for LEC exploitation of natural monopoly power and to further what were determined to be a number of social goals, included among which is the goal of universal service.

2.2. Regulators

2.2.1. The Communications Act of 1934 and the FCC

There is little disagreement among stakeholders on these historical justifications and goals for the regulation of the telecommunications industry (see Table 1). In their comments and testimony in regulatory proceedings, stakeholders frequently referred to the language embodied in the Communications Act, passed by Congress in 1934. The Act, under which the FCC was created, mandates that the Commission shall regulate interstate telecommunications services "so as to make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide . . . communications service, with adequate facilities at reasonable charges."[1] Within this mandate, the FCC considered its responsibilities to be to protect universal service, foster technological advancement of the public network, protect ratepayers against the potential exercise of monopoly power by carriers, and

[1] 47 U.S.C. Section 151.

promote the efficient provision of interstate services at reasonable rates.

Title II of the Act adds that any unjust or unreasonable charge, practice, classification or regulation is unlawful. The FCC recently asserted that its primary objective is "protecting ratepayers against unreasonable charges for services," which must be balanced with the carriers' need for flexibility to introduce new and innovative services quickly and to provide the most efficient mix of services in their network. The FCC added that rate of return regulation "is intended to prevent a firm with market power from exercising monopoly power. . . . [It] promises to the regulated firm the opportunity to earn sufficient revenues to cover its costs, including a fair rate of return on equity. It also promises to shield ratepayers from the exorbitant rates that a monopoly, left unregulated, could otherwise impose."[2]

2.2.2. State regulators

2.2.2.1. Justifications

Those state regulators discussing the historical justifications for regulation emphasized the nature of the telecommunications industry as a natural monopoly which, like other monopolies, will have incentives to charge prices in excess of costs. Citing the classic argument for regulation of private firms as market failure and the failure to yield a combination of price and output that maximizes society's welfare, the Illinois Commerce Commission asserted that an unregulated monopolist may use its power to restrict output and charge excessive prices. However, the Commission continued, this is contrary to the "subscribership externality" factor: the indirect benefit customers gain when additional subscribers are added to the network. According to the

[2]FCC NPRM, CC Docket No. 87-313; August 4, 1987, p. 2, 9, 4.

Commission, the result is that social welfare is not maximized, and government intervention in the marketplace may be justified.[3]

The staff of the Colorado PUC discussed technical characteristics "which inevitably lead to monopoly or at least ineffective forms of competition," and added the necessity of services as two characteristics of firms to which regulation is applied. According to the staff, "[m]ost public utilities share certain economic characteristics which historically make them prime targets for regulation. The industries tend to be natural monopolies or natural oligopolies." The staff added a number of additional justifications for regulation, including the high fixed cost relative to variable costs often results in aberrant competitive behavior; the high level of investment would result in higher rates in the long run if there is more than one supplier; right of way or use of public property is required; and the product or service is of an essential nature.[4] However, the staff also noted that no firm has a total monopoly; the Washington UTC similarly noted that public service companies "provide an important public service in exchange for a measure of freedom from competition."[5]

2.2.2.2. Goals

State regulators, like the FCC, frequently cited the Communications Act and state regulatory codes as their references for the goals of regulation. Primary goals cited include universal high quality service, the protection of ratepayers against the potential for monopoly abuses, the balancing of consumer and investor interests, and the enforcement of a local service franchise. Many regulators added that the goal of

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[3]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 2.

[4]Comments of CO PUC Staff, NTIA Docket No. 61091-6191; December 15, 1986, pp. 2-4.

[5]Comments of WA UTC, NTIA Docket No. 61091-6191; December 15, 1986, p. 1.

regulation is to act as a substitute for competition where it does not exist.

According to the Illinois Commerce Commission, since the early twentieth century, "it has been an explicit goal of U.S. telecommunications policy to achieve and preserve a high level of telephone penetration in the United States so that all persons desiring telephone service would have such service available to them at <u>just and reasonable rates</u>."[6] The West Virginia PSC similarly noted that "[o]ne of the primary concerns of [the PSC] is the preservation of universal telephone service."[7] The Commission also stated that, consistent with the West Virginia Code, it is "obligated to provide for the availability of adequate, economical, and reliable telephone service throughout West Virginia."[8] The staff of the New Hampshire PUC also stated that universal service is its "fundamental telephone policy."[9]

Critical to the achievement of universal service goals is the protection of ratepayers from unjust or unreasonable rates or other potential monopoly abuses. According to the District of Columbia PSC, its statutory charge is "to insure that every public utility doing business within the District of Columbia . . . furnish[es] services and facilities reasonably safe and adequate and in all respects just and reasonable."[10] The Commission added that the goal of regulation is "to

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[6]Comments of IL CC, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

[7]WV PSC Order, Case No. 85-022-T-P; June 30, 1986, p. 13. (Filed as comments in NTIA Docket No. 61091-6191, December 15, 1986)

[8]Comments of WV PSC, FCC CC Docket No. 87-313; October 19, 1987, p. 1. (Cited WV Code, Section 24-1-1, et seq.)

[9]Comments of NH PUC, NTIA Docket No. 61091-6191; December 15, 1986, p. 6.

[10]Comments of DC PSC, NTIA Docket No. 61091-6191, December 15, 1986, p. 1. (Citing D.C. Code Section 43-402, 1986)

protect all members of society from the inefficiencies of monopolistic pricing of essential services."[11]

The Washington UTC asserted that "[a] regulatory structure should . . . [protect] monopoly ratepayers from rate discrimination and abuse."[12] In its review of the Vermont Telecommunications Agreement, the Vermont PSB asserted that its "first concern must be for the protection of basic exchange ratepayers, who will still be faced with a monopoly supplier."[13] The Maryland PSC stated, "[t]he concept of just and reasonable rates is the cornerstone of regulation in Maryland and every other jurisdiction of the United States."[14] And the Illinois Commerce Commission added that ratepayer protection may include protection from service abandonment in markets where service is provided by a single supplier.

Many regulators noted the creation of the original social contract between regulators and LECs as an agreement whereby each party was bound by certain conditions. This agreement was intended to result in a balance between ratepayer and investor (shareowner) interests. According to the Maryland PSC, "[i]n essence, there is a regulatory bargain in which the natural monopolist gives up its freedom to charge what would otherwise be monopoly rates in exchange for protection from competition."[15]

The Washington UTC similarly asserted that "[t]he traditional concept of public service regulation was inextricably tied to the 'social

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[11]Comments of DC PSC, NTIA Docket No. 61091-6191, December 15, 1986, p. 16.

[12]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 3.

[13]Vermont PSB Order, Docket No. 5252; July 12, 1988, p. 46.

[14]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 42.

[15]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 86.

contract' theory, which in turn was tied to the concept of limited entry. . . . Under the social contract theory a public service company assumes a responsibility to provide an important public service in exchange for a measure of freedom from competition and authority to charge rates which will provide a reasonable return on investment devoted to public service." The UTC added that the obligation to serve is "usually compensated by franchise protection."[16]

According to the Illinois Commerce Commission, while protecting ratepayers from potential monopoly abuses, it also protects the monopoly from "hit-and-run entry by cream skimmers."[17] The staff of the New Hampshire PUC also noted that while protecting the public from excessive rates, it must also insure the utility a reasonable return on costs.

Finally, some regulators added that regulation provides a surrogate for the forces of a competitive marketplace. As the Washington UTC stated, "[a] regulatory structure should inspire companies to perform as their free market counterparts."[18] The West Virginia PSC similarly stated that "[r]egulation is a substitute for competition."[19] The Maryland PSC also noted that "[h]istorically, regulation of public utilities by the Public Service Commission has functioned as a substitute for competition in what is generally considered to be a natural monopoly situation."[20]

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[16]Comments of WA UTC, NTIA Docket No. 61091-6191; December 15, 1986, pp. 1-2.

[17]Comments of IL CC, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[18]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 3.

[19]WV PSC Order, Case No. 85-022-T-P; June 30, 1986, p. 12. (Submitted by the PSC as comments in NTIA Docket No. 61091-6191, December 15, 1986.)

[20]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 86.

2.3. LECs

2.3.1. RBOCs and large independents

Local exchange carriers cited justifications and goals for government regulation very similar to those cited by regulators. However, LECs placed additional emphasis on the natural monopoly rationale and the resulting obligation of regulators, under the original "social contract" between regulators and utilities, to protect regulated firms from competition. LECs also focused on the goal of regulation to serve as a substitute for competition in markets characterized as natural monopolies.

2.3.1.1. Justifications

Those LECs discussing the justifications for imposing government regulation of telecommunications markets focused on the historic nature of the industry as a natural monopoly providing an essential service. As Telephone and Data Systems (TDS) stated, "[t]he underlying reason for the public utility concept was that telephone services are so important to citizens they require oversight by the government." TDS added that the firms were considered natural monopolies because the large investment required to develop and maintain systems and the high level of fixed costs resulted in an industry where competition was not economically beneficial and a duplication of resources would waste society's resources. The result, according to TDS, was that regulation was introduced to prevent the potential for the sole provider of an essential service to "charge and obtain rates in excess of the costs of service."[21]

Other LECs provided similar discussions. Illinois Bell stated that as the telephone industry developed, "[i]t became apparent that the provision of telephone service was a natural monopoly. A single firm

[21] Comments of TDS, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

could serve all customers, take advantage of declining average costs and avoid the costly duplication of overlapping networks. . . . However, a sole provider industry structure threatened the captive public with the potential for monopoly abuse. Thus, the basis was established for achieving maximum customer benefits via regulation of the industry, in concert with a sanctioned monopoly arrangement."[22] GTE North, which noted the "fundamental nature" of utility service, also stated that "[t]he prevalence of a single firm will lead to monopoly pricing and excessive profits in the absence of some form of control."[23]

The development of government regulation, according to the LECs, was rooted in the development of the original "social contract," or agreement, between regulators and the utility firms. According to GTE North, part of the function of a regulator balancing the interests of investors and ratepayers is the "effort to make service available to all and to maintain some protection to the company through franchise and other rights of use."[24] Mountain Bell noted the requirements regulation imposed on utilities, including entry-exit restriction; prices fixed on a rate base rate-of-return formulation; regulation of quality and conditions of service; and a legal obligation to serve all those requesting service. In return, Mountain Bell continued, the regulated firm was "afforded general protection of its private property (including the exclusive right to provide service within franchised areas), the right to collect a reasonable price for services rendered to cover its costs, authority to impose reasonable service rules and regulations on customers and eminent domain power."

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[22]Comments of Illinois Bell, IL CC Docket 87-NOI-3; March 8, 1988, p. 2.

[23]Comments of GTE, IL CC Docket 87-NOI-3; March 8, 1988, p. 2.

[24]Comments of GTE, IL CC Docket 87-NOI-3; March 8, 1988, p. 4.

According to Mountain Bell, "[t]his is the original 'social contract' between the sovereign and the investor-owned company which balanced the rights and obligations of each."[25] As the National Telephone Cooperative Association (NTCA) stated, under the existing rate of return regulation model, developed over the past 100 years, "entry into and exit from a market is controlled and service providers obtain a reasonable opportunity to earn fair returns in exchange for government regulation and requirements to offer service essentially to all comers. This model amounts to an existing 'social contract.'"[26]

2.3.1.2. Goals

Many LECs cited statutory goals of this original "social contract" regulation as a high-quality, feature-rich, reasonably priced, economically efficient, and universally available network. However, while citing many goals of regulation similar to those cited by regulators, many LECs placed primary emphasis on the overall goals of regulation to act as a substitute for competitive market forces and to protect consumers of monopoly services. According to these LECs, the goals of regulation have been furthered to accommodate certain social goals.

As Rochester Telephone stated, "[t]he principal goal of utility regulation is to replicate the market forces of competition absent from a monopoly market. In translating this broad objective into action, regulators have sought to prevent 'excessive' monopoly profits and 'unreasonable' price discrimination while maintaining acceptable levels of service quality." Rochester added that "[a] further goal of traditional telephone regulation has been the attainment of certain social objectives, in contrast to purely economic objectives. Universal

[25]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, pp. 6-7.

[26]Comments of NTCA, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

telephone service . . . has been a major accomplishment of the regulated telephone industry and its regulators."[27] Rochester later stated that "[w]here substitutes are not available, it is incumbent upon the Commission to create an environment simulating a fully competitive situation."[28]

According to Ameritech, "[w]ith respect to monopoly services, the conceptual objective of rate of return regulation has been consistent and universally accepted -- to replicate the return levels, resource utilization and efficiencies that would exist if competition were viable and in place." (In these comments, Ameritech added that the assumption of the existence of monopoly characteristics for some subset of telecommunications services was being assumed for purposes of the limited NTIA inquiry.)[29]

GTE concluded, "[i]n summary, [rate of return] regulation was supposed to substitute for competition in the sense of trying to simulate the incentive structure that would exist in a competitive market. But over time, [rate of return regulation] of the telephone industry has been stretched to become a mechanism for the kind of social distribution cited [subsidizing one class of customers at the expense of others] -- an outcome that a competitive market would not produce."[30]

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[27]Comments of Rochester Telephone, NTIA Docket No. 61091-6191; December 15, 1986; p. 7.

[28]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[29]Comments of Ameritech, NTIA Docket No. 61091-6191; December 15, 1986, p. 4.

[30]Comments of GTE, NTIA Docket No. 61091-6191; December 15, 1986, p. 8.

2.3.2. Small independents

While in general agreement with the larger LECs, smaller and rural LECs placed more emphasis on the social goal of universal service. As NTCA stated, "[a] fundamental national goal is to make universal telecommunications service available to the American public through adequate facilities at reasonable rates, as embodied in Section 1 of the Communications Act of 1934."[31] NTCA also noted that telecommunications service is vital, particularly in rural America.

The National Rural Telecom Association (NRTA) similarly discussed the "marketplace failure" to bring telephone service to rural America, and the creation of financing opportunities to enable rural areas to obtain high quality telephone service. According to NRTA, the Rural Electrification Act reaffirms the congressional objective of universal service. Section 201 of the Act, which provides for financing for rural LECs, declares congressional policy that "adequate telephone service be made generally available in rural areas through the improvement and expansion of existing telephone facilities and the construction and operation of such additional facilities as are required to assure the availability of adequate telephone service to the widest practicable number of rural users of such service."[32]

2.4. IXCs

Interexchange carriers focused on the monopoly nature of services provided as justification of government regulation and on the assurance of just and reasonable non-discriminatory rates, which would normally be assured by the exercise of market forces in a competitive market, as

[31] Comments of NTCA, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[32] Comments of NRTA, NTIA Docket No. 61091-6191; December 15, 1986, p. 5; citing Section 201 of the Rural Electrification Act, 7 USC Sec. 921.

regulatory goals. As CompTel stated, "[r]ate of return regulation has provided a means by which to curb the possible abuses of monopoly power. A monopolist, for instance, has the ability to raise prices at will because the demand for its services is usually inelastic."[33] AT&T added that "[f]or centuries, it has been recognized that a business 'affected with the public interest' should be subject to government regulation."[34] AT&T further stated that regulation is "applied generally to companies that provide necessary goods or services and would otherwise have a high degree of market power i.e., power to set prices and to exclude competition."[35]

According to the IXCs, regulation of LECs prevents various potential monopoly abuses. As AT&T asserted, "[t]he essence of rate of return regulation is to constrain and, ideally, eliminate the exercise of monopoly power that results in supranormal profits accruing to the firm and its owners."[36] MCI added that "in the absence of competition, regulation is necessary to protect consumers from exploitation by monopoly providers."[37]

The potential abuse of monopoly power most frequently cited is rate abuse. ALC Communications, citing the Communications Act, stated that "[t]he [FCC] still is responsible for ensuring that charges for telecommunications services are 'just and reasonable' and are not 'unreasonably discriminatory.' Most importantly, the [FCC] retains the statutory obligation to regulate telecommunications in the public

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[33]Comments of CompTel, NTIA Docket No. 61091-6191; December 15, 1986, p. 1.

[34]Brief of AT&T, VT PSB Docket No. 5252; May 31, 1988, p. 8.

[35]Brief of AT&T, VT PSB Docket No. 5252; May 31, 1988, p. 10.

[36]Comments of AT&T, NM SCC Docket No. 87-54-TC; July 2, 1987, p. 3.

[37]Response of MCI, CA PUC Notice of En Banc Hearing on Alternatives to Cost of Service Regulation for LECs; September 11, 1987, p. 2.

interest."[38] AT&T agreed that the fundamental obligation of the FCC under the Communications Act is to require "just and reasonable rates" and added that the principal rationale for rate of return regulation is to protect consumers from monopoly prices.[39] AT&T also discussed the regulatory prohibition against unreasonable discrimination "so that customers similarly situated do not pay different prices for the same or functionally similar services."[40]

Interexchange carriers noted that these goals of regulation are an attempt to replicate the competitive market outcome in a market where competition does not exist. As MCI stated, "[r]ate of return regulation is designed to make public utilities perform as though they were competitive rather than monopoly firms."[41] US Sprint similarly asserted that "[u]nder well-established economic principles, the effort of regulation should be to replicate the workings of the marketplace under competition."[42] AT&T concluded that

> [t]he traditional regulatory model is frequently described as a substitute for competition where competition is non-existent or inchoate. Regulation is held necessary in these instances because the level of competition is insufficient to restrain market power and unable to provide the ordinary discipline and benefits of effectively competitive markets, including reasonable prices, variety and abundance of resproducts and services, cost constraints, responsiveness to consumer demands and preferences, innovation, and service and product improvement.[43]

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[38] Comments of ALC, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[39] Comments of AT&T, FCC CC Docket No. 87-313; October 19, 1987, p. 19.

[40] Brief of AT&T, VT PSB Docket No. 5252; May 31, 1988, p. 9.

[41] Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 5.

[42] Comments of US Sprint, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[43] Brief of AT&T, VT PSB Docket No. 5252; May 31, 1988, p. 10.

2.5. Other Industry Organizations

Other industry representatives similarly discussed the lack of competition in local exchange markets and the resulting need for regulation to curb potential monopoly abuses, and in particular to assure the provision of just, reasonable, and non-discriminatory rates. According to the industry organizations, regulation will thus provide the market constraints normally provided by the presence of competitive alternatives.

The American Newspaper Publishers Association (ANPA) described the need for regulation of LECs. According to ANPA, "[r]ates are the most powerful, and potentially most malleable, regulator of access to the nation's telecommunications system. Onerous rates can operate to deny access unreasonably. Because public access to vital information is at stake, the basis for those rates must be examined directly and the rates calculated with more in mind than maximizing monopoly profits."[44] The Independent Data Communications Manufacturers Association (IDCMA) similarly noted that "[a]s a result of their continuing monopoly power, these carriers could charge excessive rates, cross-subsidize unregulated activities, and foreclose any significant competition in the market. To prevent this anticompetitive conduct and protect the public interest, the Commission must maintain an effective regulatory system."[45]

The industry organizations cited the goal of preventing the potential abuse of monopoly power and exploitation of customers by charging excessive rates. Many organizations added that this goal is a statutory requirement under the Communications Act. According to the Ad Hoc Telecommunications Users Committee, the Communications Act compels the

[44]Comments of ANPA, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[45]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 11.

FCC to monitor earnings because it "places on the Commission continuing responsibility to prevent carriers from charging rates which are not just and reasonable, and in particular to prevent carriers from exploiting their ratepayers by earning 'creamy' returns."[46]

The Committee of Corporate Telecommunications Users (CCTU) cited the Communications Act, stating that it mandates that the Commission regulate in the "public interest." CCTU added that "[t]his means that all Commission actions must be taken with the purpose of furthering this mandate."[47] Quoting the Act, CCTU added that in the regulation of carrier rates, this means "[a]ll charges, practices, classifications, and regulations for and in connection with such communication service, shall be just and reasonable."[48] CCTU asserted that the Commission's first interest is in assuring that rates are just and reasonable, given a carrier's costs of providing service. The International Communications Association (ICA) similarly asserted that "the FCC's principal function [is] insuring that rates are just, reasonable and nondiscriminatory."[49]

According to many of the organizations, the "just and reasonable" standard requires an examination of carrier costs. Capital Cities/ABC, CBS, and NBC -- also citing the Communications Act -- stated that "[d]ecades of judicial review of agency determinations . . . have established the basic principle that 'just and reasonable' rates are those that fall within a 'zone of reasonableness' where rates are neither less than compensatory to carriers nor excessive to

[46]Reply Comments of Ad Hoc Users, FCC CC Docket No. 87-313; December 4, 1987, p. 28.

[47]Reply Comments of CCTU, FCC CC Docket No. 87-313; December 4, 1987, p. 16.

[48]47 U.S.C. Section 201(b).

[49]Reply Comments of ICA, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

consumers."[50] According to the Ad Hoc Users, this "zone of reasonableness" is "bounded at the top by exploitation of consumers and at the bottom by confiscation of carriers' property."[51] In this manner, according to the organizations, regulation should seek to balance ratepayer and investor interests.

Given the existence of a natural monopoly industry and the resulting need for regulation, some industry organizations cited the regulatory goal of replicating the competitive market outcome. According to the Department of Defense (DoD) and other Federal Executive Agencies, "[i]n an environment without competition, regulation is intended to simulate competition and dissuade firms from using their monopoly powers to restrict output and raise prices to maximize profits."[52] ADAPSO added, "[t]he fundamental goal underlying rate of return regulation is to create an environment that, despite the existence of a monopoly, closely resembles that which would exist in a competitive market."[53] IBM and Lee L. Selwyn (in his report for ICA and the Ad Hoc Telecommunications Users Committee) both noted this competitive market goal in markets that are "less than effectively competitive."[54]

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[50]Reply Comments of ABC, et al., FCC CC Docket No. 87-313; December 4, 1987, p. 9.

[51]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

[52]Comments of DoD, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 2.

[53]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[54]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 4; and Incentive-Base Regulation of Telecommunications Utilities, a report to the Ad Hoc Users and ICA by Dr. Lee L. Selwyn, provided as an attachment to comments filed in NTIA Docket 61091-6191; December 15, 1986, p. 2.

2.6. Consumer Organizations

Like the other stakeholder groups, consumer organizations discussing the justification and goals of regulation cited the presence of natural monopoly market conditions. As the Consumer Federation of America (CFA) stated, "the current form of regulation is a 'contract' between the people of a franchise territory and the company, written by the legislature and overseen by the regulators." CFA stated that these contracts were necessary due to the

> absence of competition (the existence of a natural monopoly) in the provision of basic necessity services. Competition normally provides the function of restraining profits in our economy by attracting entrants into businesses which are excessively profitable. Absent competition, such restraint is lacking in the marketplace and regulation has filled that role for virtually all utility services for about half a century.[55]

CFA also asserted that the economic characteristics of telecommunications -- large economies of scale and scope -- underlie natural monopoly. According to CFA, natural monopoly is "one of the strongest justifications for circumscribing profits."[56]

According to the Maryland People's Counsel, "[t]he existence of telecommunications regulation stems directly from the historically monopolistic structure of the telecommunications industry, and the consequent need to protect ratepayers from abuses of monopoly power while at the same time inducing economically efficient delivery of services desired by the public." The Counsel added that "[s]o long as the predominant characteristic of the industry remains that of a

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[55] Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 8.

[56] Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 65.

monopoly, the need for substantial regulation to protect the public interest will be unavoidable."[57]

The result of this need to protect ratepayers was manifested in the regulatory goal of "just and reasonable" rates, as articulated in the Communications Act. According to CFA, "[t]he requirement of fair rates, neither confiscatory nor inordinately profitable, is the cornerstone of the Communications Act's universal service goal." CFA added that "the courts have consistently interpreted the 'just and reasonable' legislative mandate of other statutes to allow regulatory discretion within 'a zone of reasonableness' based upon determination of a fair rate of return."[58]

According to the Illinois Citizens Utility Board, "the proper goals of regulation are: universal service, economic efficiency; just, reasonable and affordable rates; and reliability and maintenance of the network."[59] According to CFA, these goals form an integral part of the original social contract between LECs and consumers. CFA asserted that "[u]nder the existing social contracts, companies are given the opportunity to earn a profit commensurate with the risk they incur, in exchange for providing high quality service at just and reasonable rates."[60]

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[57]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[58]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 6, 10.

[59]Reply Comments of CUB, IL CC Docket No. 87-NOI-3; April 26, 1988, p. 1.

[60]Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 8.

2.7. Summary

In conclusion, the various stakeholder groups generally agreed upon the historical goals and justifications for regulation: given a natural monopoly industry providing an essential service, regulation is necessary to protect ratepayers from potential monopoly abuses. Regulation provides this protection through the mandate of just, reasonable, and non-discriminatory rates and the opportunity for the firm to earn a fair rate of return in its protected franchise territory. In effect, regulation seeks to replicate, in a monopoly market, the competitive market outcome.

However, some stakeholders asserted that the regulatory goal of universal service, which they identify as a social as opposed to an economic goal, has resulted in an outcome that a competitive marketplace would not produce: the subsidy of one group of customers by another.

LECs in particular also emphasized the presence of natural monopoly market conditions and the goal of regulation to protect the regulated LEC from competition within its franchise territory under the original social contract. Stakeholders' positions on the continued relevance of the need for regulation and traditional regulatory goals will be determined by their perceptions of what changes have occurred in the telecommunications market since the introduction of traditional LEC regulation, and whether the conditions that led to LEC regulation are still present.

CHAPTER 3

CHANGES IN THE TELECOMMUNICATIONS ENVIRONMENT

Table 2

Changes in the Environment

Local Exchange Carriers (LECs)	**Regional Bell Operating Companies (RBOCs)**	– Rapid technological developments have resulted in reduced barriers to entry, expanded market opportunities – Current telecom markets are highly competitive – Increasing levels of competition result in mixed competitive/regulated markets applied to LECs to prevent inappropriate subsidies [3.3.1]
	Large Independents	– Changes in technology and government policy have led to a highly competitive telecom market – LECs are subject to increased regulatory burdens not applied to competitors – Local exchange may still be a monopoly [3.3.1]
	Small Independents	– Telecom market is becoming highly competitive – Traditional LEC revenue streams are threatened – Local exchange may still be a monopoly [3.3.2]
Interexchange Carriers (IXCs)		– Basic local services remain a natural monopoly – Prospect for local service competition distant – LEC joint provision of competitive/monopoly services [3.4]
Other Industry[1]		– Dominant carriers have diversified into many competitive services – Existence of selective competition and partial deregulation – Many LEC services remain a monopoly [3.5]
Consumers		– LEC diversification has resulted in monopolies devoting considerable talent and resources to competitive enterprises – Basic service remains a monopoly [3.6]
Regulators	**Federal Communications Commission (FCC)**	– Federal and state decisions have eroded monopoly powers and supported competition – Dominant carriers have diversified into many competitive services – Presence of mixed competitive and regulated markets [3.2.1]
	State Commissions and Commission Staff	– Varying levels of competition present in certain markets – Change an uncertainty due to technological developments, federal regulatory decisions – LECs maintain local exchange monopoly – LEC diversification into competitive markets [3.2.2]

[1] "Other Industry" represents positions of industries which may be large users of LEC services, LEC competitors, or both.

CHAPTER 3

CHANGES IN THE TELECOMMUNICATIONS ENVIRONMENT

3.1. Overview

The telecommunications environment has changed dramatically since the introduction of state and federal regulation in the early twentieth century. In fact, it has changed dramatically since 1950. Significant technological developments, as well as general economic expansion, fueled the domestic telephone industry's growth during the period following World War II. A rapid expansion of LEC plant aided industry and regulatory efforts toward achieving universal telephone service. By 1988, domestic telephone penetration had reached nearly 93%.[61]

The technological developments that helped make this growth possible were also resulting in confused boundaries between the regulated monopoly telephone service market and the emerging competitive computer and information services market. The government filed an antitrust suit against AT&T in 1949, which was settled in 1956.[62] The result of this settlement, the AT&T Consent Decree, was to limit AT&T and its associated Bell System local telephone companies from providing data processing products or services. AT&T was limited to providing "plain old telephone service" (POTS). But the provision of computer services was only one area of service where the boundaries between regulated

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[61] Trends in Telephone Service, FCC Industry Analysis Division, Common Carrier Bureau; August 1, 1988, p. 2. The FCC cited penetration as 92.9% effective March, 1988.

[62] US v. Western Electric Co. and AT&T, Civil Action No. 17-49, 13 RR 2143; 161 USPQ (BNA) 705; 1956 Trade Cas. (CCH) Section 68246, at p. 71134 (D.C.N.J. 1956).

monopoly and competitive services were becoming blurred with the introduction of new technologies.

Through a series of legal and regulatory decisions, competition entered previously regulated markets throughout the 1950s and 1960s. Competition for the provision of customer equipment was given a significant boost in 1957 with the Hush-A-Phone decision and in 1968 with the Carterfone decision.[63] The Hush-A-Phone decision permitted the attachment of equipment to the telephone receiver to shield the caller's conversation. The Carterfone issue was partly a result of the technological developments in computers; in this decision, the FCC authorized the interconnection of non-AT&T equipment to the AT&T network. The introduction of competition into the equipment markets was complete by 1980, when the FCC in its Computer Inquiry II decision fully deregulated customer premise equipment markets.[64]

Competition for transmission services also developed during this period. In 1959, the FCC Above 890 decision authorized private companies to provide their own point-to-point microwave transmission services.[65] Through a series of decisions, this authorization led to the introduction of competition in message telecommunications service (MTS) markets.

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[63]Hush-A-Phone v. AT&T et al., FCC Docket No. 9189; Decision and Order on Remand, 22 FCC 112 (1957). Carterfone (In the Matter of Use of the Carterfone Device in Message Toll Telephone Service), FCC Docket Nos. 16942, 17073; Decision and Order, 13 FCC 2d 240 (1968).

[64]Second Computer Inquiry (Amendment of Section 64.702 of the Commission's Rules and Regulations), FCC Docket No. 20828; Final Decision 77 FCC 2d 384 (1980), modified on reconsideration, 84 FCC 2d 50 (1980), modified on further reconsideration, 88 FCC 2d 512 (1981).

[65]Above 890 (Allocation of Frequencies in the Bands Above 890 Mc.), FCC Docket No. 11866; Report and Order, 27 FCC 359 (1959).

In 1974, the United States government brought another antitrust suit against AT&T, charging it with attempting to use its monopoly power to thwart competition. The result of the suit was a settlement reached in 1982, in which AT&T admitted no wrongdoing, and the result of which would be the complete restructuring of the domestic telecommunications industry. This Modified Final Judgement (a modification of the original 1956 Consent Decree) divested AT&T of its local telephone operations, while permitting AT&T into data transmission and processing services.[66] Effective January 1, 1984, the newly created seven regional Bell Operating Companies (BOCs) were prohibited from providing services beyond Local Access Transport Areas (LATAs) and from providing equipment except through a separate subsidiary.[67] AT&T provided services in the competitive long distance (interLATA) market, data processing and services markets, and equipment markets, while the BOCs provided primarily regulated monopoly services.

These changes are an indisputable fact of history. However, the nature of the resulting local exchange markets is very much at the center of controversy (see Table 2). In their comments and testimony, many stakeholders asserted that the existence of competition -- or lack of competition -- should determine the need for regulatory reforms. Others asserted that the determination of regulatory reform should hinge not just on the level of competition, but on the ability to regulate more effectively as well as to provide flexibility where competition exists.

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[66]US v. AT&T, Modification of Final Judgment, 552 F. Supp. 131 (D.D.C. 1982), aff'd mem., 103 S.Ct. 1240 (1983).

[67]The seven BOCs are Ameritech, Bell Atlantic, BellSouth, NYNEX, Pacific Telesis, Southwestern Bell, and US West.

3.2. Regulators

3.2.1. FCC

The FCC has asserted that the need for changes in the regulatory treatment of LECs is due to the presence of mixed competitive/regulated markets. According to the FCC, "experience and changed circumstances now prompt us to begin a reexamination of how we regulate the service rates charged by AT&T, Alascom and the local exchange carriers (LECs)." Adding that it adopted rate of return regulation "at a point in time when competition appeared to be confined to one segment of the interstate market," the FCC noted that the subsequent open availability of new technologies and decisions at the federal and state levels "have further eroded [AT&T and the LECs'] monopoly power." Due to these market changes, the FCC asserted that "fewer and fewer" of dominant carriers' services are subject to rate of return regulation, which may make its application to remaining services particularly ineffective.[68]

3.2.2. State regulators

Many state regulators also noted the impacts of increasing levels of competition in markets previously characterized as monopolies. Noting that "[e]ven a casual observer of the telecommunications industry is aware of the substantial changes that have occurred in recent years with regard to both technology and regulation," the Maryland PSC discussed "[c]ompetitive inroads in various areas of telecommunications [that] have been occurring at least since the 1950s." The Commission stated that the increases in the competitiveness of the industry are "substantial."[69] The Vermont PSB similarly asserted that "[t]he last decade has seen a radical transformation of our nation's telecommunications network. Technological innovations have offered new services. . . . They have also made it possible for many users --

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[68]FCC NPRM, CC Docket No. 87-313; August 4, 1987, pp. 2-4.

[69]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 38.

especially large users -- to seek alternatives to the public switched network."[70] The Washington UTC concluded that "substantial segments of the Washington telecommunications market are open to effective competition."[71] The West Virginia PSC, in a report to the state legislature, asserted that the telecommunications industry "is rapidly moving towards a competitive marketplace" and added that it "shall continue to hold hearings to determine the requisite level of regulation of the telecommunications industry in West Virginia."[72] As a result of these competitive inroads into traditionally regulated monopoly markets, the Illinois Commerce Commission concluded that

> [t]he combined processes of service diversification, rapid technological advance, decentralization of market power and increased competition have given rise to an industry with behavior and structure far different from that envisioned when rate of return regulation was initiated. The current environment . . . is the result of forces which are inconsistent with, and undesirably constrained by, the traditional regime of rate of return regulation.[73]

Despite these major changes that many regulators assert have occurred within LEC markets, many regulators also asserted the continued existence of LEC monopoly market power in certain markets. As the Washington UTC stated, "[d]espite the development of competition for some services, many markets remain effective monopolies. For example, there is no effective competition for local exchange service."[74] The Vermont Commission asserted that its primary concern "must be for the protection of basic exchange ratepayers, who still are faced with a

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[70]VT PSB Order, Docket No. 5252; July 12, 1988, p. 9.

[71]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 1.

[72]Report of WV PSC to WV Legislature, <u>Concepts in Utility Management, Rate Design and Conservation</u>; January 1987, p. 45.

[73]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 1.

[74]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 1.

monopoly supplier."[75] Other regulatory agencies, such as the New York DPS, similarly concluded that "there is currently no basis for concluding that [effective] competition exists with respect to the basic services provided by local telephone companies."[76] Some regulators, such as the District of Columbia PSC, questioned "whether true competition exists in any area of telecommunications."[77]

According to the regulators, the result of these technological changes and increasing competition in certain markets is that LECs now operate in mixed competitive/regulated markets. As the staff of the New Hampshire PUC stated, "[t]oday, local telephone companies operate in a unique environment. They are required to make some quality offerings that are still natural monopoly services, for instance, basic telephone service. . . . At the same time, these companies would like to enter into the imperfectly competitive, fast growing business service markets."[78] In a draft report to the Michigan legislature, the Michigan PSC asserted that "[t]he basic short-term dilemma of the regulator is to balance the goals of promoting competition in the telecommunications industry while assuring the maintenance of universal telephone service at a reasonable price." The PSC noted that competition changes the regulatory environment by reducing contributions toward fixed costs, while technology results in quicker depreciation rates. By offering both regulated monopoly services and competitive services, the report

[75]VT PSB Order, Docket No. 5252; July 12, 1988, p. 46.

[76]Comments of NY DPS, NTIA Docket No. 61091-6191; December 15, 1986, p. 1.

[77]Comments of DC PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 20.

[78]Comments of NH PUC staff, NTIA Docket No. 61091-6191; December 15, 1986, p. 4.

continued, LEC costs must be carefully scrutinized and separated between regulated and competitive activities.[79]

3.3. LECs

The local exchange carriers, like many regulators, noted the increasing level of competition in their markets. In fact, many LECs asserted that many of their markets no longer may be considered a monopoly or natural monopoly: competition has entered markets that should have been protected by the original social contract. According to the LECs, this competition has been made possible by rapid technological innovation and by regulatory decisions.

As Illinois Bell asserted

> in contrast to the industry for which the regulatory system was designed, today's telecommunications markets are no longer characterized by end to end natural monopoly. Technological change, driven by the electronic revolution, has fundamentally altered the economics of providing telecommunications services. . . . The time is rapidly approaching when no part of the telecommunications business will be protected from competition.[80]

Mountain Bell similarly asserted that "[t]echnological change and attendant shifts in market structure are eroding the 'natural monopoly' and 'market dominant' status attributed to various communications market segments and communications firms such as Mountain Bell." Mountain Bell later added, "It is clear that the industry that has been regulated in the past as a monopoly under rate-of-return regulation is not the telecommunications industry of today. A combination of technological change, entrepreneurial talent, and court and regulatory decisions has created an industry that differs markedly from that of just a few years

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[79]MI PSC Draft Report to the Michigan Legislature: The Status of Telecommunications Competition in Michigan; October 2, 1987, pp. 39-40.

[80]Comments of Illinois Bell, IL CC Docket 87-NOI-3; March 8, 1988, p. 4.

ago."[81] Southwestern Bell also stated that "advances in technology and production processes have mitigated the natural monopoly rationale that justified rate of return regulation of all products and services offered by telephone companies, and have encouraged open entry and competition."[82] As Rochester Telephone concluded, "the accelerating trend of technological development in the telecommunications industry has forever altered the notion that the industry constitutes a natural monopoly."[83]

LECs unanimously cited the increasing levels of competition in some of their markets. Telephone Utilities of Washington, Inter-Island Telephone Corporation, and Peninsula Telephone Corporation asserted that "[l]ocal exchange carriers are no longer the sole providers of many services. For example, mobile telephone service, pay telephones, and enhanced services such as speed calling and call waiting experience some form of competition."[84] The Chesapeake and Potomac Telephone Company of Maryland (C&P of MD) noted that "[s]ince divestiture, the number and variety of competitive entrants into aspects of the telecommunications business have been unprecedented. . . . [N]ew technologies will only cause this trend to accelerate, and C&P will face increasing competition from telecommunications providers who concentrate on specialized, profitable segments of the market."[85]

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[81]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 3, 7.

[82]Comments of Southwestern Bell, NTIA Docket No. 61091-6191; December 15, 1986; p. 4.

[83]Comments of Rochester Telephone, NTIA Docket No. 61091-6191; December 15, 1986, p. 6.

[84]Comments of TUW, IITC and PTC, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 3.

[85]Direct Testimony of J. Henry Butta, C&P - MD, MD PSC Case No. 8106; March 9, 1988, p. 2.

In its proposed regulatory reform trial, C&P of MD asserted that market forces would be sufficient to constrain prices for many services. Among these services were included intraLATA toll and WATS, coin usage and semi-public stations, Centrex, billing and collection, operator services, private line, switched and special access, and business message unit rate and service charges.[86] According to C&P, all of these services are competitive or will be during the term of the proposed trial (July 1, 1988 to June 30, 1992) or are optional, discretionary services.[87] LEC proposals and comments filed in other intrastate proceedings identified similar lists of services subject to competition.[88]

Discussing interstate services, USTA, noting that "a growing number of firms are providing facilities that are substitutable for local exchange carrier access services," asserted that "[s]pecial access services, in particular, are subject to growing competition in all major markets."[89] NYNEX similarly asserted that "[t]he classic arrangement under which telephone companies are the sole suppliers of interstate access services has, to a significant extent, been abrogated by the introduction of competition into the telecommunications marketplace."[90]

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[86] Direct Testimony of Paul Kemp, C&P - MD, MD PSC Case No. 8106; March 9, 1988, pp. 9-12.

[87] C&P Modified Comprehensive Report on Regulatory Reform; December 8, 1987, p. 15.

[88] For examples, see Position Statement of Mountain Bell, UT PSC Case No. 88-999-02, May 3, 1988, pp. 6-8; Response of Illinois Bell, IL CC Docket No. 87-0662, February 8, 1988, pp. 4-6 (Illinois Bell Incentive Regulation proposal); Comments of Contel, IL CC Docket No. 87-NOI-3, March 4, 1988, pp. 2-4 (Service Tier proposal); Petition of Southern Bell for Rate Stabilization Order and Other Relief, FL PSC Docket No. 880069-TL, January 13, 1988, pp. 5, 9-12.

[89] Reply Comments of USTA, FCC CC Docket No. 87-313; December 4, 1987, p. 16.

[90] Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 12.

In summary, as GTE stated, "[t]he existence and persistence of competition throughout the telecommunications marketplace are becoming obvious."[91]

Despite the emphasis on the rapidly emerging competition in many LEC service markets, some LECs noted that certain markets -- primarily local exchange access and usage for residence and small business customers -- remains subject to limited competition, or may be considered a monopoly. As GTE stated, "[f]or the typical single line business and residential user, the only service realistically available is standard MTS."[92] Describing its Illinois operations as "actually an aggregation of many small rural serving areas," Contel asserted that "[e]xcept for possible limited applications of CATV or cellular, there is very little competition today within . . . the local loop."[93]

However, according to the Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO), potential competitive entry for local services exists and is growing. OPASTCO cited the ability to order foreign exchange (FX) lines from neighboring companies as well as the "newer forms of local exchange bypass, such as MEGACOM and MEGACOM 800."[94] The United Telephone System companies further asserted that "[a]lthough the local exchange monopoly is not likely to be a candidate for total deregulation within the next few

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[91]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 5.

[92]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[93]Comments of Contel, IL CC Docket No. 87-NOI-3; March 4, 1988, p. 2.

[94]Comments of OPASTCO, NTIA Docket No. 61091-6191; December 15, 1986, p. 9.

years, technology will facilitate an increasingly competitive local exchange market."[95]

3.3.1. Summary

In summary, LECs asserted that they face continually increasing levels of competition for many -- if not all -- of their services. As Bell Atlantic stated, following a period of "explosive growth in competition . . . exchange companies face competition for most of their services."[96] Southern Bell asserted that "[w]ith the exception of basic local exchange service, essentially all services provided by a local exchange carrier are discretionary and/or competitive."[97] GTE added that while the mix of varying levels of competition for various LEC services currently exists, "[t]he probability is that over time there will be more competitive alternatives available to all users."[98]

The result, according to Mountain Bell, is that "the reality of today's telecommunications environment is that it is a competitive continuum. At one extreme it is highly contested. At the other extreme new technology is just now beginning to provide alternatives. Further, the entire spectrum of services is constantly moving in the direction of increasing competition." Mountain Bell concluded that "the market structure for the telecommunications industry has been radically altered.

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[95]Comments of United Telephone, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[96]Comments of Bell Atlantic, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

[97]Testimony of David B. Denton, Southern Bell, FL PSC Docket No. 871254-TL; June 3, 1988, p. 7.

[98]Comments of GTE - Northwest, WA UTC Docket No. 87-1320-SI; November 1987, p. 7.

"From the perspective of rate of return regulation, the most fundamental of these changes has been in the area of competitive entry. . . . There is no longer an ability for the regulators to meet their obligation under the original social contract."[99] Regarding the absolution of the original social contract, NYNEX asserted that "[t]he classic arrangement under which telephone companies were granted an exclusive franchise in return for a commitment to serve all customers for a governmentally limited rate of return has in large part been abrogated by the introduction of competition into the telecommunications marketplace."[100] The result may be particularly troublesome for many LECs that face tremendous amounts of competition for selected markets, such as Illinois Bell's Chicago Loop area, generating 20% of the company's revenues from an area representing less than 1% of its service territory.[101]

3.4. IXCs

In contrast to LEC concerns over increasing levels of competition, IXCs generally asserted that very little has changed in the local exchange access markets that would warrant regulatory reform. According to the IXCs, LECs maintain their monopoly position and power, leading to the potential for a host of ratepayer (IXC) abuses.

According to MCI, "basic telecommunications services offered by the LECs remain subject to natural monopoly bottleneck conditions, and LECs retain overwhelming market power for all services they provide in the

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[99]Comments of Mountain Bell, NM PSC Docket No. 87-54-TC; September 11, 1987, p. 18, 29.

[100]Comments of NYNEX, NTIA Docket No. 61091-6191; December 15, 1986, p. i.

[101]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 24.

exchange access market."[102] Western Union asserted that "[w]hile it is true that [the LECs] are subject to some competition, they are now the overwhelmingly dominant suppliers of interstate access services. The LECs have a virtual monopoly on the local loop, which is the backbone of interstate access and a true bottleneck service."[103] United States Transmission Systems considered a competitive alternative to LEC services as very remote. CompTel added that "[t]he LECs, and the BOCs in particular, indisputably continue to wield monopoly control over the local exchange bottleneck. . . . None of their services faces anything approaching meaningful competition."[104] Like other IXCs, ALC cited the conclusions of the Department of Justice (in its triennial review of the AT&T divestiture decree) that 99.9% of all IXC traffic volume and 99.9999% of all customers rely on LEC access services.[105]

The IXCs asserted that the <u>prospect</u> for local exchange service competition is also distant. According to ALC, LECs "continue to possess and exercise monopoly power and will face no meaningful competition in any of their services for the forseeable future. . . . There is no competitive threat to the LECs' monopoly provision of exchange access coming on the horizon."[106] MCI also asserted that "local exchange markets show no promise of becoming competitive in the

[102] Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 22.

[103] Comments of Western Union, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[104] Comments of CompTel, FCC CC Docket No. 87-313; October 19, 1987, p. 27.

[105] Comments of ALC, FCC CC Docket No. 87-313; October 19, 1987, p. 36. See also Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. 46; Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 18.

[106] Comments of ALC, FCC CC Docket No. 87-313; October 19, 1987, p. 36.

forseeable future."[107] As TS Communications concluded, "local services are still largely monopoly services subject to abuse."[108]

Many IXCs noted that any change in the local exchange market may focus on the joint provision of competitive and monopoly services by LECs, which may exacerbate potential monopoly abuses. IXCs expressed concern that the continued monopoly control over certain services while jointly providing competitive services could be an invitation to LECs to cross-subsidize and anticompetitively price services. ALC asserted that "[c]ost-shifting would be a highly effective tool the LECs could use to stamp out any nascent competition through discriminatory pricing."[109] AT&T and MCI both discussed the potential for a LEC to leverage the provision of its competitive services. According to AT&T, a LEC may advantage its own competitive toll services by "bundling competitive and non-competitive services at below-cost rates, or not imputing the cost of access to its own interexchange toll rates." AT&T added that

> [a] further issue involves the potential for discriminatory behavior, both in pricing of identical services to different customers . . . and in the tying of the provision of a monopoly service . . . to the purchase of a competitive service. A third issue arising from the fact of common provision is the potential for cross-subsidization of the prices of competitive services, new or traditional, with the revenues received from monopoly service offerings.[110]

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[107]Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. iii.

[108]Comments of TS Communications, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 1.

[109]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 33.

[110]Position Statement of AT&T, UT PSC Case No. 88-999-02; April 28, 1988, p. 7.

3.5. Other Industry Organizations

Like the IXCs, industry organizations asserted that the fundamental premise behind regulating the LECs has not changed: they still consider LECs to control access to bottleneck monopoly local access services. Some organizations also cited LEC diversification into competitive services, complicating LEC regulation.

According to IDCMA, LECs "continue to have substantial market power due to their control over local exchange facilities." IDCMA added that LECs' market power "is likely to persist for many years" due to their possession of exclusive local franchises, the natural monopoly conditions surrounding provision of local exchange access, their lock on small users' switched traffic, and their significant economies of scale and scope.[111] ANPA asserted that there was a "total void of information in the [FCC's price cap docket] record establishing that competition exists or is likely in the near future for local exchange service, and more specifically for the generic service that is most widely available and relied upon by practically all customers." ANPA added that "[i]t cannot legitimately be disputed that most BOC services do not presently have, or have the prospect of, truly competitive alternatives."[112] The Tele-Communications Association (TCA) also asserted that "[w]ithout a doubt, the vast majority of users of LEC services have no alternative source of supply."[113] According to TCA, "the local exchange, with its well-documented and basically insurmountable barriers to entry, does not

[111]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 9.

[112]Reply Comments of ANPA, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

[113]Reply Comments of TCA, FCC CC Docket No. 87-313; December 4, 1987, p. 20.

represent a contestable market."[114] ICA, refuting LEC claims of the availability of bypass alternatives for large users, added that its members are dependent "today and for the forseeable future" on LEC services.[115] Many organizations cited as evidence of this continued bottleneck control over local exchange access the 1987 Report on Competition in the Telephone Industry by Peter Huber and the subsequent decision of Judge Greene in the triennial review of the AT&T Consent Decree.

Many industry organizations commented on the joint provision of competitive and regulated monopoly services by LECs, and the resulting cross-subsidy and anticompetitive pricing concerns. CCTU, for example, noted that "LECs now have virtual carte blanche to invest in non-telecommunications businesses."[116] The result, according to the Utilities Telecommunications Council, is that "[t]he juxtaposition of core and non-core services offered by the same carrier may . . . create the potential for cross-subsidization between services."[117] ANPA asserted that "cross-subsidization remains a potent threat wherever companies monopolize regulated services while participating, and seeking to participate, in competitive markets."[118]

The result of cross-subsidization of LEC competitive services would be, according to IBM, to "deprive ratepayers of the price reductions

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[114]Comments of TCA, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[115]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 24.

[116]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 14.

[117]Comments of UTC, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

[118]Reply Comments of ANPA, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

that would normally result from cost reductions, and [to] give the carriers' competitive offerings an unfair advantage over competing CPE and enhanced service providers."[119] IDCMA, noting the adverse impacts potential LEC abuses could have on competition, asserted that LECs, who "have unfettered discretion as to whose CPE they will include in a systems solution package," can through the choice of serving office equipment "determine whether a specific manufacturer's CPE will be anything from extraordinarily useful to utterly useless."[120] The Enhanced Services Providers Association similarly asserted that LECs will be "both essential network suppliers and eventually direct competitors" and that their pricing of access and other services gives them "potential life and death control over the success or failure of an [enhanced services provider]."[121]

3.6. Consumer Organizations

Consumer organizations also asserted that the underlying premise of regulation -- LECs' monopoly power -- remains unchanged, while LECs have diversified into many competitive activities. As the Maryland Peoples Counsel stated, "[t]here is no prospect in the forseeable future for significant competition in the markets of LECs and therefore no justification for departing from existing forms of regulation."[122] CFA asserted that "[t]he assumption that there is, or soon will be, vigorous competition across a broad spectrum of services and geographic areas, thereby making it possible to eliminate significant amounts of

[119]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

[120]Comments of IDCMA, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[121]Comments of ESPA, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[122]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

regulation, does not comport with the realities of today's marketplace." CFA added that "there are few prospects of technological breakthroughs which will threaten the local monopoly. Local companies continue to control information about usage and billing as well as design and equipment decisions which reinforce control over the bottleneck facilities."[123]

CFA also stated that "[t]he threat of bypass . . . has never materialized" and that "[f]our years after divestiture, the local companies remain a firmly entrenched monopoly."[124] As the Citizens of Florida stated, "[l]ocal exchange companies . . . face no effective competition at all for the vast bulk of their access services."[125] Like other stakeholders asserting the continued monopoly power of LECs, consumer organizations frequently cited the 1987 Huber report and the subsequent decision of Judge Harold Greene in the triennial review of the AT&T Consent Decree, which asserted that LECs maintain substantial market power. In conclusion, in the words of the Maryland Peoples Counsel, consumer organizations asserted that "LEC competition is nil."[126]

What change may be occurring in the telecommunications industry, according to some consumer organizations, is that LECs are diversifying into competitive markets. As CFA stated, "some of the nation's most heavily capitalized corporations own monopoly local exchange telephone companies and devote considerable talent and resources to competitive

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[123]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 38, 58.

[124]Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 4, 9.

[125]Comments of Citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 16.

[126]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 20.

enterprises." According to CFA, these companies "are using excessive returns to capital to further diversification into unregulated, competitive industries."[127] CFA added that "[t]hey have also invested heavily and lost large sums in non-telecommunications businesses."[128] The result of this diversification, both in competitive telecommunications businesses and in nontelecommunications businesses, is concern over potential cross-subsidies, according to the consumer organizations. The Washington Public Counsel stated that "[w]e have substantial concerns that companies are becoming more interested in selling 'bells and whistles' than in providing quality basic service, even though the revenues from these essentially monopoly services is used to finance their new ventures."[129] The People of Cook County similarly asserted that "cross-subsidies form non-competitive to competitive services must first be eliminated" and that they are concerned "that residential customers who are satisfied with plain old telephone service are paying for the installation of the advanced technology equipment to meet [competition in certain markets]."[130] CFA concluded that LECs may neglect their basic business while using these monopoly revenues to subsidize competitive activities.

While asserting that "the telecommunications industry has . . . undergone substantial changes in the past several years," the National Association of State Utility Consumer Advocates (NASUCA) added that the effect of these changes has been to increase the price of basic

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[127]Comments of CFA, NTIA Docket No. 61091-6191; December 15, 1986, p. 1, 3.

[128]Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 5.

[129]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 4.

[130]Reply Comments of People of Cook County, IL CC Docket No. 87-NOI-3; May 4, 1988, p. 2.

telephone service for the average consumer.[131] However, NASUCA added that "[t]he telephone industry is on a declining cost curve that will continue into the forseeable future."[132] CFA agreed, stating that "[w]eak competitive forces in a declining cost industry give all major players an incentive to increase profits by propping up prices, rather than competing them down."[133]

In conclusion, consumer organizations asserted that LECs maintain monopoly control over the local exchange access market, while attempting to diversify into competitive telecommunications and nontelecommunications businesses. While this development led to increased concerns over potential cross-subsidies, the rationale for regulation remains unchanged. As NASUCA stated, "[t]he conditions that led to rate of return regulation are essentially unchanged."[134]

3.7. Summary

Overall, stakeholders held widely varying positions on the extent and nature of competition within the telecommunications industry. While LECs asserted that competition exists for many -- if not all -- of their services, consumers and competitors of LEC services strongly disagreed. According to the LECs, this competition, fueled by technological and regulatory changes, is rapidly altering the nature of the telecommunications industry and is breaking down the traditional natural monopoly rationale for regulation, as well as the ability of regulators to

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[131] Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

[132] Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[133] Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 80.

[134] Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

satisfy the original social contract under which the LEC was provided with franchise territory protection from competitors. On the other hand, IXCs, industry, and consumer organizations asserted that alternatives to LEC services are not available and will not be in the forseeable future. These organizations, frequently citing the 1987 Huber Report, noted that the use of bypass facilities is "nil" and that for the vast majority of services, there are no alternatives. What changes have occurred, according to the organizations, is that LECs have diversified into competitive activities, paving the way for potential abuses such as cross-subsidies of competitive services with monopoly service revenues and predatory pricing.

Once again, regulators are caught in the middle -- some recognize the existence of competition for certain services, while others remain a monopoly, and are uncertain of whether they can actually define markets or prevent competition from entering markets as technology makes it feasible.

Stakeholder evaluations of regulatory alternatives, including traditional rate of return regulation, will be determined by stakeholders' perceptions of the current telecommunications environment, the need for regulation and the goals of regulation given the environmental conditions, and the ability of regulatory goals to be met under each of the regulatory alternatives.

CHAPTER 4

STAKEHOLDER EVALUATIONS
OF RATE BASE/RATE OF RETURN REGULATION

Table 3

RB/ROR Regulation

		Strengths	Weaknesses
Local Exchange Carriers (LECs)	**Regional Bell Operating Companies (RBOCs)**	– Universal service has been achieved (may be due to political pressure to maintain artificially low prices) [4.3.2]	– Significant direct and indirect costs – Distorts investment decisions – Reduces innovation – Failure to provide proper incentives – May only be effective in the absence of competition – Regulatory lag reduces ability of the LECs to compete or to respond to market changes – May result in returns below competitive levels – Inefficient pricing and welfare losses – Cost allocation difficult [4.3.3]
Local Exchange Carriers (LECs)	**Large Independents**	– Universal service has been achieved through cross-subsidization [4.3.2]	– Significant direct and indirect costs – Decisions not economically justified – Inefficient pricing – Distorts investment decisions – Reduces innovation – Regulatory lag – Anachronistic in a competitive environment – Consumer welfare losses – Cost allocation difficult [4.3.3]
Local Exchange Carriers (LECs)	**Small Independents**	– Universal service has been achieved – Historical success at meeting regulatory goals [4.3.2]	– Significant direct and indirect costs – Application of ROR to LECs in competitive markets reduces efficiency and results in price increases to consumers – ROR rate process especially burdensome to small LECs – Regulatory lag [4.4.3]
Inter-Exchange Carriers (IXCs)		– Requires cost-based rates while allowing LECs a fair rate of return – Permits competition without cross-subsidy fears – Strengths outweigh weaknesses [4.4.1]	– Direct costs – Likelihood of substantial inefficiencies [4.4.2]
Other Industry[1]		– Serves as an aggregate measure of overall profitability and price levels – Historical success at meeting regulatory goals – Weaknesses may be corrected through proper enforcement and administration – Minimal direct costs [4.5.1]	– Difficult and subjective cost allocations necessary to address LEC diversification – Improper administration allows LECs to earn as close as possible to prescribed ROR – Improper incentives (cross- subsidies and rate base expansion) – Does not promote efficiency – Does not result in price stability or predictability [4.5.2]
Consumers		– Protects consumers of monopoly services – Promotes universal service – Promotes just and reasonable prices – Protects financial integrity of LEC – Effectively enforced, prevents predatory pricing and cross-subsidies, encourages competitive services – Actual record of ROR regulation is excellent – Minimal direct costs [4.6.1]	– No significant weaknesses have been proven [4.6.2]
Regulators	**Federal Communications Commission (FCC)**	– Conceptually fair to regulated company and customers – Shields ratepayers from potentially exorbitant monopoly rates – Promises company a fair rate of return [4.2.1.1]	– Significant direct and indirect costs – Elaborate and cumbersome regulatory framework – Fails to provide proper incentives to companies – Potential to create price shelters for less efficient carriers or to exclude more efficient carriers [4.2.1.2]
Regulators	**State Commissions and Commission Staff**	– Historically proven success of RB/ROR at meeting regulatory objectives – Costs are minimal, especially when weighed against benefits – Effective, cost-efficient and proven [4.2.2.2]	– Failure to provide proper incentives – Accounting difficulties • asset evaluation • cross-subsidies – Regulatory delays – Complex and costly administration [4.2.2.1]

[1] "Other Industry" represents positions of industries which may be large users of LEC services, LEC competitors, or both.

CHAPTER 4

STAKEHOLDER EVALUATIONS OF RATE BASE/RATE OF RETURN REGULATION

4.1. Overview

The perceived need for an alternative form of regulation will depend on a stakeholder's evaluation of the current form of regulation and its success in the current telecommunications environment. Frequently, this evaluation was influenced by the stakeholders' perceptions of change in the telecommunications market. Stakeholders who believe that competition is increasing in many telecommunications markets may be more critical in their review of rate of return regulation, and seek to determine whether it can adapt to the new environment or whether any regulation is necessary where a market is competitive. This may be particularly true where the stakeholder considers regulation as a surrogate for competition in a monopoly market. Conversely, stakeholders emphasizing the protection of monopoly ratepayers and considering little, if any, competition to be present in local exchange markets may support traditional rate of return regulation (see Table 3).

Traditional regulation of franchised monopoly providers of local exchange telecommunications services involves the rights and obligations of both the regulator and the regulated. The regulated firm must provide universally available, high-quality service on nondiscriminatory terms and at just and reasonable rates. Regulators agree to protect the property of the regulated firm from confiscatory rates, provide for an adequate return on investment, and protect the firm from competition within its service territories. As an integral part of this "social contract," rate base/rate of return regulation has been the regulatory method most frequently employed by regulators in their efforts to achieve these goals.

Rate of return regulation, or profit regulation, entails determining a carrier's overall operating and depreciation expenses and taxes (based on a test year period) and setting prices for individual services (based on demand forecasts) in order to recover these expenses, plus a commission-authorized rate of return on the net relevant rate base. The following simplified formula determines a carrier's revenue requirements:

Revenue Requirements = (Net Rate Base x Authorized Rate of Return) + Operating Expenses + Depreciation Expenses + Taxes

4.2. Regulators

4.2.1. FCC

4.2.1.1. Strengths

According to the FCC, rate of return regulation seems to be conceptually fair to the regulated company and its customers. The FCC stated that rate of return regulation "promises to the regulated firm the opportunity to earn sufficient revenues to cover its costs, including a fair rate of return on equity. It also promises to shield ratepayers from the exorbitant rates that a monopoly, left unregulated, could otherwise impose."[135]

4.2.1.2. Weaknesses

However, the FCC added that rate of return regulation is costly to administer and imposes many indirect costs on customers and shareowners, "even if done correctly and well." The FCC specifically noted the incentive to inflate the rate base as the only means by which a rate of return regulated LEC can increase earnings and the incentive to shift costs from competitive to monopoly services. Regarding crosssubsidies, the FCC added that "[a]s the share of the carrier's costs and revenues associated with competitive offerings grows, the potentially adverse

[135] FCC NPRM, CC Docket No. 87-313; August 4, 1987, p. 4.

impact on captive ratepayers grows concomitantly." The FCC also added that regulatory micro-management of the firms is not possible and that while cost allocation rules may limit cross-subsidy incentives, "costs" are an "elusive" concept. As for direct costs, the FCC asserted that "the framework erected to support [rate of return] regulation is elaborate and often cumbersome."[136]

4.2.2. State regulators

While some state regulators did cite weaknesses of rate of return regulation similar to those cited by the FCC, others emphasized its historical success at meeting regulatory goals and its minimal costs.

4.2.2.1. Strengths

Despite the weaknesses cited by some regulators, many regulators supported the strengths of rate of return regulation. Most frequently cited were the historical success of rate of return regulation at meeting regulatory goals of universal service, reasonable and nondiscriminatory rates, innovation and development of the most advanced telecommunications network in the world, and overall monopoly service ratepayer protection. In addition, many regulators added that all of these benefits were provided at minimal cost.

Summarizing the strengths of rate of return regulation, the District of Columbia PSC asserted that "rate of return regulation as it is currently administered is an effective, cost-efficient, and proven means of balancing the interests of telecommunications consumers against those of telephone company shareholders and creditors. Local public service commission (PSC) procedures are established, accepted, and well-understood; they are the cornerstone of utility regulation, which has enabled the United States to foster the most sophisticated telecommunications network in the world. This regulatory framework has made telephone service available to persons of even the most modest

[136] FCC NPRM, CC Docket No. 87-313; August 4, 1987, pp. 2-4.

means. Rate of return regulation has helped to ensure the financial health of companies providing essential communications services while maintaining a check on local exchange carrier monopoly power. These public interest concerns remain valid today."[137]

Other regulators noted that while rate of return regulation may provide certain incorrect incentives to LECs, it also provides a means to correct for these weaknesses. For example, the New York DPS asserted that "rate base padding can be minimized by making the hard decision to allow only clearly necessary investments. Cross-subsidization may be encouraged by cost-of-service regulation, but this regulatory regime also provides a means to control it."[138] The Iowa SUB similarly asserted that under rate of return regulation, detailed commission oversight, effective cost allocation, review of prudency and necessity, and scrutiny of the cost of capital are available to diminish incentives to gold-plate the network. The Board also asserted that rate of return regulation based on accounting costs "provides unique oversight in the form of explicit cost allocation" to prevent cross-subsidies.[139] The staff of the Colorado PUC noted that "[g]old plating in Colorado would be difficult given the intense scrutiny by the CPUC staff and intervenors to telecommunications firms and other public utilities in this state." The staff concluded that "[t]he incentive to inflate costs may be present but the opportunity is minimal."[140]

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[137]Comments of DC PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

[138]Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. 3.

[139]Comments of IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. 9.

[140]Comments of CO PUC Staff, NTIA Docket No. 61091-6191; December 15, 1986, p. 12.

Many regulators also noted that regulatory lag, described by the Colorado staff as the "bogey man of regulation," may be a problem during periods of high inflation and high interest rates. However, they added that the post-divestiture period has been a period of low inflation and low interest rates. As the New York PSC stated, while inflationary periods may result in earnings below authorized levels, "a reversal in inflationary trends and interest rates has the opposite effect." The Commission, like others, added that regulatory lag provides a strong incentive for LECs to control costs and generate additional revenues when costs are increasing.[141]

The low direct costs of rate of return regulation were cited by many regulators as a strength. The District of Columbia PSC and Office of People's Counsel noted that the cost assessed to C&P (the only LEC serving DC) accounted for less than 0.6% of its operating revenues.[142] The Colorado staff similarly noted that its assessment to Mountain Bell customers was less than $.27 per month, and that "[t]he assessment to all Colorado utilities for the PUC operation is such a small percentage of a customer's total monthly utility bills (sum of electric, gas and telephone) that it is virtually immeasurable."[143] The New York PSC, noting that its expenditure on telecommunications firms represents less than one-third of one percent of the gross revenues of the companies regulated by the PSC, added that many LEC regulatory costs would not be avoided if rate of return regulation were abolished because most regulatory personnel are also involved in other operations of the

[141]Comments of NY PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 5.

[142]Comments of DC PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 6.

[143]Comments of CO PUC Staff, NTIA Docket No. 61091-6191; December 15, 1986, p. 9.

business.[144] However, the District of Columbia PSC asserted that the rate case process, which some stakeholders noted was burdensome and expensive, is necessary in order to provide for broad public comment and reasoned and balanced decision making. The Washington UTC concluded that the costs of regulation are "de minimus" relative to other costs of service.[145]

According to many of the regulators, the minimal costs of rate of return regulation must also be measured in comparison to other realistic options. For example, the Virginia SCC noted that "the model of perfect competition is, for the most part, a theoretical concept." The Commission added that in its present form, rate of return regulation is also imperfect, but that "it is safe to say that any form of regulation imposes costs and distortions on both society and the regulated entity."[146] The Kentucky PSC similarly asserted that "any regulatory framework imposes costs that would not otherwise exist" and added that "these costs are the price that society bears to prevent monopoly abuse of market power."[147] Regarding the costs of regulation, the Washington UTC concluded that "[r]atepayers who guarantee a rate of return deserve regulatory protection and are usually willing to pay for regulatory expenses."[148] As the Colorado staff asserted, "[t]he imperfect world of

[144]Comments of NY PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 4.

[145]Comments of WA UTC, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[146]Comments of VA SCC, NTIA Docket No. 61091-6191; December 15, 1986, p. 1.

[147]Comments of KY PSC, FCC CC Docket No. 87-313; October 16, 1987, p. 3.

[148]Comments of WA UTC, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

regulation . . . should not be compared with an idealized theoretical construct."[149]

4.2.2.2. Weaknesses

In contrast to those regulators citing minimal cost as a strength of return regulation, others cited direct and indirect costs as weaknesses. The Illinois Commerce Commission cited the expenses of an adversarial process "in which commissions, staffs, companies, and intervenors expend large amounts of time and money in preparing exhibits, conducting hearings, and hiring lawyers, consultants and expert witnesses in order to determine a litany of appropriate figures and methodologies." The Commission further asserted that "ratepayers ultimately shoulder the burden of all regulatory costs."[150] The staff of the Michigan PSC similarly noted that the implementation of rate of return regulation is "administratively complex and costly."[151]

Among the indirect costs cited by state regulators were the lack of efficiency or innovation incentives. The Virginia SCC, noting that "the increasingly competitive nature of the telecommunications market has focused concern upon the problems associated with rate base/rate of return regulation," asserted that "[m]any of the problems of our traditional regulatory approach, such as not providing proper incentives, have been apparent for years."[152] According to the Michigan PSC staff, some of the distorted incentives of rate of return regulation are as follows: that it encourages inefficiency and inhibits innovation

[149]Comments of CO PUC Staff, NTIA Docket No. 61091-6191; December 15, 1986, p. 7.

[150]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 9.

[151]Comments of MI PSC staff, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[152]Comments of VA SCC, NTIA Docket No. 61091-6191; December 15, 1986, p. 15.

by shifting costs from competitive to regulated services; provides incentives to inflate the rate base; provides incentives to exploit factors within their control to increase earnings at ratepayers' expense; and does not distinguish or allow for the possibility of entrepreneurial profits, thereby inducing the LEC to keep service prices higher than they need to be.[153]

While some regulators discussed the lack of efficiency incentives under rate of return regulation, the Illinois Commerce Commission was one of very few parties to assert the existence of the Averch-Johnson network gold-plating effect. (Most other stakeholders specifically denied its existence.) According to the Commission, "in allowing a guaranteed return on investment, rate of return regulation is susceptible to the creation of a gold-plated network employing the most costly, rather than the most efficient or most appropriate, technologies."[154]

Other weaknesses of rate of return regulation discussed include the limited upside potential associated with high-risk innovative products, thereby dampening incentives to innovate, and incentives on the part of the LEC to misallocate costs to regulated services and regulators' incentives to allocate additional costs to competitive services, either harming consumers of monopoly services or creating a price umbrella for competitors.

Some regulators asserted that rate of return regulation may be counterproductive when it is applied in mixed competitive/monopoly markets. According to the Maryland PSC, in these markets, regulation may impede competition. The PSC asserted that "requiring evidence of

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[153]Comments of MI PSC Staff, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[154]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 8.

actual competition has the potential of creating a conflict because regulation itself is often a primary impediment to competition." The Commission added that regulation also retards the efforts of a regulated company to compete on equal terms with new entrants, which may leave monopoly basic service customers covering the full investments of the LEC. The Commission concluded that "[t]he problem with waiting to provide regulatory flexibility until after the competitive alternatives are widely available is that once the investments have been made by others, it may be too late for a regulated company to recapture lost business."[155] The Illinois Commerce Commission similarly asserted that "[t]he current environment, in which competitive and noncompetitive services exist side by side and are often provided by the same firm, is the result of forces which are inconsistent with, and undesirably constrained by, the traditional regime of rate of return regulation." The Commission concluded that "[r]ate of return regulation has become increasingly counterproductive to the achievement of [regulatory objectives] in the modern environment, especially when applied to dominant telecommunications carriers engaged in the provision of both competitive and noncompetitive services."[156] The staff of the California PUC added that traditional subsidy flows from high revenue competitive services to basic services are not sustainable over the long term.

Finally, some regulators noted that the emergence of competition may be considered a violation of the original regulatory bargain with LECs. Under that bargain, the monopolist LEC gave up the freedom to charge what would otherwise be monopoly rates in exchange for protection from competition. Regulators may no longer be able to control the entrance of competitors to markets when technology and consumer demand makes this

[155]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, pp. 95-96.

[156]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 1, 28.

entry feasible. As the Maryland PSC stated, "[i]n very few cases today could it be argued that regulated utilities are in the entirety of their services natural monopolies and it would be even less plausible to argue that the Commission protects the regulated utility from competition by new entrants." The Commission concluded that it "is alert to the possibility that its traditional regulatory methods are becoming outmoded" and recognized "that regulatory policies and procedures must be modified from time to time to accommodate new realities."[157]

4.2.3. Summary

Regulators fell on opposite ends of the spectrum and at points in between when evaluating rate of return regulation. On one end, the Illinois Commerce Commission asserted that "[t]he static model of regulation has been severely constrained by recent events in the telecommunications industry." The Commission added that "[m]any, if not the majority of the aspects of local telecommunications supply are affected by competitive factors." The result, according to the Commission, is that already difficult and arbitrary joint cost allocations take on additional importance and competition may not be encouraged where it is efficient. In addition, the Commission asserted, traditional subsidies of local service are antithetical to technologically-driven competition.[158] On the opposite end of the spectrum was the District of Columbia PSC, which, questioning if true competition exists in any area of telecommunications, asserted that it "views the continuation of rate of return regulation as a matter of the greatest importance."[159] The Iowa SUB noted that while it has deregulated competitive markets, where regulation is to be relied on in markets that are not competitive, rate of return regulation should be

[157]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 86.

[158]Comments of IL CC, NTIA Docket No. 61091-6191; December 15, 1986, pp. 11-14.

[159]Comments of DC PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

used. The Board asserted that it provides "the continual oversight and superior flexibility necessary to regulate in variable economic conditions."[160]

In between these extreme ends of the spectrum were many other regulators, such as the New York PSC. The New York Commission asserted that "rate of return regulation [is] absolutely essential" to regulate the provision of basic monopoly services.[161] However, the Commission added that it has taken measures to permit companies more flexibility within the traditional regulatory framework. The Washington UTC asserted that "[o]n the whole . . . traditional regulation has worked well in telecommunications," but that "[i]n a time of increased change in the industry, however, traditional regulation may no longer be in the best interest of monopoly ratepayers. Instead, ratepayers might be better served by a system of regulation which retains the best attributes of the old system while improving it to provide incentives for companies to operate efficiently."[162] The Division of Public Utilities of the Utah PSC similarly stated that "the substantive criticisms of rate base, rate of return regulation can be resolved within the existing regulatory structure."[163] According to the Kentucky PSC, the best method to balance the interests of consumers and investors is rate of return regulation, flexibly applied.[164]

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[160]Comments of IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. 6.

[161]Comments of NY PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 1.

[162]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 3.

[163]Comments of UT PSC Staff, Docket No. 88-999-02; May 2, 1988, p. 2.

[164]Comments of KY PSC, FCC CC Docket No. 87-313; October 16, 1987, p. 3.

4.3. LECs

4.3.1. Overview

According to virtually all of the LECs, the search for a better form of regulation may be overdue. LEC evaluations of rate of return regulation, while citing its historical success at meeting certain primarily social goals under conditions very different than those existing in the 1980s, cited numerous weaknesses with traditional regulatory methods in a mixed competitive/regulated environment. LECs cited many direct and indirect costs of regulation, and asserted that many of the costs are magnified where competition exists. Others questioned the existence of regulation -- whose goal is to replicate a competitive market outcome -- where competition exists.

4.3.2. Strengths

In some of the few kind words for rate of return regulation, Southern New England Telephone stated that it has "served the telecommunications industry reasonably well; universal service has been fostered and exists today, technological advances have indeed been made, regulators' responsibility of protecting ratepayers has been exercised, and prices to consumers have been controlled by regulators, balancing the needs of consumers and shareholders."[165] The National Telephone Cooperative Association, noting that rate of return regulation amounts to an existing social contract that "has been in place and working reasonably well for nearly a century" asserted that it "has been able to handle technological and other changes in the industry that often have been as dramatic as those occurring today."[166]

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[165]Comments of SNET, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[166]Comments of NTCA, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

However, the LECs most frequently applauded traditional regulation solely for the ability of the industry and regulators to achieve universal service under it. As Illinois Bell stated, under rate of return regulation, "the telephone network has developed successfully and telephone service has been extended to the overwhelming majority of Americans."[167] But as Rochester Telephone asserted, the achievement of universal telephone service "has been possible only through the uneconomic practice of cross-subsidization; a practice considered incompatible with the competitive marketplace regulation set out to emulate."[168] Ameritech added that "[t]o put it bluntly, political pressures and social forces, not the full-blown rate of return regulatory process, have kept rates for basic services well below the economically correct level," resulting in universally available and reasonably priced core services. Ameritech further noted that "with the possible exception of certain core basic services, all telecommunications services are subject to competition. As to those competitive services, regulation involves costs but offers no discernible benefits."[169]

4.3.3. Weaknesses

The introduction of competition into LEC markets, and the resulting collapse of the natural monopoly justification for regulation and the inability of regulators to protect LECs from competition, were cited by LECs as creating and magnifying weaknesses of traditional rate of return regulation. As Southwestern Bell stated, "regulation of telephone companies by the traditional rate of return method can be effective only

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[167]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 3.

[168]Comments of Rochester Telephone, NTIA Docket No. 61091-6191; December 15, 1986, p. 8.

[169]Comments of Ameritech, NTIA Docket No. 61091-6191; December 15, 1986, pp. 18-19.

in the absence of competition."[170] United Telephone added that "[t]he principal difficulties, and inefficiencies, associated with current regulation result from the coexistence of competitive entry with the continuation of traditional, public utility type regulation."[171] LECs cited both direct and indirect costs of regulation.

According to Ameritech, "[t]he direct costs of regulation include the costs incurred by carriers in dealing with their regulators, by regulators in monitoring and directing the regulated industry, and by interested parties in participating in the regulatory process." Ameritech added that the direct costs of special regulatory accounting, separations and depreciation practices are even greater where cost allocation is necessary between competitive and regulated services."[172]

Mountain Bell similarly noted that direct costs of regulation "include regulatory proceedings, special studies, jurisdictional separations activities, rate and tariff administration, regulatory audits, docket management, economic studies, capital recovery proceedings and public notice expenses." Mountain Bell added that less easily estimated are the "additional costs to society of third-party intervenors and [commission] staff in regulatory proceedings." And like Ameritech, Mountain Bell asserted that much of the reason regulatory proceedings are "so time consuming and expensive" is the concern over cross-subsidization of competitive services, "which is rooted in the continued application of rate of return regulation."[173] Like many of

[170]Comments of Southwestern Bell, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[171]Comments of United Telephone System, NTIA Docket No. 61091-6191; December 15, 1986, p. 4.

[172]Comments of Ameritech, NTIA Docket No. 61091-6191; December 15, 1986, p. 13.

[173]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, pp. 23-24.

the LECs, United Telephone noted that the expense of the growing burden of "horrendous record keeping and reporting requirements" is being borne by ratepayers.[174]

Many LECs filing comments in various proceedings provided actual costs of certain regulatory activities as evidence of the magnitude of regulatory expenses being incurred and ultimately paid for by ratepayers. For example, GTE reported that its October 1987 access tariff filing "included approximately 11,000 pages of material per copy -- and a number of copies were to be submitted."[175] For its filing, the United Telephone System Companies "filed over 6,000 pages of material for its study areas." United added that to develop new rates each year, it uses 60 computer programs and maintains over 3,000 computer files containing 3 billion bytes of information; the development of demand data required approximately 70 man months of effort.[176] Overall, BellSouth estimated its annual direct cost of regulation to be $46 million; Mountain Bell estimated its expenses in New Mexico alone to be $7.3 million annually and estimated costs of $2 million annually for third-party intervenors and commission staff; and Pacific Bell estimated its direct expenditures for state-related regulatory affairs at $14.3 million in 1985.[177]

Many smaller LECs emphasized the extraordinary burden direct regulatory costs place on them and their customers. As USTA observed,

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[174]Comments of United Telephone System, FCC CC Docket No. 87-313; October 19, 1987, p. ii.

[175]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[176]Comments of United Telephone System, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[177]Comments of BellSouth, NTIA Docket No. 61091-6191, December 15, 1986, p. 8; Comments of Mountain Bell, NM SCC Docket No. 87-54-TC, September 11, 1987, p. 24; Comments of Pacific Telesis, NTIA Docket No. 61091-6191, December 15, 1986, p. 6.

"regulatory costs make up a proportionately higher percentage of overhead expense for smaller carriers."[178] The Taconic Telephone Corporation et al. cited as examples of the costs associated with rate of return regulation a 1986 company-specific tariff prepared by the Elkhart Telephone Company, which cost over $30,000, or approximately $22 per access line, and Telephone Electronics Corporations' 1985 interstate access tariff costs of $170,000, or $23 per access line.[179] The National Telephone Cooperative Association asserted that "[s]mall [exchange carriers] simply do not have the staff size or revenue streams necessary to support extensive regulatory burdens and the associated administrative costs."[180] In fact, the Taconic Telephone Corporation et al. asserted that costs associated with local rate case filing requirements "often result in the costs of the rate case exceeding the actual award."[181] OPASTCO concluded that "[t]he most important aspect of these and related costs is that they are necessarily passed on to customers in the form of higher rates. For small companies, this is particularly onerous because of the small customer base."[182]

As an overall estimate of the direct costs of rate of return regulation, many LECs cited the July 1987 National Telecommunications and Information Administration (NTIA) Regulatory Alternatives Report. According to NTIA, "[t]he total direct costs of inter- and intrastate regulation probably range from at least $8 to $10 per access line per

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[178]Comments of USTA, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[179]Comments of Taconic Telephone Corp. et al., FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[180]Comments of NTCA, NTIA Docket No. 61091-6191; December 15, 1986, p. 5.

[181]Comments of Taconic Telephone Corp. et al., NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

[182]Comments of OPASTCO, NTIA Docket No. 61091-6191; December 15, 1986, p. 6.

year. These average figures, moreover, do not reflect the disproportionate burden that regulation imposes on smaller telephone companies. As USTA indicated, the regulatory costs for those companies are as much as $45 per access line per year since requirements tend to be the same, regardless of the subscriber base across which costs can be spread."[183] NTIA noted that these cost estimates may be understated because they do not include third-party regulatory expenditures, or may be overstated because certain expenses may be incurred even if rate of return regulation were eliminated and because some regulatory expenses may be incurred with any regulatory scheme. However, NTIA estimated total direct costs of rate of return regulation at $1.1 billion annually.[184]

Many LECs also sharply criticized the indirect costs of rate of return regulation. Among the major weaknesses cited were regulatory lag and the slow pace of rate of return regulation, reduced efficiency and innovation incentives, and prices unrelated to true economic costs. Many of these weaknesses, according to the LECs, are exacerbated in the presence of competition.

LECs asserted that regulatory lag and the inability to respond to market demands, as Contel stated, "result in depressed earnings and increased financial risk."[185] NYNEX noted that the maximum state regulatory lag (time lapse between filing for a rate change and granting of the change) within its region ranges from 210 to 330 days, or 7 to 13 months. According to NYNEX, these delays can decrease profits and cause

[183] <u>NTIA Regulatory Alternatives Report</u>, US Department of Commerce; July 1987, p. 23. (Citing Comments of USTA, NTIA Docket No. 61091-6191; December 15, 1986, p. 8.)

[184] <u>NTIA Regulatory Alternatives Report</u>, US Department of Commerce; July 1987, p. 23.

[185] Comments of Contel, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

the realized rate of return to fall below the allowed rate of return, decreasing incentives to invest and making it more difficult for the LEC to attract capital.[186] The Taconic Telephone Corporation et al. asserted that the regulatory lag problem is "particularly severe" for small LECs; according to Taconic, "[i]t is not unusual for a small carrier to refrain from implementing a much-needed rate change because the costs and delays associated with filing and implementing the new rate more than offset the potential benefits of the change."[187]

The LECs argued that the problem of regulatory lag is worsened when competition exists in some LEC markets. As Contel stated, "[a]lthough regulatory lag has traditionally been considered a problem for utilities operating in monopoly markets, it is especially troublesome in the face of competition."[188] Bell Atlantic added that in the natural monopoly environment, "there were no thorny questions about the allocation of costs between competitive and non-competitive services, and regulators could afford to proceed at the deliberate pace mandated by rate of return regulation. That is not true today." Bell Atlantic asserted that rate of return regulation, applied to mixed competitive and non-competitive markets, has "led to a seemingly endless series of administrative and judicial proceedings which have attempted to harmonize rate of return regulation with competition, and a tangled web of administrative rules which have chilled innovation and delayed the delivery of new services to the consuming public."[189] Rochester Telephone concluded that "[t]he traditional regulatory process is ill-

[186]Comments of NYNEX, NTIA Docket No. 61091-6191; December 15, 1986, p. 5.

[187]Comments of Taconic Telephone Corp. et al., NTIA Docket No. 61091-6191; December 15, 1986, p. 10.

[188]Comments of Contel, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

[189]Comments of Bell Atlantic, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

suited for the pace at which competitive markets evolve. Unlike the bygone monopoly era, today's telecommunications markets do not remain frozen while the administrative process drags on."[190]

A key factor in the "cumbersome burden" of regulatory proceedings, according to many LECs, are the attempts regulators make to identify and separate costs associated with competitive activities. As Centel asserted, "cost allocations are a critical but terribly cumbersome, expensive and often uneconomic component of rate of return regulation."[191] NYNEX added that cost allocation "is a source of continuing debate in the regulatory arena."[192] LECs asserted that many allocations determined following an examination and review of detailed cost data are subjective. According to United Telephone, "[i]mplicit in the current cost of service regulation structure is the incentive for regulators to require increasingly detailed information from carriers in an effort to define costs ever more discretely, using techniques that are admittedly arbitrary."[193] As Illinois Bell concluded, "[w]hen a utility provides both regulated and non-regulated services using shared investments, the rate of return process requires the assignment of a portion of the non-identifiable fixed cost of in-place investments to the rate base of regulated services. By definition, this assignment would be arbitrary, rendering rate of return regulation unworkable for a utility providing regulated and non-regulated services."[194] Mountain

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[190]Comments of Rochester Telephone, NTIA Docket No. 61091-6191; December 15, 1986, p. 16.

[191]Comments of Centel, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 5.

[192]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[193]Comments of United Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[194]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 18.

Bell concluded that "[a]ny exhaustive allocation of common and joint costs to separate products, services or markets is an expensive, time-consuming, and many argue, futile process."[195]

Potential competitors may also use the regulatory process to delay the introduction of LEC services or to burden it with additional costs, according to the LECs. As Pacific Northwest Bell stated, under rate of return regulation, "any special interest party can allege that its rights to due process have been infringed unless there is a full contested hearing on a particular issue. In a competitive environment, delay and the regulatory process work to the advantage of the [LECs'] competitors."[196] Alfred Kahn and William Shew, writing for BellSouth, asserted that competitors are eager to persuade regulators to hold the price of LECs' competitive offerings high in order for them to be more easily able to compete, and commissions and consumer groups similarly are eager to maintain high prices for competitive services in order to continue the subsidization of residential consumer services.[197] Rochester Telephone noted that the result is that the rewards of rate of return regulation "tend to flow to competitors who are most adept at playing the regulatory game, rather than those who are most efficient in the marketplace."[198]

Regulatory lag, the exposure of LEC marketing and cost data, and the potential to "load" costs on to competitive products, according to the LECs, will result in reduced incentives and ability to offer new and

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[195]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 20.

[196]Comments of Pacific Northwest Bell, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 21.

[197]Alfred E. Kahn and William B. Shew, Appendix to Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[198]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

innovative services or to respond to customer demands. Pacific Telesis asserted that regulatory-imposed delay due to "cumbersome regulatory requirements and review processes" slows the delivery of new products and services to the marketplace and that "[p]otential competitors can gain timing advantages by abusing and prolonging regulatory comment proceedings."[199] Southwestern Bell similarly asserted that "[e]xisting regulatory processes, with attendant regulatory lag, can retard or eliminate the development of new, innovative services." According to Southwestern, "[p]otential competitors of regulated telephone services take advantage of extended regulatory review as a means of delaying the [LECs'] implementation of a new service, or of attempting to restructure the service to be less attractive to customers, or to preclude approval of the service offering by the regulator." Southwestern added that "[t]he need in a regulatory hearing environment to perform detailed cost and demand analyses and the requirement to reveal those analyses to potential competitors reduce the incentive of a regulated firm to innovate. . . . The fact that any new service actually developed and introduced will remain under continuing regulatory scrutiny and challenged by competitors further retards incentives to introduce new services."[200] As Centel concluded, "[r]ate or return regulation slows the implementation of technological innovation by (1) creating incentives against cost cutting and new offerings, (2) requiring carriers to justify new investments and risk disallowance or unrealistic depreciation practices, and (3) delaying new service offerings. Current regulation works to deprive consumers of the benefits of new technologies."[201] LECs also noted that the additional expense associated with seeking regulatory approval of a new product or service

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[199]Comments of Pacific Telesis, NTIA Docket No. 61091-6191; December 15, 1986, p. 10.

[200]Comments of Southwestern Bell, NTIA Docket No. 61091-6191; December 15, 1986, pp. 14-15.

[201]Comments of Centel, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 17.

may further reduce LEC incentives to introduce them except where potential profits may justify the necessary time and expense.

Under rate of return regulation, the potential shareowner rewards of any new service offering are limited, further reducing incentives to innovate, according to the LECs. NYNEX asserted that where the allowed rate of return is the average return over all goods and services, it may not be sufficient to induce investors to take the risk to invest in new services with potentially high rewards. As a result, according to NYNEX, "[t]runcating the distribution of expected returns can have the effect of discouraging [research and development] expenditures."[202] As Ameritech added, "constraining a firm to a fixed-profit margin no greater than its financial cost of capital discourages the risk-taking that accompanies innovative behavior."[203] GTE further added that in the case of new software-based services, which do not result in rate base growth, rate of return regulation utilizes additional earnings to reduce rates, removing LECs' profit incentives for innovation.[204]

LECs also cited the lack of efficiency incentives under rate of return ("cost-plus") regulation. According to Pacific Northwest Bell, "[a]s long as rate of return regulation, in any form, remains the mechanism by which providers of monopoly services are regulated, inappropriate incentives and inefficient costs will continue to exist."[205] Centel asserted that "[r]ate of return regulation by its nature does not provide the highest incentive for improving efficiency,

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[202]Comments of NYNEX, NTIA Docket No. 61091-6191; December 15, 1986, p. A-26.

[203]Comments of Ameritech, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

[204]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 27.

[205]Comments of Pacific Northwest Bell, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 16.

upgrading service quality, and introducing new services."[206] Rochester Telephone even stated that "[r]ate of return regulation . . . creates a disincentive to cut expenses, because lower expenses lead to higher profits, which ultimately lead to lower rates and even to refunds if the profits sufficiently exceed the prescribed rate of return."[207]

Uneconomic pricing may also lead to distorted investment decisions, according to the LECs. Uneconomic pricing may occur due to the prescription of inappropriate extended depreciation lives by regulators seeking to keep short-term costs down, due to cross-subsidies of targeted services such as residential and single-line business, or due to the arbitrary nature of cost allocations.

Typical of concerns over depreciation rates, Mountain Bell noted that in the monopoly pre-divestiture period, capital recovery periods were long "because under rate of return regulation, if expenses are held down, particularly depreciation expense, rates can be held down. There was little incentive to match the regulatory depreciation schedule with the economic life of telephone plant." Mountain Bell asserted that in the current environment of rapidly changing technology and competition, depreciation rates should be much faster. As evidence of its depreciation concerns, Mountain Bell compared the US West depreciation reserve of 25% to 55.3% for Xerox, 48.3% for General Electric, 42.9% for IBM, and 42.8% for AT&T.[208]

USTA similarly asserted that in a competitive environment, "companies can no longer afford the luxury of lengthy amortization periods,

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[206]Comments of Centel, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 2.

[207]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[208]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, pp. 27-28.

particularly in classes of equipment subject to rapid technological evolution."[209] Noting that depreciation expense is an allowable cost used in regulatory rate-setting, NYNEX asserted that "if measures of depreciation other than real economic depreciation are used . . . then the wrong signals are sent and resources are used inefficiently."[210] Rochester Telephone concluded that the response of regulation to the technological revolution has been to suppress it. As Rochester stated, "[r]egulators, seeking to foster universal telephone service, sought to hold prices for telephone services down through a variety of practices, including artificially low depreciation rates. Such a depreciation policy discouraged the replacement of older technologies."[211]

Many LECs emphasized the uneconomic subsidization of one class of services (residential and single line business) by all other services. According to United Telephone, "[c]onsumer welfare suffers to the extent that the current regulatory environment contains pricing inefficiencies due to the cross-subsidization of regulated services. . . . These arbitrary rate relationships send false economic signals to potential market entrants, and if competitors move into a market based on these false economic signals, society's resources will be wasted through potentially duplicative facilities."

Adding that innovation is driven by competition, United stated that "[t]o the extent that regulatory constraints stifle competition, new services will not be available to the customer."[212] Mountain Bell noted

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[209]Comments of USTA, NTIA Docket No. 61091-6191; December 15, 1986, p. 9.

[210]Comments of NYNEX, NTIA Docket No. 61091-6191; December 15, 1986, p. A-10.

[211]Comments of Rochester Telephone, NTIA Docket No. 61091-6191; December 15, 1986, p. 11.

[212]Comments of United Telephone System, NTIA Docket No. 61019-6191; December 15, 1986, pp. 4-5.

that either LECs may be driven from markets where competitors are able to undercut prices based on arbitrarily assigned costs, or LECs' prices may serve as inefficient price umbrellas.[213] Ameritech, noting that rate of return regulation distorts the competitive outcome objective by introducing "systemic incentives for inefficient allocation of resources," stated that the requirement that LECs provide service to all customers on a nondiscriminatory basis "means that some subscribers receive their service for a small fraction of the cost of providing their service, while others must make up the difference."[214] Illinois Bell added that current telecommunications continue to reflect historic subsidies through the underpricing of basic residential services regardless of the individual consumer's ability to pay.[215]

LECs asserted that the continued use of rate of return regulation in a competitive environment will handicap them in their ability to compete with unregulated firms and in meeting the needs of the market. In fact, many LECs noted that in these circumstances, continued use of rate of return regulation will not only harm consumers, but may even jeopardize the achievement of regulatory goals such as universal service. LECs frequently noted that rate of return regulation severely restricts their ability to compete. As Illinois Bell stated, "[t]he regulated firm is particularly vulnerable to the detriments of regulatory lag when it is exposed to competition. Effective competition requires quick response to the demands of the marketplace."

Illinois Bell added that regulation also adds direct costs to a LECs' competitive services and places them "at a disadvantage in that the

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[213]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 22.

[214]Comments of Ameritech, NTIA Docket No. 61091-6191; December 15, 1986, p. 10.

[215]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 5.

services are subject to regulatory scrutiny while its competitors and their services are not."[216] Rochester Telephone similarly asserted that rate of return regulation "impedes competition by denying dominant carriers the ability to respond to market forces competitively. . . . The situation may be exacerbated when competitors, who may have a vested interest in delay, choose to participate in the regulatory process."[217]

The result of the inability of LECs to compete with their unregulated competitors, as Centel asserted, is that "continued use of rate of return regulation threatens the goal of universal service as well as the goal of financial stability of existing carriers." Centel noted that "[c]ost allocations coupled with the historical residual rate-making process create the potential for a regulated carrier to lose traffic, resulting in higher costs that must be borne by basic residential subscribers and threatening the financial viability of existing carriers." Centel added that rate of return regulation impedes the carriers' ability to respond to competition -- which Centel asserts is already significant and is growing.[218] USTA similarly asserted that "[t]raditional and inflexible rate of return regulation delays the LECs' ability to respond to customer needs. Non-market-related pricing will eventually limit the responses that exchange carriers can offer and may ultimately threaten the viability of the local network."[219] Telephone and Data Systems specifically addressed bypass of the local network, stating that "competition for large users aimed at diverting them from using a local exchange carrier which already has the necessary

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[216]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 12, 19.

[217]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[218]Comments of Centel, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 12, 17.

[219]Comments of USTA, NTIA Docket No. 61091-6191; December 15, 1986, p. 5.

facilities and services in place" will result in the remaining local subscribers and society paying the cost.[220]

4.3.4. Summary

The overall conclusion of many LECs was that rate of return regulation simply cannot adapt to an increasingly competitive telecommunications market. In fact, as GTE asserted, many LECs argued that "[o]nce competitors begin to enter the market, the lengthy oversight process established to balance needs of customers and stockholders will cause harm to both."[221] NYNEX asserted that "[t]raditional regulation, applied to today's modern, technology intensive and increasingly competitive telecommunications marketplace, has proven inconsistent with the public interest goals of regulation." NYNEX added that the telecommunications market has changed since the inception of rate of return regulation, and is no longer a monopoly, "yet we continue to rely on an outmoded regulatory structure more suited to the previously static and predictable telecommunications environment." NYNEX concluded that continued use of rate of return regulation will deprive customers of the benefits of a fully competitive environment.[222]

Pacific Northwest Bell stated that "traditional monopoly oriented rate of return regulation . . . is not compatible with the current competitive environment. Not only does it increase the costs of service to ratepayers, but it is not able to adapt to the changes the industry is undergoing in this dynamic new era."[223] Pacific Bell similarly noted

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[220]Comments of Telephone and Data Systems, NTIA Docket No. 61091-6191; December 15, 1986, p. 8.

[221]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 4.

[222]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 8, 13.

[223]Comments of Pacific Northwest Bell, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 1.

that "[t]he current regulatory framework, developed for more stable times when LECs were the sole providers of telecommunications service, is now cumbersome and inefficient; it inhibits LECs from competing effectively, and threatens their ability to continue to fulfill the Commission's longstanding goals."[224] Contel asserted that "[e]ven under the best of circumstances, rate of return regulation requires that substantial resources be devoted to a regulatory process that dampens the economic incentives of the carrier to operate in a way which, over the long run, will benefit both the carriers' ratepayers and shareholders. Moreover, the costs of such regulation are magnified in an industry environment that has become increasingly competitive in the last decade."[225]

Finally, Mountain Bell concluded that "[a] governmental regulatory process is simply not able to provide the incentives required to meet the diverse needs of markets and services which are generated in a competitive environment. It is a process designed for and predicated upon the concept of a monopoly." Mountain Bell further stated that "rate of return regulation is not designed to deal with an industry that has both competitive and residual monopoly aspects to the services it provides."[226]

As USTA concluded, "[t]he current telecommunications marketplace appears to be outgrowing the traditional comprehensive rate of return regulatory framework."[227] BellSouth asserted that "technological

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[224]Comments of Pacific Bell, CA PUC En Banc Hearing on Regulatory Alternatives; September 11, 1987, p. 1.

[225]Comments of Contel, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[226]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 25, 58.

[227]Comments of USTA, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

changes and market forces are clearly eroding the assumptions that have traditionally justified the existence of rate of return regulation."[228] LEC positions emphasized the introduction of competition, due to both technological and regulatory changes, into previously monopoly markets. According to the LECs, the result is a violation of the original social contract, under which the regulator provided the carrier with franchise protection, and the need for flexibility to respond to competition, which may not be possible under rate of return regulation. In markets where competition exists, the question may even be asked whether regulation -- the goal of which is to simulate the competitive market outcome -- is necessary. According to Rochester Telephone, rate of return regulation "is fundamentally flawed and should be eliminated entirely."[229] United Telephone asserted that rate of return regulation is counterproductive, and Centel asserted that "[t]he difficulties and concerns associated with rate of return regulation are so severe that attempts to patch it should not be made."[230]

In its comments before the Illinois Commerce Commission, Illinois Bell provided statements that summarize many concerns LECs have with the weaknesses of rate of return regulation. According to Illinois Bell

> [t]he time is rapidly approaching when no part of the telecommunications business will be protected from competition. Thus, the evolution of the modern telecommunications era has taken the industry to the point where rate of return regulation is no longer workable. Regulation is not required as a substitute for ruinous competition for many services because competition is now efficient and effective.

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[228]Comments of BellSouth, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

[229]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. i.

[230]Comments of United Telephone, FCC CC Docket No. 87-313, October 19, 1987, p. 9; Comments of Centel, IL CC Docket No. 87-NOI-3, March 8, 1988, p. 16.

Illinois Bell added that "[i]n a noncompetitive environment, mere refinement of traditional regulation might have been sufficient. However, since this environment no longer exits, more than refinement is required." Illinois Bell concluded that "rate of return regulation is not an effective method of addressing the future to assure consumers the benefits of competition."[231]

4.4. IXCs

While arguing that rate of return regulation is not appropriate in competitive markets, IXCs asserted that LECs continue to provide monopoly services. Though rate of return regulation, as administered, may have some weaknesses, many IXCs noted that given the continued nature of the market, its benefits outweigh its weaknesses.

4.4.1. Strengths

As MCI asserted, while recognizing certain problems with rate of return regulation, "in monopoly markets, such criticism pales in comparison to the countervailing economic benefits that rate of return regulation guarantees."[232] For example, in Utah MCI asserted that "Utah's approach [rate of return regulation] may not be perfect in that government oversight of the industry is not one hundred percent effective. Yet Utah's consumers appear thus far at least to have been protected from monopoly pricing. New services are being offered and the industry is increasingly responsive to consumer demands."[233] TS Communications added that rate of return regulation "allows some of the cost of universal service to be spread among the entire rate paying public, thereby increasing universal service; it allows for innovation

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[231]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 4, 22.

[232]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 6.

[233]Position Statement of MCI, UT PSC Docket No. 88-999-02; April 13, 1988, p. 1.

and modernization to be included within the rate base; it can be used to assure just, reasonable, and affordable rates; and it almost insures a reliable and highly maintained network."[234] Tel America concluded that "[t]he current mode of regulation has not been demonstrated to be inadequate in any material respect."

Tel America noted that a full examination of the issues would support the conclusion "the present mode of regulation is the best mechanism currently available to insure the consumers of the state that they will have available to them the best possible telecommunications services at just and reasonable rates."[235] CompTel similarly asserted that rate of return regulation provides regulators with "objective criteria to judge whether the rates of the LECs are reasonable." CompTel added that rate of return regulation "has generally precluded the LECs from engaging in discriminatory practices; provided the LECs the incentive to maintain high service standards; and has allowed the LECs to achieve substantial profitability."[236]

While citing the many benefits of rate of return regulation, some IXCs supported reforms within the traditional regulatory framework to enable it to deal effectively with the mixed competitive/monopoly market structure. MCI urged efforts to improve the regulation of monopoly services. According to MCI, "existing revenue requirements are likely based upon a misallocation, to monopoly ratepayers, of costs incurred in developing capabilities to enter competitive markets. Rate of return regulation appears to remain the most effective method, therefore, for regulating LEC monopoly services." Noting that rate of return

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[234]Comments of TS Communications, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 2.

[235]Position Statement of Tel America, UT PSC Docket No. 88-999-02; April 29, 1988, p. 3.

[236]Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 29.

regulation has "effectively promoted the development of universal service while holding in check the monopoly power afforded by ubiquitous local service," MCI added that "there is substantial benefit to the public to be gained by refining certain aspects of the manner in which rate-based regulation is presently applied to the LECs." MCI concluded that tariffed rates must be forced to correspond more closely to costs through a thorough examination of LEC revenue requirements, asserting that "rate of return regulation is an appropriate tool for restraining abuse of LEC market power." MCI encouraged the search for "ways in which the application of [rate of return] regulation will yield a closer approximation of effective competition and the public benefit inherent therein."[237] MCI also suggested that given their monopoly control of the local access bottleneck, their control over the pace and scope of competition within the local exchange market, "and given the demonstrated misuse by the LECs of their market power, more intense regulatory scrutiny of their activities is required."[238]

Some other IXCs also supported maintaining and improving rate of return regulation. ALC asserted that "[r]ather than abandoning cost of service regulation for the LECs, the [FCC] should continue to concentrate its efforts on improving its ability to subject those carriers to more effective cost of service regulation."[239] National Telecommunications Network (NTN) concluded that a review of existing LEC pricing practices is necessary and urged the FCC to "devote substantial attention over the next several years to restraining the LECs from abusing their access bottleneck." NTN asserted that any inquiry into an alternative to rate of return regulation of LECs "at this time is

[237]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, pp. 2-10.

[238]Comments of MCI, FCC CC Docket No. 87-313; October 19, 1987, p. 20.

[239]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

entirely premature."[240] According to NTN, the rate of return regulatory framework is necessary for regulators to have the opportunity "to evaluate the reasonableness of any access discrimination, and reject LEC access rate structures that are anticompetitive."[241] CompTel similarly noted that "[t]he absence of competition demands effective Commission controls to ensure that LECs charge reasonable and non-discriminatory rates and provide uniformly high quality service." CompTel added that "[i]n the absence of meaningful cost justification, the LECs could charge unreasonably low, preferential rates for targeted 'new' services, cross-subsidized by rates kept at unreasonably high levels for other services."[242]

4.4.2. Weaknesses

Despite support of a vigorous application of rate of return to monopoly services, IXCs cited weaknesses of rate of return regulation very similar to those cited by LECs when it is applied to competitive markets. As MCI stated, "[t]he character of rate of return regulation makes it inherently inappropriate for application to a competitive services market; competitive market conditions are, in fact, what rate of return regulation seeks to approximate." MCI added that competition can provide significant benefits over rate of return regulation: "[s]pecifically, incentives to overinvest in capital, inflate costs, and cross-subsidize among services will be replaced by the competitive spur to make available better technology, equitable cost-based pricing and more efficient use of the network."[243] US Sprint asserted that "[w]here service is fully competitive, there is no reason to regulate further and

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[240]Comments of NTN, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

[241]Reply Comments of NTN, FCC CC Docket No. 87-313; December 4, 1988, p. 20.

[242]Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 21, 25.

[243]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 8.

such regulation can only create inefficiency and cost by interfering with free competition."[244] AT&T, discussing the interexchange market, which AT&T asserted is competitive, stated that "[b]y its very design, rate of return regulation prevents the competitive interexchange market from functioning as competitively and efficiently as it could."[245]

Despite their assertion that LECs continue to be monopoly providers of local exchange access services, IXCs also noted the high administrative costs of rate of return regulation of LECs, and the potential for rate base inflation and the lack of efficiency incentives. According to AT&T, the shortcomings of rate of return regulation include "the complexity and expense of prosecuting cost of service regulation, the incentives for uneconomic investments, and the lack of incentives for efficiency and productivity."[246] AT&T concluded that rate of return regulation "is complicated, cumbersome, and expensive for the Commission, the regulated utility, and its customers."[247] MCI added that where competitive and monopoly services are jointly provided, "the firm subject to [rate of return] constraints has incentives to deviate from the competitive ideal by engaging in cross-subsidy or over-capitalization in order to expand its rate base, and consequently its profits."[248]

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[244]Comments of US Sprint, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[245]Comments of AT&T, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[246]Comments of AT&T, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 4.

[247]Comments of AT&T, CA PUC En Banc Hearing on Alternatives to Cost of Service Regulation for LECs; September 11, 1987, p. 11.

[248]Comments of MCI, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

4.5. Other Industry Organizations

Many other industry organizations opposed the implementation of any alternatives to rate of return regulation of LECs. Rather, like some IXCs, they supported a commitment to more effective administration of rate of return regulation in order to correct existing weaknesses.

4.5.1. Strengths

Among the strengths of rate of return cited by industry organizations was its historic success at meeting the goals of high-quality, affordable service. As TRACER stated, "[w]hile a reexamination of traditional rate of return regulation is desirable and should be undertaken, TRACER believes firmly that the existing regulatory structure . . . has performed exceptionally well in achieving the policy objectives of providing high quality, affordable telecommunications services to the people and businesses of this state, protecting monopoly ratepayers from subsidizing the competitive ventures of regulated companies, and promoting diversity in the supply of telecommunications goods and services."[249]

The Ad Hoc Telecommunications Users Committee added that "traditional, rate of return regulation has been maligned far too much by its detractors. While not without its practical problems and drawbacks, traditional regulation has also produced a great deal of positive good for telecommunications consumers in maintaining rates at just and reasonable levels."[250] ADAPSO similarly asserted that "[a]lthough not without its problems, a properly enforced system of rate of return regulation ensures that consumers benefit from just, reasonable and nondiscriminatory rates, and that the carriers earn a

[249]Comments of TRACER, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

[250]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

fair return on their equity."[251] ADAPSO concluded that "[i]n its existing form, rate of return regulation theoretically offers the best of both worlds: the maintenance of reasonable rates for the user community while fostering the goal of universal service and guaranteeing investors a reasonable return on their investment." ADAPSO added that rate of return regulation "has a proven track record of achieving these two important goals of common carrier regulation."[252]

Other strengths of rate of return regulation cited by industry organizations included the prevention of supracompetitive returns, its provisions for public input into the regulatory process, and its low direct costs (cited by Lee Selwyn, in his report for ICA and the Ad Hoc Telecommunications Users Committee, as "something less than 0.9% of all customer telephone rate payments in the United States" based on the NTIA estimate of the costs of regulation as $1.1 billion[253]). As the Department of Defense concluded, "[r]ate of return regulation has proven viable for regulation of firms with monopoly powers since the early 1900s and it remains a reasonable format for regulation where regulation is needed."[254]

Despite criticisms of rate of return regulation, some organizations staunchly defended it. As the Committee of Corporate Telecommunications Users (CCTU) asserted, "[r]ate of return regulation appears to be the new 'whipping' boy in the industry. The CCTU agrees that rate of return regulation has not, and does not, solve all problems. However, it has

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[251]Comments of ADAPSO, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[252]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 2.

[253]Implementing Price Caps for AT&T or Other Dominant Carriers, by W. Page Montgomery and Lee L. Selwyn, attached to Comments of ICA and the Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

[254]Comments of DoD, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 2.

provided ratepayers with certain identifiable benefits, such as affordable universal service, diversity in the services offered and competition among independent service providers."[255] Noting the goals of regulation as "protecting and promoting consumer welfare as well as protecting the public interest in an efficient and reasonably priced telecommunications system and preserving and promoting competition in the telecommunications market," IDCMA asserted that "[a]lthough there may be problems with the present regulatory framework, it has not been shown that cost of service regulation has failed."[256]

4.5.2. Weaknesses

Among those weaknesses of rate of return regulation cited by industry organizations were the lack of cost control or innovation incentives, its complex and subjective allocations, and the difficulties and weaknesses associated with attempts to allocate costs among jointly provided competitive and monopoly services. The result of these weaknesses, according to the Computer and Communications Industry Association, is that rate of return regulation "unreasonably skews business decisions and is an active disincentive to increased productivity and lowered costs to the user."[257]

According to IBM, "experience has shown that cost of service regulation encourages carriers to inflate their investments, while giving them little incentive to control their expenses."[258] ADAPSO elaborated on this weakness. According to ADAPSO, "there is the

[255]Reply Comments of CCTU, FCC CC Docket No. 87-313; December 4, 1987, p. 15.

[256]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 2.

[257]Comments of CCIA, FCC CC Docket No. 87-313; October 20, 1987, p. 5.

[258]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

inherent problem associated with the fact that a primary means of increasing profits is for a carrier to expand its rate base." ADAPSO added that the problem is that "both the Commission and the user community have traditionally found it extremely difficult to distinguish between needed improvements and unwanted and unnecessary features."[259] The Computer and Communications Industry Association added that "[n]ot only are carriers not rewarded for becoming more efficient, they are actually apt to be penalized for such efforts. In fact, under the rate of return approach, carriers have a significant incentive to inflate costs and swell the capital rate base because they receive a return based on their level of expenditures."[260] Texas Power & Light noted that rate of return regulation "can introduce a 'cost plus' mentality in the regulated firms themselves."[261] The Department of Defense (DoD) further asserted that these incentives to inflate rate bases may be most prevalent if costs are declining or earnings are approaching authorized levels. According to the DoD, "[i]f costs are declining and the company is confronted with the prospect of rate reductions if its rate of return exceeds a specified level, it has an incentive to inflate costs and thereby drive down that rate of return."[262]

ADAPSO asserted that the "delay associated with the implementation of new services" under the current regulatory system is "a burden to both the carriers and the consuming public."[263] The Computer and Communications Industry Association added that the delay of the

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[259]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 4.

[260]Comments of CCIA, FCC CC Docket No. 87-313; October 20, 1987, p. 6.

[261]Comments of TP&L, NTIA Docket No. 61091-6191; December 15, 1986, p. 5.

[262]Comments of DoD, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 6.

[263]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 4.

regulatory process "unnecessarily delays the introduction of new, competitively priced services."[264] According to Texas Power & Light, this "sluggishness and lack of innovativeness can be in part traced to being subject to too many years of stifling rate regulation."[265]

As the DoD noted, the analysis of tremendous amounts of complex information under rate of return regulation "places a tremendous burden on regulators, utilities and intervenors and often introduces very subjective judgments into the process." The DoD added that "[t]he application of rate of return regulation to competitive markets is not appropriate and often fosters rates that are not cost-based."[266]

ADAPSO also noted that the application of rate of return regulation "becomes increasingly more difficult as competition develops in some, but not all, aspects of a once purely monopolistic market." According to ADAPSO, regulators "the world over" must attempt "to make existing regulatory schemes responsive to rapidly changing technology. No where is this more acute than in those markets comprised of both monopoly and competitive services." Of particular concern under these circumstances, ADAPSO noted, is the resulting incentive to shift costs from more competitive to less competitive service offerings.[267] IBM similarly noted this concern, asserting that rate of return regulation "encourages

[264]Comments of CCIA, FCC CC Docket No. 87-313; October 20, 1987, p. 7.

[265]Comments of TP&L, NTIA Docket No. 61091-6191; December 15, 1986, p. 5.

[266]Reply Comments of DoD, IL CC Docket No. 87-NOI-3; April 22, 1988, p. 3.

[267]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 4.

carriers to cross-subsidize competitive ventures by shifting costs of those ventures to regulated offerings."[268]

However, some organizations asserted that the cited weaknesses of rate of return regulation, in addition to concerns over rate churn and strategic, non-cost based rates, are due to ineffective administration of existing regulation. As IDCMA asserted, "[t]he current system is by no means flawless, but surely could be improved by more rigorous efforts to enforce existing rules."[269] According to IDCMA, weaknesses of rate of return administration include the following: "(1) the time allowed for challenges to tariff filings does not allow a sufficient opportunity for analysis of proposed tariffs and preparation of responsive pleadings; (2) carriers are not required to provide information necessary to permit an informed evaluation of tariff filings; (3) the Commission regularly permits tariffs to go into effect even though serious legal and policy challenges have been presented, while initiating 'investigation' that may drag on for years; (4) the Commission's refusals to suspend or reject tariff filings are not judicially reviewable; (5) the Commission's accounting rules suffer from numerous deficiencies; and (6) the Commission has no significant experience in auditing cost of service records." However, IDCMA added that "virtually all of these problems could be ameliorated if the Commission had the will and the resources to administer its current rules more effectively."[270]

The International Communications Association (ICA) provided the harshest criticisms of the administration of rate of return regulation

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[268]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[269]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 16.

[270]Comments of IDCMA, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

and the resulting negative consequences on ratepayers. According to ICA, "rate of return regulation, as presently applied, has become a means for assuring the carriers that they will earn as close to the prescribed maximum rate of return as is humanly possible. Meanwhile, little or no attention is paid to the ratepayers' interests in having an opportunity to obtain carrier services at cost-based, relatively stable and predictable prices."[271] ICA noted that the FCC's lack of resources is responsible "for the length of time the Commission takes to act on petitions for reconsideration, applications for review, and requests for stay . . . very little effort appears to be dedicated to the tariff concerns of ratepayers."[272] Among the concerns that ICA claims are not properly addressed are LEC 'strategic' above cost pricing, which ICA asserts is inconsistent with the Commission's goal of just and reasonable, nondiscriminatory rates, and rate churn, the net effect of which ICA asserts is that "prices for different access services change so frequently, at uncoordinated points in time, that users cannot maintain efficient service acquisition and planning, or effective financial controls for their telecommunications expenditures."[273] Also inconsistent with the Commission's public interest mandate, according to ICA, are standardized "boilerplate" orders finding LEC tariff filings "not patently unlawful."

ICA concluded that "the principal cause of the concerns users have with the present cost of service system is that the Commission has lacked any consistent commitment to effective tariff oversight."[274] ICA

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[271]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 29.

[272]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[273]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 14.

[274]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 20.

added that the FCC's Notice of Proposed Rulemaking on price cap regulation "evidences a predisposition, not unique to the FCC among Washington policymakers, to eliminate rather than improve rate of return regulation." According to ICA, "if there are any deficiencies in rate of return regulation, they are attributable in large measure to the fact that some federal policymakers are unwilling to implement the current scheme in the manner Congress intended when the Communications Act of 1934 was enacted." ICA asserted that the Commission's policy-level officials simply "are not fully committed to effective implementation and enforcement of the existing system of regulation."[275]

Finally, some of the organizations noted that any system of regulation will impose some costs. As IBM stated, "[n]o form of regulation . . . can duplicate the performance of a competitive marketplace, as the Commission itself has recognized. Every form of regulation imposes some burdens and costs on regulated entities and, ultimately, on their customers."[276] ADAPSO similarly noted that "[a]lthough there are significant administrative costs associated with the present system [of regulation], many of these costs are inherent in any form of regulation."[277]

4.5.3. Summary

While some industry organizations, such as the Computer and Communications Industry Association, asserted that "traditional rate of return regulation is just not capable of meeting the needs of carriers or ratepayers in the current dynamic market environment," others asserted that the weaknesses of rate of return regulation can be reduced

[275]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, pp. 27-28.

[276]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[277]Comments of ADAPSO, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

through effective commitment and administration.[278] As ANPA stated, "to the extent that problems exist with rate of return regulation, they need not be remedied by wholly substituting some other system. Considering refinements to the current system could be the better course."[279] ADAPSO similarly asserted that two of the most frequently cited weaknesses of rate of return regulation can be solved through more effective administration. According to ADAPSO, "the carriers' incentives to inflate the rate base and shift costs are not incapable of regulatory review . . . but can be addressed through active and consistent oversight."[280] Others, such as the New York Clearinghouse Association and the Committee of Corporate Telecommunications Users, added that the existing public processes "may be unwieldy, but in the long run they produce the soundest basis for Commission decisions."[281] CCTU, also noting that "[f]ull rate regulation in the absence of demonstrable competition must remain," added that the under the existing public processes, the Commission "has benefitted historically from the intervention of consumer representatives who identify and address carrier proposals which may not auger well for the ratepayer."[282]

4.6. Consumer Organizations

Consumer organizations also felt that any weaknesses that may be present under rate of return regulation may be corrected through its

[278]Comments of CCIA, FCC CC Docket No. 87-313; October 20, 1987, p. 9.

[279]Comments of ANPA, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[280]Comments of ADAPSO, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[281]Response of NYCHA and CCTU, NY PSC Case No. 28961; March 4, 1987, p. 14.

[282]Reply Comments of CCTU, FCC CC Docket No. 87-313; December 4, 1987, p. 16.

more effective administration. However, the consensus of the organizations was clearly on the many overall strengths of rate of return regulation and its historically proven ability to satisfy regulatory goals of just, reasonable, and nondiscriminatory rates for universal, high-quality service in markets that they asserted continue to be characterized as monopoly in nature. The organizations added that the alleged weaknesses of rate of return regulation cited by its detractors have not been proven, and cannot stand up to its proven record of success.

4.6.1. Strengths

Among the strengths of rate of return regulation discussed by the consumer organizations were the achievement (or near achievement) of universal high-quality service and the development of the greatest telecommunications system in the world, the enforcement of reasonable rates, including protections against cross-subsidies, and the provision of stable returns to the LECs. As CFA stated, "during the era of rate of return regulation in telecommunications, one can trace a clear line from research and innovation through capital accumulation to declining consumer prices and increasing market penetration. The goals of the [Communications] Act have been well served."[283]

According to the Maryland Peoples Counsel, "[i]n the case of basic telecommunications, the world's largest and best telephone system has been made available to the highest proportion of a population anywhere" under rate of return regulation.[284] NASUCA similarly asserted that "history has cast rate of return regulation in a very favorable light: we have a highly advanced, high quality, almost ubiquitous telecommunications network that allows nearly everyone in the nation to

[283]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

[284]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

call nearly anyone else."[285] NASUCA added that rate of return regulation has facilitated "the development of the world's most technologically sophisticated and ubiquitous telephone network."[286] The People of Cook County (Illinois) also agreed that under rate of return regulation, "service has been reliable and well maintained and universal service has been achieved."[287]

Consumer organizations asserted that rate of return regulation assures reasonable rates, through an examination of costs, providing protections against cross-subsidies of competitive services and declining prices as costs decline. According to the Office of the Indiana Utility Consumer Counselor, rate of return regulation ensures "generally reasonable rates for consumers."[288] CFA added that "[s]ince the passage of the Communications Act of 1934, the rate of increase in prices for telephone services has been about half the rate of increase for all items. . . . Rate of return regulation has played an essential role in driving the real cost of telephone service down by more than 60 percent over the last 50 years."[289] According to the consumer organizations, the examination of costs under rate of return regulation assures consumers of declining prices for services that reflect carriers' declining costs of providing those services. Through the examination of costs, the consumer organizations also asserted that rate of return regulation will prevent inappropriate cross-subsidies. As the

[285]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[286]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

[287]Reply Comments of People of Cook County, IL CC Docket No. 87-NOI-3; May 4, 1988, p. 1.

[288]Comments of Indiana Consumers, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[289]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 15, 17.

Maryland Peoples Counsel stated, "in the practical world . . . profit containment measures are required in order to limit cross-subsidy."[290] The Washington Public Counsel concluded that while rate of return general rate cases "can be arduous, complex and lengthy, they offer the only opportunity to review in detail the total financial picture of a company."[291]

Rate of return regulation also provides for stable returns and incentives to be innovative and efficient, given the opportunity to achieve authorized returns, according to the consumer organizations. As the Indiana Office of Utility Consumer Counselor noted, rate of return regulation has been "a prime catalyst" in the development of the greatest telecommunications system in the world "by ensuring recovery of costs for the industry."[292] Community Action for Fair Utility Practice added that rate of return regulation "provides sufficient incentive for LECs. The opportunity to earn their awarded rate of return has spurred utility efficiencies in recent years."[293] The Office of the Consumers' Counsel of Ohio similarly noted that "[t]here certainly have been efficiency gains under [rate of return] regulation," and the Maryland Peoples Counsel added that rate of return regulation has not measurably discouraged efficiency or innovation.[294] As CFA summarized, rate of return regulation has provided stable and attractive returns to investors; has resulted in productivity growth almost three times

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[290]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 16.

[291]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

[292]Comments of Indiana Consumers, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[293]Reply Comments of CAFFUP, IL CC Docket No. 87-NOI-3; April 22, 1988, p. 3.

[294]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

greater than the average for all nonresidential business since World War II; and has provided incentives for huge capital investments, including those in research and development, where investments have exceeded the Standard and Poor's 400 between 1957 and 1986, indicating that returns to investors have been sufficient to attract capital.[295]

4.6.2. Weaknesses

Standing alone among consumer organizations studied, the New York City Energy and Telecommunications Office (Enertel) cited numerous inherent deficiencies in rate of return regulation. Among these were its failure to make the distinction between monopoly and efficiency generated earnings, thus undermining regulators' obligation to protect consumers against excessive earnings derived solely as a result of monopoly power; its lack of incentives for efficiency or innovation; potential incentives to increase costs and rate base in order to increase earnings; the inability of limited regulatory staffs to micro-manage or second guess carrier decisions; the cumbersome and inefficient regulatory process; and incentives to allocate costs to services experiencing less competitive pressures. While Enertel did not directly discuss rate of return regulation of LECs, it concluded that given these "regulatory imperfections and shortcomings," an alternative to rate of return regulation of AT&T is in the public interest.[296]

Despite the many strengths of rate of return regulation cited by the consumer organizations, some did note that no regulation is perfect. However, they added that not only are the costs of rate of return insignificant in comparison to its benefits to consumers, but that any existing problems with it may be due to its ineffective administration. In any case, the organizations consistently asserted that no significant

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[295]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, pp. 12-21.

[296]Comments of Enertel, FCC CC Docket No. 87-313; October 19, 1987, pp. 11-12.

failures or inherent weaknesses of rate of return regulation have been proven.

The Washington Public Counsel asserted that "[a]lthough no system of regulation is perfect . . . traditional regulation has on balance served ratepayers and the public well." The Counsel added that rate of return regulation is the most effective form of regulation.[297] The Maryland Peoples Counsel added that "[t]he issue is not whether regulation imposes costs, which will always be true in some degree, but what results have been made possible while pursuing the goals of regulation."[298] In addition to all of the strengths of rate of return regulation already cited, consumer organizations added that any sort of cost/benefit analysis would show that the costs or rate of return regulation are insignificant relative to the potential cost of improperly set monopoly rates. As the Illinois Citizens Utility Board stated, "regulatory costs are comparatively insignificant relative to the costs to society of improperly set rates."[299] CFA asserted that the administrative and transaction costs of rate of return regulation are "minuscule." According to CFA, clearly documented estimates of administrative costs "are few and far between," and "even rough guesses reveal that the cost of rate of return regulation is not very large." Noting that the NTIA estimate of $1 billion represents less than one percent of the total output of the industry, CFA noted that "[i]njudiciously unleashing the market power of the industry could cost the residential consumer, who has the least bargaining power, many times that amount."[300]

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[297]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

[298]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[299]Comments of CUB, IL CC Docket No. 87-NOI-3; March 7, 1988, p. 1.

[300]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 36.

Consumer organizations also asserted that many of the alleged weaknesses of rate of return regulation are theoretical and not supported by its historical record. NASUCA stated that the detractors have not been able to offer empirical evidence quantifying the alleged defects; according to NASUCA, "[t]heir complaints rely entirely on rhetoric and on inconclusive research."[301] Regarding specific alleged defects, NASUCA stated that rate of return regulation has not measurably discouraged innovation or efficiency, and that "there is no historical evidence that [rate of return] regulation has dampened AT&T's efforts to remain a leader in industrial research and development. To the contrary, the performance of AT&T and the BOCs while subject to this method of regulation points in the opposite direction."[302] Noting that corporate managers (not the philosophical approach to regulation) would cause a LEC to pad expenses, inflate the rate base, or manipulate books, the Citizens of Florida stated that "in numerous hearings before the Florida Public Service Commission, we have never heard a witness for a local exchange company or interexchange carrier admit to inflating rate base or padding expenses."[303] The Maryland Peoples Counsel, also noting that "there is little empirical data to show that cost of service regulation has inhibited either technological or administrative innovation," added that "carriers have long claimed, notwithstanding the regulatory framework, that they are constantly enhancing the efficiency of their operations."[304] In conclusion, CFA, like the other consumer organizations, noted that "[p]roponents of regulatory change offer a variety of theoretical arguments purporting to show why rate of return

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[301]Reply Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[302]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

[303]Comments of Citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[304]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

regulation inherently causes inefficiencies. Empirical tests of these theories, however, have not made a case against rate of return regulation." CFA concluded that "one cannot identify any significant regulatory failures under the rule of rate of return regulation."[305]

Any problems with rate of return regulation that may exist, the organizations asserted, are due to ineffective administration, rather than with the system of regulation itself. NASUCA stated that it "recognizes that [rate of return] regulation has its shortcomings and undoubtedly creates some inefficiencies and perverse incentives. However, most of these deficiencies are problems of implementation rather than flaws in the basic theory of [rate of return] regulation."[306] While the staff of the California PUC (which is charged with representing California ratepayers) stated that gold-plating and overinvestment in plant are among the "usual negative tendacies of cost-plus monopolies,"[307] the Office of the Consumers' Counsel of Ohio noted that it "cannot recall an Ohio carrier advising a regulatory commission that its rate base was inflated," and added that rate of return regulation provides "ample avenues of remedy." The Counsel asserted that if particular commissions do not avail themselves of these remedies, it is the fault of the individuals -- not of rate of return regulation.[308]

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[305]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 24, 13.

[306]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

[307]Comments of Public Staff, CA PUC En Banc Hearing on Regulatory Alternatives; September 11, 1987, p. 2.

[308]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 10.

4.6.3. Section Summary

In conclusion, the majority of consumer organizations applauded the many strengths of rate of return regulation. According to these organizations, rate of return regulation ensures just and reasonable prices, high-quality service, and attractive rates of return to investors. In addition, the organizations cited its historical success at achieving universal service (in most areas) and developing the greatest telecommunications system in the world. The organizations also asserted, in the words of the Illinois Citizens Utility Board, that rate of return regulation "is sufficiently dynamic to regulated carriers in the current environment."[309]

Echoing the sentiments of many consumer organizations, the Public Counsel of Washington stated that "[a]ttacks on traditional regulation are currently in vogue from telecommunications companies, but it is generally done with an eye to increasing profits rather than service."[310] Some organizations added that current rates and earnings are excessive, and that LECs are seeking regulatory reform in order to avoid regulatory scrutiny and potential rate reductions. Many organizations reached conclusions similar to that of CFA's: "the record of rate of return regulation in telecommunications is so strong that a careful review of the evidence would make it impossible to justify major changes."[311] As NASUCA asserted in the FCC price cap proceeding, reform "is a solution in search of a problem."[312]

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[309]Reply Comments of CUB, IL CC Docket No. 87-NOI-3; April 26, 1988, p. 1.

[310]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 3.

[311]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 15.

[312]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

4.7. Summary

The fundamental differences between stakeholders' positions on the strengths and weaknesses of rate of return regulation were based on their perceptions of the nature of the current telecommunications environment. LECs, citing the rapid emergence of a competitive market, asserted that unregulated competitors can use the regulatory process to their advantage, while LECs cannot respond to market needs on a timely basis; ultimately, LECs asserted that this inability to compete could threaten the viability of the public local switched network.

However, industry (large consumers and competitors) and consumer organizations cited the historical success of rate of return regulation at meeting traditional regulatory goals and asserted that while LECs have diversified into competitive markets, competition for most LEC services is minimal or nonexistent. Due to potential anticompetitive abuses and monopolistic exploitation that LEC diversification could permit, these organizations asserted the continued need for effective administration of a proven method of strict profit and price regulation.

While LECs cited the high level of direct and indirect costs of regulation -- ultimately paid by consumers of LEC services -- industry and consumer organizations asserted that the direct costs are minimal with respect to total industry revenues and benefits received. As for indirect costs, the organizations either claimed that their existence has not been proven, or that where they may exist, more effective administration of rate of return regulation could correct them. In between these two diverse positions, regulators acknowledged both the weaknesses of rate of return regulation in the dynamic telecommunications market (including their inability to provide franchise protection, as agreed to under the original social contract) as well as its historical ability to meet regulatory goals of universal, high-quality service at just and reasonable rates while providing LECs with the opportunity to earn a fair rate of return.

CHAPTER 5

STAKEHOLDER EVALUATIONS OF ALTERNATIVES TO RATE OF RETURN REGULATION

Table 4

Social Contract

		Strengths	Weaknesses
Local Exchange Carriers (LECs)	**Regional Bell Operating Companies (RBOCs)**	– Eliminates incentives to cross-subsidize – Encourages efficiency – Reduces delays of regulatory lag – Encourages innovation – Promotes residential rate stability and predictability – Minimizes regulatory distortions – Protects consumers from potential monopoly abuses [5.1.2.1]	– (Many do not cite any significant weaknesses) – Maintains subsidies of regulated services by competitive services (which they may not be capable of) – Prices and price changes may not reflect cost of providing service [5.1.2.2]
	Large Independents	– Economically efficient – Administratively simple – Maintains telephone penetration levels – Protects consumers [5.1.2.1]	– Maintains inappropriate subsidies – Subsidies may weaken LECs' ability to compete [5.1.2.2]
	Small Independents		– Relies too heavily on arbitrary frozen rate levels and rate change formulas – May injure LECs' ability to respond to economic, market and regulatory changes [5.1.2.2]
Interexchange Carriers (IXCs)		– Permits rapid introduction of new products and services – With adequate safeguards, may promote toll competition [5.1.3.1]	– Service quality may deteriorate and must be adequately monitored – Does not assure reasonable, non-discriminatory cost-based pricing – Access rates may not reflect cost savings; customers may not benefit from rate reductions – LECs may engage in predatory/ anti-competitive behavior, cross- subsidizing competitive services [5.1.3.2]
Other Industry[1]		– Provides LEC with flexibility to compete – Promotes price stability for basic services [5.1.4.1]	– Can make a bad situation worse – Currently unjustified and excessive rates become a springboard for future increases – No assurance of reasonable or economically sound prices – Lacks performance or profitability index – Permits LEC predatory pricing and anti-competitive behavior [5.1.4.2]
Consumers		– Stable rates (real rate decreases) – Promotes competition – Limited term of trial permits examination and review [5.1.5.1]	– Questionable legality in many jurisdictions – Does not allow commissions to review fairness and reasonableness of rates or increases – Rate decreases may be appropriate – May perpetuate current excessive rate levels – Local service is not competitive – May not prevent cross-subsidization – Opportunity for public input is limited [5.1.5.2]
Regulators	**Federal Communications Commission (FCC)**		
	State Commissions and Commission Staff	– Assures just and reasonable rates – Promotes rate stability – Encourages competition – Corrects monopoly abuses – Provides efficiency incentives – Commission retains regulatory jurisdiction – LEC flexibility [5.1.1.1]	– Potentially unsupported price increases – May preclude rate decreases – Lack of cost information available at terminaton of contract – Service quality may suffer – May not prevent consumer exploitation or abuse [5.1.1.2]

[1] "Other Industry" represents positions of industries which may be large users of LEC services, LEC competitors, or both.

Table 5

Price Caps

		Strengths	Weaknesses
Local Exchange Carriers (LECs)	**Regional Bell Operating Companies (RBOCs)** / **Large Independents**	– Provides benefits to all LEC customers – Results in real rate reductions – Encourages efficiency – Encourages innovation – Eliminates cross-subsidy and predatory pricing incentives – Promotes rate predictability and reduces incentives to bypass LECs – Reduces complexity and burdens of regulatory process – Provides LEC with flexibility to meet market changes – Enhances global competitiveness – "Win-win" situation for consumers and investors [5.2.3.1]	– If combined with ROR monitoring, costs and complexities of regulation could increase – If applied to AT&T first, could reduce consumer benefits and increase bypass incentives [5.2.3.2]
		(These positions are shared by RBOCs and Large Independents)	
	Small Independents	– Same as RBOC – Streamlined regulation and flexibility can be especially beneficial for small LECs [5.2.3.1]	– Same as RBOC – Should not be applied to carrier common line pool without assurances of long term support – May result in deaveraged toll rates [5.2.3.2]
Interexchange Carriers (IXCs)		– May be appropriate only for truly competitive services [5.2.4.2]	– LEC monopoly control of access bottleneck requires ROR constraints to prevent abuse – May not provide an effective deterrent to predatory pricing – Premature and inappropriate method to regulate LECs – Existing access charge distortions must first be addressed – Streamlined tariff review particularly inappropriate for new services – Potential deterioration of service quality – Benefits may not be flowed through to consumers [5.2.4.1]
Other Industry[1]		– May provide efficiency and innovation incentives [5.2.5.3]	– Currently unjustified and excessive rates become a springboard for future increases – May require additional regulatory resources for appropriate monitoring – Potential deterioration of service quality – May benefit shareholders at expense of consumers – Insensitive to ratepayer concerns – May permit cross-subsidies, predatory pricing or other anti-competitive behavior [5.2.5.1, 5.2.5.2]
Consumers			– Vigorous competition does not exist – Shareholders may benefit at expense of consumers – May provide no benefits for consumers – Declining costs may not be passed on to consumers – Potential deterioration of service quality [5.2.6 (all secs)]
Regulators	**Federal Communications Commission (FCC)**	– Protects consumers of less competitive services – Encourages continued growth of competition – Encourages innovation and efficiency – Provides appropriate incentives – Simplifies regulatory administration and reduces regulatory costs [5.2.1.1]	– Difficult to administer to 1400 LECs with two pools and depooling dates – Focus on prices may permit excessive profits – Monitoring profits may reduce administrative efficiency or incentive benefits [5.2.1.2]
	State Commissions and Commission Staff		– May adversly impact states' ability to regulate – Rates and quality of service may be adversely impacted – Pooling revenue shifts must be addressed – LECs may not flow-through benefits to ratepayers – Many ROR burdens may remain – May permit predatory pricing or cross-subsidies [5.2.2]

[1] "Other Industry" represents positions of industries which may be large users of LEC services, LEC competitors, or both.

Table 6

Incentive Regulation

		Strengths	Weaknesses
Local Exchange Carriers (LECs)	**Regional Bell Operating Companies (RBOCs)**	– Provides rate stability – Provides efficiency incentives – Reduces regulatory burdens [5.3.3.1]	– Does not provide sufficient flexibility – Maintains ROR regulations – Returns shared on 'upside' should be reciprocated on 'downside' – May increase regulatory burdens [5.3.3.2]
	Large Independents		
	Small Independents		
Interexchange Carriers (IXCs)		– May provide efficiency incentives [5.3.4.2]	– Does not reduce costs of ROR regulation – Additional regulation necessary to prevent over-earning or service quality deterioration – Does not correct cross-subsidy incentives [5.3.4.1]
Other Industry[1]		– Postpones burden of rate cases – Provides incentives to control costs – Ratepayers share in benefits of cost savings [5.3.5.1]	– May not provide parties an opportunity to participate in regulatory process – Rate moratorium may aggravate discrepancy between prices and costs, particularly where costs are declining – Places burden of proof on parties opposing rate changes – Potential deterioration of service quality [5.3.5.2]
Consumers		– Provides incentives to control costs – Promotes rate stability [5.3.6.2]	– May not provide opportunity for participation in review of costs and revenues – May lock in unnecessarily high rates while costs decline – Potential deterioration of service quality [5.3.6.1]
Regulators	**Federal Communications Commission (FCC)**		
	State Commissions and Commission Staff	– Ties financial success of LEC to efficiency – Promotes efficiency and service incentives – Ratepayers share in benefits of cost savings – Reduces burdens of cumbersome rate litigation – Commission powers unaffected – Rate stability [5.3.2.1]	– Refunds and triggering mechanisms may be complex – Potential LEC manipulation of reports [5.3.2.2]

[1] "Other Industry" represents positions of industries which may be large users of LEC services, LEC competitors, or both.

CHAPTER 5

STAKEHOLDER EVALUATIONS OF ALTERNATIVES TO RATE OF RETURN REGULATION

5.1. Social Contract

Social contract regulation is an alternative to traditional rate base/rate of return regulation that focuses on service prices, rather than costs, profits, and prices. A social contract in the traditional sense is the "agreement" between the regulated utility and society, represented by the regulator. Under the traditional social contract, the regulated utility is granted a monopoly status within its franchise territory as well as the opportunity to recoup expenses and to earn an established fair rate of return on investments. In return, the utility agrees to set prices targeted to its allowed rate of return, be regulated by the regulatory agency, and provide high quality service on non-discriminatory terms to all requesting it within its franchise territory. The term "social contract" regulation, as it applies to the proposed alternatives to rate base/rate of return regulation, is the modification of the original social contract to accommodate changes, such as the introduction of competition and the resulting end to exclusive local franchises, in the telecommunications environment.

Under social contract regulation, LECs would generally provide price commitments, such as freezes or limited increases, for targeted basic services while being granted earnings flexibility and pricing for non-basic, discretionary, and competitive services. Rate base/rate of return determinations and monitoring would be eliminated, with LECs' profitability determined by the marketplace and by their efficiencies in the provision of price regulated services. The proposals, which may be tailored by regulators, LECs, or other stakeholders to accommodate unique jurisdictional needs, frequently contain modernization or investment commitments, prohibitions on resale restrictions, guarantees to maintain services and routes, and service quality commitments. The LEC would assume a level of risk -- maintaining local service prices regardless of inflation and other economic factors (although escape clauses often exist in the event of extraordinary circumstances beyond the firm's control), or failures or successes in competitive markets -- in return for the freedom to compete more freely and to retain additional earnings generated through efficiencies, new services or marketing initiatives (see Table 4).

5.1.1. State regulators

5.1.1.1. Strengths

As with their evaluations of rate of return regulation, state commissions vary in their positions regarding social contract proposals. Regulators' support of social contracts focused on the perceived benefits of rate stability and "just and reasonable" rates, the promotion of competition, the correction of incentives, the maintenance of regulatory jurisdiction, and the limited time frame (or trial nature) of a social contract agreement. As the staff of the Maryland Public Service Commission stated, adoption of a social contract regulation trial

> will extend the period of rate stability, . . . will provide the company with an incentive to cut costs (which will clearly benefit ratepayers should the company ever be returned to a traditional mode of regulation), and will provide the company with the flexibility it needs to respond to the emerging competition.[313]

The primary focus of many regulators was on the impact social contract regulation could have on basic service rates. The Division of Public Utilities (staff of the Utah PSC) emphasized the predictability and stability of prices to consumers for capped services under a social contract, while LECs would be provided with incentives to operate more

[313] Brief MD PSC Staff, MD PSC Case No. 8106; May 31, 1988, p. 1.

efficiently. The Division concluded that "[r]atepayers in the short run would not have to worry about the threat of increased prices."[314] According to the staff of the Maryland Public Service Commission, most consumers are risk averse; therefore, "given the uncertainty associated with [LECs'] future costs . . . a guaranteed reduction in basic service rates followed by a conditional four-year freeze would be very attractive to most consumers of these services." The staff concluded that consumers' desire to avoid a rate increase would exceed their concern about possibly forgoing a decrease in rates.[315] The staff further added that existing rates have been found to be "just and reasonable" by the Commission, and "will continue to be just and reasonable until such time as evidence is presented sufficient to persuade the Commission otherwise."[316]

Some regulators asserted that social contract regulation would also promote competition. According to the Illinois Commerce Commission, "[t]he introduction of new telecommunications technologies, systems, and suppliers has made competition in the telecommunications industry technologically and economically desirable in many markets."[317] The staff of the Maryland Public Service Commission asserted that, in Maryland, the LEC (Chesapeake and Potomac Telephone Company of Maryland, C&P) "does not have substantial market power" in a number of markets. The staff added that it is their position that "in those markets where C&P does not have substantial power, the market place will protect the

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[314] Comments of Division of Public Utilities, UT PSC Docket No. 88-999-02; May 2, 1988, p. 11.

[315] Direct Testimony of Douglas E. Kinney, MD PSC Staff, MD PSC Case No. 8106; March 9, 1988, p. 26.

[316] Brief of PSC Staff, MD PSC Case No. 8106; May 31, 1988, p. 5.

[317] Comments of the Illinois Commerce Commission, NTIA Docket No. 61091-6191; December 12, 1986, p. 6.

public interest."[318] According to the staff, given certain safeguards, social contract regulation would encourage competition. Regulators added that competition will result in the benefits of efficiency and consumer choice.

Providing LECs with the flexibility to compete is one way social contract regulation may promote competition, according to some regulators. The staff of the Maryland Public Service Commission noted that this flexibility does not exist under the rate base/rate of return regulatory framework, which "is cumbersome and could result in market response lags on the part of [the LEC] that may jeopardize the Company's ability to respond to competitive situations."[319] Social contract regulation may also promote competition by eliminating incentives for or the ability to cross-subsidize competitive services with monopoly service revenues, according to some regulators. These regulators asserted that a LEC would have no financial incentive to engage in predatory pricing under social contract regulation because the LEC would experience a short-term drop in earnings with no long-term gain, since revenue losses could not be recovered by raising "frozen" service rates. Regulators added that imputation of access charges to the LEC, reporting requirements, prohibitions on resale restrictions, and market forces would further protect against any potential for anticompetitive pricing.

Social contract regulation may also provide efficiency incentives not present under rate of return regulation. The Illinois Commerce Commission (ICC) noted that the competitive threat will provide LECs and competitors with a strong impetus for efficiency, which in turn will

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[318]Brief of PSC Staff, MD PSC Case No. 8106; May 31, 1988, p. 30. The markets where staff does not believe C&P maintains substantial power are as follow: switched access for high-volume end-users; special access for high-volume end-users; Centrex; intraLATA toll; and discretionary services, such as Custom Calling and Audiotex.

[319]Direct Testimony of William J. Coyle, MD PSC Staff, MD PSC Case No. 8106; March 9, 1988, p. 36.

enhance continued development of the advanced telecommunications network infrastructure. According to the ICC, "[b]y allowing LECs to retain all revenues earned (saved) through increased efficiency, the social contract appropriately places an incentive for efficiency."[320] The staff of the Maryland Public Service Commission agreed, stating that these incentives exist where cost reductions flow through to the bottom line "just as they would in the case of an unregulated business."[321] The staff of the Utah Public Service Commission added that "the company has every incentive to cut costs to a minimum consistent with the prescribed quality of service."[322]

The staff of the Maryland Public Service Commission asserted that a social contract "trial," effective for a limited period, "should serve as a test of the practicality and economic superiority of an alternate form of regulation."[323] The staff also noted that under the proposed social contract, the LEC "might earn more or less than its cost-of-capital," but that the potential to earn supra-normal profits does not signify improper behavior or regulation. According to the staff, such profits occasionally occur in markets, and may not be undesirable unless they are derived from the sustained exercise of market power by the supplier of a vital commodity; however, the finite term of the social contract trial "is significant because it would automatically limit the length of time over which C&P could exercise whatever power it has."[324]

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[320]Comments of IL CC, NTIA Docket No. 61091-6191; December 12, 1986, p. 29.

[321]Direct testimony of Douglas E. Kinney, MD PSC Staff, MD PSC Case No. 8106; March 9, 1988, p. 25.

[322]Comments of Division of Public Utilities, UT PSC Docket No. 88-999-02; May 2, 1988, p. 11.

[323]Direct Testimony of Douglas E. Kinney, MD PSC Staff, MD PSC Case No. 8106; March 9, 1988, p. 4.

[324]Direct Testimony of Douglas E. Kinney, MD PSC Staff, MD PSC Case No. 8106; March 9, 1988, p. 30.

The Vermont PSB added that the finite nature of the social contract "should provide a powerful external incentive for the parties to the Agreement to implement it in ways which promote the general good throughout the period of the [Vermont Telecommunications Agreement]."[325]

However, some regulators asserted that the finite nature of a social contract trial would result in the need to maintain rate of return reporting requirements and complaint procedures. According to the staff of the Maryland Public Service Commission, aggregate financial data would not be satisfactory, since it would not permit a meaningful evaluation of the trial. The staff added that cost-of-service information required by the Commission must be maintained during any social contract trial "in order to ensure that rate base/rate of return regulation is a viable option at the end of the trial."[326] Complaint procedures and jurisdiction would also be necessary, according to the regulators, in case the LEC were to abuse its flexibility during the trial.

Regulators added that social contract regulation would not inhibit their ability to regulate. A vital aspect of regulatory control, for example, is the authority of the commission to establish and enforce service quality requirements. According to the staff of the Maryland Public Service Commission, the maintenance of this power is an essential feature of a social contract trial, ensuring that LECs do not profit at the expense of service quality. The staff stated that under social contract regulation, "[t]he Commission is free at any time to change rates as it deems necessary, to entertain appropriate complaints, and in general to exercise all of its authority . . . including the authority

[325]VT PSB Order, VT PSB Docket No. 5252; July 12, 1988, p. 69.

[326]Direct Testimony of Douglas E. Kinney, MD PSC Staff, MD PSC Case No. 8106; March 9, 1988, p. 35.

to set just and reasonable rates."[327] The West Virginia Public Service Commission, in its order approving a social contract stipulation, stated that "the regulatory flexibility which is being granted to [the LECs] does not diminish this Commission's jurisdiction to grant, modify or withhold final regulatory approval. . . . [T]he Commission will invoke its jurisdiction to investigate the reasonableness of rate or tariff changes, either upon complaint or on the Commission's own motion, if it appears necessary to do so to protect customers from unreasonable rates or practices by [the LECs]." The Commission concluded that the order approving the stipulation "may be reconsidered and the Commission may assert its jurisdiction if in some future proceeding there is a determination that the public interest requires a modification of any of the terms of the stipulation."[328]

Thus, the focus of regulatory agencies supporting the social contract concept was on consumer protections combined with market flexibility for LECs and the continued support of competition: in short, correction of perceived weaknesses of rate of return regulation. As the Illinois Commerce Commission stated, "[t]he goal of the new contract is twofold. The new contract must protect captive LEC customers from monopoly prices while encouraging technological advancements. Second, and of utmost importance, is the necessity to insulate and protect those same customers from the risks and uncertainties of the emerging competitive market."[329]

[327]Brief of MD PSC Staff, MD PSC Case No. 8106; May 31, 1988, p. 2.

[328]WV PSC Order, WV PSC Case Nos. 83-259-T-SC, et al.; April 27, 1988, p. 12.

[329]Comments of IL CC, NTIA Docket No. 61091-6191; December 12, 1986, p. 27.

5.1.1.2. Weaknesses

Many state commissions, including those citing benefits associated with social contracts, also cited weaknesses of this alternative to rate base/rate of return regulation. The primary concerns among state regulators were, as the District of Columbia PSC stated, the potential for future unsupported price increases and the "invitation to monopoly conduct which would have a deleterious effect on all ratepayers."[330] As the Washington Utilities and Transportation Commission stated, "[s]ocial contract models can open the way for the abuse of monopoly ratepayers or for disinvestment by local telephone companies."[331]

While social contract proposals would freeze or limit maximum basic service price increases, some regulators expressed concern over the appropriateness of the Consumer Price Index (CPI) or other adjustment factors, which may have no relationship to costs, as gauges for price increases. The Virginia State Corporation Commission noted that the CPI may or may not be representative of the utility's cost changes and that the "[u]se of a CPI or any other arbitrarily designated index as a cap on increases appears to preclude the possibility of a rate decrease."[332] The Illinois Commerce Commission noted that LECs would have incentives to raise rates by the maximum allowable percentage each year, and the staff of the Utah Public Service Commission noted that there may be "no provision to reduce prices to monopoly customers to reflect reduced costs or increased productivity not anticipated prior to setting the capped price."[333]

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[330] Comments of DC PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 14.

[331] WA UTC NOI, WA UTC Docket No. 87-1320-SI; September 16, 1987, p. 4.

[332] Comments of VA SCC, NTIA Docket 61091-6191; December 15, 1986, p. 6.

[333] Comments of the Division of Public Utilities, UT PSC Docket No. 88-999-02; May 2, 1988, p. 12.

The consensus among regulators expressing pricing concerns was that they would lose their ability to ensure the reasonableness of rates, since there may be no provision to tie the prices of monopoly services to the cost of providing the service. LECs, these regulators feared, would be free to price as "an unfettered monopoly," increasing prices regardless of costs.[334] The New Hampshire Public Service Commission also expressed concern over setting new rate levels at the expiration of the contract without the necessary cost information to determine joint and common costs or cross-subsidies.

Some regulators also feared the potential negative consequences LEC flexibility could have on competition. These regulators, such as the District of Columbia Public Service Commission, asserted that "in most proposed unregulated markets, insufficient competition exists. Subscribers receiving service on an unregulated basis would suffer because of the tremendous leverage monopolist carriers would wield." The Commission concluded that "[r]ates could become unconscionably high. Service could deteriorate."[335] The staff of the New Hampshire Public Utilities Commission similarly noted that "[w]ith the exception of Centrex, no proof of competition for services has been shown. No showing has been made that competition would protect consumers."[336] A concern of these regulators is that earnings generated from "competitive" markets where LECs maintain market power, or even potentially from "frozen" markets, could be used to subsidize anti-competitive pricing practices in truly competitive markets. While supporting social contract regulation, the staff of the Maryland Public

[334]Comments of CO PUC Staff, NTIA Docket No. 61091-6191; December 15, 1986, p. 16.

[335]Comments of DC PSC, NTIA Docket No. 61091-6191; December 15, 1986, p. 15.

[336]Comments of NH PUC Staff, NTIA Docket No. 61091-6191; December 15, 1986, p. 5.

Service Commission noted the need for prohibitions on resale restrictions in order to prevent such potential price discrimination.

Given LECs' market power, some regulators, such as the District of Columbia Public Service Commission, noted the potential for service quality deterioration under social contract regulation. With reduced regulatory controls, LECs may permit service to deteriorate in order to increase earnings. Earnings freedom in unregulated markets may further exacerbate this situation by providing incentives to concentrate resources in those markets. Another potential cause for service quality deterioration under social contract proposals, according to the Virginia State Corporation Commission, is that the CPI or other pre-determined price increases may not be sufficient to cover increased costs of providing service. As the staff of the Utah Public Service Commission stated, "absent some 'calamity' clause, the utility's financial integrity would be jeopardized if there are unanticipated cost increases which exceed any increases built into the price cap escalators."[337]

Finally, in order to ensure "just and reasonable" rates and because social contract regulation must be evaluated, some regulators asserted that many accounting systems and staffs must remain in place, limiting the savings associated with regulatory reform. In addition, LECs must continue to be required to submit sufficient information to allow the Commission to determine the appropriate treatment of new services. However, some regulators added that such measurement and comparison of the results of social contract regulation against rate base/rate of return regulation may influence the behavior of the LEC during the trial, making a valid evaluation of the trial difficult.

[337]Comments of the Division of Public Utilities, UT PSC Docket No. 88-999-02; May 2, 1988, p. 13.

5.1.2. LECs

In contrast to the variation among regulators' positions on strengths and weaknesses of social contract regulation, among LECs there was a general consensus of support for social contract proposals. According to the LECs, primary benefits are rate stability, efficiency and innovation incentives, competitive stimulation and freedoms, and the direct and indirect administrative costs of regulation. However, weaknesses cited by some LECs include critical pricing and subsidy concerns.

5.1.2.1. Strengths

Many LECs noted the benefits of social contracts for consumers of basic services. For example, Pacific Telesis, like many other LECs, noted that under social contract proposals many cross-subsidies can be reduced or eliminated, while selected subsidies may be retained and targeted toward residence services. According to New England Telephone, "by focusing on guaranteed prices for local exchange services, the approach preserves the affordability of that most basic telephone service, local access."[338] Through continued subsidies and rate freezes, residence customers would thus be assured of rate stability and predictability, regardless of LEC success or failure in competitive markets. Service quality would also continue to be regulated under social contract regulation.

In summary, according to US West, social contract (price regulation) proposals ensure reasonably priced network access and "protect end users against any potential monopoly abuses."[339] United Telephone added that this continued protection of basic service ratepayers (whom they consider to be customers who do not have alternative supplier options)

[338]Direct Testimony of Edward B. Dinan, NET, VT PSB Docket No. 5252; October 1987, p. 9.

[339]Comments of US West, NTIA Docket No. 61091-6191; December 15, 1986, p. 20.

will preserve the goal of universal service. The Chesapeake and Potomac Telephone Company of Maryland similarly noted that an immediate basic service rate reduction followed by rate stabilization would result in the increasing affordability of basic telephone service. According to C&P, "[t]hat promise will ensure that basic telephone service remains affordable in Maryland and will continue this Company's historic commitment to universal service."[340] New England Telephone concluded that social contract regulation "provides the real advantage of stability for basic exchange services and the guarantee of Statewide access to a high quality modern network, while fostering competition for other telecommunications services."[341]

While promoting basic service rate stability and predictability, LECs supporting social contract regulation added that it would also result in the correction of efficiency and innovation incentives. Perhaps the most frequently cited market distortions present under rate of return regulation that LECs considered to be corrected under social contract regulation were the lack of these incentives. According to LECs, replacement of rate of return regulatory intervention with market control, in the words of Stanford Levin writing comments on behalf of Bell Atlantic, creates incentives to "reduce costs and increase efficiency . . . implement any cost reducing technology, as well as to provide all new products and services that look profitable."[342]

Similarly, Pacific Telesis stated that "efficiency" includes the introduction of cost reducing technology, the prudent introduction of

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[340]Direct Testimony of J. Henry Butta, C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 13.

[341]Direct Testimony of Edward B. Dinan, NET, VT PSB Docket No. 5252; October 1987, p. 8.

[342]Statement of Stanford L. Levin (Chairman and Professor of Economics at Southern Illinois University at Edwardsville), attached to Comments of Bell Atlantic; NTIA Docket No. 61091-6191; December 19, 1986; p. A-14.

new services, the efficient deployment of capital, and the encouragement of full use of the network by customers and by service providers. New England Telephone added that stronger incentives to innovate and be creative in developing products and services that meet customer demands will benefit consumers, by offering them a wider range of choices.

As the Chesapeake and Potomac Telephone Company of Maryland emphasized, however, "[a] fundamental aspect of C&P's proposal enabling it to protect basic telephone service for four years, is the opportunity for C&P to reap the rewards of innovations in developing and marketing new technologies and services at the leading edge of the telecommunications market."[343] The Chesapeake and Potomac Telephone Company of West Virginia added that "[t]he Company is assuming the risks of open competition in exchange for greater market, price and earnings freedom."[344] According to the LECs, this freedom is necessary to offset the risks faced by the companies' agreement to freeze many basic service rates. As New England Telephone stated, the ability to offer competitive services will result in contributions that will help keep prices for other services lower: "they therefore afford the Company the opportunity to meet its revenue requirement while adhering to the stringent price limits set on basic and commonly used services. Without this flexibility, the Company could not have made the commitments it has made under the [Vermont social contract] Agreement."[345]

An important transitional regulatory benefit of social contract regulation, according to LECs, is that commissions would retain

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[343]The Chesapeake and Potomac Telephone Company of Maryland Modified Comprehensive Report on Regulatory Reform; December 8, 1987, p. 37A.

[344]Proposal of the Chesapeake and Potomac Telephone Company of West Virginia for Flexible Regulation of Telecommunications, Case No. 83-259-T-SC, et al.; April 17, 1987, p. 9.

[345]Direct testimony of Edward B. Dinan, NET, VT PSB Docket No. 5252; October 1987, p. 25.

jurisdiction over the companies during the contract "agreement." According to Frank Alessio, providing testimony on behalf of the Chesapeake and Potomac Telephone Company of Maryland, the C&P social contract proposal "allows for regulatory oversight that is consistent with the current and future competitive environment in telecommunications markets in Maryland."[346] Regulatory jurisdiction would address potential concerns over quality of service; commissions would have the authority to prescribe and enforce service quality standards. The Chesapeake and Potomac Telephone Company of Maryland stated that "the Commission will continue to have the same authority over the quality of basic telephone services as it has today, and the Company will continue to meet the service quality standards required by the Commission."[347]

When efficiency and innovation incentives are combined with continued commitments to service quality, New England Telephone concluded that all areas of the state "will be positioned to participate in and to take advantage of the opportunities presented by the 'information age.'"[348] According to New England Telephone, the capabilities provided by information age technologies will form an increasingly important segment of the economic infrastructure.[349] Mountain Bell added that under price regulation, such "unique and innovative uses of the network would be invited and encouraged."[350] The Chesapeake and Potomac Telephone

[346]Direct testimony of Frank J. Alessio, Ph.D., on behalf of C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 4.

[347]Direct testimony of J. Henry Butta, C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 4.

[348]Direct Testimony of Edward B. Dinan, NET, VT PSB Docket No. 5252; October 1987, p. 23.

[349]Direct Testimony of David J. Usher, NET, VT PSB Docket No. 5252; October 1987, p. 9.

[350]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 60.

Company of Maryland noted that a "state-of-the-art telecommunications network is imperative if the State of Maryland is to continue to be attractive to businesses in the information age."[351] C&P of West Virginia similarly noted that the encouragement of the development of an efficient, state-of-the-art communications network would "produce tangible benefits for the State of West Virginia, its economy, and its educational and social systems."[352] According to C&P, social contract regulation will also "permit telephone customers throughout the State, as well as the State itself, to enjoy the benefits of competition, technological innovation, and economic expansion."[353] Social contract agreements and proposals in Vermont and West Virginia, for example, include a LEC commitment to investments in the telecommunications infrastructure of the state as well as service quality commitments.[354]

The LECs asserted that many of their services face competition, which, as Alessio stated, "has the strong potential to increase in the near future."[355] The LECs added that under social contract regulation, services to be market priced or offered with price caps are offered in

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[351]Direct Testimony of J. Henry Butta, C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 14.

[352]Proposal of the Chesapeake and Potomac Telephone Company of West Virginia for Flexible Regulation of Telecommunications, Case No. 83-259-T-SC, et al.; April 17, 1987, p. 4.

[353]Direct testimony of Robert L. Swoope, C&P-WV, WV PSC Case No. 83-259-T-SC, et al.; March 11, 1988, p. 13.

[354]Investments are set at a minimum of $200M to $250M in Vermont over the five-year contract, with all Vermont New England Telephone exchanges interconnected with digital facilities by the end of 1990 and 94% of customer lines served by computer based software-controlled systems by the end of 1991. In West Virginia investments are set at $300M over the three-year agreement, with an agreement by C&P to serve, within two years, all currently undesignated areas of the state that are contiguous to C&P's service territory.

[355]Direct testimony of Frank J. Alessio, Ph.D., on behalf of C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 4.

either actively competitive or contestable markets or are discretionary services. Therefore, the LECs asserted that traditional public utility regulation is not necessary in these markets. Rather, they continued, competitive market forces could be relied on to constrain price increases. In these markets, LECs would be spared the rate of return regulatory burden of regulatory lag and price-setting. Free from the regulatory constraints of regulatory lag, provided with the incentives of retaining earnings, and with pricing set by the markets, LECs argued that they would be able to compete effectively, resulting in increased responsiveness to customers and market demand. New England Telephone stated that marketing flexibility would "enable the Company to offer products and services more quickly, in response to changing customer needs. . . . This flexibility allows the Company to package, price and promote products and services in a more direct relationship with its customers, to meet the customer's telecommunications demands."[356] Mountain Bell concluded that under price regulation, it would be able to "more fully respond to market conditions," and that the public would benefit "as competition causes rates to tend toward the costs of the most efficient vendor."[357]

Also included among the efficiencies of competitive markets cited by the LECs, and in contrast to concerns cited by some regulators, would be the elimination of incentives to cross-subsidize competitive services with noncompetitive services. These incentives are eliminated, according to the LECs, because basic service prices are frozen or limited, regardless of cost subsidies. The Chesapeake and Potomac Telephone Company of Maryland, Mountain States Telephone and Telegraph, and other LECs noted that under social contract regulation, innovation

[356]Direct testimony of Edward B. Dinan, NET, VT PSB Docket No. 5252; October 1987, p. 24.

[357]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 62.

incentives result in no risk to basic ratepayers, whose rates are frozen or limited. As Mountain Bell asserted, "[p]rices of basic service are . . . independent of any success or failure in other markets, thus insuring that basic services do not bear the risk of competitive markets. . . . With price regulation, the focus is removed from a search for the 'correct' allocation system."[358] NYNEX added that in competitive markets, an additional reduction in the administrative costs of regulation would occur because under-pricing (cross-subsidy) concerns can be handled through antitrust laws and over-pricing concerns are handled through competitive market entry.

Corresponding to the frequently cited complexities and administrative burdens of rate base/rate of return regulation as evaluated by LECs, it is not surprising that the simplicity of administering social contract proposals received praise from virtually all of the LECs. Ameritech noted that social contract proposals "bypass all the costly administrative trappings that exist today" while maintaining politically determined core service rate levels.[359] Alessio added that "[t]he Commission also would benefit from avoiding the ongoing, time-consuming and litigious processes inherent in other means of pursuing regulatory reform, such as the service-by-service processes."[360] Mountain Bell noted that among the direct costs of regulation avoided by focusing on price regulation are the costs of allocating joint and common costs, frequent regulatory proceedings, and regulatory lag. According to Mountain Bell, "[b]oth companies and customers would reap the benefits

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[358]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 59.

[359]Comments of Ameritech, NTIA Docket No. 61091-6191; December 15, 1986, p. 26.

[360]Direct testimony of Frank Alessio, on behalf of C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 31.

of this advantage in the form of decreased costs."[361] Other LECs also noted that the reduction in regulatory involvement, with its many related complex and controversial issues, will reduce regulatory market intervention and distortions. The result of lessening pervasive regulations, C&P of West Virginia concluded, would be that "C&P, along with the others in the communications industry, will be freed up to provide for the State and its citizens a low-cost, efficient, and reliable telecommunications network."[362]

5.1.2.2. Weaknesses

Despite the frequency of consensus among LECs supporting many of the social contract proposals, pricing and subsidy issues were the focus of some LECs' concerns with the proposals. However, unlike the regulators' concern that pricing increases not linked to costs could lead to an upward pricing spiral regardless of costs (and potentially permitting subsidies of competitive ventures by captive ratepayers), LEC concerns were that social contract agreements could perpetuate current competitive-to-monopoly service subsidies. As BellSouth noted, "[s]ubsidization of services which are price regulated by other services which are deregulated is not a viable alternative. By their very nature, services which have sufficient competitive alternatives to warrant full deregulation do not have the capability to sustain price levels sufficient to provide a reasonable return to investors as well as to maintain a subsidy flow to a price regulated service." BellSouth added that its 1985 subsidy level to residence service was $2.225 billion.[363]

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[361]Position Statement of the Mountain Bell, UT PSC Docket No. 88-999-02; May 3, 1988, p. 24.

[362]Direct testimony of Robert L. Swoope, C&P-WV, WV PSC Case No. 83-259-T-SC, et al.; March 11, 1988, p. 13.

[363]Comments of BellSouth, NTIA Docket No. 61091-6191; December 15, 1986, p. 39.

This problem could be exacerbated, BellSouth continued, where arbitrary changes in price levels that are not reflective of LEC cost changes could result in increased subsidies. The General Telephone Operating Companies and Telephone and Data Systems Companies both also noted these concerns, as well as the negative impact these subsidies would have on LEC abilities to compete in increasingly competitive world markets. GTE North added that negotiated social contracts may not readily allow for changes in the environment. According to GTE, "[t]o contract a certain level of rates . . . for a predetermined time period of several years may result in severe problems for the LEC if the environment strays from its present course."[364] The United States Telephone Association further questioned the constitutionality of price freezes, particularly where the freeze would prevent movement toward cost or market based pricing.

Like the regulators, LECs noted the limited time frame of social contract proposals as potentially both a strength and a weakness. Southwestern Bell, for example, noted that the limited time frame is a weakness of the social contract, since regulatory relief by definition may only last for this limited period, followed by review. On the other hand, the periodic review may provide the relief necessary for the LEC to realign costs and prices for those services which remain price regulated. The Chesapeake and Potomac Telephone Company of Maryland added that "[t]he telecommunications business is changing rapidly, and C&P cannot predict what will happen during the next four years. Precisely for that reason, C&P has not proposed a permanent change in the regulatory system, but has proposed a four-year trial."[365] Under the C&P proposal, the company would, based on the experience gained

[364]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 19.

[365]Direct Testimony of J. Henry Butta, C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 8.

during the trial, develop a proposal for the appropriate method of regulatory oversight following the trial period.

5.1.2.3. Summary

In summary, the focus of LEC support of social contract regulation was on the advent of competition (or the erosion of the traditional concept of a public utility franchise), and the need for regulation to adapt to the newly competitive environment. Social contract regulation would respond to these changes in the telecommunications environment by focusing on price and service quality regulation for consumers with no supplier options while encouraging the development of competition and new technologies. Alessio stated that the Chesapeake and Potomac Telephone Company of Maryland social contract proposal would "benefit customers, C&P itself, the Maryland Commission, the State of Maryland . . . . C&P's proposal keeps the price for basic local service reasonable and avoids large, discrete changes in residence and business local telephone bills, yet, at the same time, allows the opportunity for competitive benefits from other services to be enjoyed by all customers and the state generally."[366]

Alessio further concluded that the social contract proposal would produce widespread benefits because it would balance LEC and customer needs. LECs emphasized that this balance is a delicate one: in exchange for a commitment to freeze or limit increases in basic service rates, the companies must be given earnings and pricing flexibility for other services. LECs asserted that this regulatory flexibility will result in a strengthened telecommunications infrastructure, with more choices for consumers. And because basic service rate levels would be frozen or capped, the risks (and rewards) of LEC investments in new, competitive services would be borne by shareowners, protecting basic service ratepayers while permitting LECs to offer potentially profitable

[366]Direct testimony of Frank J. Alessio Ph.D., on behalf C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 28.

new services. The LEC, therefore, would be able "to be more of a participant than a bystander in the process of change."[367] The Commission would be able "to anticipate and manage the competitive and technological changes that take place in the telecommunications market, rather than lag behind and react to them."[368] Many of the LECs concluded that, as Alessio stated, "all parties benefit because the proposed trial is a realistic transition to regulatory oversight that is consistent with the competitive, dynamic trends in telecommunications markets."[369] Contel added, "[t]he most workable alternative to rate of return regulation for basic 'core' services presently is the social contract approach."[370]

5.1.3. IXCs

Interexchange carriers (IXCs), including toll service resellers, focused their evaluations of social contract regulation on access and other service charges that impact their bottom line as well as on services offered by LECs, such as intraLATA toll, that compete with IXC services. While generally offering that competitive services should be deregulated, IXCs urged the continuation of full regulation for monopoly services or services offered by companies providing both competitive and monopoly services. Access charges, IXCs' largest expense, would remain fully regulated under IXC proposals.

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[367]Direct Testimony of Edward B. Dinan, NET, VT PSB Docket No. 5252; October 1987, p. 27.

[368]Proposal of the Chesapeake and Potomac Telephone Company of West Virginia for Flexible Regulation of Telecommunications, Case No. 83-259-T-SC, et al.; April 17, 1987, p. 4.

[369]Direct Testimony of Frank J. Alessio, Ph.D., on behalf of C&P-MD, MD PSC Case No. 8106; March 9, 1988, p. 29.

[370]Comments of Contel, UT PSC Docket No. 88-999-02; April 29, 1988, p. 10.

5.1.3.1. Strengths

IXC support of social contract regulation may exist under particular circumstances and where adequate safeguards are incorporated into the agreement. In West Virginia, AT&T, MCI, and US Sprint entered into a Stipulation with C&P of West Virginia, the staff of the Public Service Commission, and the Consumer Advocate Division. Among the many provisions of that social contract agreement are the following: resale restrictions are removed for interexchange purposes from private line, channel, and intraLATA toll services; access service rates may be reduced (but not increased) on thirty days' notice so long as rate structure is not changed; parties may petition the Commission to change the LEC-proposed category for new services; C&P shall complete an access service cost study and negotiate with the IXCs regarding changes in access prices deemed appropriate by either C&P or the IXCs; C&P intraLATA toll rates and interexchange private line rates will be set at a level at least sufficient to recover the amount equivalent to the access charges it imposes on IXCs; and, to the extent access charges paid by IXCs are treated by the Commission to support the cost of regulated services, access charges attributed to C&P will be treated the same way. The Stipulation specifically stated that it is "a negotiated compromise of opposing views on numerous issues and that the particular compromises reached [in the agreement] apply only to the unique circumstances of the West Virginia telecommunications market and its regulation by the Commission."[371]

According to AT&T, a significant benefit of the West Virginia Stipulation will be the implementation of intraLATA competition, which will "enable suppliers with the most useful ideas and the most efficient technologies to prevail in the marketplace by meeting the needs of the consuming public." AT&T further stated that "[a]n economically efficient and competitive intraLATA communications market can help West

[371]Stipulation, West Virginia PSC Case No. 83-259-T-SC, et al.; February 19, 1988, p. 21.

Virginia attract and maintain jobs."[372] Similarly, US Sprint noted that "by providing customers with a choice among various long distance providers, the Commission will encourage the introduction of innovative new services, provide an inducement for heightened customer service awareness, as well as a sharpened incentive to the established carrier . . . to operate as efficiently as possible."[373]

Generally, IXC support of social contract regulation was qualified, and subject to certain conditions. For example, in West Virginia, US Sprint asserted that access charge attribution is necessary to prevent a monopoly-leveraged price squeeze, and the separation of investments is necessary to prevent cross-subsidies. AT&T emphasized the critical nature of the segregation of LEC expenses and investment of fully- and flexibly-regulated services, the access charge attribution, and the elimination of resale restrictions as safeguards against the LEC gaining a competitive advantage due to its ownership and control over the "monopoly local exchange network."[374]

5.1.3.2. Weaknesses

Far more frequent than IXC support were discussions of the weaknesses of social contract proposals, particularly with respect to access services. Representative of IXC concerns over access charges was a statement by AT&T in Utah: "Any service of the LECs that is monopoly-provided and makes use of the LECs' local distribution networks should remain fully regulated and subject to the requirement of tariffing with respect to costs, prices, terms, and conditions. In particular, because the LECs are the monopoly providers of the access services . . . the

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[372]Direct Testimony of John D. Schell, Jr., AT&T, WV PSC Case No. 83-259-T-SC, et al.; March 11, 1988, p. 3.

[373]Direct Testimony of Brad E. Mutschelknaus, US Sprint, WV PSC Case No. 83-259-T-SC, et al.; March 11, 1988, p. 2.

[374]Direct Testimony of John D. Schell, Jr., AT&T, WV PSC Case No. 83-259-T-SC, et al.; March 11, 1988, p. 7.

Commission should continue to regulate such services through the mechanisms and oversight of traditional regulation."[375] In Vermont, AT&T stated that "[a]t this time, AT&T knows of no other vendor from whom AT&T could procure the switched or special access service that will be necessary for AT&T to provide its services within [New England Telephone's] territory in Vermont."[376] In Maryland, AT&T cited the Huber Report (The Geodesic Network: 1987 Report on Competition in the Telephone Industry, January 1987) conclusion that 99.9% of interexchange carrier traffic is routed through LEC facilities. AT&T noted that "the force of competition from within [local exchange access] markets is extremely weak at this time . . . there are legal, technical and economic barriers to entry and expansion that prevent new firms and existing fringe competitors from entering these markets and, thereby, disciplining C&P's pricing behavior. At competitive, cost-based prices, interexchange carriers simply face no good substitutes for local exchange access from C&P." AT&T concluded that "in the absence of regulatory control, these markets would be subject to monopolistic exploitation."[377]

AT&T was not alone among IXCs and resellers in its position regarding the continued monopoly over local exchange access. In Maryland, MCI stated that "[i]nterexchange carriers do not realistically have any competitive alternative to [LEC] local access services. Accordingly, there should be neither elimination nor relaxation of the regulation that currently applies to [LEC] special and switched access services." MCI added that there are simply "no alternatives that provide the

[375]Position Statement of AT&T, UT PSC Case No. 88-999-02; April 28, 1988, p. 19.

[376]Direct Testimony of Lee J. Globerson, AT&T, VT PSB Docket No. 5252; February 23, 1988, p. 3.

[377]Direct Testimony of John W. Mayo, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 13.

ubiquitous reach of [the LEC] local access network."[378] In Illinois, MCI asserted that "the local exchange markets are bottleneck monopolies and will remain so into the foreseeable future."[379] US Sprint similarly noted that "[t]here is considerable evidence that switched access is a monopoly business characterized by steadily declining costs."[380] Burlington Telephone, a Vermont reseller, also noted its total dependence on New England Telephone for "bottleneck facilities" at the present time.[381]

Based on their assertion of the continued LEC bottleneck monopoly over local exchange access, IXCs argued for the continued regulation of LEC services. IXCs cited potential monopoly abuses, including pricing concerns, and the potential for LECs to use predatory pricing and cross-subsidies to stifle competition. According to Tel America of Salt Lake City, a reseller, deregulation of LEC services would leave consumers with no viable choice in the marketplace, and "subject to the whims and caprice of the current telecommunications utility."[382]

Access charges are IXCs' single largest expense. Therefore, it is not surprising that IXCs focused on access rate levels. IXCs cited existing access service subsidies of non-traffic sensitive (NTS) costs, which they consider to be inappropriate, as well as declining costs and increasing traffic volumes. The IXCs concluded that LEC access rates should be dropping -- something which they feared may not happen under

[378]Direct Testimony of Michael Ozburn, MCI, MD PSC Case No. 8106; March 9, 1988, p. 15.

[379]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 1.

[380]Direct Testimony of Brad E. Mutschelknaus, US Sprint, VT PSB Docket No. 5252; February 23, 1988, p. 7.

[381]Supplemental Testimony of Richard W. Silberman, Burlington Telephone, VT PSB Docket No. 5252; March 23, 1988, p. 8.

[382]Position Statement of Tel America, UT PSC Docket No. 88-999-02; April 29, 1988, p. 13.

social contract regulation. As MCI stated in Maryland, "C&P's access charges levied on interexchange carriers are not cost-based, are already overpriced in relationship to their underlying costs, and contain a substantial subsidy."[383] AT&T further stated that "[a] careful analysis of the current system of cross-subsidization in telecommunications indicates that it is laden with costs and has no substantive benefits." AT&T continued, stating that the IXC subsidy of NTS costs is "(1) inefficient, (2) inequitable, and (3) increasingly impractical."[384] AT&T concluded that these subsidies are not effective in promoting universal service.

IXCs frequently asserted that LECs' access services costs are decreasing. As US Sprint stated, switched access services are characterized by "steadily declining costs." In joint testimony filed on behalf of MCI, US Sprint, and Cable & Wireless Communications, economist Michael Pelcovits stated that "[j]ust because local rates have risen in the past, does not mean they must rise in the future. . . . The new technologies being put into place by telephone companies nationwide should be dramatically lowering the cost of providing telephone service."[385] Pelcovits cited the reduced costs of added capacity and maintenance and the reductions in average costs as demand growth occurs. AT&T noted the potential for these cost reductions, as well as an anticipated leveling off of depreciation expenses, reductions in equal access conversion expenses, and, in some jurisdictions, shifts of intrastate costs to interstate with the transition to a 25% interstate gross allocator. The IXCs added that the deployment of new, more efficient technology will also result in new service (revenue)

[383]Direct Testimony of Michael Ozburn, MCI, MD PSC Case No. 8106; March 9, 1988, p. 15.

[384]Direct Testimony of John W. Mayo, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 16.

[385]Direct Testimony of Michael D. Pelcovits on behalf of MCI, US Sprint, C&W, MD PSC Case No. 8106; March 9, 1988, p. 16.

opportunities for the LECs. As AT&T stated, the conclusion drawn by the IXCs is that "[a]fter years of continuing cost increases, the local telephone exchange industry is now experiencing a declining cost structure."[386]

IXCs frequently expressed concerns that social contract regulation may permit LECs to either lock in rates at "unacceptable" levels or selectively pass through cost savings to particular customers or in particular (competitive) markets. MCI asserted that "the introduction of new technologies . . . will reduce the cost of providing local exchange services; the growing demand for exchange services relative to their fixed costs will produce lower costs per unit of service; and the pace of local exchange research and design will lead to future lower prices."[387] Nina Cornell, in direct testimony filed on behalf of MCI in Vermont, concluded that the proposed Vermont Telecommunications Agreement (VTA) "would allow [New England Telephone] to recover substantially in excess of the projected revenue requirements during the 1988 through 1991 life of the Contract."[388] Also in Vermont, US Sprint added its concern over "the VTA's failure to provide a mechanism for seeking access charge reductions."[389] In his testimony filed for MCI, US Sprint, and Cable & Wireless, Michael Pelcovits noted that freezing rates of access services may not make customers better off "because these rates potentially may be lower under more traditional regulatory

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[386]Direct Testimony of John D. Schell, Jr., AT&T, MD PSC Case No. 8106; March 9, 1988, p. 19.

[387]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 11.

[388]Direct Testimony of Nina Cornell on behalf of MCI, VT PSB Docket No. 5252; February 23, 1988, p. 4.

[389]Direct Testimony of Brad E. Mutschelknaus, US Sprint, VT PSB Docket No. 5252; February 23, 1988, p. 3.

procedures."[390] He concluded that the LEC may be "trying to avoid the risk of having the rates of its monopoly services lowered by the Commission."[391] AT&T made similar arguments, noting that a proposed freeze of basic rates "could simply lock in price levels not supportable later in the trial period."[392] According to AT&T, a social contract proposal which does not provide incentives to reflect cost savings in rates is "unacceptable."[393]

AT&T, like the other IXCs, added that "[c]ost savings resulting from the deployment of new technologies and electronic intelligence in the monopoly local exchange network should be reflected in reduced prices for all services which use the local exchange network, and not just [LECs'] competitive services."[394] IXCs feared that LECs could engage in anticompetitive and discriminatory pricing practices under social contract regulation, using their monopoly/competitor position to stifle potential competition. This would occur, according to the IXCs, due to LECs' control over the local exchange bottleneck and their ability to realize significant related economies of scale in the provision of competitive services. According to AT&T, the potential for discriminatory pricing includes "the pricing of identical services to different customers . . . [and] the tying of the provision of a monopoly service . . . to the purchase of a competitive service . . . and the potential for cross-subsidization of the prices of competitive services

[390]Direct Testimony of Michael D. Pelcovits on behalf of MCI, US Sprint, and C&W, MD PSC Case No. 8106; March 9, 1988, p. 5.

[391]Direct Testimony of Michael D. Pelcovits on behalf of MCI, US Sprint and C&W, MD PSC Case No. 8106; March 9, 1988, p. 35.

[392]Direct Testimony of Diana L. Truman, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 9.

[393]Direct Testimony of Thomas J. Cosgrove, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 14.

[394]Direct Testimony of John D. Schell, Jr., AT&T, MD PSC Case No. 8106; March 9, 1988, p. 28.

. . . with the revenues received from monopoly service offerings."[395] For example, AT&T noted that permitting the LEC to contract separately with individual customers "could result in customers with leverage gaining a price advantage."[396]

Michael Pelcovits, in his testimony on behalf of MCI, US Sprint, and Cable & Wireless Communications, asserted that a LEC's most effective strategy "would be to target rate reductions (if necessary, below cost) only in those parts of the market where it faces the greatest actual or potential competition."[397] According to Pelcovits, under the C&P social contract proposal, "new" services could be created to target markets, and customer-by-customer contracting would be possible. The IXCs added that the LEC may be able to use its role as a supplier and competitor of its access customers, disadvantaging competitors by packaging existing Access Services with other services at a lower rate than it offers existing Access Service alone.[398] Nina Cornell, in her testimony for MCI, noted that New England Telephone, as a regulated monopolist, has "both the ability and the incentive to extend its monopoly power by preventing the entry of suppliers who would compete"; according to Cornell, the proposed VTA "would allow NET to engage in anticompetitive strategies that would disadvantage efficient would-be competitors, and therefore would allow NET to hinder the development of competition."[399]

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[395]Position Statement of AT&T, Utah PSC Case No. 88-999-02; April 28, 1988, p. 7.

[396]Direct Testimony of Lee J. Globerson, AT&T, VT PSB Docket No. 5252; February 23, 1988, p. 11.

[397]Direct Testimony of Michael D. Pelcovits, on behalf of MCI, US Sprint, and C&W, MD PSC Case No. 8106; March 9, 1988, p. 28.

[398]For examples, see Direct Testimony of Lee J. Globerson, AT&T, VT PSB Docket 5252; February 23, 1988, p. 13; Direct Testimony of Nina W. Cornell on behalf of MCI, VT PSB Docket 5252; February 23, 1988, p. 28.

[399]Direct Testimony of Nina W. Cornell on behalf of MCI, VT PSB Docket No. 5252; February 23, 1988, p. 27.

One anticompetitive strategy feared by the IXCs is the leveraging of monopoly power over bottleneck services to other services that are potentially more competitive. This would be possible by creating service bundles that include monopoly services, exacerbated by the ability to offer them on special terms to particular customers. As Pelcovits stated in his testimony on behalf of the IXCs, LECs would "have the ability to leverage [their] market power and squeeze competitors out of the market for market-priced services that rely on [their] bottleneck."[400] According to AT&T, "the leveraging of the monopoly to an additional market services as a device to exploit or extend the firm's incumbent market power."[401] AT&T asserted that in a mixed regulated/competitive environment, and given the freedoms of social contract regulation, LECs would have a profit incentive to engage in anticompetitive monopoly leveraging. MCI similarly asserted that LECs "can leverage monopoly power from one service to another by bundling the prices of these services."[402]

IXCs also noted the potential for "vertical price squeezes" under social contract regulation, another method they asserted LECs could use to stifle competition. A vertical price squeeze occurs when a LEC provides a monopoly product that is used as an input in the provision of a competitive service provided by the LEC and other competitors. For example, IXCs often cited the LECs' provision of intraLATA access, an input necessary for the provision of intraLATA toll service. (Though

[400]Direct Testimony of Michael D. Pelcovits on behalf of MCI, US Sprint, and C&W, MD PSC Case No. 8106; March 9, 1988, p. 12. See also Direct Testimony of Nina W. Cornell on behalf of MCI, VT PSB Docket No. 5252, pp. 27-29; February 23, 1988; Position Statement of AT&T, UT PSC Case No. 88-999-02; April 28, 1988, p. 7; Direct Testimony of John W. Mayo, AT&T, MD PSC Case No. 8106; March 9, 1988.

[401]Direct Testimony of John W. Mayo, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 10.

[402]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 16.

AT&T provided some discussion of Centrex vs. PBX leveraging possibilities, the intraLATA toll market more directly impacts the other IXCs.) According to the IXCs, a LEC may charge different, albeit frozen, rates to itself than to its competitors. Burlington Telephone noted that in the intraLATA toll market, "[o]ne competitor has total control over the access facilities that are the lifeline of all the other carriers."[403] As Cornell described in her testimony on behalf of MCI, "[t]o set up a price squeeze, [the LEC] charges a high wholesale price for a bottleneck monopoly service that a potential competitor must purchase, and then sets a low retail price to customers for their own services using an equivalent bottleneck service."[404] As AT&T stated, because the LEC is the sole provider of intraLATA (intrastate in a single LATA state) access to its competitors, "AT&T is concerned that [the LEC] may not have an incentive to undertake modifications that are desirable to its customers."[405]

Central to IXC concerns over price discrimination and anticompetitive behavior under social contract regulation was the ability of the LECs to cross-subsidize competitive services with monopoly service revenues. According to Pelcovits, the LECs have incentives to "stop competition dead in its tracks as early as possible" because the effects of anticompetitive pricing can be so long-lasting. He noted that "[t]he most potent weapon that [the LEC] can wield against actual or even 'potential' competition is to lower prices below the level at which these competitors can survive."[406] The IXCs noted that if revenue

[403]Supplemental Testimony of Richard W. Silberman, Burlington Telephone, VT PSB Docket No. 5252; March 23, 1988, p. 8.

[404]Direct Testimony of Nina W. Cornell on behalf of MCI, VT PSB Docket No. 5252; February 23, 1988, p. 30.

[405]Direct Testimony of Lee J. Globerson, AT&T, VT PSB Docket No. 5252; February 23, 1988, p. 9.

[406]Direct Testimony of Michael D. Pelcovits on behalf of MCI, US Sprint, and C&W, MD PSC Case No. 8106; March 9, 1988, p. 24.

requirements are falling relative to potential revenue growth, rates may be frozen at artificially high levels, which would build in the funding of cross-subsidies. Additional cross-subsidies could be generated by "market-priced" services not subject to effective competition.

IXCs also opposed proposals that "new" services would be offered on a flexibly-priced, or deregulated, basis under social contract regulation. IXCs asserted that new services may be repackaged existing services or services relying predominantly on monopoly services or facilities, as discussed. AT&T asserted that where no competitive alternative exists for new services, the LEC could price the services "significantly above cost" in order to subsidize competitive services. The revenues -- and profits -- from these services may not be used to benefit the regulated services which have borne the costs.[407] As US Sprint stated, LECs may use the marketing flexibility granted under social contract regulation "to design optional calling plans or 'new' toll services that would put US Sprint and other intrastate competitors at a major pricing disadvantage."[408]

The temporary nature of social contract proposals may also impact LEC actions under them, according to some IXCs. In her rebuttal testimony filed on behalf of MCI, Cornell asserted that she expects that "[NET] would continue to behave during the term of such a contract as if its rate of return were limited. . . . I am confident that NET understands that its profitability during the three-and-a-half years this Contract would run would have a very large influence on what happens to NET after 1991. This alone would create an incentive, if NET's profits were rising, to engage in leveraging behavior in order to reduce its apparent

[407]Direct Testimony of Diana L. Truman, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 32.

[408]Direct Testimony of Brad E. Mutschelknaus, US Sprint, VT PSB Docket No. 5252; February 23, 1988, p. 8.

profits."[409] Similarly, Pelcovits, in his testimony for the IXCs, noted that excess profits at the termination of the contract may result in rate reductions or jeopardize further deregulation: "Since one of the alternatives to showing excess profits is to spend these profits on below-cost pricing in competitive markets . . . [the LEC's] incentive to do precisely that would not be changed by the adoption of [a social contract] plan."[410]

In conclusion, IXCs' arguments opposing social contract regulation concentrated on continued LEC monopoly control over access and other services, the potential abuses that would occur given the flexibility of social contract regulation, and the shift of the burden of proof from the LECs to parties opposing their filings. IXCs added that known LEC cost reductions may not be flowed through to ratepayers under social contract regulation, that rates may be locked in at inappropriately high levels, and that LECs would use their market freedoms to price services anticompetitively. As Cornell stated, "[t]he [Vermont social contract] may be 'insurance' against higher local rate increases three or four years from now. A forecast is not a guarantee. It is, however, very expensive insurance."[411] MCI also asserted that under social contract regulation, LECs would be "allowed to earn the highest profit they can within the constraints of guaranteed rate increases for basic services and feeble competition for other services, subject to a risk of 'competition' that is minimal or non-existent."[412] MCI concluded that "social contract does not effectively serve the principle purpose of

[409]Rebuttal Testimony of Nina W. Cornell, on behalf of MCI, VT PSB Docket 5252; April 13, 1988, p. 25.

[410]Direct Testimony of Michael D. Pelcovits on behalf of MCI, US Sprint, and C&W, MD PSC Case No. 8106; March 9, 1988, p. 28.

[411]Direct Testimony of Nina W. Cornell on behalf of MCI, VT PSB Docket No. 5252; February 23, 1988, p. 22.

[412]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 17.

regulation: the protection of consumers from the abuses or potential abuses of monopolists."[413]

The IXCs favored the complete regulation of monopoly services or services provided jointly with monopoly services. The IXCs asserted that the potential for monopoly abuses requires full rate of return regulation including regulatory review of customer appeals. However, they added, these procedures would be lacking under social contract regulation. According to Burlington Telephone, the existence of the state commission and the availability of its procedures "can only improve the responsiveness of [the LEC]."[414] Burlington Telephone concluded, as did other IXCs, that "the playing field is not level" and that procedures to take disputes to an impartial arbiter are important to IXCs. Burlington stated that "preservation of the [state commission's] current complaint procedures is required to assure that interexchange carriers such as [Burlington Telephone] have adequate recourse in the event that they are unable to resolve differences with [the LEC] through negotiations."[415] US Sprint also noted the concern over the potential inability to petition for suspension, review, and hearings. MCI added that precluding the Commission from acting on complaints "would remove any guarantee that [the LEC] is charging 'just and reasonable' rates."[416] MCI concluded that "social contract regulation seriously deserves the public interest by shifting on to ratepayers the onerous burden of proof as to the propriety of proposed

[413]Comments of MCI, CA PUC En Banc Hearings on Regulatory Alternatives; September 11, 1987, p. 9.

[414]Supplemental Testimony of Richard W. Silberman, Burlington Telephone, VT PSB Docket No. 5252; March 23, 1988, p. 8.

[415]Rebuttal Testimony of Randall Plimpton, Burlington Telephone, VT PSB Docket No. 5252; April 13, 1988, p. 13.

[416]Direct Testimony of Michael Ozburn, MCI, MD PSC Case No. 8106; March 9, 1988, p. 8.

rates."[417] AT&T, concluding that a number of safeguards are necessary prior to adopting any sort of regulatory reform, and that monopoly services must be subject to full regulation, stated that the telecommunications industry "needs an impartial third party empowered to regulate [terms and conditions imposed on the purchase of access] and to adjudicate industry differences."[418] The IXCs asserted the need for full regulation of monopoly services to ensure their provision in a non-discriminatory fashion.

In Maryland, while asserting that it would support granting C&P of Maryland some pricing flexibility "under the proper conditions" and that "[t]o hamstring C&P by denying it the necessary flexibility to respond to competitive pressures could dull the intensity of market forces and thereby penalize consumers,"[419] AT&T added that adequate safeguards must be in place and that pricing flexibility should only be granted where effective competition exists. Concerning competition, IXC comments focused on the safeguards necessary for competition to the monopoly provider to develop. Without safeguards, they argued, effective competition will never develop. According to MCI, "[t]he benefits associated with effective competition (e.g., greater choice of providers, greater responsiveness to consumer demand, forcing carriers to seek out lower cost means of providing services, technological innovation, etc.) may never be realized unless cross-subsidization provisions are strictly enforced."[420]

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[417]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 17.

[418]Direct Testimony of John D. Schell, Jr., AT&T, MD PSC Case No. 8106; March 9, 1988, p. 31.

[419]Direct Testimony of John W. Mayo, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 18.

[420]Position Statement of MCI, UT PSC Docket No. 88-999-02; April 13, 1988, p. 6.

IXCs cited equal access to the local network, complaint procedures, cross-subsidy protections, limitations on bundling of monopoly and competitive services, attribution of the costs of monopoly elements (such as access) to the price of LEC services (such as intraLATA toll), maintenance of monitoring and complaint procedures as well as reporting requirements, and a prohibition against resale restrictions as required safeguards. According to the IXCs, these safeguards are necessary to "prevent any anticompetitive abuses of the monopoly power still held by [the LEC] in local exchange service and local exchange access markets."[421]

5.1.4. Other industry organizations

Arguments supporting social contracts focused on the need for regulatory reforms and flexibility to adapt regulation to a new telecommunications environment, the benefits of competition to large customers while smaller customers without competitive alternatives are protected by rate freezes, and overall rate stability and predictability. Those opposing social contracts frequently cited LECs' continued monopoly power, and the resulting potential for pricing and service abuses; reductions in LEC cost, making rate freezes inappropriate; need for traditional complaint processes; and potential for the LEC to leverage its monopoly power into other related markets, particularly if "new" services are offered on a flexible or deregulated basis. Other industries and industry organizations' positions both opposing and supporting social contract proposals contain many of the same elements noted in the positions of regulators, LECs, and IXCs.

5.1.4.1. Strengths

Industry support of social contract regulation centered on technological advances, the advent and support of competition and customer choices, and assurances of rate stability and predictability.

[421]Direct Testimony of John W. Mayo, AT&T, MD PSC Case No. 8106; March 9, 1988, p. 18.

Robert Schoeplein, Director of Research at the Maryland Department of Economic and Employment Development, and a member of the Telecommunications Task Force, noted that "[t]elecommunications today is a diverse set of services because of rapidly advancing technology. . . . Vigorous competition among several providers in a market economy will address the needs of Maryland businesses. Such competition stimulates innovation, quality control, cost reductions, maintenance and services, and price competition."[422] Schoeplein further stated that permitting C&P to compete would add to the stimulation of vigorous competition, which will generate the modern telecommunications infrastructure necessary for the Maryland economy to grow. The LEC commitment to invest in the network will further accelerate this modernization, according to Schoeplein. The Department of Defense similarly noted that giving the LEC flexibility to compete in federal procurement bids will provide the competitive benefit of lower cost bids. ICC asserted that "[i]t is appropriate for the Commission to ease the administrative burden on C&P where to do so would not prejudice the consumer or competitors." ICC cautioned that if the Commission chose to implement a regulatory alternative, it is appropriate to consider the status of the market and to ensure that the regulatory alternative chosen does not undermine competition."[423]

Other industry supporters of the social contract concept added that under a social contract, the benefits of competition would be achieved while monopoly ratepayers are protected. In addition to the price guarantees, the Department of Defense (DoD) noted the further benefit to monopoly ratepayers of allowing the LEC to compete: according to the DoD, "a very large portion" of C&P's market consists of large customers who are increasingly purchasing their communications services from

[422]Statement of Robert N. Schoeplein (Director of Research, Maryland Department of Economic and Employment Development), Telecommunications Task Force; February 11, 1988, p. 1.

[423]Brief of ICC, MD PSC Case No. 8106; May 26, 1988, p. 9.

competitive vendors; to the extent that C&P can retain these customers, it can increase service density, reducing unit costs. Conversely, the DoD asserted that constraining C&P's ability to compete will result in increases in monopoly service rates "to cover the greater costs of this less efficient network."[424]

In conclusion, Texas Power & Light, noting that "the time is ripe for [the National Telecommunications and Information Administration] to explore other means of regulating firms thought to be in need of price and service regulation," stated that "[i]n order to bring about a more rational and efficient regulatory regime, [Texas Power & Light] believes that a reevaluation of the fundamental principles underlying many of the FCC's regulatory policies should be undertaken." Adding that "it is unlikely that any market can remain immune from competitive entry forever, . . . it should be the first priority of the Commission to promote competitive entry in all telecommunications markets," the company concluded that social contracts voluntarily negotiated between LECs and their regulators in the states "may be appropriate."[425]

According to the business representative on the Maryland Telecommunications Task Force reviewing the C&P social contract proposal, "one finds in the business community a general impression of sympathy for C&P's position and a recognition that the present regulatory system needs to be reformed in light of technological and legal changes to the landscape of the telecommunications industry. . . . What business desires is to balance C&P's need for flexibility and less

[424]Direct Testimony of Charles W. King on behalf of DoD and FEAs, MD PSC Case No. 8106; March 9, 1988, p. 5.

[425]Comments of Texas Power & Light Company, NTIA Docket No. 61091-6191; December 15, 1986, p. 3, 6, 12, 11.

regulation to compete in a changing environment with a certain level of comfort and price stability for business users of C&P services."[426]

5.1.4.2. Weaknesses

As with the IXCs, limited support for social contract regulation was offset by industry concerns with the continued LEC monopoly over the provision of many services. The Maryland Coalition of Shared Telecommunications Service Providers asserted that "[f]or access to the local exchange network, there is no alternative to [LEC] services."[427] The Mid-Atlantic Alarm Security Association and the Maryland Alarm Association (Alarm Organizations) similarly noted that private and switched lines over which alarm signals are transmitted "in the vast majority of cases . . . are provided by the telephone company as a monopoly service."[428] Institutional Communications Company (ICC) -- owner and operator of a 4200-fiber, mile-long alternative local distribution and long distance access network in the metropolitan Washington, DC, area -- added that while C&P of Maryland has "singled out ICC as evidence of competition . . . [ICC] does not provide the level of competition sufficient to constrain C&P in its pricing decisions. Moreover, the largest portion of the high capacity market is inaccessible to ICC because it involves interconnection to serving

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[426]Comments on C&P's Modified Comprehensive Report on Regulatory Reform by Thomas S. Saquella (Maryland Retail Merchants Association), Business Representative, Telecommunications Task Force; December 21, 1988, p. 3.

[427]Direct Testimony of Kathleen M. Webb on behalf of the Maryland Coalition of Shared Telecommunications Service Providers, Maryland PSC Case No. 8106; March 8, 1988, p. 8.

[428]Direct Testimony of Thomas F. Smith on behalf of the Mid-Atlantic Alarm Security Association and the Maryland Alarm Association, MD PSC Case No. 8106; March 9, 1988, p. 3.

offices of C&P -- something ICC is forbidden to do."[429] ICC classified its market strength as "negligible."[430]

On a national scale, the International Communications Association (ICA) asserted that its members, large telecommunications users, "rarely have alternatives to the local loop. . . . [T]here is no meaningful alternative to local exchange services for most of the large users' needs in most of their locations."[431] Noting that if a market were effectively competitive it would be deregulated, Lee Selwyn of Economics and Technology, Inc., in comments prepared for ICA and the Ad Hoc Telecommunications Users Committee, asserted that "markets for many significant telecommunications service lack effective competition."[432] LECs' continued status as monopoly providers of local telecommunications services formed much of the basis for industry opposition to social contract regulation. The organizations expressed concerns that there would not be assurances that rates would be "just and reasonable" and nondiscriminatory and that the LECs would have the opportunity to leverage their monopoly power into other markets, adversely impacting competition. In his comments prepared for ICA and the Ad Hoc Telecommunications Users Committee, Selwyn noted that under a social contract "there is no assurance that the regulated prices . . . are

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[429]Brief of ICC, MD PSC Case No. 8106; May 31, 1988, p. 5.

[430]Direct Testimony of Jose L. Santiago, ICC, MD PSC Case No. 8106; March 8, 1988, p. 7.

[431]Comments of ICA, NTIA Docket No. 61091-6191; December 22, 1986, p. 5.

[432]Incentive-Based Regulation of Telephone Utilities: Modifying Public Utility Rate of Return Regulation in a Dynamic Industry Environment, by Lee L. Selwyn, Economics and Technology, Inc.; December 24, 1986, p. 6. (Report prepared for the Ad Hoc Telecommunications Users Committee and the International Communications Association, and filed as joint comments in NTIA Docket No. 61091-6191.)

themselves reasonable or even economically sound."[433] Due to their monopoly status, industry organizations asserted that LECs would not reflect cost reductions in their rates, resulting in inappropriately high rates. According to the Alarm Organizations, the Maryland social contract proposal would "freeze prices at or near their current levels while [the LECs'] telephone related costs may be expected to decline substantially."[434]

In a report supported by seven members of the Maryland Industrial Group, Selwyn noted that historically, telephone rates have risen less than the overall price level, and that this pattern should become more pronounced as new low-cost technologies, paid for by LEC ratepayers, are put into service. According to Selwyn, not only the costs of maintenance will be significantly reduced, but also new revenue opportunities will be possible with "relatively low incremental cost."[435] Finally, some organizations added that price freeze "guarantees" should be examined closely: not only may contingencies in the social contract render the "guarantees" very weak, but the LECs may still utilize their constitutional protection from confiscation of property should their rates result in insufficient income.

The International Communications Association asserted that under social contract regulation, "the currently excessive rates for many

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[433] Incentive-Based Regulation of Utilities, Lee L. Selwyn, NTIA Docket No. 61091-6191; December 24, 1986, p. 13.

[434] Brief of the Mid-Atlantic Alarm Security Association and the Maryland Alarm Association, MD PSC Case No. 8106; May 31, 1988, p. 3.

[435] Direct Testimony of Lee L. Selwyn on behalf of seven members of the Maryland Industrial Group, MD PSC Case No. 8106; March 9, 1988, p. 19. (Other members of the Maryland Industrial Group declined support of the comments or participation in the proceeding; see hearing transcript at 1395 - 1429. Participating were: Carr-Lowrey Glass Company, Convergent Dealership Systems, Enterprise Answering Service, Inc., FMC Corporation, GE Information Services, Lever Brothers Company, and the Maryland Association of Realtors.)

services will become nothing more than jumping-off points for future unjustified and unreviewable rate increases."[436] Selwyn, in his comments filed by ICA and the Ad Hoc Telecommunications Users Committee, added that because many of these proposals presume the reasonableness of current rates, "[t]o the extent that the existing pricing structure contains any uneconomic attributes, those conditions would be perpetuated under the 'social contract' scheme."[437] Selwyn also asserted that because of the lack of effective competition, rate flexibility for LEC services would be synonymous with "rate increases."

Beyond strictly being concerned with price levels, industry organizations noted the potential for LEC use of monopoly power to sustain discriminatory pricing and cross-subsidies and to defeat competition. According to the Reuben H. Donnelley Corporation, a self-described LEC competitor, "[t]elephone companies which provide regulated telephone services and unregulated businesses, like yellow pages, have an incentive to transfer costs from competitive to regulated businesses and to discriminate against competitors."[438] The Alarm Organizations added that the Maryland social contract proposal would "strip this Commission of the ability to ferret out any anti-competitive cross-subsidy by [the LEC] during the trial period."[439] The Maryland Coalition of Shared Telecommunications Service Providers noted that while generally supporting the principle of the market as a more efficient regulator of competitive services than the government, the principle is qualified "by our concern that effective competition can be

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[436]Comments of ICA, NTIA Docket No. 61091-6191; December 22, 1986, p. 5.

[437]Incentive-Based Regulation of Telephone Utilities, Lee L. Selwyn, NTIA Docket No. 61091-6191; December 24, 1986, p. 14.

[438]Direct Testimony of Robert T. Sullivan, Reuben H. Donnelley Corporation, MD PSC Case No. 8106; March 9, 1988, p. 7.

[439]Brief of the Mid-Atlantic Alarm Security Association and the Maryland Alarm Association, MD PSC Case No. 8106; May 31, 1988, p. 4.

negated by the ability of a market-dominant firm . . . to cross-subsidize between competitive and non-competitive services."[440] As an example, Selwyn, in his report for seven members of the Maryland Industrial Group, stated that LECs "have the incentive and the ability to -- and are -- taking steps to leverage their total monopoly position over switched network services to minimize the potential for competitive inroads in the case of dedicated services."[441]

Some industry organizations also noted concerns over the definition of, and pricing flexibility for, "new" services under social contract regulation. Among those expressing these concerns, many noted the potential that "new" services may actually be monopoly services, in which case "unfair" rates may be assured.[442] For example, some organizations noted the "Basic Service Elements" and "Basic Serving Arrangements" to be offered under Open Network Architecture. Selwyn asserted that "[b]y their very nature and definition, these features and functions do not have competitively-supplied alternatives." To flexibly price new services would permit LECs to "impose what may well be excessive, supracompetitive prices for these basic network functions."[443] Selwyn added that the existence of the common network permits LECs to embark on capital programs (such as the development of new services and technologies) that may ultimately benefit shareowners,

[440]Direct Testimony of Kathleen M. Webb on behalf of the Maryland Coalition of Shared Telecommunications Service Providers, MD PSC Case No. 8106; March 8, 1988, p. 16.

[441]Direct Testimony of Lee L. Selwyn on behalf of seven members of the Maryland Industrial Group, MD PSC Case No. 8106; March 9, 1988, p. 37.

[442]Direct Testimony of Thomas F. Smith on behalf of the Mid-Atlantic Alarm Security Association and the Maryland Alarm Association, MD PSC Case No. 8106; March 9, 1988, p. 4.

[443]Direct Testimony of Lee L. Selwyn on behalf of seven members of the Maryland Industrial Group, MD PSC Case No. 8106; March 9, 1988, p. 51.

while conferring risks on monopoly ratepayers. The Maryland Coalition of Shared Telecommunications Service Providers also noted the potential to repackage existing services, such as Centrex, and anticompetitively price them.

Particularly with the potential for monopoly abuses, some organizations asserted the need to maintain complaint procedures and financial reporting requirements. The California Hotel and Motel Association, noting the lack of opportunity for public input, asserted that the adoption of social contract regulation "would effectively deprive the Commission of the ability to oversee utility rate design in a comprehensive fashion."[444] ICC added that among the safeguards necessary to protect consumers and competitors where regulatory flexibility may be granted are the continued jurisdiction of the Commission to hear and investigate complaints and to require cost data during investigations. ICC further asserted that in order to protect against cross-subsidies, a segregation of expenses and revenues between flexibly- and fully-regulated services, or other appropriate measures, is necessary.[445] The seven members of the Maryland Industrial Group asserted that if monopoly services are to be cost-based and supracompetitive prices are to be avoided for market priced services, "it is imperative that this Commission be given not only the monthly financial data which it already receives, but also cost studies and data which provide investments/revenues/costs relationships for all services on a service-by-service basis, regulated and unregulated."[446]

In summary, industry organizations opposing social contract regulation focused on the monopoly status of LECs and the potential

[444] Comments of CA Hotel & Motel Association, CA PUC En Banc Hearing on Regulatory Alternatives; September 11, 1987, p. 10.

[445] Brief of ICC, MD Case No. 8106; May 31, 1988, p. 9.

[446] Brief of seven members of the Maryland Industrial Group, MD PSC Case No. 8106; May 31, 1988, p. 38.

abuses that a monopoly provider could engage in. Some noted that in a period of falling costs, rate freezes may result in inappropriate rates; others added that market pricing services may result in excessive returns being provided to shareowners at the expense of ratepayers. ICA asserted that social contract regulation, which would provide no assurances that regulated prices would be reasonable or economically sound, "has the potential to make a bad situation even worse."[447]

5.1.5. Consumer organizations

Many consumer organizations, charged with representing residential and small-business customers, held positions similar to those of many IXCs and industry organizations. Among cited weaknesses of social contract regulation were the potential for pricing abuses due to continued LEC monopoly power, declining costs and the potential for lower rates under traditional regulation, the limited powers of the regulatory commissions and their limited ability to determine "just and reasonable" rates, and the difficulty associated with "re-regulating" the LEC following the trial period. Support focused on the benefits of stable rates (real rate decreases) while maintaining service quality, the promotion of competition and its benefits to consumers, and the finite term of the trial period, giving regulators an opportunity to evaluate the social contract.

5.1.5.1. Strengths

Consumer organizations supporting the trial of social contract regulation cited its overall benefits to ratepayers. The West Virginia Consumer Advocate Division of the Public Service Commission asserted that while the Commission must consider a wide range of interests, "its most important concern should be the impact on the captive basic ratepayer." The Division concluded that the West Virginia social contract stipulations "are in the public interest and of benefit to

[447]Comments of ICA, NTIA Docket No. 61091-6191; December 22, 1988, p. 4.

captive basic ratepayers for several reasons."[448] The benefits cited under the West Virginia agreement included an immediate rate reduction, a three-year period of rate stability, and the introduction of intraLATA toll competition. According to the Division, the introduction of toll competition will result in the benefits of driving prices toward cost and greater options for consumers.

The Vermont Department of Public Service similarly asserted that the proposed Vermont Telecommunications Agreement (social contract) would benefit consumers. Gene Laber, in prefiled testimony of the Vermont Department of Public Service before the Public Service Board elaborated further: "[T]he Contract is favorable to Vermont consumers. It will provide rate stability for the basic telephone service, ensure that prices for essential telephone services are constrained, support the competitive environment that is developing in Vermont, and provide incentives for [New England Telephone] to control costs and offer new products and services."[449] Laber concluded that "the potential is for some customers to be made better off, while none is made worse off. That can only enhance society's welfare."[450] The Maryland Office of People's Counsel, while noting certain weaknesses and the potential for negative implications for future regulation, also concluded that "as long as the complaint procedure remains intact, from the point of view of residential ratepayers, the [C&P social contract proposal] should be advantageous and acceptable."[451]

[448]Direct Testimony of Billy Jack Gregg, WV PSC Consumer Advocate Division, WV PSC Case No. 83-259-T-SC, et al.; March 11, 1988, p. 6.

[449]Prefiled Direct Testimony of Gene Laber, VT DPS, VT PSB Docket No. 5252; October 27, 1987, p. 4.

[450]Prefiled Direct Testimony of Gene Laber, VT DPS, VT PSB Docket No. 5252; October 27, 1987, p. 36

[451]Brief of OPC-MD, MD PSC Case No. 8106; May 31, 1988, p. 5.

West Virginia, Maryland, and Vermont consumer advocates also noted the finite term of the social contract agreement. In contrast to arguments alleging the negative incentives for LEC conduct during a temporary trial period, the West Virginia Consumer Advocate Division cited the immediate benefits of a contract tailored to meet the regulatory needs of the state, while the unknown long-term consequences of social contract regulation may be examined during the course of the trial. According to the Division, "while the stipulations provide for innovative flexible and streamlined regulation of telephone services, the temporal term . . . will not irrevocably commit the Commission or the parties to a permanent method of regulation, and will allow evaluation of the results of this plan before taking further action."[452]

Addressing the concerns expressed over LECs' declining costs, the Division added that a freeze of any more than three years would be inappropriate; following the period of frozen rates, revenue levels will be examined. The Maryland Office of People's Counsel added that timely and reliable financial data would be necessary in order to determine the profitability of the company, and hence the "justness and reasonableness" of its rates, as well as to evaluate the trial and the appropriate method of regulation following the trial. Gene Laber of the Vermont Department of Public Service similarly asserted that the limited time frame of a social contract would allow all parties an opportunity to reevaluate their positions.

Support for certain elements of social contract regulation was also provided by consumer organizations attempting to adapt regulation to the dynamic mixed competitive/regulated telecommunications environment. Bruce Louiselle, in his testimony on behalf of the Maryland Office of People's Counsel, noted that since LEC competitors have the freedom to engage in short-term pricing strategies, the LEC should also have that

[452]Direct Testimony of Billy Jack Gregg, WV PSC Consumer Advocate Division, WV PSC Case No. 83-259-T-SC, et al.; March 11, 1988, p. 1.

capability -- given certain safeguards. David Barasch, the Pennsylvania Consumer Advocate, while opposing social contract regulation and adding that mixed competitive/regulated markets may require strengthened regulatory oversight, stated that the Office of Consumer Advocate "has no objection to a serious reexamination and even a possible redefinition of regulatory authority in those areas where there are truly competitive telephone products and services."[453] Walter Bolter and Richard Huriaux, commenting on behalf of the Vermont Public Contract Advocate, similarly noted that where competitive telecommunications markets exist, traditional regulation is not appropriate.[454]

5.1.5.2. Weaknesses

Despite this support of social contract regulation, many consumer organizations -- both supporting and opposing social contracts -- noted that while there is competition for some LEC services, LECs maintain a monopoly or substantial market power over the local network and for the majority of their services. According to the Consumer Federation of America (CFA), "except for large corporations with private networks, we are <u>still</u> in the era of monopoly industry organization for consumers who need dial-tone service for local exchange telecommunications and all other services connected to the local exchange network."[455] In its December 1987 report, <u>Divestiture Plus Four: Take the Money and Run</u>, CFA reiterated its position: "Four years after divestiture, the local companies remain a firmly entrenched monopoly."[456] The Office of the

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[453]Testimony of David M. Barasch, Consumer Advocate of Pennsylvania, before the House Consumer Affairs Committee, Regarding the Future of State Telephone Regulation; April 29, 1987, p. 15.

[454]Direct Testimony of Walter G. Bolter and Richard D. Huriaux (Bethesda Research Institute) on behalf of the VT Public Contract Advocate, VT PSB Docket No. 5252; February 24, 1988, p. 18.

[455]Comments of CFA, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[456]<u>Divestiture Plus Four: Take the Money and Run</u>, CFA; December 1987, p. 9.

Consumers' Counsel of Ohio (OCCO) added that although it cannot be predicted how long it will be before local exchange service is competitive in Ohio, it "surely" would not be within five years, and "expects" that it will not be within twenty years.[457] Despite limited competition for some LEC services, the Maryland Office of People's Counsel noted that LEC pricing actions indicate that the LEC does not believe its competitors control a great deal of market power.[458]

Noting that "non-telephone company competitors have, overall, made only relatively insignificant inroads into [New England Telephone's] Vermont markets," Walter Bolter and Richard Huriaux asserted that the reduced scrutiny of the LEC "is likely to encourage strategic pricing and service provisioning . . . [and] will make cross-subsidies even harder to find than is the case under the traditional regulatory scheme."[459] David Barasch similarly noted that deregulation of LEC services "would threaten competitors by allowing the phone companies to use their market dominance to compete unfairly in markets which are far from fully competitive."[460] CFA also noted the importance of detecting improper cross-subsidies and stated that "the corporations which own the [Bell Operating Companies] are using excessive returns to capital to further diversification into unregulated, competitive industries."[461] Bruce Louiselle, in testimony filed on behalf of the Maryland Office of

[457] Comments of OCCO, NITA Docket No. 61091-6191; December 29, 1986, p. 13.

[458] Brief of OPC-MD, MD PSC Case No. 8106; May 31, 1988, p. 13.

[459] Direct Testimony of Walter G. Bolter and Richard D. Huriaux (Bethesda Research Institute) on behalf of VT Public Contract Advocate, VT PSB Docket No. 5252; February 24, 1988, p. 6, 10.

[460] Testimony of David M. Barasch, Consumer Advocate of Pennsylvania, Before the Senate Consumer Protection and Professional Licensure Committee, on the Pennsylvania Telephone Association Proposal for Telephone Deregulation; December 2, 1987, p. 10.

[461] Comments of CFA, NTIA Docket No. 61091-6191; December 15, 1986, p. 3.

People's Counsel, added that social contract regulation will "not consider the extent to which costs related to the services which are joint in nature are already being recovered in the rates charged to the regulated ratepayer."[462] The OCCO concluded that social contract regulation "may encourage a tremendous waste of society's resources by those foolhardy enough to compete with a natural monopoly."[463]

Two characteristics of social contract regulation could exacerbate anticompetitive cross-subsidies, according to consumer organizations. First, the temporary nature of social contracts may, according to the Maryland Office of People's Counsel, "increase the risk of cross-subsidization because [the LEC] may not wish to see increased earnings reflected in rising profits. [The LEC] may have an interest . . . in employing added income to decrease rates for competitive services in an anti-competitive fashion so that the Commission's attention will not be attracted to [the LEC's] operations by reports of growing profitability."[464] The OCCO added that the finite term of a social contract "experiment" may also "be better characterized as an opportunity for a three-year charade of telco beneficence to win the hearts and minds of the public. Following these years would be the darker, final effectuation of [former FCC Chairman] Fowler's vision of cost-causation, where the telcos would be freed from the alleged "below-cost provision of local exchange services for residence and small business customers'."[465]

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[462]Direct Testimony of Bruce M. Louiselle, ECONAT, Inc., on behalf of OPC-MD, MD PSC Case No. 8106; February 1988, p. 8.

[463]Comments of OCCO, NTIA Docket No. 61091-6191; December 29, 1986, p. 14.

[464]Brief of OPC-MD, MD PSC Case No. 8106; May 31, 1988, p. 17.

[465]Comments of OCCO, NTIA Docket No. 61091-6191; December 29, 1986, p. 16.

Secondly, many consumer organizations asserted that LECs' costs are declining. Among the many reasons for cost reductions cited are general economic developments, reduced maintenance and incremental service expansion expenses associated with new technology, recent accelerated depreciation rates, and amortizations of certain plant. On this topic, the OCCO stated that "[w]e doubt that the local telcos' interest in these plans is merely coincidental with the recent tax reductions, near-zero inflation, and favorable capital markets."[466] Richard Huriaux, describing the lower unit costs associated with new technologies and reduced levels of inflation and interest rates, concluded that under rate of return regulation, there could be downward pressure on local rates. However, he added that under social contracts, "local ratepayers may not realize the benefits of lower telephone costs."[467] The result, according to Bolter and Huriaux, is that "the ability to engage in strategic pricing of [non-basic] services could actually be increasing without any change in local services pricing."[468]

The potential for cost reductions, which may not be flowed through to ratepayers through rate reductions, underlies the concern of some consumer organizations that rates may bear no relevance to costs. Consumer representatives asserted that social contract regulation, while focusing on <u>prices</u> for services, does not examine <u>costs</u> or profit levels. The Maryland Office of People's Counsel noted that "[a]lthough the Commission may ignore cost for now, to the extent that customers of certain services have their rates increased during the period of the trial, the Commission will be without basis to justify these increases

[466]Comments of OCCO, NTIA Docket No. 61091-6191; December 29, 1986, p. 15.

[467]Supplemental Testimony of Richard D. Huriaux (Bethesda Research Institute) on behalf of the VT Public Contract Advocate, VT PSB Docket No. 5252; March 23, 1988, p. 8.

[468]Direct Testimony of Walter G. Bolter and Richard D. Huriaux (Bethesda Research Institute) on behalf of the VT Public Contract Advocate, VT PSB Docket No. 5252; February 24, 1988, p. 10.

other than by contending that it felt that the benefit of a rate freeze for basic services makes the toleration of such increases consistent with the public interest."[469] According to some of the organizations, it may be particularly difficult for a Commission to meet its statutory requirement to enforce "just and reasonable" rates when, in fact, it is approving increases a number of years in advance, with little or no cost data upon which to support the increases. "New" services, which may be market priced without cost support, may even be monopoly services, some of the organizations asserted.

Many consumer organizations, including those supporting social contracts, emphasized the need to maintain complaint, appeal, and reporting procedures. Minimal notice requirements and no tariff suspension periods may prevent effective objections to LEC proposals for new services or tariff revisions for existing services. In addition, there is concern that generally reducing the enforcement powers of regulatory commissions may make quick compliance to orders difficult. Even where the complaint process is still available to consumers, the CFA noted that under many social contract proposals, "the burden on the company to prove that its rates are reasonable has been lifted and shifted to consumers (or their representatives)."[470]

The consumer organizations asserted that in order for the complaint process to be effective, or for the commissions to evaluate the success of social contract regulation, LECs must provide appropriate information. According to Bruce Louiselle, "the Commission should require [the LEC] to furnish to the appropriate parties whatever relevant information it has to support the justness and reasonableness

[469]Brief of OPC-MD, MD PSC Case No. 8106; May 31, 1988, p. 18.

[470]Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 14.

of new filings."[471] The Maryland Office of People's Counsel added that "[a] determination of whether a public service company's rates are just and reasonable, depends on a determination of the profitability of the company." The Counsel noted that to evaluate LEC earnings and in order to evaluate the success or failure of the trial, the Commission will need "timely, reliable financial data."[472]

In summary, the opposition of social contract regulation from consumer organizations centered on their perception of limited -- if any -- competition for many LEC services and the potential for rate reductions under traditional rate base/rate of return regulation. The market power of the LECs, it was argued, would permit them to charge unrestrained monopoly prices where customers have no alternatives; profits from these services could be anticompetitively used to cross-subsidize LEC services facing competitive threats.

Regarding rate freezes, the Consumer Advocate of Pennsylvania, David Barasch, asserted that "the chief problem with this overly simplistic response is that it assumes that local exchange rates are presently too low and that they should inevitably increase over the next several years. . . . Simply put, there is a significant risk that a freeze of local exchange rates at the present time will mean that ratepayers will be robbed of justified rate decreases rather than protected against rate hikes."[473] The Consumer Federation of America concluded that "[w]ith these huge earnings excesses . . . it is not surprising to find the [Regional Bell Operating Companies] desperately seeking to avoid regulatory scrutiny." According to the CFA, these "new wave" social

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[471]Direct Testimony of Bruce M. Louiselle (ECONAT) on behalf of OPC-MD, MD PSC Case No. 8106; February 1988, p. 26.

[472]Brief of OPC-MD, MD PSC Case No. 8106; May 31, 1988, p. 21.

[473]Testimony of David M. Barasch, Consumer Advocate of Pennsylvania, before the House Consumer Affairs Committee, Regarding the Future of State Telephone Regulation; April 29, 1987, p. 5, 9.

contracts would change the terms of current social contracts to benefit the LECs, giving them freedoms while restricting regulatory authority.[474] Finally, there was concern that, particularly if LECs are not required to provide necessary accounting and financial records, "the end of the bargained contract [may be] utter deregulation."[475]

5.1.6. Social contract: summary

Support for social contract regulation focused on the promotion of universal service through rate stability and real rate decreases for basic services, the provision of competitive incentives and flexibility for LECs, and administrative simplicity. While the limited LEC concerns focused on the ability to provide rate commitments and the ability of competitive services to continue to agree to subsidies to targeted basic services, consumer/competitors focused on the potential for locking-in rates during a period of declining costs and the ability for LECs to use monopoly service revenues to anticompetitively cross-subsidize competitive services.

While LECs asserted that existing regulatory standards and competitive market forces, including incentives to invest in new technologies, would promote continued high levels of service quality, consumers/competitors asserted that LECs' monopoly position could provide incentives to allow service quality to deteriorate in order to increase profits. Once again, the perceived level of competition was the basis for many stakeholder positions. Though some LECs asserted that social contract regulation could provide a more efficient method of regulation, regardless of competition, many consumer/competitors countered that the lack of competition for LEC services mandates adequate safeguards which preclude many regulatory "short-cuts."

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[474]Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 8.

[475]Comments of OCCO, NTIA Docket No. 61091-6191; December 29, 1986, p. 12.

5.2. Price Caps

Like the social contract proposals for alternatives to rate base/rate of return regulation, price cap alternatives are a form of price, rather than earnings, regulation. Under price cap regulation, price caps are established, either at existing rates or following a rate prescription. Pricing flexibility would be granted below the price cap, but regulatory approval would be required to increase the price cap. Numerous variables for price cap implementation include the determination of service categories (or services) to which specific price caps would apply, the establishment of initial or "going in" price caps, and the determination of adjustment factors, such as annual adjustment factors and automatic increases or decreases to price caps based on factors beyond the control of the carriers (see Table 5).

5.2.1. FCC

5.2.1.1. Strengths

The FCC issued a Notice of Proposed Rulemaking (NPRM) on August 21, 1987 (Common Carrier Docket 87-313), proposing price cap regulation for AT&T and eventually the LECs. In its notice, the FCC cited many strengths of price cap regulation over rate of return regulation. Among these strengths were the encouragement of greater efficiency and innovation, and reductions in carrier incentives to shift costs to less competitive service offerings or to inflate the rate base. According to the FCC, price cap regulation would also be simpler to administer than rate of return regulation, resulting in reductions in the levels of resources committed to regulatory administrative processes. The movement from the regulatory process toward a competitive, market-based rate setting process, according to the FCC, would also protect consumers from sudden steep rate increases. Many of these strengths directly address alleged weaknesses of rate of return regulation.

5.2.1.2. Weaknesses

However, the FCC did not consider price cap regulation to be without its faults. According to the FCC, regulatory focus aimed strictly on prices, as in the purest form of price cap regulation, may result in carriers earning excessive profits "beyond the zone of reasonableness." Modifications to "pure" price cap regulation aimed at correcting this potential weakness through a continued monitoring of earnings could have the negative consequences of restoring incentives to misallocate between regulated and competitive services and, the FCC continued, could also reduce efficiency incentives and administrative savings. The FCC also noted that administrative issues associated with the implementation of LEC price cap regulation raise many complex issues due to pooling arrangements, the large number of diverse LECs, and other factors.

5.2.1.3. FCC summary

In summary, the FCC concluded that a "preliminary examination of the price cap model suggests that it could simultaneously protect consumers of less competitive services from exorbitant rates and encourage competition's continued growth in those market segments where it has already taken hold, accomplishing this at a lower cost to society than our current regulatory regime."[476] While not a perfect form of regulation, the FCC stated that "we tentatively conclude that a price cap approach to regulating rates promises many benefits to consumers which outweigh the disadvantages it may possess."[477]

5.2.2. State regulators: concerns

While there was some diversity among the state regulators on the specific strengths and weaknesses of price cap regulation, many common themes were present among their views. These themes, consistent with the stated goals of regulation, focus on the maintenance of service

[476] FCC NPRM, CC Docket No. 87-313; August 4, 1987, p. 1.

[477] FCC NPRM, CC Docket No. 87-313; August 4, 1987, p. 14.

quality and ratepayer protection. As the New York DPS stated, "[a] price cap regulatory scheme would have to be accompanied by many safeguards in order to provide a fair outcome to monopoly consumers. These would include, first and foremost, the adoption of minimum quality of service standards to assure that companies do not enrich themselves by cutting service quality."[478] This common concern among state regulators was that LECs, under price cap regulation, would have the incentive to use their monopoly position to enable them to maximize profits by allowing service quality to deteriorate. As the Arkansas PSC stated, price caps "could provide the incentives for companies not to make the investments necessary to maintain the integrity of the public switched network."[479]

To correct this tendency, the New York DPS concluded that "there must be strict supervision over the quality of service provided, and a minimum level of quality for those services not subject to significant competition must be enforced."[480] Though the Illinois Commerce Commission stated that "the presence of competitive alternatives should provide firms with strong incentives to maintain and improve service quality levels in competitive sectors," it also agreed that "minimum quality standards and enforcement procedures (fines, penalties, etc.) are necessary to ensure maintenance of high service quality in all sectors."[481]

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[478]Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. i.

[479]Comments of AR PSC, FCC CC Docket No. 87-313; October 16, 1987, p. 4.

[480]Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. 11.

[481]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 12.

The Iowa SUB related the frequently cited regulator concerns over service quality levels to another common concern among regulators: monopoly ratepayer protection. The Board noted that because ratepayers are the only captive "participants" in utility operations, price caps will always work against them. This is because only ratepayers -- unlike suppliers, shareowners, debt holders, and employees -- have no choice but to purchase services from the utility or to go without service. Therefore, should price caps be set too far above cost, ratepayers would contribute more than is necessary for the provision of the service they consume. If price caps are set below cost, service quality would suffer. According to the Board, "ratepayers lose in either situation by either paying unnecessarily high rates or by receiving inadequate service."[482] The New Hampshire PUC similarly noted that "it is not abundantly clear that [price caps] would not produce excessive or extortionate rates."[483] The Commission further asserted that price cap regulation may not result in rates covering the cost of investments and a reasonable return, resulting in disincentives for companies to invest in new technology.

Concerns over the level of benefits accruing to ratepayers were expressed by many commissions and state agencies. Though many acknowledged the presence of added incentives toward efficiency under price cap regulation, they questioned the value of these benefits to ratepayers where there are no provisions for them to share in these gains. In addition, regulators expressed concern that during a period of falling costs, imputing a productivity factor into the caps may only partially assign benefits to ratepayers. The New York DPS noted that due to these weaknesses, "the pure price cap model offers little improvement from the consumers' point of view. . . . [B]enefits of

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[482]Comments of IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. 7.

[483]Comments of NH PUC, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

resulting efficiency gains will not flow to ratepayers unless some mechanism forces prices to reflect these efficiency improvements."[484]

In fact, the Department continued, should any inefficiencies associated with rate of return regulation exist going in to price caps, the pure price cap method of regulation would not pass on to consumers the benefits of any corrective savings. Regarding any existing subsidies, the Department noted that pure price cap regulation "would cast these inequities in stone and perpetuate them indefinitely."[485] The Illinois Commerce Commission similarly noted that if existing rates are used to set price caps, they may lock in existing price distortions. However, the Commission also asserted that "[p]erforming long-run marginal cost studies is complicated, time-consuming and expensive. Furthermore, they require the assignment of joint and common costs, and may be open to controversy and litigation over methodology."[486]

The Alabama PSC also expressed concern over the potential for gains to be flowed strictly to shareowners. The Commission stated that ratepayers should benefit from regulatory improvements, and that _if_ the shareowners of the company are to profit from regulatory reform, a price cap mechanism should be implemented that would allow the benefits to be shared on a pre-determined basis.

Pricing and subsidy issues beyond the sharing of benefits derived from regulatory reform were the focus of additional regulator concerns. Among these are the ability of the LEC to engage in predatory or monopolistic pricing and to employ cross-subsidies of competitive

[484]Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. 3.

[485]Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. 5.

[486]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 13.

services to maximize profitability. The New Hampshire PUC, representative of commissions expressing these concerns, stated that the proposed price cap regulation "would not comply with [the FCC's] statutory obligation to set rates which are just and reasonable." The Commission also noted that "the rate cap methodology . . . does nothing to eliminate the ability of carriers to cross-subsidize" and does not protect the ratepayer because "it promotes predatory pricing which can promote the preservation of monopolies."[487] Other regulators, such as the staff of the Missouri PSC, also concluded that price cap regulation would not be as effective as rate of return regulation at insuring rates for regulated LEC services are just and reasonable.

The Iowa SUB, like many commissions, asserted that due to the potential for LECs to "raise prices to captive customers and use these revenues to finance cross-subsidization of otherwise competitive markets" and to seek rate increases when its costs increase, periodic or petitioned examinations and reviews of company transactions and accounts may be necessary.[488] These company reviews would be in addition to the comprehensive cost review some commissions suggested may be necessary in order to set the correct "going-in" price caps. Potentially frequent claims by competitors that LECs are engaging in cross-subsidies could exacerbate this situation, as could subsidies within service categories subject to caps. The staff of the Colorado PUC noted that these "political and economic factors outside of the Commission's control" may significantly increase regulatory administrative burdens.[489]

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[487]Comments of NH PUC, FCC CC Docket No. 87-313; October 19, 1987, pp. 4-5.

[488]Comments of IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. 9.

[489]Comments of CO PUC Staff, FCC CC Docket No. 87-313; October 16, 1987, p. 5.

Regulators also noted that other administrative burdens associated with rate base/rate of return regulation may also continue to exist under price cap regulation. Among these are the use of separations procedures to identify interstate and intrastate expenses. According to the Colorado PUC staff, "this is one of the most arcane and most difficult portions of cost of service regulation."[490] The Iowa SUB also noted the continued need for cost allocation since any rate design "at least implicitly allocates costs."[491] However, the New York DPS concluded that "any such review automatically reintroduces the incentive to cross-subsidize allegedly created by cost of service regulation."[492] The overall result, as the Missouri PSC staff stated, is that "the question becomes whether or not the system of price caps merely replaces one set of elaborate, complex and demanding regulatory requirements with another equally demanding, complex, but less precise set of requirements."[493]

The issue of administrative complexity and related issues associated with price caps are especially acute, according to some state regulators, where they would be applied to over 1400 LECs nationwide. Some state commissions noted that averaged rates, pooled revenues, and LECs' monopoly status would also further complicate the potential implementation of price cap regulation in LEC markets. Of particular concern to some commissions were the "unique and complex problems facing each state jurisdiction" which "vary widely by region and size," according to the Illinois Commerce Commission.

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[490] Comments of CO PUC Staff, FCC CC Docket No. 87-313; October 16, 1987, p. 2.

[491] Comments of IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. 11.

[492] Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. 5.

[493] Comments of MO PSC Staff, FCC CC Docket No. 87-313; October 1987, p. 4.

The Commission concluded that "state legislatures and public utility commissions, as primary regulators of local exchange markets, are the only entities capable of implementing regulatory reforms which can successfully address the unique conditions existing in their respective local telecommunications service markets."[494] Other commissions concluded that the magnitude of complex jurisdictional, pooling, access and separations issues require an in-depth proceeding to focus on these issues. For example, the West Virginia PSC concluded that "regulatory reform for the LECs should be the subject of an independent, comprehensive inquiry into the reasonableness and effectiveness of such reform."[495]

Until such time as a thorough inquiry has been completed, many of the commissions were concerned with the proposals to replace what they consider to be a proven successful regulatory tool (rate of return regulation) for an unproven one (price caps). Convinced that "rate of return regulation is, at this time, the appropriate method to use in regulating firms that operate in the telecommunications industry," the Arkansas PSC asserted that alternate forms of regulation have not been proven to result in improved efficiencies or reduced costs.[496] The Kentucky PSC asserted that the FCC should "avoid erroneous experimentation."[497] The Iowa SUB cited the historical failure of price caps. According to the Board, price cap regulation where implemented has been "unworkable" and "difficult to administer" and resulted in harm

[494]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 29.

[495]Comments of WV PSC, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

[496]Comments of AR PSC, FCC CC Docket No. 87-313; October 16, 1987, p. 3.

[497]Comments of KY PSC, FCC CC Docket No. 87-313; October 16, 1987, p. 2.

to the financial health of the utility, in rate discrimination, and in rate structures that did not meet customer needs.[498]

Experimentation with price caps could be particularly harmful, in the opinion of some commissions, where effective competition does not exist. Some commissions, such as the Missouri PSC, were "unaware of any convincing evidence that the market for LEC's access services is sufficiently competitive to justify such lesser degree of regulation."[499] Others discussed the potential for pricing inequities associated with LEC "monopoly" services. Some commissions noted the unique nature of the current telecommunications market. According to the Illinois Commerce Commission, the LEC market "is primarily characterized by a core of basic monopoly services (ex. local access), around which a variety of increasingly competitive services are arrayed."[500] The Iowa SUB, noting the emergence of competition into certain telecommunications markets, has for several years "successfully implemented a policy of deregulating competitive markets," and fully regulating all other markets. The implementation of price cap regulation of non-competitive services "does not generally produce desirable results," the ISUB continued.[501] In non-competitive markets, regulators feared that price caps may result in formal or informal price fixing near the level of the cap or price leading by the dominant carrier, creating an umbrella for less-efficient carriers.

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[498]Comments of IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. i.

[499]Comments of MO PSC Staff, FCC CC Docket No. 87-313; October 1987, p. 5.

[500]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 28.

[501]Comments of IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. 3.

Finally, some regulators asserted that if a market is competitive, market forces should replace rate of return regulation. Thus, price cap regulation would not provide LECs with the level of freedom these regulators consider appropriate for services in these markets. While recommending that "cost of service regulation should be abandoned, if at all, only gradually and only if accompanied by stringent controls on quality of service," the New York DPS stated that the presence of effective competition "would obviate the need for any regulatory scheme."[502] The Iowa SUB similarly asserted that "continued regulation of competitive markets is generally inappropriate."[503] And the Illinois Commerce Commission noted that under the Illinois Universal Telephone Service Protection Law of 1985, telecommunications companies are allowed to offer competitive services with complete pricing flexibility as long as prices are set above marginal cost.

5.2.3. LECs

5.2.3.1. Strengths

In contrast to the many concerns expressed by state regulators, comments of the LECs were in virtual harmony in their support of price cap regulation of LEC services concurrent with AT&T services. While there are minor differences among the LECs, primarily regarding specific mechanics of implementation, their appeals for the immediate implementation of price caps and their support of the benefits it will confer on ratepayers, regulators, and themselves all become very quickly familiar. As Southwestern Bell stated, price cap regulation "would provide protection and benefits for the consuming public, needed pricing flexibility for AT&T and the LECs, and reduced regulatory burdens for

[502]Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987; p. 2, 5.

[503]Comments of the IA SUB, FCC CC Docket No. 87-313; October 15, 1987, p. i.

the Commission."[504] Price cap benefits cited by LECs included the following: the elimination of many cumbersome regulatory burdens present under rate of return regulation, substitution of appropriate market-based competitive incentives in place of inappropriate regulatory-imposed incentives, ability to offer new and innovative services demanded by the market on a timely basis, elimination of predatory pricing and cross-subsidy concerns, and overall ability of the US telecommunications industry to develop and offer the innovative services necessary in order to maintain its position as the world leader in telecommunications services. Among the direct benefits to consumers, LECs cited real rate reductions, rate stability, the availability of new services, and the reduced threat of bypass and its serious negative impacts on the local distribution network.

As an industry spokesman, USTA stated that "price cap regulation simply offers a more efficient means of regulation."[505] As many of the individual LECs discussed, USTA cited many complex and burdensome regulatory requirements associated with rate of return regulation that would no longer be necessary under price cap regulation. These include tariff filing procedures, rate of return procedures, and individual cost element allocation requirements. GTE also cited the elimination of the "detailed and burdensome" monitoring set up in FCC Docket 84-800 (Authorized Rates of Return for the Interstate Services of AT&T Communications and Phase 1 of Exchange Telephone Carriers) and 86-182 (Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies (Parts 31, 43, 67, and 69 of the FCC Rules)).[506] GTE noted that the elimination of these requirements would significantly

[504]Comments of Southwestern Bell, FCC CC Docket No. 87-313; October 19, 1987, p. ii.

[505]Reply Comments of USTA, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

[506]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

reduce the cost of regulation and would have the added "ecological benefit of saving a small forest each October."[507]

Rochester Telephone applauded the "very large reduction in the costs of regulation, including the costs of rate setting and adjustment, rate of return represcription, depreciation rate represcription, cost accounting proceedings and procedures, and authorizations to construct or operate new facilities." Emphasizing its point, Rochester Telephone stated that under price caps, "there is no need whatsoever for rate of return regulations (47 CFR Part 65)."[508] To this list of regulatory burdens no longer necessary under price caps, BellSouth added the cost allocation rules used to allocate costs between regulated and non-regulated services. "The modification or elimination of these rules," according to BellSouth, "will have the salutary effect of substantially reducing both the direct and indirect costs of regulation, without adverse consequences to the public."[509]

A major cost of rate of return regulation, according to the LECs, is the tariff filing and review process. GTE, like many of the LECs, advocated the replacement of FCC tariff filing requirements with streamlined tariff approval procedures for price and service changes that do not result in aggregate prices exceeding the price cap. According to the GTE, "tariff review procedures for [services provided to those users who have few service alternatives] should be minimal so long as there is compliance with the Commission's price cap rules."[510]

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[507]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[508]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

[509]Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 55.

[510]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 33.

Streamlined tariff review procedures, as approved by the FCC in CC Docket 86-421, presume lawfulness and provide that a party requesting suspension make a substantial showing of justification. Under these procedures, proposed tariff changes would become effective on 14 days' notice without the economic support required by Part 61.38. Proposed tariff changes that would result in rates above the cap, according to Southern New England Telephone (SNET), would have to be accompanied by "factors necessitating the change (being) fully substantiated," a position in concert with the majority of the LECs.[511] However, the form that this support should take was one of the minor differences among the LECs. For example, while SNET stated that it should be in the form of economic cost data, US West proposed the application of the traditional regulatory procedures of Section 61.38.

LECs asserted that streamlining the tariff filing and review process and eliminating burdensome regulatory procedures associated with rate of return regulation would save consumers many of the direct expenses of regulation. As NYNEX stated, "the resources expended on rate of return regulation are enormous compared to the public interest benefits that may be achieved. . . . A major source of cost savings, both direct and indirect, will flow from the reduction, if not elimination, of proceedings that involve the allocation of joint and common costs. Under rate of return regulation, cost allocation is a source of continuing debate in the regulatory arena."[512] Southwestern Bell similarly noted that those proceedings required under price cap regulation "should be far less contentious than under existing cost of service regulation."[513] NYNEX further stated that in addition to

[511]Comments of SNET, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

[512]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

[513]Comments of Southwestern Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 23.

"substantial" cost savings, Commission resources currently devoted to reviewing voluminous materials submitted by carriers can be more effectively redeployed. Pacific and Nevada Bell suggested that such redeployment could be "to explore other new policy initiatives that would serve the public interest."[514]

Aside from the direct, and, as the United Telephone System Companies stated, "staggering" costs associated with "horrendous record keeping and reporting requirements," replacement of rate of return regulation with price cap regulation would provide LECs "flexibility consistent with streamlined regulation to adjust prices in response to changes in cost, supply and demand, and in response to bypass threats, so long as the changes in the aggregate do not exceed the established price cap."[515] NYNEX stated that the flexibility of price cap regulation would allow carriers to respond more quickly to changes in customer utilization of facilities. This, in turn, would minimize customer abandonment of the public network "which is currently motivated by the uneconomic pricing schemes that exist under rate of return regulation."[516] Addressing FCC objectives, Ameritech noted that market-based pricing under price cap regulation would promote "just and reasonable" rates.

Reducing regulatory burdens would not only enable LECs to respond to market demands through changes to the pricing of existing services, the LECs continued, but also provide them with incentives to introduce new and innovative services. The carriers cited numerous reasons that this would occur under price caps, the most frequent of which being that they

[514]Comments of Pacific Bell and Nevada Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

[515]Comments of United Telephone System, FCC CC Docket No. 87-313; October 19, 1987, p. ii.

[516]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 18.

would have profit incentives to introduce new services. Whereas under rate of return regulation profits are capped, providing limited upside potential to shareowners investing in risky ventures, LEC shareowners would now face the upside as well as downside potential of new services. As GTE stated, price cap regulation would provide LECs "an opportunity to generate appropriate earnings, if the carrier can increase productivity beyond the index level and successfully meet changing customer needs and increasing competition."[517]

Freed of the "burden" of devoting substantial resources to the cost of service regulatory system, Pacific and Nevada Bell noted that another reason price caps would result in new service introductions is that LECs and their competitors would be "able to concentrate their energies and resources on improving the quality and efficiency of their service offerings, as well as on introducing new and innovative services to meet emerging consumer demand."[518] Furthermore, use of streamlined tariffing procedures would substantially reduce the length of time it may take to bring a service to market, as well as reducing its start-up costs, so that, as Centel stated, "innovations will not be impeded by the expense and delay of cost-supported tariff filings."[519] Streamlined regulatory procedures, added Pacific and Nevada Bell, would result in the removal of "unwarranted competitive handicaps" associated with "unjustified cost-of-service pricing constraints."[520]

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[517]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 28.

[518]Comments of Pacific Bell and Nevada Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

[519]Comments of Centel, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[520]Comments of Pacific Bell and Nevada Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

Given the potential for earnings growth from investments in research, development, and new service introduction, BellSouth cited another common theme. According to BellSouth, price cap regulation would provide increased incentives for research and development investments, "thereby enhancing prospects for a modern, feature-rich network. The investments made in modern technology will also improve service quality and reduce costs."[521] Similarly, United Telephone noted that the deployment of "new, highly efficient digital technology," which would be promoted under price caps, "will not only reduce costs, but it also makes available to customers improved service quality and a wealth of service enhancements."[522] GTE added that under price cap regulation, LECs would have incentives to "introduce innovations, and make the necessary ongoing investment in order to maintain and enhance service quality and variety so as to fully develop the industry's potential for an information-rich network serving the public interest."[523] LECs added that under price cap regulation, LEC management and shareowners would bear the risks of investments in new products and services, alleviating concerns over potential "gold-plating" under rate of return regulation.

Many LECs correlated incentives to innovate and introduce new services with national concerns over the global trade competitiveness of the United States. According to Southern New England Telephone, price caps are a regulatory scheme "which has the potential to enhance the role of telecommunications in the development and growth of the American economy."[524] In addition to providing consumers with "the benefits of

[521]Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[522]Comments of United Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 14.

[523]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 46.

[524]Comments of SNET, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

lower prices and good service," Bell Atlantic noted that price cap regulation would "provide strong incentives to the exchange carriers to energetically market new services to improve their earnings, thereby closing the technology gap that has opened between the US telephone system and foreign systems that already offer mass-market, information age services."[525] According to NYNEX, "the domestic telephone industry and its regulatory authorities today stand at a critical point in time: technological development promises, and international competitiveness demands, timely deployment of a telecommunications infrastructure that can maintain the Nation's leadership position in the world economy." NYNEX further warned that without regulatory reform such as price cap regulation, "there is significant danger that United States consumers will be deprived of the benefits of a public telecommunications network capable of providing information age services at reasonable prices."[526]

Ameritech directly confronted price cap critics' concerns over service quality, stating that "the notion that the LECs would allow the local exchange network to become a technological backwater defies logic." Ameritech noted four reasons for this. First, because the strength of LECs is their network, they have incentives to induce customers to use it. Second, new technology reduces costs, and shareowners will share in the benefits. Third, cost-of-service regulation that discourages innovation. Fourth, "the LECs are not fly-by-night, quick-buck artists. Their financial strength and stability depends on solid earnings in the long run," which will be possible only by maintaining a state-of-the-art network.[527] USTA similarly noted that because "the major portion of exchange carrier revenues as well as the

[525]Comments of Bell Atlantic, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[526]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 2, 46.

[527]Comments of Ameritech, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

capability to offer new or enhanced services depend upon the continued viability of the basic network, local exchange carriers have every incentive to maintain technological advances in the network and to continue high quality service."[528] Finally, as Centel and other LECs added, LEC access customers are "sophisticated users that will not idly tolerate declining levels of service."[529]

The sophistication of LEC interstate customers -- and the availability of competitive alternatives to LEC services -- was yet another common theme among LECs. According to NYNEX, price cap regulation would give LECs the flexibility and incentives to provide new services to retain and attract customers. NYNEX asserted that under rate of return regulation, if a customer leaves the public network, revenue losses must be made up from remaining customers, which causes additional customers to migrate to alternative facilities. NYNEX stated that the flexibility of price cap regulation would "help ensure the availability of a high quality, reasonably priced, feature-rich network for all customers, rather than the development of 'have' private networks and a 'have not' public network."[530] NYNEX continued, "one of the significant benefits of price level regulation over rate of return regulation is that it will enable dominant carriers to bring new services to the marketplace at a more rapid pace and thereby facilitate a flowering of the information age."[531] Pacific Bell and Nevada Bell similarly asserted that "[i]n order to compete effectively against bypass alternatives, the LECs must offer satisfactory service as well as

[528]Comments of USTA, FCC CC Docket No. 87-313; October 19, 1987, p. 13.

[529]Comments of Centel, FCC CC Docket No. 87-313; October 19, 1987, p. 19.

[530]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 18.

[531]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 34.

reasonable prices."[532] Many LECs also noted that their large, sophisticated interstate customers are very well-acquainted with the complaint processes available to them as well as the service standards contained in LEC access tariffs, neither of which is jeopardized by the implementation of price cap regulation.

Many LECs also clearly emphasized the point that implementation of price cap regulation of LECs would in no way compromise the authority of the FCC or its ability to fulfill its statutory obligations. The FCC would still have the authority to require "just and reasonable" rates, prohibit unreasonable rate discrimination, promote universal service, and monitor and enforce service quality. As BellSouth stated, "nothing in the price cap proposal affects the power of the commission to investigate the tariffs filed pursuant to the price cap plan or to hear complaints filed by the affected parties. . . . The Commission's ability to enforce these statutory obligations is not altered by the change in the form of regulation from cost of service regulation to price regulation."[533] Bell Atlantic added that "[p]rice cap regulation does not, of course, deprive the Commission of its normal jurisdiction over the quality of service."[534] In conclusion, LECs asserted that the FCC would retain its statutory authority, and the achievement of important traditional goals would be aided.

LECs also asserted that price cap regulation would result in the additional consumer benefits of rate stability and real rate reductions, and in the elimination of cross-subsidy and predatory pricing concerns. Real rate reductions -- that is, reductions in rates after inflation

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[532]Comments of Pacific Bell and Nevada Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 31.

[533]Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

[534]Comments of Bell Atlantic, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

adjustments -- were cited by LECs as a major consumer benefit of price cap regulation. As GTE stated, by allowing LECs to retain additional earnings generated by increased efficiency, "perhaps the greatest promise of a price cap mechanism is the potential for increased incentives for suppliers to be efficient." Allowing price caps to increase by an adjustment factor, such as the change in the Consumer Price Index adjusted for a productivity factor, would result in the productivity factor becoming a hurdle for LECs to strive for and surpass. GTE added that "if successful, the supplier can benefit by lowering its costs by more than the prescribed reduction in real prices implied in the adjustment formula."[535] USTA concurred, stating that the productivity offset "will further restrain prices and will assure consumers of real price decreases over time."[536] Ameritech noted that the promotion of economic efficiency, including economically efficient pricing and resource allocation, would promote universal service. Because price caps promote economic efficiency, Ameritech continued, it follows that price caps would promote universal service. According to Pacific Bell and Nevada Bell, price caps would "increase LEC productive efficiency objectives and thus promote the Commission's statutory objective more effectively than its current regulatory process," as well as "favorably" affecting the allocative efficiency objective by holding prices to "just and reasonable" levels. Moreover, the Companies continued, "LEC prices overall would not increase in real terms," and "a significant portion of any LEC gain in productive efficiency would be passed through promptly in the prices paid by customers on an ongoing basis."[537]

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[535]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 18.

[536]Reply Comments of USTA, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[537]Comments of Pacific Bell and Nevada Bell, FCC Docket No. 87-313; October 19, 1987, p. 29.

Ratepayers would also be protected, LECs noted, by the increased stability of rates under price caps. As discussed by US West, rate of return regulation has resulted in "significant rate changes" and rate restructures. US West noted that no form of regulation will end price changes, but "price regulation can and will restrain the velocity of price changes, and will provide the important benefit of rate stability to customers."[538] United Telephone added that rate instability is also costly to the LECs: many changes, required by regulatory orders, require "massive reallocation of internal resources, the cost of which is ultimately borne by consumers."[539] In summary, USTA noted that "price cap regulation will enhance rate stability, since customers will know that overall prices will not exceed a specific level without a full cost-of-service tariff filing."[540]

Additional ratepayer protection would also be provided, under the plans proposed by many of the LECs, by rate stability achieved through capping increases in certain individual services. Representing a position taken by many LECs, USTA recommended "that the Commission develop pricing rules to provide specific consumer safeguards to ensure the stability, predictability and reasonableness of rates. For example, certain rules could be crafted to protect customers of services for which no competitive alternatives exist."[541] Contel added that price

[538]Comments of US West, FCC CC Docket No. 87-313; October 19, 1987, p. 14, 18.

[539]Comments of United Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[540]Reply Comments of USTA, FCC CC Docket No. 87-313; December 4, 1987, p. 10.

[541]Reply Comments of USTA, FCC CC Docket No. 87-313; December 4, 1987, p. 24.

cap regulation would protect subscribers from "precipitous rate increases."[542]

NYNEX was more specific and proposed a plan that "affords a measure of rate protection to consumers of less competitive services by limiting annual Discretionary Adjustments to 2 percent for each switched access service and to 10 percent for each special access service."[543] However, in one of the few areas of differences among LEC positions, Southern New England Telephone, "concerned about the extent of subsidies and non-economic cost allocations required under the current rate plan" stated that "flexibility must be allowed for access element prices to move within the cap without restriction."[544]

In addition to echoing the support for averaged toll rates expressed by many LECs, small LECs also emphasized the importance of small and rural company support. As the Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO) noted, "many smaller carriers serve high cost areas and are dependent on some form of financial assistance to maintain reasonable rates. . . . [I]t is essential that the Commission continue to provide for long term, small company support as an essential element of its price cap methodology."[545] This continued support was considered necessary to protect the goal of universal service. The Taconic Telephone Corporation et al. added that pooling contributes to rate stability by

[542]Comments of Contel, FCC CC Docket No. 87-313; October 19, 1987, p. 22.

[543]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 30.

[544]Comments of SNET, FCC CC Docket No. 87-313; October 19, 1987, p. 14.

[545]Comments of OPASTCO, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

diluting the impact of some regulatory decisions as well as preventing excessive rates in rural parts of the country.

The elimination of predatory pricing and cross-subsidy concerns were also cited by many LECs as a benefit of price cap regulation. Many LECs did not consider predatory pricing to be economically rational behavior, and considered its existence to be speculative. Frequently cited as evidence was the US Supreme Court decision in Matsushita Electric Industrial Co. v. Zenith Radio Corp., in which the Court stated that "a predatory pricing conspiracy is by nature speculative."[546] For a number of reasons, as cited by Southwestern Bell, the "conditions for successful predation are unlikely to be present under a price cap model of regulation."[547] As Bell Atlantic stated, "the suspicion of cross-subsidy will always linger if the regulated carriers have an opportunity to recover costs by shifting them. Price cap regulation destroys this opportunity."[548] According to the LECs, under price cap regulation, a predator would not have the means to finance losses in the target market since losses could not be recovered by raising prices for other services. Additionally, the Commission ban on resale restrictions would permit market re-entry by competitors who would seek to share in potential excessive or monopoly profits, thereby preventing them. And finally, antitrust laws would continue to apply in telecommunications markets.

In conclusion, US West asserted that while concern over perceived or proclaimed cross-subsidies has often risen "to the level of paranoia," a key positive aspect of the price cap concept is that it would "eliminate

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[546]Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 US 574, 89 L.Ed. 2d 538, 553 (1986).

[547]Comments of Southwestern Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

[548]Comments of Bell Atlantic, FCC CC Docket No. 87-313; October 19, 1987, p. 15.

most, if not all, bona fide cross-subsidization concerns" and the incentives to engage in such activity. US West, like other LECs, therefore concluded that price floors would be unnecessary.[549] However, Centel added that "the threat of later implementing a price floor for certain services based on evidence of predation, or taking other remedial actions, would also deter any predatory action."[550] In summary, Rochester Telephone noted that a predator "would lose money by charging below-cost rates and never be able to recoup the loss by charging monopoly rates."[551] These points are particulary true, OPASTCO noted, in the case of small LECs "since they lack the economic resources and market strength necessary to successfully engage in predatory pricing."[552] Again speaking in unison with the other LECs, US West concluded that "elimination of the rate of return-based cross-subsidization incentive through a proper price cap approach is such a powerful economic device that such regulation would also eliminate the rationale for price 'floors' for competitive services."[553] GTE added that "the Commission's complaint process would provide adequate opportunity to challenge any attempt by the carrier to engage in predatory pricing."[554]

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[549]Comments of US West, FCC CC Docket No. 87-313; October 19, 1987, p. 6, 7, 13.

[550]Comments of Centel, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[551]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 15.

[552]Comments of OPASTCO, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[553]Comments of US West, FCC CC Docket No. 87-313; October 19, 1987, p. 44.

[554]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 33.

Addressing concerns and debate over the level of competition in LEC service markets, LECs asserted that the replacement of rate of return regulation with price cap regulation would not be tantamount to deregulation. While many of the companies stated that their services subject to competition should be deregulated, they noted that deregulation initiatives should be addressed in a separate deregulation proceeding, rather than the FCC proceeding on price cap regulation. As USTA stated, the proposal "is to substitute a more efficient form of regulation for a portion of the current method of regulation."[555] Noting that "special access customers, most of which are large businesses, are perfectly capable of evaluating their alternatives and selecting whatever carrier or contractor can offer them the lowest costs," Rochester Telephone stated that "the market itself thus establishes a cap for these services," and "neither price cap nor rate of return regulation is appropriate for services for which customers have competitive alternatives. When there are alternatives, the market should be allowed to determine prices."[556]

Similarly, US West asserted that "competition, where viable, is a far more efficient price regulator than even the most sophisticated regulatory system" and that "in the long run, services subject to competition should be deregulated, not simply regulated more efficiently."[557] However, United Telephone added that "the chief shortcomings of cost-of-service regulation and advantages of price cap regulation are unrelated to the presence or absence of competition in a

[555]Reply Comments of USTA, FCC CC Docket No. 87-313; December 4, 1987, p. 15.

[556]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 1, 4.

[557]Comments of US West, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

carrier's market."[558] Bell Atlantic similarly asserted that the issue of competition is irrelevant to price cap regulation. According to Bell Atlantic, "[t]hose who oppose price cap regulation on this ground, therefore, simply misunderstand the proposal -- it is not a substitute for deregulation."[559]

While providing many benefits to ratepayers, the LECs also noted that price cap regulation would not deny them their statutory protection from confiscation of property. Pacific Bell and Nevada Bell noted that "the Commission may not adopt procedures that will deprive these carriers of the opportunity to earn a reasonable return on the capital they have invested in the provision of regulated telecommunications common carrier services."[560] The Commission, the companies continued, must assure that rates are in a "zone of reasonableness" between the low point (beyond which the financial integrity of the enterprise is in doubt) and the high point (which is "excessive"). Using these criteria, LECs cited the proposed "exogenous factor" adjustment to price caps to adjust for extraordinary changes beyond the control of the carriers and the ability to file tariffs, subject to full scrutiny, that would raise existing price caps. As Contel stated, "[a] carrier would always have the right to file for rates above the price cap, particularly if rates at or below the cap would be confiscatory."[561]

[558]Comments of United Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[559]Reply Comments of Bell Atlantic, FCC CC Docket No. 87-313; December 4, 1987, p. 12.

[560]Comments of Pacific Bell and Nevada Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

[561]Comments of Contel, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

5.2.3.2. Weaknesses

For the maximum benefits of price cap regulation to be achieved, for the carriers and ratepayers alike, LECs unanimously supported concurrent implementation for AT&T and LECs. According to the LECs, to implement price caps first for AT&T, and later for the LECs, would reduce the level of benefits flowing directly to ratepayers, and would also provide incentives to AT&T to bypass the local network.

Southwestern Bell, for example, asserted that "[d]elaying implementation [of LEC price cap regulation] would certainly reduce the publicly perceived gains from the adoption of price cap regulation and would have an adverse impact on the LECs."[562] Because access charges represent approximately 50% of AT&T's interstate service prices, Ameritech asserted that "any inefficiencies and distortions inherent in cost-of-service generated access charges would be passed along at 50% strength to interexchange ratepayers."[563]

In addition to concerns over the level of benefits accruing to consumers, LECs asserted that under price cap regulation, AT&T would have the incentive to bypass LEC access facilities in an effort to reduce expenses below those dictated by traditional regulation. As BellSouth stated, "by shifting to price cap regulation for the LECs, the Commission will signal that the LECs will be allowed, over time, to price their access services in a more economically efficient fashion, thereby minimizing the threat of uneconomic bypass."[564] NYNEX further asserted that when AT&T engages in uneconomic bypass, under rate of return regulation "the LECs would offset any resulting revenue loss by

[562]Comments of Southwestern Bell, FCC CC Docket No. 87-313; October 19, 1987, p. ii.

[563]Comments of Ameritech, FCC CC Docket No. 87-313; October 19, 1987, p. 13.

[564]Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 44.

increasing prices, which in turn would trigger an increase in AT&T's price cap ceiling and in AT&T's prices. This, in turn, would encourage additional uneconomic bypass, triggering yet additional price increases -- a spiral effect."[565] As Ameritech stated, providing AT&T with pricing freedom denied LECs would "leave the LECs out in the competitive cold."[566] Conversely, Southwestern Bell asserted that "[c]ontemporaneous implementation of price cap regulation would result in a slowdown and possibly a reduction of uneconomic bypass of the LECs' switched network. Such reductions in the rate of bypass would lead to more efficient use of economic resources and, ultimately, to lower prices for consumers."[567] Thus, LECs concluded that concurrent implementation of price cap regulation for AT&T and the LECs would resolve the concerns over uneconomic bypass, as well as result in real price benefits to ratepayers where reductions in AT&T access costs are flowed through to them as an exogenous price cap adjustment factor.

Regarding the FCC's concern that implementation of price caps may result in certain complexities, Southwestern Bell noted that "the fact that there are many LECs to deal with is an observation, not a constraint. Under any regulatory scheme, the Commission would have to interface with the same number of LECs." Southwestern Bell concluded that "the diversity of the LECs should not preclude nor delay implementation of price cap regulation for them."[568] According to BellSouth, while it is more complex to regulate 1400 LECs than a single AT&T, that complexity "exists under cost-of-service regulation at least

[565]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 24.

[566]Comments of Ameritech, FCC CC Docket No. 87-313; October 19, 1987, p. 14.

[567]Comments of Southwestern Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 24.

[568]Comments of Southwestern Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 14.

as much as under the much simpler price cap regulation." BellSouth concluded, "the administrative problems associated with price cap regulation of the LECs should be substantially less than those the Commission will encounter in continuing cost of service regulation."[569] Bell Atlantic further asserted that implementation of price cap regulation of LECs could be simpler than for AT&T. According to Bell Atlantic, "AT&T's domestic MTS and WATS tariffs include 991 different rate elements. By contrast, Bell Atlantic's switched access tariff, which is the primary access complement to these AT&T services, includes only 115 rate elements."[570]

LECs also agreed on the need to introduce regulatory reform without adding a layer of regulation to the current rate of return regulatory regime. As BellSouth noted, "it is clear that the only way that substituting price caps for cost of service regulation will reduce the direct and indirect cost of regulation to society is if the Commission eliminates that portion of the regulatory infrastructure that will no longer be required under the new methodology." In fact, BellSouth asserted that "if the monitoring plan selected [by the Commission to monitor LEC earnings] amounts to little more than overlaying price cap regulation on top of existing cost of service regulation, both consumers and carriers will be harmed rather than benefited."[571] Southern New England Telephone (SNET) agreed, asserting that "price cap regulation and rate of return regulation are mutually exclusive," and that "retention of any rate of return parameters will simply impose a dual system of regulation upon the LECs, thereby increasing the regulatory burden and jeopardizing the benefits which could accrue under the

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[569]Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 40.

[570]Reply Comments of Bell Atlantic, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

[571]Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 38, 49.

proposed regime." SNET further noted that monitoring for excess earnings would carry with it the impending threat of refunds, and concluded that "LECs' incentives for increasing their efficiencies will be compromised by the extensive reporting and refund mechanisms which are in place today." SNET concluded that the result would be that "the experiment will fail."[572]

GTE agreed, stating that "the increased incentives for productivity and innovation sought by the Commission in this proceeding will not be realized so long as carriers continue to be burdened with unnecessary pricing restrictions and cost of service monitoring and with rigid ROR limitations."[573] GTE added that adding a layer of regulation would further constrict LECs' ability to be responsive to the marketplace, and Rochester Telephone added that it would maintain perverse incentives to be inefficient and to cross-subsidize competitive services. Taconic Telephone et al. also stated that the Commission "must refrain from adopting complicated regulations . . . developed for rate of return regulation." According to these companies, imposing these regulations would "unnecessarily complicate the price cap regulatory procedures without providing any corresponding public interest benefits."[574]

Bell Atlantic concluded that proposals to share "excess" earnings under price cap regulation with ratepayers do not address the need for a potential for rewards not subject to Commission forfeiture in return for the risks carriers will assume under price caps. The result of such proposals, Bell Atlantic asserted, would be "an enormous increase in administrative red tape: more regulations, more data, more studies, and

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[572]Comments of SNET, FCC CC Docket No. 87-313; October 19, 1987, p. v., 4, 20.

[573]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 45.

[574]Comments of the Taconic Telephone Corp., et al., FCC CC Docket No. 87-313; October 19, 1987, p. 8.

more pleadings which will gladden the hearts of Washington lawyers and their troupes of academic experts but which will confer no benefits whatsoever on the public at large."[575]

5.2.3.3. Differences among LEC positions

The only major differences among LECs generally concerned the mechanics of implementing price cap regulation. These differences concerned the timing of implementation, including the determination of which carriers should be eligible for price cap regulation first, and the appropriate productivity factors to be used. While differing on the specific level of aggregation of price cap categories, LECs agreed that a high level of aggregation would be appropriate and necessary in order to reduce regulatory burdens and provide LECs with the pricing flexibility necessary to respond to customer demand and competition. As US West asserted, too high a level of disaggregation "would result in a regulatory situation which would be even more complex and cumbersome than rate of return regulation."[576]

LECs generally provided reasons why implementation to their subset of carriers would not involve an inordinate level of complexity. For example, Ameritech offered a voluntary approach, "letting the major LECs opt for price cap regulation" while "recognizing the diversity of the LECs by permitting the smaller companies to retain cost of service regulation where that traditional approach remains more appropriate."[577] Pacific Bell and Nevada Bell asserted that the National Exchange Carrier Association traffic sensitive pool "does not create any additional 'complications' in implementing price cap regulation promptly for LECs

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[575]Comments of Bell Atlantic, FCC CC Docket No. 87-313; October 19, 1987, p. 17.

[576]Comments of US West, FCC CC Docket No. 87-313; October 19, 1987, p. 30.

[577]Comments of Ameritech, FCC CC Docket No. 87-313; October 19, 1987, p. 32.

not participating in that pool" and concluded that these eligibility criteria "would effectively limit the number of LECs that would initially implement a system of price cap regulation to a manageable total."

However, to assure that a small number of LECs initially participate in price cap regulation, Pacific Bell and Nevada Bell proposed that if necessary, the Commission could limit initial participation to LECs with more than 50,000 access lines filing their own traffic-sensitive tariffs. While thus limiting the number of eligible carriers, they noted that these LECs "would likely account for more than 90 percent of the nation's access lines [making] the benefits of price cap regulation promptly available to the vast majority of consumers in this country."[578] Southwestern Bell concurred, stating that approximately 100 of the 1400 LECs do not participate in the traffic-sensitive pool, yet they account for over 90 percent of the total traffic-sensitive revenue requirement.[579]

However, the Taconic Telephone et al. disagreed, asserting that "the smaller, locally owned and operated carriers appear to be particularly well-suited for price cap regulation."[580] Taconic cited as evidence the successful use of average schedules, which it stated is a similar form of regulation to price cap regulation, which has not resulted in exorbitant rates, predation, or customer complaints. They also noted that smaller companies lack the financial ability and incentives to engage in anticompetitive conduct. Centel proposed that "because of the special circumstances associated with small LECs (under 50,000 access

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[578]Comments of Pacific Bell and Nevada Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 27.

[579]Comments of Southwestern Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[580]Comments of Taconic Telephone et al., FCC CC Docket No. 87-313; October 19, 1987, p. 4.

lines in a study area) that do not file their own tariffs, price regulation should be optional."[581]

Centel also expressed the viewpoint that individual LEC characteristics should be taken into consideration in the determination of an appropriate productivity adjustment. According to Centel, the productivity factor must be flexible enough to "provide added incentive for those LECs that have already undertaken major programs to increase productivity and reduce operating costs." Centel continued, "[t]o impose an industry-wide productivity factor would unfairly penalize and discriminate against those LECs . . . which have been progressive because further efficiency gains will be harder for them to achieve."[582]

However, Taconic Telephone et al. opposed the use of a productivity factor for small companies at all, since it "would likely result in underearnings by the smaller carriers since they can not experience increases in productivity comparable to those of the BOCs."[583] OPASTCO further stated that a productivity factor for small companies would be "irrelevant, unnecessary and detrimental."[584] While agreeing that a productivity factor should not apply to small telephone companies, Contel agreed with Centel that the factor applied to other carriers must take into consideration the ability of each carrier to implement productivity improvements; Contel suggested a "simple to compute formula that would determine a carrier's productivity index based, for example, on such factors as percentage of digital switches and expenses per

[581]Comments of Centel, FCC CC Docket No. 87-313; October 19, 1987, p. 19.

[582]Comments of Centel, FCC CC Docket No. 87-313; October 19, 1987, p. 14.

[583]Comments of Taconic Telephone et. al., FCC CC Docket No. 87-313; October 19, 1987, p. 10.

[584]Comments of OPASTCO, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

access line." (Contel also noted that it has "already converted a large percentage of its offices to digital switches.")[585] However, Ameritech stated that any use of a productivity factor beyond the Consumer Price Index (CPI) would not be necessary because "the CPI already reflects productivity gains."[586] Conversely, BellSouth proposed that price caps be adjusted for both inflation and productivity to insure "that consumers benefit from reduced real cost of telephone service over time."[587] Representing yet another variation on the productivity proposals, GTE suggested a weighted productivity factor based on the relative size of LEC study areas, "since, for the LECs, productivity improvements are often related to economies of scale."[588]

Other differences in LEC positions involved the mechanics of handling remaining pooling arrangements and the need for a more specific proposal from the FCC. While Contel stated that "a properly designed and implemented price cap plan can free the telecommunications industry from the costly constraints of rate of return regulation, permit pricing flexibility in response to competition, and protect ratepayers in those instances where the carrier might retain vestiges of market power," it requested the Commission to "issue a further notice in this proceeding to provide interested parties opportunity to comment on the details of a complete price cap plan." These details, according to Contel, will determine whether or not the plan will actually serve the public

[585]Comments of Contel, FCC CC Docket No. 87-313; October 19, 1987, p. 17, iii.

[586]Comments of Ameritech, FCC CC Docket No. 87-313; October 19, 1987, p. 22.

[587]Comments of BellSouth, FCC CC Docket No. 87-313; October 19, 1987, p. 24.

[588]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 23.

interest.[589] Similarly, Cincinnati Bell supported regulatory reform that "encourages increased efficiency and innovation while lessening regulatory burdens and administrative costs," but "does not believe that any price cap model has been sufficiently defined to permit a determination as to whether its implementation . . . satisfies those criteria and would serve the public interest."[590]

Alone among LECs filing comments in the FCC price cap docket (FCC CC Docket 87-313), CP National, a high cost fund NECA tariff company serving rural areas of the west and southwest, opposed price cap regulation of LECs. CP National cited some concerns expressed by other LECs, including problems associated with unequal AT&T/LEC implementation, productivity differences, and the creation of an additional layer of regulation if the FCC continues to monitor rate of return. Other concerns included the potential for conflicts between federal price cap policy and intrastate cost-based regulation and the possibility of network deterioration (though "CP National does not believe this dire result will necessarily occur").[591] CP National added that pooling, small company development, and the maintenance of average interstate rates were not adequately addressed in the Notice of Proposed Rulemaking issued by the FCC. In conclusion, CP National offered to participate in a "more systematic" review of amendments to the regulatory process.

[589]Reply Comments of Contel, FCC CC Docket No. 87-313; December 4, 1987, p. 13.

[590]Comments of Cincinnati Bell, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

[591]Comments of CP National, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

5.2.4. IXCs: overview

While their positions conflict with those taken by the vast majority of the LECs, the IXCs were, like the LECs, virtually unanimous in many of their positions regarding LEC price cap regulation. While the IXCs generally did not engage in overall philosophical discussions regarding the concept of price cap regulation of LEC services, they cited many overwhelming weaknesses that would make such regulation inappropriate. Among these weaknesses are LECs' monopoly control of bottleneck exchange access, and the resultant ability of LECs to use their market power to cross-subsidize services and price discriminate among customers; their use of predatory pricing to stifle competition; the incentive price cap regulation would provide to maximize profits at the expense of service quality; the difficulty of administering price cap regulation for 1400 diverse LECs and the LEC revenue pools; and the administrative complexity associated with the necessary maintenance of rate of return monitoring, on top of price cap regulation, to ensure the protection of monopoly customers. In fact, the limited support price cap regulation of LECs received was generally from those IXCs suggesting the FCC institute a separate, more complete, proceeding if it intends to pursue price cap regulation of LECs further.

5.2.4.1. Weaknesses

The most frequent and most vociferously stated IXC position on price cap regulation of LECs was that LECs retain their monopoly status as providers of local access services, and that consumer protections are therefore necessary to "protect the public interest." MCI asserted that "the LECs continue to control exclusive access to bottleneck facilities required by other providers of telecommunications services. They also control both the pace and scope of the development of competition within the local exchange market."[592] AT&T agreed, noting that the LECs' control of "a near total monopoly in the provision of their exchange

[592] Comments of MCI, FCC CC Docket No. 87-313; October 19, 1987, p. 20.

access services" results in "considerable discretion in setting the prices for individual services."[593] ALC Communications noted that technological developments have not changed this monopoly control, stating that "large users, like residential and small business customers, cannot do without the LEC monopoly bottlenecks -- they are prisoners of the local switching and transmission capabilities of the LECs."[594] As evidence of this continued monopoly control, many IXCs cited Peter Huber's report to the Department of Justice during the triennial review of the Modified Final Judgement and the subsequent decision of Judge Harold Greene; he concluded that local competition has not developed "because of the economic and technological infeasibility of alternative local distribution technologies."[595]

The monopoly control of this network, concluded the National Telecommunications Network, "gives [the LECs] far greater ability than AT&T to charge excessive and unreasonable monopoly rates, and therefore requires different regulatory attention."[596] MCI agreed, concluding that "under these circumstances, and given the demonstrated misuse by the LECs of their market power, more intense regulatory scrutiny of their activities is required."[597] The Competitive Telecommunications Association (CompTel) agreed, stating "the absence of any competitive pressures on the LECs makes it essential that the Commission ensure that vital access services are priced reasonably, in light of their

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[593]Comments of AT&T, FCC CC Docket No. 87-313; October 19, 1987, p. 39.

[594]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 30.

[595]US v. Western Electric Co., C.A. No. 82-1192, D.D.C. September 10, 1987.

[596]Comments of NTN, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[597]Comments of MCI, FCC CC Docket No. 87-313; October 19, 1987, p. 20.

underlying costs, since the marketplace cannot drive the LECs' prices down to costs."[598]

Due to this control of the local distribution bottleneck by LECs, many IXCs, as ALC Communications stated, opposed "application of any alternative scheme for regulating the LECs as premature and wholly inappropriate."[599] United States Transmission Systems (USTS) further asserted that "a competitive alternative for local exchange carrier services is so remote at this point that deviations from existing cost of service regulation for those carriers cannot realistically be considered in the course of this [FCC CC Docket 87-313] rulemaking proceeding."[600] CompTel, stating that "it is simply incontrovertible that the LECs continue to exercise monopoly power," asserted that the public interest goal of regulation to curb the abuse of LEC monopoly power would not be met under price cap regulation. Moreover, CompTel further stated that there is "no justification for depriving consumers and interexchange carriers who lack viable competitive alternatives of the protection of cost of service regulation."[601]

Taking this notion one step further, ALC Communications proposed that "rather than abandoning cost of service regulation for the LECs, the Commission should continue to concentrate its efforts on improving its ability to subject those carriers to more effective cost of service

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[598]Comments of CompTel, FCC CC Docket No. 87-313; October 19, 1987, p. 28.

[599]Comments of ALC; p. 2.

[600]Comments of USTS, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

[601]Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 20; and Comments of CompTel, FCC CC Docket No. 87-313; October 19, 1987, p. 27.

regulation."[602] MCI mirrored this recommendation, noting that "because of the LECs' market power . . . virtually all parties argued that cost of service regulation together with the full set of customer protections inherent in the Commission's tariffing policies and rules must be maintained for LECs -- and, indeed, improved and enforced." In fact, MCI further proposed that "administrative resources that might be 'freed-up' from the unnecessary regulation of AT&T could more effectively be applied to preventing continued abuse by the LECs of their market position."[603]

Given the widely-held position that LECs maintain a monopoly over local access services, IXCs based their support of continued -- and improved -- regulatory scrutiny of LECs on the many abuses that they assert would occur under relaxed regulation such as price caps. Summarizing IXC concerns over abuses, National Telecommunications Network asserted that the "near total absence of competition to the LECs leaves them all the more free to exercise their monopoly pricing power, reduce service quality, and block any incipient local exchange competition that might otherwise develop."[604]

LEC pricing abuses, according to AT&T, can take different forms, including "the potential for cross-subsidy, 'strategic pricing,' and price discrimination."[605] Western Union asserted that LECs would "have a substantial free hand . . . to provide some services at below-cost

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[602]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[603]Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. 4; Comments of MCI, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[604]Comments of NTN, FCC CC Docket No. 87-313; October 19, 1987, p. 33.

[605]Reply Comments of AT&T, FCC CC Docket No. 87-313; October 19, 1987, p. 40.

levels, imposing the cross-subsidization burden on other services."[606] National Telecommunications Network (NTN) noted that such action would lead to predatory pricing. According to NTN, LECs "have an enormous natural monopoly customer base that they can use as a source of revenue to defeat incipient fringe competition. They can exploit that customer base through higher prices, reduced service quality, or both."[607] MCI added that LECs' cross-subsidy of certain services can also "harm [interexchange] competition by implementing access charge changes that disadvantage carriers that have not had, and do not yet have, universal equal access."[608] ALC Communications agreed, fearing that "LECs would likely engage in discrimination -- pricing services to more important customers lower and subsidizing these prices with higher rates to all others."[609]

This common IXC concern of price discrimination and cross-subsidization was most forcefully argued by competitors of AT&T, who fear, in the words of CompTel, "that LECs would engage in destructive price and service discrimination favoring their most important customers, particularly AT&T. The victims of such discrimination would be AT&T's competitors and small business consumers who would be forced to cross-subsidize these strategies." CompTel further asserted that "the absence of regulatory controls means also that the LECs would have significant ability to victimize consumers who do not have alternatives through rate restructurings and by imposing onerous terms and conditions

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[606]Reply Comments of Western Union, FCC CC Docket No. 87-313; December 4, 1987, p. 4.

[607]Reply Comments of NTN, FCC CC Docket No. 87-313; December 4, 1987, p. 17.

[608]Comments of MCI, FCC CC Docket No. 87-313; October 19, 1987, p. iv.

[609]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 33.

for their services."[610] According to the IXCs, these concerns are particularly acute when broad aggregated service categories are used to determine price caps.

Many of the IXCs cited current LEC pricing behavior as evidence of the potential for even worse behavior under price cap regulation. Frequently cited were the LEC 1988 annual access tariff filings, which the IXCs claimed were "unreasonable" and "overstated." Representative of IXC concerns, Western Union claimed that the 1988 tariff filings contained "cost material . . . [that] was woefully deficient . . . and there was substantial evidence of over-allocations of costs to the special access revenue requirement."[611] MCI also noted a consensus of concern among user groups on LEC use of strategic pricing, rate churn, and price increases, as well as LECs' "unfettered ability and demonstrated willingness to continue to price special access services substantially above costs," all of which evidence a lack of concern about competitive alternatives. Regarding the 1988 access tariff filings, MCI stated that they "do not inspire confidence that those carriers can be relied upon to follow a more reasonable, rational approach to pricing access services if the current tariffing process is substantially overhauled."[612]

Refuting LEC claims of bypass threats, IXCs claimed that alternatives are not available to them; the LEC bottleneck monopoly control extends to access services. National Telecommunications Network noted that "neither NTN nor any of its members use bypass facilities for even five

[610] Comments of CompTel, FCC CC Docket No. 87-313; October 19, 1987, p. 28; and Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 25.

[611] Reply Comments of Western Union, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

[612] Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. 4, 43.

percent of their traffic, and several members use virtually no bypass at all."[613] NTN asserted that it would use more bypass if alternative access were available, because access rates are often unreasonably discriminatory. In addition, many IXCs noted that under rate of return regulation, LECs have the flexibility to reduce access service elements in response to bypass threats, but continued over-pricing is evidence of the lack of true bypass alternatives. As further evidence of LEC monopoly power, MCI cited market share statistics provided by LOCATE (a provider of alternative access), claiming LEC market share at 99.99995%. MCI also claimed that while there is "no impediment to the LECs reducing their access charges today and earning lower rates of return," proposed increases and rates of return "up to 40% or more" indicate "a great deal of flexibility under the existing framework to reduce their rates to reasonable levels." The fact that they have not reduced rates, according to MCI, reflects "a lack of genuine concern about the existence of possible competitive alternatives."[614]

Again basing their positions on the alleged LEC monopoly dominance of access service markets and their resulting ability to abuse their market power, IXCs expressed concerns about LEC incentives to allow service quality to deteriorate under price cap regulation in an effort to maximize profits. AT&T recommended that the Commission "should consider safeguards to assure that the substitution of price caps for full rate of return regulation does not lead to a deterioration in service quality."[615] Perhaps less optimistic that price cap regulation will be applied to LECs, MCI, referring to equal access concerns, asserted that "LECs assurances that they have, and will have, the incentive to

[613]Comments of NTN, FCC CC Docket No. 87-313; October 19, 1987, p. 34.

[614]Comments of MCI, FCC CC Docket No. 87-313, October 19, 1987, p. 47.

[615]Comments of AT&T, FCC CC Docket No. 87-313; October 19, 1987, p. 53.

maintain high quality service are contradicted by their current level of performance."[616] ALC Communications related service quality concerns to the LECs' position as a monopolist: "degradation of LEC service quality could develop into a serious problem under a price cap approach. LECs could increase profits dramatically by reducing their investment in the network . . . without running the risk that they will lose market share."[617] National Telecommunications Network concluded that "LEC incentives to profit-maximize will inevitably lead to <u>reductions</u> in service quality."[618]

The potential reduction in service quality, many competitors to AT&T noted, could be detrimental to the very interexchange competition the FCC has promoted, due to its discriminatory impact. As CompTel asserted, "LECs would be primarily motivated to make profit-maximizing decisions to upgrade their networks on a selective basis so as to benefit their most important customers."[619] ICF economists Kenneth Baseman and Stephen Silberman, writing for MCI, agreed with these IXC concerns and asserted that "under price cap regulation, firms that can expect to retain monopoly power for the foreseeable future will have an incentive to increase profits by reducing quality and its associated costs."[620] Baseman and Silberman also cited the potential for service

[616]Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. 54.

[617]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 34.

[618]Reply Comments of NTN, FCC CC Docket No. 87-313; December 4, 1987, p. 18.

[619]Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 21.

[620]<u>An Analysis of the Utility of Price Cap Regulation as Applied to Local Exchange Carriers</u>, by Kenneth Baseman and Stephen Silberman, Appendix to Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. A-10.

quality to suffer where price caps may provide inadequate returns to the LECs.

Also as a result of LECs' monopoly market position, IXCs asserted that LECs would not have any incentives to flow the benefits of reduced costs or pricing flexibility to consumers. ALC Communications stated that "as monopolists, LECs can and will maximize profits" but that "carrier cost savings will not be flowed through to most customers in the form of rate decreases in the absence of competitive pressures which force them to be."[621]

IXCs noted that despite the previously cited flexibility, which was not properly utilized, LECs do not need pricing flexibility because they do not face competition. CompTel asserted that "since the LECs do not experience meaningful competitive pressures, they do not require the additional pricing flexibility that would be afforded by any new regulatory plan."[622] ALC Communications, agreeing that LECs "do not require the pricing flexibility which would be afforded by a price cap plan," also claimed that such flexibility could only lead to cost shifting, "a highly effective tool the LECs could use to stamp out any nascent competition through discriminatory pricing."[623]

To guard against the potential abuses they cited, many IXCs asserted that any price cap regulation applied to LECs must be combined with the precautionary use of rate of return regulatory monitoring. According to Baseman and Silberman, price caps may permit a carrier, in the long run, "to earn substantially in excess of currently allowed rates of return."

[621]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 34.

[622]Comments of CompTel, FCC CC Docket No. 87-313; October 19, 1987, p. 28.

[623]Reply Comments of ALC, FCC CC Docket No. 87-313; December 4, 1987, p. 33.

They concluded that over the long run, the only method to determine that ratepayers are not paying monopoly rates is to examine LEC profits; political considerations, they added, are likely to support this conclusion.

However, the result would be, according to Baseman and Silberman, that the LECs "would continue to behave as if they were rate of return regulated."[624] Western Union added that using rate of return regulation to evaluate price cap regulation, while necessary, would result in maintaining "virtually all the regulatory paraphernalia associated with cost of service ratemaking," while necessitating construction of "an entirely new and complex machinery." This would be particularly so, Western Union noted, where LECs retain "the option of filing under the price cap model if it produces high rates of return, and filing under the cost of service model, where the price cap results in inadequate earnings."[625] In addition, as Baseman and Silberman noted, while the "ex ante" tariff filing reviews of cost of service regulation may be eliminated, "ex post" reviews of regulatory costs, "to police anticompetitive pricing, including antitrust actions, could increase."[626]

Other modifications to a "pure" price cap plan would be necessary, according to IXCs, should their application to LECs be considered. These modifications would be necessary to address the number and diversity of LECs, as well as the pooling mechanisms, as cited by the FCC in its Notice of Proposed Rulemaking. As CompTel stated, "the financial and structural circumstances of individual LECs do vary

[624]Report of Baseman and Silberman, Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. A-4, A-7.

[625]Comments of Western Union, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[626]Report of Baseman and Silberman, Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. A-12.

considerably."[627] IXCs asserted that this results in the need to modify price cap plans to fit individual LECs and their circumstances. However, National Telecommunications Network cited the absence of such tailoring as "the principle flaw of the Notice."[628] AT&T asserted that any regulatory reforms must "take account of carriers' different market positions and administrative characteristics, and include conditions which safeguard the legitimate interests of all customers who purchase service from carriers operating under alternative regulatory schemes."[629]

A major factor to be considered, according to the IXCs, is the productivity factor proposed as an adjustment to the price caps. As MCI stated, "the technological advances that have fueled productivity gains in the interexchange sector will increasingly be introduced in the local exchange. . . . Collectively, these trends should produce material gains in the efficiency of local exchange networks in the years ahead."[630] AT&T asserted that since the LECs

> argue at length that they will be substantially more productive after the inefficiencies and disincentives of rate of return regulation are removed . . . there is every reason to expect that the LECs' productivity growth under price cap regulation would exceed both their own past productivity gains as well as future productivity gains in the interexchange industry.[631]

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[627]Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 27.

[628]Comments of NTN, FCC CC Docket No. 87-313, October 19, 1987, p. 10.

[629]Comments of AT&T, FCC CC Docket No. 87-313; October 19, 1987, p. iv.

[630]Comments of MCI, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

[631]Reply Comments of AT&T, FCC CC Docket No. 87-313; December 4, 1987, p. 48.

The determination of an appropriate productivity factor would be further complicated by the diversity of the LECs, the IXCs continued. As Western Union noted, "the individual carriers exhibit too much variation among them to provide any confidence" that a single industry factor will be workable when applied to individual carriers. "As a consequence," Western Union concluded, "the price caps are likely to result in grossly excessive (or inadequate) earnings for individual carriers."[632] According to the IXCs, one of two results may occur. Either customers may not receive the full benefit of efficiency gains if an average factor is used and price cap participation is voluntary -- LECs experiencing higher productivity gains would participate and those with lower gains would remain under cost of service regulation -- or the selection of appropriate factors "can be expected to absorb substantial resources."[633]

Price cap regulation of LECs, according to the IXCs, would be further complicated by the need to establish narrowly-defined service category caps. The IXCs asserted that this would be necessary in order to counter the potential for cross-subsidies and predatory pricing that the LECs, as monopolists seeking to maximize profits, would exhibit. According to Baseman and Silberman, since price cap regulation would eliminate the opportunity for regulators to routinely examine LEC costs, "it would enhance the ability of the carriers to cross-subsidize, especially if there were a single broad rate cap rather than separate caps for different classes of service."[634] USTS similarly asserted that "[a]ny broadly aggregated price caps . . . would inherently lend themselves to rate manipulation within the aggregated price cap, leading

[632]Comments of Western Union, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[633]Report of Baseman and Silberman, Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. A-11.

[634]Report of Baseman and Silberman, Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. A-9.

to cross-subsidization and other anti-competitive behavior detrimental to both competitors and consumers."[635] A detailed examination of price caps would be necessary in addition to the review of "going in" prices that would be necessary, according to IXCs, to determine that the rates be "just, reasonable, and non-discriminatory."

Finally, in addition to the general complexity associated with the LEC revenue pools cited by the IXCs, AT&T also expressed concern over LEC proposals to apply price cap regulation to access services not subject to pooling, leaving pooled services and service rate elements under existing regulation. AT&T claimed that this "could pose a serious risk that costs could be shifted from capped to uncapped categories, leading to higher prices overall."[636]

5.2.4.2. Limited support

Clearly, IXCs generally did not support price cap regulation of LECs. However, tempering their opposition slightly, some IXCs stated that if the FCC intends to replace rate of return regulation of LECs, then a separate and more detailed proceeding would be necessary. For example, while US Sprint stated that "where a service is fully competitive, there is no reason to regulate further" and cited weaknesses associated with rate of return regulation, including its inability to handle competition or "partial or sequential deregulation," it concluded that there are implementation problems for LECs. US Sprint, therefore, "takes no position on whether a form of price cap regulation is suitable for the LECs" and recommended that price caps for LECs be examined in a separate phase of the FCC proceeding. (US Sprint noted that "it is possible that in this separate phase, the Commission will want to inquire further as

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[635]Reply Comments of USTS, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[636]Reply Comments of AT&T, FCC CC Docket No. 87-313; December 4, 1987, p. 44.

to the competitive status of the LECs.")[637] CompTel agreed, suggesting that "if the Commission decides to examine further departing from cost of service regulation of the LECs, it should do so in a separate proceeding."[638] National Telecommunications Network also stated that a separate proceeding would be necessary, but only after the Commission devotes "attention over the next several years to restraining the LECs from abusing their access bottleneck."[639] However, MCI represented the view that as long as LECs continue to earn "excessive" rates of return and "persist in increasing rates to captive customers for special access services and non-recurring items," then price cap regulation for LECs should not be considered.[640]

Even the two voices among the IXCs expressing limited support for price cap regulation of LECs, AT&T and the Alternative Carrier Telecommunications Association (ACTA), tempered this support. ACTA concluded that while the Commission supports the lessening of regulatory burdens, "it is also important for the Commission to maintain such regulation as is necessary to assure that fair and equitable competition occurs. A price cap scheme without adequate safeguards would serve neither the telecommunications industry as a whole nor the public interest."[641] Similarly, AT&T stated that it

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[637]Comments of US Sprint, FCC CC Docket No. 87-313; October 19, 1987, p. iii, 6, iv, 14.

[638]Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 33.

[639]Comments of NTN, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

[640]Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. iv.

[641]Comments of ACTA, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

> supports the general concept of eliminating rate of return egulation for all interstate services, so long as reformed regulatory procedures take account of carriers' different market positions and administrative characteristics, and include conditions which safeguard the legitimate interests of all customers who purchase service from carriers operating under alternative regulatory schemes.[642]

However, recognizing the potential delay associated with implementation of a price cap scheme for LECs, AT&T stated that

> under no circumstances . . . should consideration of regulatory alternatives for the LECs be permitted to delay initiation of price cap regulation of AT&T . . . there is no reason to deny consumers the benefit of improved regulation if one plan is ready before another.[643]

5.2.5. Other industry organizations

5.2.5.1. Alternative service providers: opposition

Communications service providers (for example, of cellular radio services and pagers as well as of alternative access) cited arguments similar to those expressed by the IXCs against the application of price cap regulation to LECs. Like the IXCs, these providers focused their concerns on LEC control of monopoly services and the resulting potential for, and ability to, abuse captive customers. LOCATE, a competitive provider of alternative access services (an LEC competitor) claimed to have a 0.00005% access service market share, leaving the LECs with a 99.99995% share. LOCATE concluded that in the case of LEC services, "all services are virtual monopoly services."[644] Telocator Network of America agreed, also noting that its members -- providers of paging,

[642]Reply Comments of AT&T, FCC CC Docket No. 87-313; December 4, 1987, p. 57.

[643]Comments of AT&T, FCC CC Docket No. 87-313; October 19, 1987, p. 64.

[644]Comments of LOCATE, FCC CC Docket No. 87-313; October 19, 1987, p. 2, 4.

two-way mobile telephone, and cellular radio services -- all "rely upon the local exchange carriers for reasonably priced interconnection."[645]

Given their monopoly position, LECs have been guilty of pricing abuses, according to the service providers. Aeronautical Radio, the communications company of the air transport industry, cited the "historical tendency of many carriers to inflate the rates for those services for which few substitutes exist in order to extract monopoly rents from captive customers."[646] LOCATE asserted that when this happens, "the public interest loses, the monopoly customer is overcharged, while the competitive customer is undercharged." Pricing abuses include predatory pricing where, according to LOCATE, LECs make "excess profits on one service to compensate for a predatory price on another, more competitive, service."[647] Like the other service providers, McCaw Communications feared the impact such pricing strategy would have on it; McCaw asserted that under price caps, "the use of highly aggregated price caps would enable LECs to cross-subsidize freely to the disadvantage of mobile services competitors, which lack network alternatives."[648]

Providers also noted the need to ascertain the appropriate level of "going-in" rates. Aeronautical Radio stated that "the Commission must establish the lawfulness of the initial rates to be capped." According to Aeronautical Radio, many existing rates "are likely to be found

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[645]Comments of Telocator, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

[646]Comments of Aeronautical Radio, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[647]Comments of LOCATE, FCC CC Docket No. 87-313; October 19, 1987, p. 3. 5.

[648]Comments of McCaw, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

unlawful in significant respects."[649] McCaw maintained that LECs use their market power to establish interconnection agreements that "amply demonstrate the propensity of many LECs to impede mobile services competition. . . . [T]he LECs can be expected -- given their past practices -- to misuse the additional flexibility afforded by price cap regulation to the injury of their competitors, or the enhancement of their wireline cellular affiliates."[650]

The result, according to the providers, is to protect consumers adequately. LOCATE recommended that "if price caps are implemented, further anti-competitive safeguards against predatory pricing are required -- most notably a prevention against strategic pricing."[651] McCaw agreed, stating "it is essential that the Commission adequately explore how the LECs' monopoly power might be constrained under price cap regulation."[652] McCaw suggested use of multiple price caps. Aeronautical Radio agreed, asserting that "the Commission must disaggregate the price caps sufficiently to prevent the extraction of monopoly rents from captive ratepayers."[653] However, LOCATE asserted that predatory and strategic pricing could occur under price caps even if individual caps were established for each service. LOCATE further asserted that price cap regulation probably would not relieve the Commission of its "tortuous" review of statistics every time a cap is changed.

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[649]Comments of Aeronautical Radio, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 5.

[650]Comments of McCaw, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[651]Comments of LOCATE, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

[652]Comments of McCaw, FCC CC Docket No. 87-313; October 19, 1987, p. 12.

[653]Comments of Aeronautical Radio, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

While not opposing price caps as strongly as the IXCs (though McCaw and Telocator noted that price cap regulation would not apply to them as mobile service co-carriers), the service providers generally supported a more detailed phase of the FCC price cap proceeding to address the potential implementation of LEC price cap regulation. Aeronautical Radio cited the "promise of a number of advantages for users" but concluded that "if the Commission determines to go forward with its price cap proposal, [Aeronautical Radio] urges it to initiate a separate proceeding for the prescription of initial price cap levels and to establish those levels on a service-by-service basis."[654] McCaw also noted that "the Commission should propose, in a separate phase of this proceeding, specific means of addressing the pooling and diversity concerns."[655] However, LOCATE disagreed; while applauding the Commission's price cap proposals as containing "the potential for further public interest pro-competitive benefits," LOCATE concluded that "the Commission should retain the cost of service methodology for all 'virtual monopoly services.' In the case of the LECs, these are all services."[656]

5.2.5.2. Industry organizations: opposition

Like the LECs and IXCs, representatives of other industries and industry organizations -- representing both large business users and potential LEC competitors -- shared among themselves many views on LEC price cap regulation. The focus of many of their positions was the monopoly control they asserted that LECs maintain over local exchange and access services. According to the organizations, this monopoly control over the local network results in LECs' abilities to engage in

[654]Comments of Aeronautical Radio, FCC CC Docket No. 87-313; October 19, 1987, p. 2, 9.

[655]Comments of McCaw, FCC CC Docket No. 87-313; October 19, 1987, p. 12.

[656]Comments of LOCATE, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

anticompetitive and discriminatory pricing and service practices; as the Committee of Corporate Telecommunications Users (CCTU) stated that LECs are "monopolists which not only have captive audiences but are fully protected from marketplace constraints against abusive practices."[657] Many organizations made specific reference to the lack of available alternatives for LEC services for members of their particular industry. In some cases, the organizations asserted that LEC alternatives to particular services essential for their business do not even exist. For example, Capital Cities/ABC, CBS, and NBC stated that "a broadcaster cannot utilize any of the various other services offered by the dominant carriers as a substitute for television service, regardless of the relative rate levels of these services."[658]

Industries and user organizations further asserted that LECs' monopoly power will not be diminished in the near term, with or without regulatory reforms such as price cap regulation. According to IBM, regulatory reform "will reduce neither the carriers' control over their basic facilities nor their competitors' reliance on those facilities."[659] The International Communications Association (ICA) further emphasized that this monopoly control extends to all users of LEC services, including the large and sophisticated users which they represent. According to ICA, large users "are dependent, today and for the foreseeable future, on the dominant local exchange carriers to provide the services and facilities needed to satisfy most of their communications needs in most of their locations. For the majority of large user needs and in most user locations, there simply is no competitive alternative." ICA later added that its members "would

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[657]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[658]Comments of Capital Cities/ABC, et al., FCC CC Docket No. 87-313; October 19, 1987, p. 13.

[659]Reply Comments of IBM, FCC CC Docket No. 87-313; December 4, 1987, p. 11.

clearly be aware of viable competitive alternatives to local service, if they existed."[660] W. Page Montgomery and Lee Selwyn of Economics and Technology (ETI), writing for the ICA and the Ad Hoc Telecommunications Users Committee, noted the growth in the absolute number of bypass arrangements, and asserted that "the demand for LEC services is growing by an even larger amount, both in absolute and in relative terms." They concluded that there is "little, if any, potential for a perceptible erosion in their market dominance."[661]

Given this monopoly control over basic services, many industry organizations expressed concern over the potential for LECs, under price cap regulation, to continue pricing practices that the organizations consider discriminatory. Expressing a concern frequently stated by the interexchange carriers, the organizations cited LEC "strategic pricing" as predatory and anticompetitive in nature. The Independent Data Communication Manufacturers Association (IDCMA) asserted that strategic pricing is inconsistent with the Communications Act and its requirements that rates be "just and reasonable" as well as nondiscriminatory. IDCMA asserted that strategic pricing is used by dominant carriers "to milk high profits from non-competitive . . . or less competitive [services] and to subsidize more competitive services." IDCMA cited rates for 1.544 Mbps service, which would yield returns of 39 to nearly 60 percent, according to IDCMA citing the FCC CC Docket 85-166 Investigation of Special Access Tariffs of Local Exchange Carriers.[662] ICA, also citing special access strategic pricing as "disruptive," suggested that "a finding that <u>all</u> strategic pricing is unlawful is long overdue, given the inherent inconsistency between strategic pricing and

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[660]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 24, 30.

[661]ETI Reply Report, Reply Comments of ICA and Ad Hoc Users, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

[662]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 37.

one of the Commission's access charge goals, the elimination of rate discrimination."[663] In fact, like the IXCs, industry organizations cited the LECs' ability to propose discriminatorily high returns on targeted services as further evidence of the lack of available alternatives to these services.

According to the industry organizations, the pricing flexibility afforded under price cap regulation could exacerbate already abusive pricing practices. The Tele-Communications Association (TCA), responding to LEC proposals to implement a single weighted cap in an effort to achieve efficient use of the network, claimed that use of an "all-encompassing aggregated cap" would underscore the dangers of price cap regulation. According to TCA, "excessive pricing flexibility under an aggregated cap would translate into discriminatory pricing, which LECs currently use to advance their particular view of how the network should be utilized."[664]

Industry concern over pricing abuses was heightened by the fact that under price cap regulation, there would be fewer opportunities for regulatory review of LEC pricing practices. According to the Committee Corporate Telecommunications Users (CCTU), user parties such the FCC have "great difficulty extracting from the carriers the data necessary to evaluate rates." CCTU stated that the results of price cap regulation would thus be "sobering": "Instead of trying to facilitate such disclosure, the Commission would give the carriers full reign . . . indicating that the carriers have finally triumphed."[665] ICA asserted that under price cap regulation, "ratepayers will find themselves

[663]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[664]Reply Comments of TCA, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

[665]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

stripped of even those limited opportunities to obtain administrative or judicial review of carrier-initiated rate increases which presently exist," thus providing the potential to "make a bad situation even worse."[666] In summary, ADAPSO, discussing carriers' incentives to shift costs to support unregulated activities, concluded that "absent rate of return regulation, there would be fewer opportunities for the Commission and other interested parties to prevent this type of abuse."[667]

To prevent cross-subsidies and other pricing abuses, industry organizations supported the implementation of service element price ceilings should price cap regulation be implemented. Establishing service element price ceilings could limit the potential for strategic pricing and other anti-competitive abuses, according to the organizations. As the Utilities Telecommunications Council (UTC) stated, to prohibit carriers from using price increases to discourage users from continuing to rely on certain services or other similar potential abusive practices, "it is imperative that prices be controlled by a system of specific limits on major rate elements within individual services."[668] TCA agreed, stating that LEC "bottleneck control of the local exchange appears to necessitate a more service-specific approach." TCA further explained that "[a]pplying price caps on an aggregated basis would enable carriers to engage in cross-subsidization, thereby departing impermissibly from the cost-based, efficient pricing that has long been the touchstone of the Commission's Title II regulation."[669]

[666]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 29.

[667]Comments of ADAPSO, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[668]Comments of UTC, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[669]Reply Comments of TCA, FCC CC Docket No. 87-313; December 4, 1987, p. 8; Comments of TCA, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

TCA further noted that minimal aggregation may be particularly necessary to ensure that rates for services essential for enhanced service providers to meet their telecommunications and local exchange access needs are cost-based rather than strategically priced. Providing additional support of disaggregated service price caps, Montgomery and Selwyn asserted that "carriers have the incentive -- and with broadly aggregated market baskets also have the ability -- to use supracompetitive prices for the more monopolistic services to permit more aggressive pricing of those subject to competitive pricing pressures."[670]

To further ensure that strategic pricing of LEC services would not occur under price cap regulation, many industry organizations asserted the need to apply price caps to all existing LEC services. According to the Ad Hoc Telecommunications Users Committee, distinctions among services to which price caps would apply "would severely undermine the checks on cross-subsidization and other manipulation which would be present in an approach affecting all services." The Committee continued, noting that "the transition to a price cap regime will be fraught with enough perils as it is -- there is no conceivable reason to add this additional layer of potential harm."[671] The Utilities Telecommunications Council further asserted that new services should fall under price cap regulation, stating that "there would be much confusion and opportunity for abuse if the rates for new services were not subject to some form of regulatory scrutiny under a price cap model."[672] TCA, agreeing that all existing services should be subject to price cap regulation, also stated the commonly expressed belief that

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[670]Reply Report of ETI, Reply Comments of ICA and Ad Hoc Users, FCC CC Docket No. 87-313; December 4, 1987, p. 32.

[671]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 18.

[672]Reply Comments of UTC, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

exemption of certain services from price cap regulation could amount to deregulation, which should be addressed in a separate proceeding. As specifically stated by the American Newspaper Publishers' Association, "price caps with too much flexibility would be impotent to protect ratepayers, and could conceivably have the effect of total deregulation."[673]

Contrary to LECs' assertions that price cap regulation would create additional incentives to maintain and increase service quality to attract and maintain customers, industry organizations expressed concern that the opposite would occur. According to these organizations, because of the LECs' monopoly status, price cap regulation would provide the incentive to cut service quality in order to reduce expenses and improve profits. The Committee of Corporate Telecommunications Users (CCTU) asserted that "the FCC's price cap proposal favors unsubstantiated cost savings at the expense of service quality . . . and undermines service quality." Elaborating on this concern, CCTU stated that "under price caps, carriers can increase their profits dramatically by reducing their investment in the network, reducing or eliminating maintenance, and laying off personnel." CCTU concluded that "absent regulatory oversight, the carriers will have an incentive to expend fewer resources and allow service quality to deteriorate."[674]

CCTU noted that this trend could be reinforced by the opportunity to invest in other, potentially more lucrative, services. The Independent Data Communications Manufacturers Association agreed, noting that "by placing ceilings on prices and allowing the carriers to keep whatever profits they can generate, the Commission's price cap approach creates incentives to reduce costs. One way to reduce costs and to increase

[673]Reply Comments of ANPA, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

[674]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 13.

profits, however, is for carriers to reduce the quality of the services they provide."[675] Given the industry organizations' assertion of LEC monopoly provision of bottleneck services, they considered these consequences to be a major weakness of LEC price cap regulation. TCA stated that while price cap regulation of carriers subject to competition may not result in service quality deterioration, they noted that LECs do not face effective competition. Thus, because "the vast majority of users of LEC services have no alternative source of supply," carriers will continue to have incentives to drive costs down, regardless of the beneficial cost impacts of new technologies. TCA concluded that "new technology, no matter how innovative or efficient, does not eliminate the possibility of poor service under a price cap regime."[676]

The potential for LECs to retain additional monopoly-generated profits under price cap regulation was another weakness cited by many industry organizations. According to these organizations, ratepayers should be the primary beneficiaries of savings associated with regulatory reforms. As IBM stated, "if the Commission decides to adopt price cap regulation, it must ensure that any resulting cost savings will be shared with all ratepayers in the form of lower prices."[677] CCTU further asserted that "the ratepayers, rather than the shareholders, should benefit first."

However, CCTU continued, this is a weakness of the FCC price cap proposal, which provides "no assurance that any cost savings would ever

[675] Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 25.

[676] Reply Comments of TCA, FCC CC Docket No. 87-313; December 4, 1987, p. 20.

[677] Reply Comments of IBM, FCC CC Docket No. 87-313; December 4, 1987, p. 2.

be passed on to consumers."[678] As the American Newspaper Publishers' Association stated, "another major flaw includes the lack of a specific requirement for passing savings on to the ratepayer in the proportion in which they are achieved."[679] IBM noted that in the absence of assurances that carriers will share benefits with ratepayers, "price cap regulation offers benefits to carriers and their shareholders only."[680] ICA, while noting that shareholders may benefit from stimulated cost-cutting and increased productivity, asserted that "these gains should not take precedence over the rights of ratepayers"; ICA emphasized that "ratepayers ultimately should enjoy the benefits of eliminating any portion of the $1.1 billion in annual regulatory costs that [the National Telecommunications Information Administration] has estimated would be realized."[681]

The Ad Hoc Telecommunications Users Committee further noted that certain future savings should be directly returned to ratepayers. These savings result from investments in new technology and other cost-saving investments funded by ratepayers. According to the Committee, "under price cap regulation, it is essential to make sure that all gains resulting from this past investment be recovered by the ratepayers who paid the price and bore the risk -- including all productivity gains associated with these assets."[682] Montgomery and Selwyn, in their report for ICA and the Ad Hoc Users, noted that

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[678]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 6.

[679]Reply Comments of ANPA, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

[680]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

[681]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 22.

[682]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

> notwithstanding the historical merits of these modernization and plant acquisition programs, their existence offers the opportunity for substantial productivity improvements over the coming years <u>even under traditional regulatory practices</u>. . . . [I]t is essential that their beneficial results be associated with the ratepayer-funded investments and risk-taking, and not lost in any new regulatory order.[683]

The Ad Hoc Users concluded that

> ratepayers have carried the risk of <u>all</u> these past investment decisions; under rate-of-return regulation, ratepayers would be compensated by a variety of future benefits. A suspension of traditional rate of return regulation threatens to shift these benefits to the carrier. This diversion to carriers of the benefits which by rights belong to the ratepayer would be inequitable on its face.[684]

In order to assure that ratepayers would share in savings under price cap regulation, many industry organizations noted the need for price cap adjustment factors to permit reductions, as well as increases, in price caps. According to the TCA, for this to occur the factor must be outside the control of the LECs: "[U]nless the adjustment factor is independent of the carrier's control, price cap regulation would merely replicate the artificial incentive to invest in unneeded facilities that is asserted to be a principal drawback of rate base regulation."[685]

Many of the organizations offered differing views on specific adjustment factors, though IBM represented a common theme when it stated that "price cap levels [should] be adjusted with reference to an index (or indices) that is reasonably related to the cost characteristics of

[683]Report of ETI, Comments of ICA and Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 12.

[684]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 22.

[685]Comments of TCA, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

the particular inputs employed by the telecommunications industry."[686] According to IBM, this would be necessary to assure users that they will share in the benefits of technological advances. Another common theme, expressed by CCTU, was that determination of the factors considered for price cap adjustments "is an activity which should be open to interested parties."[687] In addition to permitting upward and downward adjustments, CCTU asserted that the adjustment factor should guard against excessive earnings and that it should be at least as efficient, if not more so, than the existing regulatory processes. In conclusion, ICA represented the interests of many industry users in asserting that "to be acceptable to users, the productivity adjustment should be one which will permit ratepayers to realize a continued decrease in the real dollar cost of communications services if past productivity trends persist."[688]

As a consequence of their concerns over price cap regulation of LECs, many industry organizations noted that price cap regulation, if applied to LECs, may entail additional regulatory burdens if adequate safeguards are incorporated. Among the safeguards cited as necessary to protect ratepayers are the establishment of appropriate "going in" prices on a sufficiently disaggregated basis so as to prevent the virtual deregulation of LEC monopoly services; the maintenance of cost allocation and separations procedures to protect against cross-subsidization and to separate price cap-regulated interstate expenses from intrastate expenses; the continuation of rate of return monitoring to evaluate the success of price cap regulation, to assure that rates are cost-based and to evaluate LEC requests to raise prices above caps;

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[686]Reply Comments of IBM, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

[687]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[688]Reply Comments of ICA, FCC CC Docket No. 87-313; December 4, 1987, p. 13.

and the implementation of procedures to monitor and enforce service quality standards.

The need to set "going in" rates, according to many industry organizations, would be an especially critical function under price cap regulation since any existing pricing inequities could potentially be perpetuated or worsened. As discussed earlier, organizations were particularly concerned with LECs' strategic pricing, alleged cross-subsidies, predatory pricing, and other anticompetitive behavior. According to the Ad Hoc Users, "LECs' existing rate structures are riddled with deficiencies and can form no basis for a just and reasonable price cap system." The Users continued, "LECs' existing rates for access services -- especially for special access -- are patently deficient. . . . Completion of this [FCC price cap] investigation and elimination of strategic pricing is an absolute prerequisite to applying a price cap approach to the LECs. Only then can there be any hope that price cap regulation will yield just and reasonable rates for LECs."[689]

Capital Cities/ABC, CBS, and NBC further asserted that "[t]o the extent that the initial caps are not cost-based . . . these initial variances from costs will be perpetuated -- and further skewed -- throughout the duration of the new regulatory approach. Under any such price cap regulatory scheme, therefore, the Commission must ensure that the initial price caps it establishes are based on the carriers' costs of providing service."[690] Citing an alleged weakness of existing rate of return regulation, ANPA similarly stated that "to the extent that the Commission finds that rate of return regulation has incentives to

[689]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. i, 17.

[690]Comments of Capital Cities/ABC et al., FCC CC Docket No. 87-313; October 19, 1987, p. 11.

inflate the rate base, existing rates would require full investigation before initial caps might be established."[691]

In addition to concerns over "strategic" and anticompetitive pricing, many of the organizations asserted that because existing rates have not been found to be "just and reasonable," they should not be used as "going in" rates for a price cap regulatory regime. A common concern is that the Common Carrier Bureau of the FCC has used standard, "boilerplate" orders, allowing LEC tariff filings to become effective because they are found to be "not patently unlawful." ICA described the typical one-page standardized order as concluding with one or two sentences "in which the filing is found to be 'not patently unlawful' and that the issues raised do not warrant suspension and investigation."

ICA further added that Commission actions denying petitions to suspend or reject tariffs are not subject to judicial review until after completion of a "time consuming" administrative review process, and that the judicial review may occur years after objections were filed to the tariff filing. "As a consequence," ICA concluded, "since these Commission rulings are effectively unreviewable, ratepayers have been denied the opportunity of backing up their objections about rate churn, strategic pricing, mid-course corrections, and others with full judicial review by an impartial third party."[692]

Typical of concerns over individual services, Capital Cities/ABC, CBS, and NBC stated that "the Commission cannot presume that the existing rates for the television service reflect, in even the most general sense, the carriers' actual costs of providing that particular service." They further concluded that "the Commission cannot presume

[691]Comments of Capital Cities/ABC et al., FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[692]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 15, 18.

that, for purposes of establishing initial price caps, either AT&T's or the LECs' existing rates are now just and reasonable." Among the reasons for such a conclusion are the "terribly overburdened" staff, reviewing "extensive" volumes of material in little time. According to the television broadcasters, even those rates that initially may be established at potentially reasonable levels may be quickly skewed by mid-course corrections and across-the-board rate increases. The broadcasters asserted that "it is not clear whether the Commission's staff scrutinizes these mid-course corrections at all, even when they are subject to vigorous protests made by users."[693]

Even if existing rates are justified based on current costs, some of the industry organizations continued, many of those costs may be inappropriate under price cap regulation. IDCMA noted that "current rates are based on improper considerations (e.g. strategic pricing) or upon costs that are not likely to prevail in the future (e.g. high historic interest rates, accelerated depreciation rates or the transitional costs of deregulation or divestiture)."[694] W. Page Montgomery and Lee Selwyn, in their report for ICA and the Ad Hoc Users Committee, expounded upon the costs cited by IDCMA. They asserted that current prices may be higher than they should be due to "inefficient operating practices and unnecessary investment decisions included in the pre-price cap regulatory revenue requirement," high depreciation expenses due to "past excessive and unnecessary capital investments," and further increases in depreciation expense due to efforts to amortize reserve deficiencies "allegedly created by 'inadequate' depreciation rates approved by regulators in the past."

[693]Comments of Capital Cities/ABC et al., FCC CC Docket No. 87-313; October 19, 1987, p. 8, 16, 22.

[694]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 35.

According to the report, passing these inefficiencies through to price cap regulation would "institutionalize past inefficiencies into the future post rate-of-return era." The report continued, "while the adoption of price caps and the concomitant removal of an assured return and recovery for prospective capital investments may well present an appropriate set of efficient operating incentives to the carrier's management, the proposal could have the ironic result of actually rewarding the firm's management for past inefficiencies by locking in prices at prevailing revenue levels."[695]

In conclusion, industry organizations generally supported rate investigations prior to the implementation of price cap regulation. ICA further asserted that "the establishment of initial price caps may well constitute a rate prescription, and numerous court decisions have held that rates cannot be prescribed without a hearing."[696] According to ICA, "there is clearly a need to make some adjustment for [the gold-plating or over-investment] factor, in the form of a composite rate reduction . . . in the range of 2% to 3%" when the initial caps are established. Without a rate adjustment, ICA noted that "the business user community, in particular, would have a great deal of difficulty supporting any price cap system."[697]

However, some of the organizations recognized that the additional costs of rate represcription could be high. For example, IBM noted that to the extent that carriers operating under rate of return regulation have inflated rate bases, they can be expected to "trim the fat" to reduce costs as quickly as possible. However, there must be, according

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[695]ETI Report, Comments of ICA and Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 2, 17.

[696]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 23.

[697]Reply Comments of ICA, FCC CC Docket No. 87-313; December 4, 1987, p. 11.

to IBM, a mechanism to share these savings with ratepayers. IBM concluded that setting rates on the basis of a cost of service study for each service would be "unduly complex and time-consuming," while noting that setting price caps based on existing rate levels would offer ratepayers no assurance that they will share in transitional cost reductions, to which they are entitled.[698]

Many industry organizations supported some level of disaggregation in setting price caps to protect ratepayers from cross-subsidies and strategic pricing. According to IDCMA, "the only feasible way to ensure that carriers do not engage in strategic pricing under a price cap system would be to establish uniform caps for each rate element of each service."[699] The Utilities Telecommunications Council (UTC) expressed concern that setting aggregate caps "would vest far too much discretion in the carriers over matters such as the level of service to be provided to users in rural areas." UTC also noted that "there must also be safeguards to protect against volatile increases in the prices for specific services."[700] The Ad Hoc Users Committee, expressing similar concerns, asserted that a cap on averaged prices "is only an invitation to disaster: cross-subsidies, strategic pricing and discrimination could flourish unchecked." The Committee added that "carriers would be completely free to engage in strategic pricing, rate churn, and any other manipulative practices they can concoct."[701]

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[698]Reply Comments of IBM, FCC CC Docket No. 87-313, December 4, 1987, p. 8.

[699]Comments of IDCMA, FCC CC Docket No. 87-313; October 19, 1987, p. 37.

[700]Comments of UTC, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

[701]Comments of Ad Hoc Users, FCC CC Docket No. 87-313, October 19, 1987, p. 23; and Reply Comments; December 4, 1987, p. 20.

Montgomery and Selwyn, in their report for ICA and the Ad Hoc Users, also asserted that "ratepayers, who are affected only by prices for those specific services that they utilize and who do not necessarily purchase the same 'baskets' of service or in the same proportions as would be subject to an aggregate price cap, would be exposed to severe rate and service manipulation by carriers whenever services confronting significantly different levels of competitive pressures are combined within the same basket." The report further noted that under aggregated caps, LECs would have the incentive and the ability "to use supracompetitive prices for the monopolistic services to permit more aggressive pricing of those subject to competition."[702] Enhanced service providers in particular noted the impact such anticompetitive pricing ability could have on the pricing and availability of basic service elements under open network architecture. Finally, setting price caps on too highly aggregated a level may result in "de facto deregulation" according to the Ad Hoc Users, who concluded that "such entreaties must be spurned."[703]

Due to the potential for LEC pricing abuses, many industry organizations cited the need for additional regulatory resources under price cap regulation. Many supported the need for continued rate of return monitoring under price cap regulation to detect potential abuses or overearnings and to evaluate LEC requests to raise caps. For example, IBM supported the maintenance of non-structural safeguards against improper subsidization and discrimination because "carriers' ability and incentive to discriminate will be undiminished by the adoption of price cap regulation, and appropriate safeguards will continue to be required." IBM further supported the maintenance of some sort of reference to carriers' costs or profits on regulated services as

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[702] Reply Report of ETI, Reply Comments of ICA and Ad Hoc Users, FCC CC Docket No. 87-313; December 4, 1987, p. 5, 32.

[703] Reply Comments of Ad Hoc Users, FCC CC Docket No. 87-313; December 4, 1987, p. ii, 22.

being "necessary, at least in the short run, to ensure that ratepayers share in any cost savings realized through the elimination of past overinvestment." However, IBM noted that "any mechanism the Commission adopts for this purpose will benefit users through lower prices and will reinforce the carriers' incentive to cross-subsidize."[704]

IDCMA agreed. "[R]egardless of what the Commission claims to be the case in theory," maintained IDCMA, "in fact there would remain considerable incentive for the carriers to cross-subsidize both their unregulated activities and their competitive services under the Commission's price cap approach." The association asserted that "because the aggregate of regulated services is still a source of monopoly power, IDCMA strongly urges that the present safeguards be retained and fortified regardless of whether or not any price cap system of regulation is adopted." However, it added that ongoing oversight results in "the incentive to keep reported rates of return 'reasonable' and therefore to misallocate costs to regulated services."[705] The Enhanced Services Providers Association noted that the success of price cap regulation will "depend upon the conditions imposed and the adequacy of the Commission's continued oversight to guard against and promptly correct any misallocations or abuses that might develop once the program is made operative."[706]

The Ad Hoc Users Committee concluded that the Commission "must not burn its bridges." The committee supported the maintenance of "strict and comprehensive reporting and monitoring . . . in order (a) to provide the Commission sufficient knowledge to determine whether price caps are

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[704]Reply Comments of IBM, FCC CC Docket No. 87-313; December 4, 1987, p. 11.

[705]Comments of IDCMA, FCC CC Docket No. 87-313; October 19, 1987, p. 31.

[706]Comments of ESPA, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

in fact resulting in just and reasonable rates; and (b) to 'unscramble the egg' if it develops that the price cap approach has failed." In addition, the committee continued, the Commission must consider underlying costs in establishing its price cap mechanism. According to the committee, the Commission is required to assure that rates are "just and reasonable," which requires a knowledge of costs because "the boundaries of the 'zone of reasonableness' are defined by direct reference to cost. . . . The Commission has some discretion as to the procedures it employs, but it has no discretion to change the ultimate test that rates must be just and reasonable vis-a-vis costs."[707]

Commission scrutiny of costs would also be necessary to evaluate LEC requests to raise prices above existing caps, according to the industry organizations. In fact, some of the organizations noted that the LECs' ability to "hide" potentially excessive profits on the one hand, while filing for increases in caps to prevent "confiscation" on the other hand, would not only result in the carriers having the best of both worlds while ratepayers receive little protection but also serve as a weakness of price cap regulation. According to the Committee of Corporate Telecommunications Users, "although the Constitution protects carriers from confiscatory rates, the public interest is not similarly protected. . . . In the CCTU's opinion, price caps will upset the delicate balance between shareholder and ratepayer interests carefully crafted by Congress in the Communications Act."[708]

According to IDCMA, "the dominant carrier can rely on the price cap system to shield its rates from regulatory scrutiny as long as it can live within the caps. When this becomes inconvenient, the dominant carrier can file a rate case and seek to exceed the price caps." IDCMA

[707]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 6, 14.

[708]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

concluded that in addition to "new regulatory resources devoted to implementing and monitoring rates under the price cap regulation," there would also be necessary continued "investment in regulatory oversight for cost-of-service regulation of rates that are increased above the established rates."[709] The Tele-Communications Association urged the Commission to automatically "reject tariff filings that seek to raise rates above the price cap unless the carrier can convincingly demonstrate that the higher rates are necessary to avoid unconstitutional confiscation."[710] And ICA added that "the full statutory period of 90 days is likely to be necessary to permit interested parties and the Commission to review and evaluate such requests."[711]

Many industry organizations also noted the need to establish service quality standards and monitor service quality under price cap regulation. According to IDCMA, "it will be even more critical to monitor the quality of service under a price cap approach because of the incentives for dominant carriers to cut costs by sacrificing quality and pocketing the additional revenues." IDCMA concluded that without adequate quality of service standards, "deterioration in service quality would go unchecked under a price cap approach."[712] The Ad Hoc Users Committee asserted that "the Commission must adopt monitoring and surveying techniques to detect any such deterioration and must develop policies designed to ensure that quality does not slip to unacceptable

[709]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 40.

[710]Comments of TCA, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[711]Reply Comments of ICA, FCC CC Docket No. 87-313; December 4, 1987, p. 13.

[712]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. iii, 26.

levels."[713] ICA similarly noted that "the Commission must develop and administer systems for monitoring service quality to insure that carrier cost-cutting measures likely to be initiated under price caps do not adversely affect the reliability and overall quality of communications services provided to ratepayers."[714] And the Tele-Communications Association concluded that "if experience shows that [service quality and service abandonment or erosion] concerns have substance, the Commission should reassess the prudence of price cap regulation."[715]

The result of implementing regulatory tools to address pricing, service, and service quality concerns is that regulatory burdens may actually be increased under price cap regulation, according to many of the industry organizations. While current rate of return monitoring would continue, additional service quality and price cap regulatory structures would be added. Comments of ICA summarized the concerns of many organizations regarding the need for increased regulation under price caps:

> Many regulatory functions must be continued, at least at the outset, to provide benchmarks against which the efficacy of the price cap method may be measured. The underlying regulatory framework must remain in place during the transition as a fail-safe system should it prove necessary to return to cost-of-service regulation. The Commission will also need to devote resources to functions which are not performed under rate of return regulation and to functions (such as service quality standards and monitoring) which will increase in importance under any price cap system.[716]

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[713]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 40.

[714]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 26.

[715]Comments of TCA, FCC CC Docket No. 87-313; October 19, 1987, p. 15.

[716]Reply Comments of ICA, FCC CC Docket No. 87-313; December 4, 1987, p. 7.

According to IDCMA, "in the final analysis, a price cap system may require more regulatory supervision than the present system."[717]

Following their analyses of price cap regulation of LECs, many industry organizations concluded that price caps should not be imposed on LECs at this time. According to ICA, "the Commission should not even consider the application of any price cap plan to the local exchange carriers until it can demonstrate that the new plan will not permit the LECs to continue to subject the users to frequent and disruptive rate increases (the 'rate churn' phenomenon) and that the new plan will effectively curb the ability and incentive to charge rates in excess of costs to further their own strategic objectives."[718] Montgomery and Selwyn asserted that any change in regulation must result in a net gain for the US economy: because the economic "cost" of rate of return regulation is estimated at "less than 0.9% of all expenditures by customers of regulated telecommunications services in the United States," the target for improvement in customer welfare "will be a difficult one to achieve for any regulatory reform plan."[719]

Some organizations were more general in their conclusions. According to Capital Cities/ABC, CBS, and NBC, "implementation of price caps for the LECs would be exceedingly complicated."[720] The Ad Hoc Users Committee noted that "applying price caps to LECs would carry with it a host of knotty problems of implementation. . . . To proceed on a broad basis all at once . . . would be an open invitation to the LECs to seize an untried, uncertain system and, using their market dominance, quickly

[717]Reply Comments of IDCMA, FCC CC Docket No. 87-313, p. 42.

[718]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 25.

[719]ETI Report, Comments of ICA and Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[720]Reply Comments of Capital Cities/ABC, et al., FCC CC Docket No. 87-313; December 4, 1987, p. 15.

turn it to their advantage."[721] Comparing implementation of price caps to AT&T and the LECs, ADAPSO asserted that "the number of issues and their complexity is increased exponentially when considering the application of price caps to the LECs."[722]

While some industry organizations regarded the many cited weaknesses of price cap regulation as sufficient evidence to reject or defer its application to LECs, others suggested that if the Commission wants to move ahead with LEC price cap regulation, it should institute a separate proceeding.[723] Those favoring deferral most frequently based their final analysis on the alleged lack of competition in LEC markets as well as the resulting potential for abuses. Those proposing a separate proceeding frequently cited the need for a more concrete price cap proposal, addressing many complex issues raised by commenting parties -- including the lack of competitive alternatives for LEC services, strategic pricing, rate churn, service quality monitoring, and the impact on Computer III/Open Network Architecture.

5.2.5.3. Support

Despite the level of opposition to price cap regulation of LECs, many of the organizations did cite potential benefits of LEC price cap regulation. Among them, ICA expressed support for "the Commission's decision to initiate an inquiry into whether a system of price cap regulation of the rates of dominant carriers would better promote consumer welfare than the current cost of service regulation," and stated that "a well-designed and carefully implemented system of price

[721]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 17.

[722]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 10.

[723]For deferral of application to LECs, see Comments of CCTU (15), GEIS (4), API (9), Reply Comments of ANPA (1), UTC (4), ADAPSO (10). For separate proceeding, see Comments of ESP (4), AIFAC (7), Ad Hoc Users (9), Reply Comments of TCA (4), ETI (2).

cap regulation would appear to present a number of significant benefits to ratepayers." ICA warned, though, that "any price cap system which is poorly designed, hastily implemented or haphazardly monitored would create a substantial risk that many of the problems users have experienced under the existing system will persist under the new system."[724]

IBM also supported the Commission's objective "of encouraging carriers to reduce costs and encourage efficiency," adding that if the Commission adopts an alternative to rate of return regulation, "it should implement the approach in a way that facilitates the transition to an effectively competitive environment."[725] IBM also asserted that "if price cap regulation is adopted and is effective," it should result in ongoing cost reductions from policy and regulatory changes, changes in the cost of inputs, and efficiencies and short term transitional reductions as unnecessary investments are eliminated.[726] The American Petroleum Institute noted that "price cap regulation has the potential to yield substantial benefits in markets where competition exists." (However, the Institute also noted that competition for LEC services "is not reasonably foreseeable.")[727] Also supporting the FCC's "commitment to reducing unnecessary regulation," the Committee of Corporate Telecommunications Users asserted that "competition in the telecommunications marketplace should be facilitated wherever and

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[724]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. i.

[725]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 11.

[726]Reply Comments of IBM, FCC CC Docket No. 87-313; December 4, 1987, p. 2.

[727]Comments of API, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

whenever possible; however, it should not come at the expense of the public interest."[728]

The Utilities Telecommunications Council (UTC) also "applaud[ed] the Commission's effort to examine regulatory alternatives that could better protect consumers of less competitive services . . . while encouraging the continued growth of competition in those market segments where it has already taken hold."[729] UTC also noted that "one of the prime benefits that could result from price cap regulation is a greater incentive on the part of affected carriers to introduce more efficient and innovative operations." (However, UTC later noted that because "the LEC environment remains a monopoly, the incentives to lower rates and efficiencies outlined in the Commission's Notice will not present themselves.")[730]

Certain organizations also asserted that the existence of competition in LEC markets -- frequently deemed necessary in order to transition to price cap or other alternative forms of regulation -- may in fact call for and ultimately result in deregulation rather than regulatory reform. According to IBM, "every form of regulation imposes some burdens and costs on regulated entities and, ultimately, on their customers. . . . Thus, once a service becomes subject to effective competition, regulation should be completely removed."[731] The Ad Hoc Users Committee agreed, noting that "the ideal of a fully competitive industry is unexceptionable. If the telecommunications industry were in fact

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[728]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[729]Comments of UTC, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[730]Reply Comments of UTC, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[731]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

perfectly competitive, full deregulation of all carriers would undoubtedly be called for -- and repeal of Title II of the Communications Act would undoubtedly be imminent." However, citing the focal point of industry organization concerns with price cap regulation, the Committee stated that "[perfect competition] is not the state of the industry today."[732]

Supporting price cap regulation of LECs, the Computer and Communications Industry Association (CCIA) noted that "incentive-based regulation is likely to prove the only viable means for changing the present method by which carriers are regulated." The Association also asserted that "traditional rate of return regulation is just not capable of meeting the needs of carriers or ratepayers in the current dynamic market environment." Among the strengths CCIA asserted price cap regulation would result in are reductions in cross-subsidy and predatory pricing incentives; increases in incentives to innovate, cut costs, and realize efficiencies; consumer protection; and administrative simplicity. However, CCIA noted that productivity and other adjustment factors must be determined before implementing a price cap regulatory structure. In addition, while recognizing that "rate of return regulation was at one time little more than a concept," CCIA asserted that by maintaining ongoing monitoring, "should the Commission . . . detect a slide in service quality or real risk to competition, then it has the power to reimpose rate of return regulation." Not anticipating this to be the case, CCIA expected price cap implementation to result in lower prices, due to efficiencies and regulatory cost reductions, as well as the introduction of new services. "This in turn will help the industry and other businesses that depend on technology and information movement and management, and help the US maintain its leading position in competitiveness worldwide," CCIA concluded.[733]

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[732]Reply Comments of Ad Hoc Users, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

[733]Comments of CCIA, FCC CC Docket No. 87-313; October 20, 1987.

5.2.6. Consumer organizations: opposition

Many consumer organizations would disagree with the conclusions of the Computer and Communications Industry Association. Of those consumer organizations participating in the FCC's price cap docket, none supported implementation of LEC price cap regulation. In fact, in direct contrast to the CCIA position, many consumer organizations extolled the virtues of rate base/rate of return regulation. The Consumer Federation of America (CFA), rather than focusing on the one-time experiment of rate of return regulation, asserted that "price cap regulation is a hypothetical model whose theoretical benefits in no way exceed the empirical accomplishments of rate of return regulation."[734]

Also in contrast to the positions of those stakeholders supporting price cap regulation, consumer organizations focused on the abuses likely to occur due to these factors: the lack of competition for LEC services, potential for excessive LEC profits and the concurrent weakening of the intervention and regulatory review process, reduction in service offerings due to anticompetitive pricing by the LECs, potential for service quality deterioration, and need for additional regulatory resources in order to adequately protect consumers from these abuses under price cap regulation.

Central to the position of many of the consumer organizations was their perception of LECs as monopolies facing little, if any, competition. While noting that if strong competition existed in the interexchange market, no regulatory controls would be necessary; the National Association of State Utility Consumer Advocates (NASUCA) stated that LEC "market dominance remains overwhelming. Competitors have gained a toehold in the market, but their ability to get their entire foot in and eventually compete on equal terms with AT&T and the LECs is

[734]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

uncertain."[735] CFA asserted that LECs maintain tremendous market power: "Bypass of the local network is nil and there are few if any prospects of technological breakthroughs which will threaten the local monopoly."[736] NASUCA, CFA, and others cited the findings of the Huber report and the order of Judge Greene to support their conclusion that LECs face "no substantial competition."[737] Many consumer organizations believe that this lack of competition precludes any discussion or support of price cap regulation. As CFA stated, "economies of scale underlie natural monopoly and natural monopoly is one of the strongest justifications for circumscribing profits."[738]

According to the consumer organizations, it was the natural monopoly character of the telecommunications industry and the resulting need for regulation that led Congress to establish the FCC, with statutory responsibilities to foster universal service at just and reasonable rates. CFA argued that an examination of the legislative debate over the enactment reveals congressional intent for more effective regulation of communications common carriers, and the provision of the FCC with "the tools it needed to effect rate of return regulation so as to achieve that goal." It therefore concluded that "the requirement of fair rates, neither confiscatory nor inordinately profitable, is the cornerstone of the Communications Act's universal service goal." Noting that "the FCC has no authority to prescribe rates except as Congress has provided," CFA asserted that because judicial review of the regulatory process has "consistently" interpreted the mandate of "just and

[735]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 19.

[736]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 58.

[737]US v. Western Electric, Case No. 82-0192, Order at 36 (September 10, 1987).

[738]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 65.

reasonable" rates "to allow regulatory discretion within 'a zone of reasonableness' based upon determination of a fair rate of return," price cap regulation would be unable to survive a legal challenge.[739] The Maryland People's Counsel also noted the Commission's statutory requirement to set "just and reasonable" rates; according to the Counsel, such a conclusion cannot be reached "if rates established within price caps result in excessive profits."[740] The Ohio Consumers' Counsel simply stated that "'just and reasonable' rates cannot be satisfied by price caps."[741]

Consumer organizations also questioned the legality of the FCC's price cap proposal because it would shift the burden of proof to parties opposing carriers' tariffs. According to the Maryland People's Counsel, despite Commission assertions that the burden of proof would remain with the carrier, "the net effect of the Commission's revisions to the tariff-filing process for tariffs filed below the applicable price cap may result in a de facto shift of the burden of proof to parties who oppose the carrier's tariff." The Counsel asserted that, given the elimination of requirements to file economic and cost data supporting tariff changes, the Commission "must address the question of how petitioners can raise 'reasonable grounds' for a rate investigation."[742] Thus, the Office of the Consumers' Counsel of Ohio (OCCO) noted that price cap regulation would "be out of balance" because it would be "most sensitive to the investors' interest against confiscation." According to OCCO, regardless of how thorough the scrutiny of carriers' requests

[739]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 5, 6, 11, 10.

[740]Comments of the MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 20.

[741]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 2.

[742]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

to increase price caps, the carrier is advantaged by having available financial records telling it when and how much to request. However, OCCO continued, "the situation is very different for the consumers' interest against exorbitant rates. By its very nature, the price cap is not conducive to consumer action against an 'exorbitant' cap."[743]

Many consumer organizations expressed concern over the potential for exorbitant LEC profits and rates under price caps, further shifting the "balance" toward investor interests. According to NASUCA, given their monopoly status, LECs freed from "the profit constraints of ROR regulation . . . would be given the freedom to earn profits that are even more excessive than those they are currently generating."[744] The Citizens of Florida (through the Florida Public Counsel) cited, as evidence of LECs' desires to increase profits an excerpt from the 1986 five-year plan of Central Telephone Company of Florida (Centel). This excerpt was "provided showing why the company wished to advocate the elimination of rate base regulation and replace it with a rate cap type plan" during a recent overearnings case. In the document, Centel stated: Technological changes and deregulation continue to decrease the Company's rate base investment per access line. With the Florida Public Service Commission's recent decisions to use one-time depreciation expense bookings to absorb excess Company earnings, rate base regulation has become a concept that is no longer viable."

According to the Citizens, this statement shows that "rate base regulation would make the company reduce rates on account of technological advances and a lower rate base resulting from higher depreciation expenses in previous years." The Citizens further quoted Centel as proposing a rate cap system as a way "to solve this earnings

[743]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[744]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 28.

problem."[745] The Maryland People's Counsel noted that "nothing in the [text of the FCC NPRM on price cap regulation] suggests any significant level of Commission concern with the problem of excessive profits." However, the Counsel also added that the only way to meaningfully implement any mechanism to correct for excessive earnings would be to maintain "traditional rate of return procedures by which to determine what is an 'unreasonably high level of earnings.'"[746]

The generation of excessive earnings raised the concerns of consumer organizations because, they asserted, price cap regulation may not provide for a flow through or sharing of excess earnings with ratepayers, and because excess earnings may be an indication of monopoly rate levels. The potential for carriers to retain excess earnings was yet another manner in which consumer organizations noted the shift toward investor interests over ratepayer interests. According to the Maryland People's Counsel, "translation of efficiency gains into actual price reductions to ratepayers under a price cap regime is only a hope and expectation. In the absence of effective competition there is no mechanism to compel the passing of benefits to users." The Counsel concluded that while "ratepayers may receive no direct benefits under price cap regulation . . . [s]hareholders, by contrast, may enjoy unrestrained profit levels under such a system."[747] NASUCA asserted that efficiency gains "are not only uncertain but, once achieved, might not be passed along to the greater part of the consuming public." NASUCA concluded that price cap regulation "invites windfall profits for the dominant carrier. . . . As long as AT&T retained market power and unlimited profit potential, it would have little incentive to share

[745]Comments of citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 17.

[746]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 12.

[747]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 7, i.

these cost savings with its consumers." Thus, NASUCA asserted, "the only ones who will benefit from the rate cap model of regulation will be the regulated companies (AT&T and the LECs) and possibly select groups of sophisticated high-volume users."[748]

Not only were the consumer organizations concerned with the prospect of potentially excessive profits being retained by the LECs and their investors, but they further asserted that when combined with the carriers' ability to request increases in the cap levels, the carriers would enjoy "the best of both worlds." While OCCO noted that in this manner price cap regulation is "out of balance" because "it would be most sensitive to the investor's interest against confiscation," NASUCA raised the question that "if the regulated firm is allowed to reap the benefits of endogenous technological innovations and managerial efficiencies, to what extent should it continue to be protected from severe earnings erosion or possible bankruptcy resulting from management errors (e.g., overbuilding), competition, or other factors?"[749]

Price cap regulation, combined with LECs' continued monopoly status, according to many of the consumer organizations, could result in inappropriate or discriminatory rates. CFA asserted that "with firms more interested in increased profits than cutthroat competition under current market conditions, consumers run a significant risk of paying unreasonably high charges for telecommunications services under price cap regulation as proposed by the Commission." In addition, CFA continued, "in a declining cost industry like telecommunications, a cap on prices would be unlikely to reflect actual changes in costs, opening the door to discriminatory and unfair pricing." Concerned that "price

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[748]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 7, 32.

[749]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 3; Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 22.

cap regulation explicitly reduces the extent to which regulators could oversee the setting of specific prices" and recent pricing patterns in telecommunications which "clearly suggest an ability to discriminate," CFA asserted that a monopolist, allowed to set prices as it sees fit, will price services in a manner such that "specific [prices] may well be unjust or unreasonable."[750] OCCO noted that "monopolist carriers earning exorbitant profits under a price cap could manipulate rates fairly painlessly to disadvantage competitors and its relatively inelastic-demand consumers." Thus, OCCO concluded that price cap regulation "can be a means by which unjustified rate restructuring is accomplished," including "exorbitant rates for captive consumers and predatory pricing against competitors."[751]

The Office of the People's Counsel of the District of Columbia added that "to the extent that cross-subsidization existed in a pre-price cap period, cross-subsidization would also exist in the post-price cap period. . . . With the potential for earning supra-normal profits in other markets, as a result of price caps, the carrier can still underwrite losses in the subsidized markets."[752] NASUCA agreed with these concerns expressed by other consumer organizations, and further noted that "anticompetitive pricing tactics designed to weaken [LECs'] competition [would leave] consumers with fewer options and ultimately higher prices."[753]

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[750]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 80, 32, 78.

[751]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 10.

[752]Reply Comments of OPC-DC, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[753]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 9.

Deterioration of service quality in a quest for increased profits was another concern some consumer organizations associated with price cap regulation. According to the Maryland People's Counsel, "if a weakness of rate of return regulation is a tendency toward 'gold plating' or excessively high quality standards (a contention not conceded to be proved), the counterpart weakness of price cap regulation is the tendency of a carrier to allow quality to deteriorate as a means of enhancing profit margins." The Counsel further concluded that "danger exists that in the new psychology of a price cap world, not only carriers but the Commission itself would assign network quality maintenance a lower priority than it deserves."[754] OCCO asserted that "[w]hat can be said is that the price cap model would be open to return maximization by degrading service quality."[755] Such a degradation of service quality would be in sharp contrast, consumer organizations added, to the success of rate of return regulation at developing the best telecommunications network in the world.

5.2.6.1. Consumer organizations: regulatory safeguards

Due to their concerns over the above profit, cost, and service quality issues, consumer organizations advocated the addition of regulatory safeguards to any price cap regime if the FCC goes against their wishes and implements such a regulatory plan. Among the regulatory safeguards proposed are the continuation of rate of return monitoring to ensure against excess profits; establishment of appropriate initial price caps and agreement on appropriate adjustment factors to ensure that rates are not excessive; disaggregation of service caps to protect against anticompetitive, predatory, or discriminatory pricing; and establishment and active monitoring of service quality standards to protect against service quality

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[754]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 18.

[755]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 8.

degradation. Despite the apparent negative impacts such safeguards may have on the Commissions' desire for administrative simplicity, NASUCA asserted that the Commissions' primary goal is to promote consumer welfare and the public interest. According to NASUCA, where the choice between simplicity and the public interest arises, "the Commission should keep in mind that administrative convenience is not a valid public policy objective. Whatever validity it can claim is as a means to achieve other legitimate goals, such as economic efficiency."[756]

The necessity of maintaining rate of return monitoring was frequently cited by the consumer organizations. The Maryland People's Counsel noted that the Communications Act requires the Commission to prohibit carriers from earning excessive profits; it must therefore, according to the Counsel, "continue to monitor for excess earnings under price cap regulation." The Counsel asserted that the only way the Commission can correct for unreasonably high levels of earnings is to maintain rate of return regulatory procedures to determine these earnings, and a mechanism "permitting users to capture or at least share excessive profits."[757]

Underscoring its opposition to price cap regulation, CFA noted that "if the Commission is determined to experiment with a price cap model of regulation, that model must preserve earnings regulation of dominant carriers." CFA further asserted that "a revenue restraint that sets a limit on the rate of profit is necessary to prevent excessive earnings by dominant carriers." Like the Maryland People's Counsel, CFA also asserted the statutory obligation of the FCC -- as interpreted and upheld by the courts -- to allow regulatory discretion within "a zone of reasonableness" based on determination of a fair rate of return. CFA

[756]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

[757]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 7, 12.

further asserted that "the Commission cannot radically alter the regulatory framework that Congress constructed for it. Congress must do that."[758] Consumer organizations also noted the need to maintain reporting requirements to ensure ratepayers that they are receiving the benefits of cost reductions and for use in the full scrutiny of any requests to raise rate caps.[759]

Profit regulation would also be necessary, many of the consumer organizations continued, in order to limit cross-subsidies of competitive services with monopoly service revenues. To prevent against cross-subsidies as well as other pricing abuses, such as discrimination in pricing of inelastic services and the ability to restructure rates, consumer organizations asserted that appropriate "going-in" rates must be established and used to set disaggregated individual service caps. In its discussion of price cap regulation of AT&T, NASUCA recommended "that the Commission open a comprehensive rate proceeding, conducted according to current regulatory standards and procedures, to determine the initial level of caps and to more accurately project the future costs of providing services." According to NASUCA, under more simplified methods of setting "going-in" rates, "there is danger that the initial price caps would be set too high, building in as excess profits the savings from declining marginal costs -- savings that are all but certain to increase indefinitely as a result of economies of scale, stimulation, and industry-wide technological improvements."[760]

Regarding cross-subsidization issues, the Maryland People's Counsel noted that "there is an inherent logical contradiction in the

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[758]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 80, 11.

[759]See Comments of NASUCA, FCC CC Docket No. 87-313, p. 36; Comments of citizens of Florida, FCC CC Docket No. 87-313, p. 15.

[760]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 35, 4.

Commission's contention that rate of return regulation has been ineffective in preventing cross-subsidy, and the Commission's proposal to adopt the price levels currently prescribed under rate of return regulation as the initial levels for price caps."[761] OCCO similarly noted that "oddly enough, the price cap would lock in the 'past inefficiencies' which were complained of, unless the initial price cap rate is reduced to a level which excludes past increases for efficiency . . . the initial price cap rate would also have to be reduced to avoid denying consumers various rate benefits which they have been promised or have paid for, such as the longer term rate benefits of depreciation expense."[762] According to the citizens of Florida, failing to set initial rates in the context of a full rate proceeding would, in the manner described by OCCO, result in a situation where "the ratepayer will never see the turn around point or benefit from amortization schedules underlying present rates." The citizens added that "if rate of return regulation is causing excessive costs, at a minimum the initial rates set under a price cap proposal should reflect the regulatory costs which allegedly will be saved. Present rates already cover these costs, and it would then be inappropriate to use those rates as initial rates when the companies believe much of these costs will be saved with the rate cap proposal."[763]

However, CFA warned that excessive or discriminatory rates would result if "going-in" rates are set according to proposals to apply a stand-alone cost rule. According to CFA, "in the presence of economies of scale or scope, the sum total of stand-alone costs for all services provided individually will be greater than the combined cost of service

[761]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 16.

[762]Comments of OCCO, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

[763]Comments of citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 9; Reply Comments; December 4, 1987, p. 6.

provided jointly. If the stand-alone cost test is applied singly to each rate to establish the maximum allowable rate, then the carrier is guaranteed a vast overrecovery of revenues." Even with a revenue restraint, CFA argued, stand-alone costs would allow a monopolist the discretion "to set prices as it sees fit," resulting in specific rate elements which "may well be unjust or unreasonable."[764]

Many of the consumer organizations noted the further need to set individual service element price caps to prevent discriminatory pricing and cross-subsidies. According to NASUCA, adoption of aggregated price cap proposals "would give AT&T and the LECs near total pricing flexibility, which would allow them to engage in anticompetitive pricing strategies." Consequently, NASUCA concluded that "[i]f a rate cap system is adopted, caps should be established for individual rate elements, not aggregate groups of services. That is the only way to avoid manipulative pricing by the dominant carriers."[765] The citizens of Florida asserted that cost shifting can only be deterred "if each service had its own rate cap that is based initially on costs adjusted for cost decreases."[766] The consumer organizations thus concluded that the potential for pricing abuses, as OCCO asserted, "calls out for ROR regulation, but at least calls for a price cap on individual rate elements as opposed to a bundle of rates."[767] NASUCA asserted that "if a rate cap system is adopted, caps should be established for individual

[764]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 77.

[765]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 21, 23.

[766]Comments of citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[767]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 10.

rate elements, not aggregate groups of services. That is the only way to avoid manipulative pricing by the dominant carriers."[768]

While many consumer organizations consistently opposed use of the Consumer Price Index (CPI) as an adjustment factor, they also expressed concern over the difficulty of selecting and setting appropriate factors. Their most common concern was that the CPI "has little to do with the cost of telecommunications services."[769] Use of the CPI would result, maintains the Office of the People's Counsel of the District of Columbia, "in upward adjustments to the price caps in excess of the inflation rate facing the telecommunications industry. Even if the initial price caps were just and reasonable, by using the CPI to adjust the price caps, the potential exists for unjust and unreasonable rates."[770] Some consumer organizations, such as the citizens of Florida, noted that "if there is any need to increase rates, full and total rate base regulation should be reinstituted."[771] As a result of its research and analysis, CFA noted that "since World War II, the telecommunications industry has exhibited a rate of growth in productivity that is almost three times greater than the average for all nonresidential business." Thus, CFA concluded that under price caps, "the Commission would also need a very rigorous methodology for productivity adjustments. . . . In the rush to close the can of worms of cost allocation, the Commission may be opening the can of worms of productivity measurement. If it is done correctly, measuring and

[768]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 23.

[769]Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 8. See also Reply Comments of NASUCA; December 4, 1987, p. 25.

[770]Reply Comments of OPC-DC, FCC CC Docket No. 87-313; December 4, 1987, p. 6.

[771]Comments of citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 15.

allocating productivity improvements will prove no less difficult and contentious than measuring and allocating costs."[772]

To address concerns over the potential for service quality deterioration as a means to maximize profits, some consumer organizations also noted the need to establish and enforce service quality monitoring. As the Maryland People's Counsel stated, "if quality is to be maintained, the Commission will be forced not only to develop new standards for quality measurement, but to recruit a substantial staff to monitor compliance with the new standards."[773]

As a result of these necessary modifications to a pure price cap regulatory regime, the consumer groups claimed that regulatory burdens will remain. Yet, the organizations cited the need for regulatory measurements to provide consumer safeguards. As NASUCA noted, "if the rate cap system included adequate safeguards to protect the public interests, the administrative costs of the system would likely be at least as high as those of ROR regulation." NASUCA further added that due to the "tremendous market power still enjoyed by AT&T and the LECs, the social cost of the rate cap approach could, in our estimation, be substantially higher."[774]

CFA agreed. Noting the current regulatory costs of "considerably less than one percent of the total cost of goods and services," this consumer group asserted that "reformed regulation that does a good job for those captive residential consumers is not likely to save much of the administrative costs of regulation." It maintained that the

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[772]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 17, 82.

[773]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 18.

[774]Reply Comments of NASUCA, FCC CC Docket No. 87-313; December 4, 1987, p. 9.

presumption of administrative cost savings is incorrect because the presumption of vigorous competition is incorrect; therefore, CFA continued, "the residual regulation necessary to treat consumers of non-competitive services in a just and fair manner would be equally as complex and costly as rate of return regulation." CFA concluded that "[t]he facade of simplicity presented by price cap regulation glosses over a fundamental deficiency. If it is done properly, it must include earnings limitations and extensive regulatory intervention, thereby providing little hope of administrative cost savings. If it is done poorly, but cheaply, it will not protect the public interest."[775] However, the consumer organizations emphasized, it is the public interest that the Commission is charged to protect. In fact, the Commission in its NPRM cited the "public interest" standard as the measure by which they would consider the price cap regulation of AT&T and the LECs. The Maryland People's Counsel thus concluded that "alleviation of regulatory burdens on the dramatic scale forecast by the Commission cannot be accomplished except by a degree of abdication of regulatory responsibility that the Commission has denied it intends and that would invite both judicial and congressional challenge."[776]

The consumer organizations were also concerned about the potentially far-reaching impact of federal price cap regulation. NASUCA noted that "if the Commission adopts a price cap model of regulation, many states may follow suit." Such impacts, NASUCA asserted, would be in addition to the obvious direct impacts federal regulatory policies may have on intrastate services. NASUCA concluded that "whatever risks [are] inherent in this type of regulation will be multiplied."[777] The

[775]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 36, 83.

[776]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 15.

[777]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

Maryland People's Counsel concluded that this potential multiplicative impact should result in extra caution being taken in the examination of price cap regulation: "[B]ecause the proposal, if adopted, would be so far-reaching, the Commission should move ahead only on the basis of specific and quantified evidence that demonstrates its superiority by a decisive margin over present mechanisms."[778]

5.2.6.2. Summary

According to the consumer organizations, this decisive margin does not exist. Noting that "price cap regulation is a hypothetical model whose theoretical benefits in no way exceed the empirical accomplishments of rate of return regulation," CFA "urges the Commission to abandon its effort to eliminate rate of return regulation." According to its analysis, CFA concluded that "replacement of rate of return regulation in telecommunications with price cap regulation is unnecessary, unjustified and unacceptable within the mandate of the 1934 Communications Act."[779]

The Maryland People's Counsel stated a position common among the consumer organizations in asserting that "LEC competition is nil and provides no basis for even considering price cap regulation of LECs."[780] (According to the citizens of Florida, with LECs facing no effective competition, "it would be a great disservice to the nation's ratepayers to apply a rate cap approach to the local exchange companies.")[781] The Counsel, further noting that because "the bulk of comments" were

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[778]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

[779]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 82.

[780]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 20.

[781]Comments of citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 16.

confined to the pros and cons of price cap regulation as potentially applicable to AT&T, "the record thus far simply does not meet minimal standards of adequacy to support any Commission rulemaking on LEC price caps." The Counsel also asserted that "an attempt to implement LEC price caps merely by extrapolation from comments directed to interexchange price caps will be extremely vulnerable to being found arbitrary, capricious and an abuse of discretion under accepted standards of judicial review that mandate a reasoned basis for rulemaking supported by substantial evidence."[782] Noting that under price cap regulation "the average consumer will suffer," and that "the proposed system risks the transfer of substantial wealth from the consuming public to the stockholders of AT&T and the LECs," NASUCA cited the Commission's public interest obligations and concluded that "elimination of ROR regulation for the LECs would be extremely detrimental to the public interest. We urge the Commission to indefinitely delay adoption of a rate cap plan for the LECs."[783]

5.2.6.3. ENERTEL support

Standing alone among the other consumer organizations, the New York City Energy and Telecommunications Office (ENERTEL) "endorse[d] the 'tentative conclusions' of the FCC pertaining to its rate cap proposal" and "support[ed] the FCC's efforts to investigate alternatives to rate of return regulation." The office expounded upon what it considered to be the many weaknesses of rate of return regulation, particularly in the current telecommunications environment, where it "no longer provides the best mechanism for minimizing cost or for the promotion of consumer welfare and the public interest for certain services." However, after discussing three alternatives to rate of return regulation of LECs, it noted that the FCC's price cap proposal "is best suited to replace the

[782]Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[783]Comments of NASUCA, FCC CC Docket No. 87-313; October 19, 1987, p. 7; and Reply Comments; December 4, 1987, p. 28.

current rate of return regulation of AT&T." ENERTEL made no conclusions regarding the merits of interstate price cap regulation of LECs.[784]

5.2.7. Price caps: summary

As with stakeholders' evaluations of rate of return regulation and social contract regulation, their evaluations of price cap regulation frequently focused on the issue of competition. Support for price cap regulation was expressed by the FCC and the LECs, who cited changes in technology and regulation that have created an increasingly competitive market. In addition to providing LECs with the flexibility to compete, these stakeholders asserted that price cap regulation would provide ratepayer protection through capped rates that would be predictable and would decrease in real terms by passing on estimated efficiency savings. A price cap regulatory system, they continued, would also provide efficiency and innovation incentives consistent with the desired competitive market outcome and would be administratively simple.

However, its detractors, consumer/competitors, and many state regulators, voiced concern over the potential for the LEC monopolies to abuse their freedoms through discriminatory pricing practices and anticompetitive cross-subsidies. These stakeholders warn that if LEC monopolists are provided with unwarranted freedoms, price cap regulation would potentially lock in excessive rates, would divert the benefits of declining costs and past ratepayer investments to shareowners, and would permit a determination of service quality. But price cap regulation would not meet the commission's requirement to set "just and resonable" rates. Adding the necessary safeguards to prevent these abuses, the stakeholders continued, would result in a regulatory regime more burdensome than rate of return regulation.

[784]Comments of ENERTEL, FCC CC Docket No. 87-313; October 19, 1987.

5.3. Incentive Regulation

5.3.1. Overview

Incentive regulation plans are modifications of rate of return regulation which, unlike social contract and price cap proposals, retain the focus on LEC profits. They are also called "Range of Rate of Return" or "Bonus Rate of Return" plans. Under incentive regulation plans, an authorized range of return is established. The LEC is typically permitted to retain all earnings up to a threshold limit return, to share with ratepayers all earnings within a range above this threshold, and either to return to ratepayers all earnings beyond a cap or to be entered automatically into a rate case. Earning review periods may vary, as may the frequency and method of refunds. The plans frequently contain price commitments for targeted basic services and may include pricing flexibility for non-basic or competitive services. As with many other alternative forms of LEC regulation, incentive regulation plans extend for a prescribed period of time, frequently three to five years. Incentive regulation plans have been implemented in Alabama, Connecticut, New York, and Wisconsin (see Table 6).

5.3.2. State regulators

Many regulators predicted benefits to both consumers and LECs under incentive regulation plans. Benefits cited include efficiency incentives, stabilization of rates, and administrative simplicity (without relinquishing regulatory jurisdiction). However, among the weaknesses cited by regulators were the potential for administrative complexity, concerns over freezing rates during a period of declining costs and increasing demand, and the need to establish going-in rates.

5.3.2.1. Strengths

Numerous state regulators have undertaken reviews of incentive regulation, citing potential benefits to ratepayers and stockholders. Among these, the Wisconsin PSC stated that it initiated consideration of a range of return on equity combined with a rate moratorium "with the goal of providing an incentive for [Wisconsin Bell] both to minimize operating costs and to provide continued high quality service more efficiently. In an increasingly competitive environment, both ratepayers and stockholders were viewed to benefit from this proposal."[785]

Similarly and more recently, the Kentucky PSC, noted that "numerous changes affecting the company, the telecommunications industry, and the economy" have occurred since South Central Bell's most recent general rate case, and in December 1987 initiated an investigation into the company's intrastate rates.[786] The Commission stated that it "is interested in addressing issues in a manner that will enhance the long-run interests of the ratepayers and the company" and would therefore include consideration of incentive regulation and rate stabilization plans.[787] Discussing the New York rate moratorium and incentive regulation plan, the New York PSC, also citing ratepayer and shareowner interests, elaborated on these strengths: "If [New York Telephone] agrees to this proposal, both it and the ratepayers will gain substantially. Ratepayers will enjoy stable rates that will, most likely, be lower than they would be otherwise. . . . [New York Telephone] would retain whatever additional revenues it earned from an increase in the number of access lines and would enjoy the benefits of whatever steps it could take to improve the efficiency of its operations."[788]

Like the New York Commission, many regulators cited the benefit to ratepayers of stable rates under incentive regulation plans. Rate stability, combined in many cases with going-in rate reductions, would

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[785]WI PSC Order, Docket No. 6720-TI-102; July 28, 1987, p. 13.

[786]KY PSC Order, Case No. 10105; December 16, 1987, p. 1.

[787]KY PSC Order, Case No. 10105; December 16, 1987, p. 5.

[788]Statement of NY PSC, Case No. 28961; March 19, 1986, p. 12.

promise an end to "saw-tooth" rate increases and refunds that occur when regulators and LECs attempt to achieve an exact allowed rate of return, and would also further the goal of universal service. As the Alabama PSC stated, "[i]t is the intent of this Order to avoid the large general rate requests so characteristic of recent years."[789] The Connecticut DPUC added that the reduction and stabilization of rates "will encourage the availability of telephone service to all segments of society."[790] According to the Wisconsin Commission, the result is that not only do ratepayers benefit from rate stabilization, but "the commission is relieved of the burden of trying to set an annual revenue requirement for the company."[791]

Regulators cited the potential for cost savings under incentive regulation, which would also benefit both ratepayers and shareowners. According to the regulators, cost savings would primarily result from increased efficiency incentives. These incentives would exist where LECs are able to share in the benefits of cost savings. The Utah Division of Public Utilities (staff of the Utah PSC) asserted that "incentive regulation such as the earnings sharing methodology will encourage greater efficiency with lower operating costs, which benefits both the shareholder and the ratepayer."[792] The staff of the Florida PSC similarly noted that "[i]f these major efforts that will increase productivity and efficiencies are to occur, the company needs a significant incentive to improve. Allowing the company to keep 100% of earnings up to 15% ROE before splitting earnings 40/60 above that return

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[789]AL PSC Order, Docket No. 19983; November 3, 1986, p. 7.

[790]CT DPUC Order, Docket No. 86-09-06, et al.; June 16, 1987, p. 2.

[791]WI PSC Order, Docket No. 6720-TI-102; July 28, 1987, p. 17.

[792]Comments of Division of Public Utilities, Utah PSC Docket No. 88-999-02; May 2, 1988, p. 10.

provides that incentive."[793] The New York Department of Public Service concluded that "[t]he key to achieving long-term stability in the company's revenue requirements is to provide [New York Telephone] strong incentive to achieve continuing productivity and efficiencies in its operations."[794]

Some commissions also noted that incentive regulation may result in administrative savings associated with fewer general rate case proceedings, allowing commission and company resources to be more productively utilized. As the New York Commission stated, "[o]ur proposal would free both our staff and the company from the burden of the constant cycle of rate cases. Both groups would thereby become free to pursue more productive efforts. The company would be able to devote greater energies to improving its service and efficiency, while our staff would be free to direct its attention to more creative aspects of regulation that stand to provide even further benefits to ratepayers."[795]

The Alabama Commission similarly noted that "[l]engthy and costly formal rate hearings have occupied the Commission in recent years. . . . The operation of [the rate stabilization and equalization plan] will reduce the scope and frequency of major rate cases before the Commission and thus allow the Commission and its staff to monitor more closely the daily operations of the Company and to devote Commission resources to the investigation and resolution of regulatory problems previously unaddressed."[796] And the staff of the Washington UTC was particularly

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[793]Memorandum of FL PSC Staff, Docket No. 8800069-TL and 870832-TL; March 17, 1988, p. 55.

[794]Brief of NY DPS, Case No. 28961; March 30, 1987, p. 37.

[795]Statement of NY PSC, Case No. 28961; March 19, 1986, p. 14.

[796]AL PSC Order, Docket No. 19983; November 3, 1986, p. 5.

aware of the existing regulatory burdens on small LECs which "require immediate attention."[797]

Regulators stressed the continuation of their regulatory jurisdiction under incentive regulation plans. While regulators would of necessity be involved in a rate of return monitoring process, many commissions also discussed regulatory involvement in service quality measures, pricing issues, and refund mechanisms. The New York PSC, in its approval of the Alltel rate moratorium and incentive regulation plan, asserted that it expected the Commission staff "to be especially vigilant in its service oversight during the moratorium."[798]

In its order extending the New York Telephone rate moratorium and incentive regulation plan, the New York Commission noted that in addition to continuing "normal monitoring of service quality throughout the moratorium," it would also require commission approval of company proposals to change rates for existing services or to introduce new services or marketing concepts, and it would not permit non-compensatory under-pricing "that has the negative consequence of barring market entry." The Commission also reserved for itself "the authority to act on the level of [New York Telephone's] rates in the event of unforseen circumstances that, in our opinion, have such a substantial impact upon the range of earnings levels or equity returns envisioned by the agreement as to render the company's actual return unreasonable and unnecessary for the provision of safe and adequate service."[799]

In its order approving the Alabama Rate Stabilization and Equalization Plan, the Alabama Commission asserted that "no provision in this order . . . shall be construed . . . as restricting in any manner

[797]Staff Report, WA UTC Docket No. 87-1320-SI; June 21, 1988, p. 3.

[798]NY PSC Order, Case No. 29593; October 9, 1987, p. 14.

[799]NY PSC Order, Case No. 28961; May 11, 1987, p. 43.

the Commission in the exercise of its regulatory rights, powers, authority, jurisdiction and duties over South Central Bell . . . or as restricting in any manner the ratepayer complaint and Commission instituted procedures."[800] Of particular importance to some commissions was the possibility that costs may be deferred or manipulated in order to enhance LEC profits. Accordingly, many commissions emphasized the continuation of financial and service quality monitoring.[801]

In summary, in support of incentive regulation, the Washington Commission stated that "ratepayers might be better served by a system of regulation which retains the best attributes of the old system while improving it to provide incentives for companies to operate most efficiently. . . . A regulatory structure should inspire companies to perform as their free market counterparts, while protecting monopoly ratepayers from rate discrimination and abuse."[802] The Commission concluded that incentive regulation would be a promising form of regulatory reform. The New York Commission concluded that incentive regulation is "a method that discharges more effectively [the Commission's] obligation to serve as a surrogate for the disciplines of the marketplace from which a monopoly would otherwise be free."[803] The Commission also stated that incentive regulation would enhance rate stability, "further stave off the burdens of cumbersome rate litigation," and provide productivity incentives.[804]

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[800]AL PSC Order, Docket No. 19983; November 3, 1986, p. 7.

[801]See WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 5; FL PSC Staff Memorandum, Docket Nos. 8800069-TL and 870832-TL; March 17, 1988, p. 58, 102.

[802]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 3.

[803]NY PSC Statement, Case No. 28961; March 19, 1986, p. 13.

[804]See NY PSC Order, Case No. 28961; May 11, 1987, p. 38; NY PSC Order, Case No. 29593; October 9, 1987, p. 9.

5.3.2.2. Concerns

Support for incentive regulation among regulators was not universal. In addition to concerns over the potential to manipulate financial reports and delay investments in services, some regulators also noted the administrative complexity of incentive regulation. As the Washington UTC noted, "[a] potential problem with incentive regulation is the possibility that companies will secure extra earnings by service degradation and disinvestment rather than increased efficiency."[805] The UTC staff also noted that while automatic sharing has "some attractiveness," the "complexity of such a proposal could outweigh any benefits by making regulation more complex and expensive."[806] Not only must an appropriate range of return be established, as with traditional rate of return regulation, but triggering points for refunds as well as refund mechanisms and procedures themselves must be agreed upon.

The staff of the Florida Commission, for example, noted that "[i]f the company proposes that excess funds be earmarked for areas which further the company's agenda versus the Commission's agenda, the Commission gives up . . . too much of its policy making authority." The Florida staff also recommended revisions to a Southern Bell proposal, proposing annual financial audits including complete explanations of earnings above 12.5% ROE. They also proposed that the company be required to identify the effect on earnings of exogenous factors, windfalls, price increases, productivity measures, new services, customer growth, and other significant factors.[807]

Some regulators also expressed concern that incentive regulation that locks in existing rates may not take into consideration existing

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[805]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 5.

[806]WA UTC Staff Report, Docket No. 87-1320-SI; June 21, 1988, p. 6.

[807]FL PSC Staff Memorandum, Docket Nos. 880069-TL, 870832-TL; March 17, 1988, p. 30, 42.

inefficiencies, cross-subsidies, or the potential for rate decreases. The staff of the Washington UTC noted that the telephone industry is characterized by declining costs and increasing demand; the New York and Florida Commission staffs both noted the uncertainty of future conditions. While the New York staff decided that "a bird in the hand is better than two in the bush" and "[b]etween [1986] and mid-1988, anything is possible," the Florida staff discussed the need for the plan to encompass an entire business cycle in order to include inflationary and recessionary times.[808] According to the Florida staff, if a freeze covers only one side of a business cycle, rates may be frozen during a period where they otherwise would have remained stable or even been decreased under traditional rate of return regulation. Some regulators also asserted the need to fully examine going-in rates to assure their appropriateness.

5.3.3. LECs

Local exchange carriers cited many of the same strengths and weaknesses of incentive regulation as those cited by the regulators. Unlike their positions on social contract and price cap regulation, LECs were far from being in agreement on their positions on incentive regulation.

5.3.3.1. Strengths

Among the strengths cited by LECs supporting incentive regulation were the perceived benefits for both shareowners and ratepayers. According to South Central Bell, its proposed incentive regulation plan for Kentucky "has benefits for customers in the form of stabilized local exchange rates and the potential sharing of earnings, while simultaneously providing the Company with an incentive to continue its

[808]NY DPS Brief, Case No. 28961; March 30, 1987, p. 36; and FL PSC Staff Memorandum, Docket Nos. 880069-TL and 870832-TL; March 17, 1988, p. 28.

excellent service and effective management."[809] Southern Bell, another BellSouth company, asserted that its Florida proposal would "benefit all of the Company's stakeholders, the general public, customers, stockholders and employees."[810] GTE similarly asserted that implementation of an incentive regulation plan in Illinois "would be to the benefit of all parties concerned. The regulators have reduced oversight but are still involved in monitoring the earnings and action of the carrier sufficiently to protect customers. The customer benefits from service quality, cost containment, continued oversight, competitive service offerings and low income support mechanisms. Finally, all carriers are treated fairly and benefit from the incentive to manage their business efficiently and effectively to maximize earning and gain competitive inroads." GTE concluded that incentive regulation is the "best transitional form of regulation" as the telecommunications market evolves from a natural monopoly to competition.[811]

As in their evaluation of social contract and price cap proposals, LECs cited stabilized rates as a major benefit to consumers. According to the LECs, stable rates would protect customers of what continue to be monopoly services and would further the goals of universal service. The Florida Telephone Association, noting that "[t]he thirteen local exchange companies in Florida are unanimous in their belief that a more flexible regulatory environment is in the best interest of Florida ratepayers," cited as a primary benefit of incentive regulation its maintenance of "ratepayers' cost for communications at the lowest

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[809]Response of South Central Bell, KY PSC Case No. 10105; January 1988, p. 2.

[810]Petition of Southern Bell, FL PSC Docket No. 880069-TL; January 13, 1988, p. 15.

[811]Comments of GTE, IL CC 87-NOI-3; March 8, 1988, p. 25, 1.

possible level."[812] Illinois Bell added that rate stability in core services would be "in addition to the protection against increases in non-core services which inures to customers as a result of Illinois' competitive marketplace."[813] According to Southern Bell, "given recent and projected rates of inflation, a stabilized basic residential local exchange rate equates to a cost reduction in real dollar terms. . . . In addition [to being met with broad based approval from the ratepayers], a stabilized basic residential local exchange rate will assure continuation of our common goal, universal service."[814]

LECs also asserted that incentives for efficiency provided by incentive regulation would further result in lower rates at the conclusion of any incentive regulation plan, due to the increased efficiency of LEC operations. As New York Telephone stated, "[i]n addition, by spurring the Company to hold down costs, increase productivity and generate additional revenues without resort to a general rate case, the [New York rate moratorium and incentive regulation] extension could well serve as the basis for a period of further rate stability."[815] South Central Bell similarly asserted that "[t]he incentives for the Company to continue to reduce its costs and to improve efficiency will insure that any increases in local rates after [the termination of the incentive regulation plan] will be minimized."[816]

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[812]Letter from FTA Executive Director William H. Feaster II to FL PSC Chairman Katie Nichols; September 18, 1987, p. 1, 3.

[813]Response of Illinois Bell, IL CC Docket No. 87-0662; February 8, 1988, p. 7.

[814]Petition of Southern Bell, FL PSC Docket No. 880069-TL; January 13, 1988, p. 5.

[815]Brief of NYT, NY PSC Case No. 28961; March 30, 1987, p. 21.

[816]Response of SCB, KY PSC Case No. 10105; January 1988, Exhibit C (Incentive Regulation Plan) p. 1.

Further aiding in efforts to maintain stable rates, according to LECs supporting incentive regulation, would be the increased efficiencies of the regulatory process. These LECs believe that incentive regulation would eliminate the burdens associated with frequent, cumbersome and expensive general rate cases. These massive undertakings would be replaced with a reporting and sharing mechanism. As South Central Bell noted, "the ratepayers of Alabama can be spared the time and expense of extensive rate case litigation. . . . The Company, on the other hand, will be spared the expense and the effects of regulatory lag."[817] Wisconsin Bell, which noted that ratepayers cover the significant expenses associated with insuring that the Company meets its authorized rate of return (and no more or less), asserted that a rate moratorium combined with a revenue sharing mechanism "eliminates the need for constant monitoring of earnings levels, and the associated issuance of rate and refund orders, which are inevitably part of the current system . . . . Relief from such regulatory burdens and revenue contingencies is one of the most appealing aspects of the ROE range concept for Wisconsin Bell."[818] In addition to the cost savings cited by these LECs, streamlining the regulatory process would, as New York Telephone asserted, "also allow the Company to refocus its energies on serving its residential and business customers without the distraction and enormous drain on resources caused by repetitively litigated cases."[819]

Reduced regulatory burdens, combined with the ability to share in earnings generated by new and innovative services, according to supporting LECs, would result in more of these services coming to the market. Southern Bell noted that incentive regulation "will provide further incentive to the Company to strive for increased operational

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[817]Comments of SCB, AL PSC Docket No. 19983; June 19, 1986, p. 6.

[818]Reply Comments of Wisconsin Bell, WI PSC Docket No. 6720-TI-102; June 5, 1987, p. 6.

[819]Brief of NYT, NY PSC Case No. 28961; March 30, 1987, p. 6.

efficiencies and revenue generation with a heightened awareness that its efforts will be rewarded. . . . This approach removes the potential penalty imposed by traditional rate base regulation and replaces it with a system that encourages more innovation and creativity."[820] New York Telephone similarly asserted that the New York rate moratorium and incentive regulation plan would "place further incentives on the Company to reduce costs, increase productivity and generate additional revenues through refocused marketing, and the introduction of new products and services."[821] According to Illinois Bell, "under the revenue sharing concept, the public benefits from the Company's ability to . . . effect new operating efficiencies. Furthermore, the Company is itself given an incentive to achieve such gains by the opportunity for improved earnings realizable under the revenue sharing plan."[822]

These LECs also asserted that revenue sharing incentives will more closely approximate the competitive marketplace, and will permit the companies to, as Southern Bell stated, "develop a corporate culture more responsive to the rapidly increasing competitive environment."[823] Therefore, provided these economic incentives combined with pricing flexibility for competitive services, LECs asserted that they will be able to more effectively compete in a market where their competitors do not face the constraints of rate of return regulation.

Finally, many LECs noted that incentive regulation plans would not and do not limit the authority of regulators. This point may be

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[820]Petition of Southern Bell, FL PSC Docket No. 880069-TL; January 13, 1988, p. 3.

[821]Brief of NYT, NY PSC Case No. 28961; March 30, 1987, p. 7.

[822]Response of Illinois Bell, IL CC Docket No. 87-NOI-3; February 8, 1988, p. 7.

[823]Petition of Southern Bell, FL PSC Docket No. 880069-TL; January 13, 1988, p. 8.

particularly vital when addressing stakeholder concerns over service quality. GTE noted that under incentive regulation, "[t]he regulators have reduced oversight but are still involved in monitoring the earnings and action of the carrier sufficiently to protect consumers."[824] Noting that "the very modest incentives" provided by an incentive regulation plan are unlikely to cause LECs to let service quality fall, Pacific Northwest Bell stated that the Commission would continue to maintain its jurisdiction over the quality of service.[825] Illinois Bell specifically stated in its incentive regulation proposal that "the Company seeks no relaxation of any traditional obligations to serve, service quality requirements or Commission complaint remedies which currently protect the public interest."[826]

As with their discussions of social contract and price cap regulation proposals, LECs asserted that competition and change in the telecommunications environment call for a change in regulation. Many of the LECs cited incentive regulation as a step forward in the transition from a monopoly environment to what they consider to be the rapidly emerging competitive telecommunications environment. Southern Bell asserted that incentive regulation "will provide a mechanism to successfully address [changes in the rapidly evolving telecommunications marketplace] as Southern Bell transitions from a monopoly to a competitive marketplace." Southern Bell concluded that its Florida incentive regulation proposal would have the positive impacts of "reducing pressures to increase basic residential local exchange rates, . . . avoiding the high cost of general rate cases and . . . the

[824]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 25.

[825]Comments of PNB, WA UTC Docket No. U-87-1320-SI; November 2, 1987, p. 13, 20.

[826]Response of Illinois Bell, IL CC Docket No. 87-0662; February 8, 1988, p. 8.

potential virtue of simplicity."[827] GTE also described telecommunications markets as "evolving from natural monopoly markets to competitive markets" and asserted that "[i]ncentive regulation is the best transitional form of regulation" as the market turns from rate of return regulation towards market regulation.[828] United Telephone also stated that it supported incentive regulation "especially in light of the industry's transition from full regulation to competition in an open marketplace."[829]

5.3.3.2. Concerns

However, some LECs asserted that incentive regulation would not provide sufficient regulatory relief for them to compete effectively. These LECs cautiously noted that incentive regulation may be a promising alternative to rate base regulation in the short term -- during the transition to a competitive marketplace -- but that it would not provide enough relief as a permanent form of regulation. These LECs specifically cited the maintenance of rate base/rate of return calculations, potentially contentious hearings to set an appropriate range of return, and other complexities involved in the administration of incentive regulation. For example, according to Rochester Telephone, the New York rate moratorium and incentive regulation plan "is superior to traditional rate of return regulation, but is only a first step toward a permanent solution to the problems of rate of return regulation." Rochester added that the plan "retains rate of return monitoring, with many of its flaws."[830] Some LECs also asserted that the sharing of returns on the "upside" without the reciprocal sharing of

[827]Petition of Southern Bell, FL PSC Docket No. 880069-TL; January 13, 1988, p. 1, 12.

[828]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 1.

[829]Comments of United Telephone, WA UTC Docket No. U-87-1320-SI; November 1987, p. 2.

[830]Comments of Rochester Telephone, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

deficits on the "downside" would be another fundamental weakness of incentive regulation.

Key to the inability of incentive regulation to provide enough flexibility or incentives, according to these LECs, is its inherent flaw: maintaining rate base/rate of return monitoring. According to Illinois Bell, incentive regulation "does not completely solve the basic problems associated with rate of return regulation. It doesn't alleviate the need for a rate base determination representing both competitive and non-competitive products, nor does it improve pricing practices, reduce regulatory lag or regulatory costs. This change also ignores the inability of rate of return regulation to adequately function in a competitive environment."[831]

Similarly, the US West LECs unanimously asserted that incentive regulation would not provide enough flexibility to operate in a competitive environment. Mountain Bell (New Mexico) characterized incentive regulation as "plans which attempt to build additional incentives into the traditional mode of regulation."[832] In Utah, Mountain Bell continued: "Because an incentive plan is based on ROR regulation, many of the inherent problems associated with traditional regulation continue to exist. . . . Simply relaxing the earnings constraint does not guarantee that the company will have the ability to react to market conditions."[833] Noting that under incentive regulation, "the Commission is still fully bound by outdated statutes which have been designed for administering rate of return regulation in a total monopoly environment," Pacific Northwest Bell (PNB) asserted that

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[831] Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 23.

[832] Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 56.

[833] Position Statement of Mountain Bell, UT PSC Case No. 88-999-02; May 3, 1988, p. 21.

incentive regulation would "not enable companies like PNB to adequately meet the unregulated competition that it now faces. It does not do anything to streamline the very cumbersome tariff process. It does not give PNB more flexibility to design new rates and introduce new services to be competitive with other large and well financed providers of telecommunications services." PNB later stated that "[a]s long as rate of return regulation, in any form, remains the mechanism by which providers of monopoly services are regulated, inappropriate incentives and inefficient costs will continue to exist."[834] Contel similarly noted that incentive regulation "preserves the rate of return process and, therefore, might not significantly reduce direct regulatory costs below existing levels."[835]

In fact, some LECs expressed concern that incentive regulation may actually increase direct regulatory costs. Telephone Utilities of Washington, Inter-Island Telephone, and Peninsula Telephone stated that incentive regulation would "require elaborate accounting, cost allocation, and pricing methods which are not necessary."[836] The Washington Independent Telephone Association Small Company Committee added that incentive regulation "could, in fact, increase the regulatory burdens of the small companies and the cost of serving their customers." The Committee also stated that "[e]fficiency of telephone operations would be reduced with no offsetting increase in ratepayer protection."[837] Contel similarly noted that "[t]he establishment of a range in rate of return, the development of additional reporting

[834]Comments of PNB, WA UTC Docket No. U-87-1320-SI; November 2, 1987, p. 3, 16.

[835]Comments of Contel, UT PSC Docket No. 88-999-02; April 29, 1988, p. 11.

[836]Comments of Telephone Utilities, et al., WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 5.

[837]Comments of WITA Small Company Committee, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 1, 2.

standards, and the development of monitoring and refund mechanisms will all add additional layers of regulatory burden upon the existing regulatory structure. The cost of regulation will increase, not decrease."[838]

Pacific Northwest Bell agreed, and added that incentive regulation could "perpetuate the problems inherent in traditional regulation, if not exacerbate these problems. . . . An annual review process could become the equivalent of an annual rate case. In essence, this plan will increase costs, create customer confusion, will send the wrong price signals and will be difficult to manage."[839] Pacific Northwest Bell later added that by relying on rate base/rate of return regulation with "only very minor tuning, the Commission is ensuring the continuation of the same old wasteful, contentious and endless proceedings. Special interests and competitors, who now routinely intervene in nearly all telecommunications industry contested cases, will continue to debate at length about the appropriate rate of return and its range. . . . In other words, the Commission will find itself in the position of presiding over the debate of all the current issues of rate base/rate of return regulation, plus a plethora of new ones that its proposed regulatory scheme will create. The company views this process as wasteful, inefficient, often fundamentally unfair, and process for process' sake."[840]

Some LECs criticized the sharing of earnings generated above a certain level, while there would be no provisions for a sharing of revenue deficiencies. As Contel (West) stated, "if the losses fall

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[838]Comments of Contel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 4.

[839]Comments of PNB, WA UTC Docket No. U-87-1320-SI; November 2, 1987, p. 16.

[840]Reply Comments of PNB, WA UTC Docket No. 87-1320-SI; December 15, 1987, p. 4.

entirely to the company, so should the profits."[841] Contel (Northwest) offered another possibility: "If the company is going to be required to share some of the 'fruits' of its efforts, then the ratepayers should also share some of the risk."[842] Pacific Northwest Bell added that "the proposal to share the fruits of management efficiencies with ratepayers . . . would eliminate that incentive at the point it is triggered."[843] Even LECs supporting the incentive regulation concept discussed similar potential inequities under incentive regulation plans, particularly if an appropriate rate or range of return is established. Wisconsin Bell asserted that the range proposed by the Commission staff in the PSC examination of incentive regulation was too narrow. As Wisconsin Bell stated, "[w]ith an upside potential gain of only 25 basis points, and sharing thereafter, Staff is not proposing an incentive, but rather an automatic refund and return adjustment mechanism."[844]

Other problems LECs cited with incentive regulation included the lack of solutions to competitive/regulated cross-subsidy issues, which some LECs noted are inherent in any cost-plus system of regulation and the potential for free market competitors to object to the LEC potentially having an unfair advantage by offering customers a co-op type of refund or rebate. According to Pacific Northwest Bell, while the concept of incentive regulation "has theoretical attractiveness, there are many serious pitfalls, which taken together are probably fatal to the

[841]Comments of Contel, UT PSC Docket No. 88-999-02; May 2, 1988, p. 11.

[842]Comments of Contel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 4.

[843]Reply Comments of PNB, WA UTC Docket No. 87-1320-SI; December 15, 1987, p. 10.

[844]Reply Comments of Wisconsin Bell, WI PSC Docket No. 6720-TI-102; June 5, 1987, p. 5.

approach."[845] Centel similarly concluded that because "[t]he difficulties and concerns associated with rate of return regulation are so severe . . . attempts to patch it should not be made. . . . The rapid changes occurring in this industry also make patching rate of return regulation unrealistic."[846]

5.3.4. IXCs

Interexchange carriers again frequently disagreed with LECs over a fundamental aspect of proposals for incentive regulation of LECs: IXCs asserted that LECs continue to maintain a monopoly over the bottleneck local services. As such, IXCs generally opposed incentive regulation proposals as providing inappropriate regulatory freedom for LECs. According to the IXCs, as long as LECs continue to maintain a monopoly over the local distribution network and to provide competitive services jointly using their local facilities, then rate base/rate of return regulation must continue to be strictly applied.

5.3.4.1. Concerns

MCI vigorously asserted that LECs continue to control monopoly bottleneck services, and that many potential abuses of their power could result without strictly enforced rate of return regulation. Clearly differentiating the local and interexchange markets, MCI stated that "[u]nlike the interexchange market, which has the potential to become competitive, the local exchange market remains a monopoly bottleneck . . . . [B]asic telecommunications services offered by the LECs remain subject to natural monopoly bottleneck conditions, and LECs retain overwhelming market power for all services they provide in the exchange

[845]Comments of PNB, WA UTC Docket No. U-87-1320-SI; November 2, 1987, p. 8.

[846]Comments of Centel, IL CC Docket No. 87-NOI-3; March 7, 1988, p. 16.

access market."[847] MCI therefore concluded that "it is inappropriate to consider an alternative regulatory format to the rate of return framework that currently protects ratepayers against the improper exercise of market power by a monopoly utility such as a LEC."[848]

Though perhaps the most forceful, MCI was not alone among the IXCs in arguing that LECs maintain their monopoly power. AT&T, noting that the AT&T/Bell System divestiture was based on the principle of separating competitive and non-competitive services, asserted that "[t]he basic nature of the local exchange carriers who possessed this local network bottleneck has not changed since divestiture." AT&T added that it has an "overwhelming and unavoidable reliance on use of the local exchange carrier's monopoly access services."[849] Tel America also asserted that "[f]or most of the services required by the consumer, there is, as a practical matter, no choice of providers."[850] TS Communications noted that "[w]hile competition may be technologically possible in the LEC market at this time, it is neither economically feasible nor physically present with the exception of certain instances."[851]

Predicated on the continued LEC monopoly control of local exchange services, the IXCs urged extreme caution if any alternatives to rate of return regulation are even to be considered. AT&T concluded that "[l]ocal exchange services and facilities that are monopoly-provided

[847]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 22.

[848]Reply Comments of MCI, IL CC Docket No. 87-NOI-3; April 22, 1988, p. 6.

[849]Comments of AT&T, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 4, 13.

[850]Position Statement of Tel America, UT PSC Docket No. 88-999-02; May 2, 1988, p. 5.

[851]Comments of TS Communications, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 5.

should remain subject to the full panoply of Commission regulation." AT&T added that the Commission "should continue to regulate such services through the mechanisms and oversight of traditional regulation."[852] In another forum, AT&T again asserted that in a monopoly environment, "there is no substitute for sound regulation."[853] Like other carriers, AT&T emphasized concerns over the potential abuse of monopoly power through pricing discrimination, deterioration of service quality, cross-subsidies, and other anticompetitive behavior. TS Communications added that the fact that rate of return regulation "requires more investigation, work, negotiation, and decision than several alternative methods of regulation . . . makes it clear that the alternatives fail to consider what can be very significant aspects of a carrier's financial position and the reasonableness of its rates." TS concluded that it "is aware of no alternative rate regulation format which provides the necessary protection to consumers and businesses in the industry."[854]

Specifically addressing incentive regulation, IXCs noted the continued costs associated with rate of return regulation, as well as the need for additional monitoring to protect against service quality deterioration or over-earning. American Network asserted that a "range" of authorized rate of return is confusing, with "no apparent purpose" served by the lower rate. American Network also asserted that determination of the source of excess profits (to determine whether the LEC is entitled to keep excess earnings or should refund them to ratepayers) could result in a lengthy hearing process. Thus, American Network concluded, "the Commission's resources would be burdened by

[852] Position Statement of AT&T, UT PSC Case No. 88-999-02; May 2, 1988, p. 8, 19.

[853] Comments of AT&T, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 3.

[854] Comments of TS Communications, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 2-3.

bonus rate or incentive rate hearings just as they would be devoted to traditional rate hearings."[855] MCI added that the establishment of an appropriate range of return is an area of concern: "Any range has to be wide enough to give an LEC the incentive to improve its efficiency and increase its rate of return. At the same time, the band has to be narrow enough so as not to provide the LEC with windfall profits to the detriment of its ratepayers."[856]

While MCI noted that in theory, permitting a LEC to earn additional profits if costs are reduced provides incentive to cut costs, it asserted that this situation will not occur while "some form of rate of return regulation will be necessary to protect consumers as long as the firm retains its bottleneck monopoly." MCI concluded that the LEC would still have the incentives to behave as a fully-regulated firm: the LEC could engage in cross-subsidy or the inflation of costs, aware that "the regulator will 'bail it out' if it makes mistakes or otherwise is unable to make a reasonable return."[857]

American Network and MCI also commented on the potential for service quality deterioration if LECs were given earnings flexibility under incentive regulation. According to American Network, performance indices would have to be developed to ensure that LECs do not cut services or necessary capital investment in order to increase rate of return. American Network asserted that "[a]t the very least, the development and use of such indices by the Commission will require increased Commission staff efforts in monitoring the monopoly

[855]Comments of American Network, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 8.

[856]Comments of MCI, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 3.

[857]Comments of MCI, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

carriers."[858] MCI similarly asserted that "[s]hould incentive regulation be adopted, the Commission will need to establish new standards for service efficiency." MCI noted that these indices would be necessary "to ensure that service quality is not degraded."[859]

5.3.4.2. IXC support for efficiency

Overall, the IXCs clearly did not support the implementation of incentive regulation for LECs. However, the IXCs did applaud commission efforts to streamline regulation and reduce regulatory burdens as long as monopoly consumer interests are not compromised. IXCs also asserted that where competition exists, the need for regulation diminishes. For example, AT&T noted the existence of the "changing regulatory needs of emerging competition" and supported the Washington Utilities and Transportation Commission's inquiry into ways to "rectify some of the problems inherent in traditional rate of return regulation of monopoly services."[860] Before the Illinois Commerce Commission, AT&T later stated that it could "support the development of alternatives to rate of return regulation for local exchange carriers provided adequate procedures are developed for classifying services and appropriate safeguards are defined which ensure the protection of the public interest."[861]

Even MCI stated that it supported "the Commission's initiative to explore positive alternatives to the regulation of monopoly

[858]Comments of American Network, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 7.

[859]Comments of MCI, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 4.

[860]Comments of AT&T, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 12.

[861]Reply Comments of AT&T, IL CC Docket No. 87-NOI-3; April 22, 1988, p. 1.

services."[862] However, while MCI asserted that the character of rate of return regulation "makes it inherently inappropriate for application to a competitive services market" and that "problems with rate of return regulation are significantly amplified for carriers subject to competition," it stated that in monopoly markets, "such criticism pales in comparison to the countervailing economic benefits that rate of return regulation guarantees."[863]

5.3.5. Other industry organizations

Industry organizations and large users commenting on incentive regulation proposals discussed many of the same issues cited by the IXCs. Some of the organizations supported Commission examinations of alternatives to rate of return regulation and the potential for rate stability and reductions in the cost of regulation, but the overwhelming majority did not support incentive regulation proposals. Reasons cited for their opposition were familiar: the alleged LEC monopoly power and resulting potential abuses, externally-driven declines in the cost of providing local exchange services, limited opportunities for ratepayer input, and the potential for declines in service quality. In addition, some of the organizations further noted the need to maintain rate of return monitoring, with its alleged weaknesses, under incentive regulation.

5.3.5.1. Strengths

The Department of Defense, representing itself, the General Services Administration, and all other Federal Executive Agencies asserted in Illinois that it "believes the Commission's continued review and consideration of refinements to traditional rate of return regulation is appropriate now and in the future." However, the Agencies added that

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[862]Comments of MCI, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 1.

[863]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 8, 6.

they "urge caution before endorsing alternative regulatory formats."[864] McCaw Communications similarly stated that it "generally supports Commission examination of measures to streamline unnecessarily burdensome procedures and to eliminate uneconomic incentives in traditional rate base, rate of return regulation."[865] The Telecommunications Ratepayers Association for Cost-Based and Equitable Rates (TRACER) also asserted that "[w]hile a reexamination of traditional rate of return regulation is desirable and should be undertaken, TRACER believes firmly that the existing regulatory structure . . . has performed exceptionally well. . . . While there is always room for regulatory improvement, it is important that the basic structure of the existing system, which is working well, not be completely abandoned unless the [Washington Utilities and Transportation Commission] is absolutely convinced that the alternative system will serve ratepayers better."[866]

In fact, TRACER was the only industry/large user organization to support some form of incentive regulation. While others supported certain concepts, they faulted overall proposals. For example, the city of New York noted that "[t]he moratorium concept has its benefits -- better utilization of resources; less time spent in litigation; incentives for [New York Telephone] to cut costs while increasing revenues; and the potential for greater benefits flowing to the consumer."[867] The city cited shortcomings in the New York proposal, though, and in conclusion supported the moratorium extension portion of the plan with revisions. Similarly, the state of Alabama found "very

[864]Reply Comments of DoD and FEAs, IL CC Docket No. 87-NOI-3; April 22, 1988, p. 2.

[865]Comments of McCaw, WA UTC Docket No. 87-1320-SI; November 4, 1987, p. 2.

[866]Comments of TRACER, WA UTC Docket No. 87-1320-SI; November 3, 1987, p. 2.

[867]Brief of NYC, NY PSC Case No. 28961; March 27, 1987, p. 6.

attractive the goal of establishing some means of predictability for the occurrence and size of telephone rate increases," but concluded that the Alabama Rate Stabilization and Equalization plan should be rejected because of the flexibility it would provide to the LEC in rate design.[868]

TRACER asserted that it "believes that some combination of incentive regulation and the more traditional regulation may be desirable. Such a combination system might be devised to provide additional incentives to telecommunications companies to reduce costs of service while still providing protection to monopoly ratepayers both [with] respect to the prices they must pay and the quality of service they obtain."[869] Despite its support, TRACER asserted the need for certain safeguards to ensure that the LEC would not abuse its position. According to TRACER, under incentive regulation "a new, comprehensive set of service quality and performance standards and detailed reporting procedures would need to be developed." These would be necessary to ensure that the LEC would not benefit from any degradation or reduction in the quality of service, monopolistic pricing practices, re-monopolization of markets that had been determined to be effectively competitive, or events external to the LEC.[870]

5.3.5.2. Weaknesses

Potential weaknesses that TRACER's proposed safeguards would address are frequently cited by other organizations in their opposition to incentive regulation. Many of these comments also cited the continued

[868] Comments of the State of Alabama, AL PSC Docket No. 19983; June 23, 1986, p. 1, 4.

[869] Comments of TRACER, WA UTC Docket No. 87-1320-SI; November 3, 1987, p. 3.

[870] Comments of TRACER, WA UTC Docket No. 87-1320-SI; November 3, 1987, p. 3.

monopoly that LECs' maintain over local exchange services, and the resulting potential abuses that require strict regulatory control.

Many organizations noted that LECs' costs are declining, due to technological advances as well as external factors, such as a general improvement in the economy and tax reforms. As the New York Clearing House Association and the Committee of Corporate Telecommunications Users stated, "[c]urrent and projected costs are now (finally) declining, and ratepayers should enjoy the benefits of those declines in the form of lower rates." The Association and Committee later noted that "[New York Telephone] has always sought prompt rate increases when its debt costs rise, and it should give prompt decreases when those costs fall."[871]

The city of New York similarly asserted that the New York moratorium concept was introduced at "precisely that point in time when a continuation of the traditional future test year methodology and an open forum examination might lead to substantial reductions . . . in rate levels." The city further stated that while rate moratoriums appear attractive to consumers when compared with the past trend of steadily rising costs, "when viewed in the context of what might result from continued application of the same regulatory standards that were employed over the past decade, in the more stable current economic environment the proposal that is being presented to the consumer could, in reality, result in rates which are higher than necessary and which will be fixed for the next several years."[872]

Industry and user organizations were concerned with the trend in declining costs because a rate moratorium, combined with shared excess earnings, could result in inappropriately high rates being "locked-in,"

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[871]Brief of NYCHA/CCTU, NY PSC Case No. 28961; March 30, 1987, p. 8, 18.

[872]Brief of NYC, NY PSC Case No. 28961; March 27, 1988, p. 7.

and inappropriate profits accruing to LECs. The Federal Agencies asserted that "[t]he existence and magnitude of unrealized efficiencies under the current [regulatory] format should be explored before implementing incentive regulation." The Agencies also noted that

> [i]n the early 1980's, the telephone companies presented themselves as helpless victims of the external forces of inflation which inexorably forced costs upward and required revenue relief in the form of rate increases imposed on ratepayers. Now, when costs appear to be declining, the same companies represent themselves as the authors of those declining costs and capable, with sufficient incentives, to cause those costs to decline yet further.[873]

The New York Clearing House Association and the Committee of Corporate Telecommunications Users noted as an example that where inflation is dropping, permitting LECs to maintain rates based on an historic cost of equity would "divorce the Company's rate of return even further from the realities of the marketplace."[874] The organizations asserted that many other factors external to the LECs will result in cost decreases. As the city of New York asserted, because such cost savings are not self-generated, "the full benefit of the savings, as determined by the Commission, should be returned to ratepayers."[875] The Federal Agencies also asserted that "any excess earnings caused by these external cost reductions should be passed through dollar-for-dollar to ratepayers because, in the reverse condition, increases in those same costs were also passed through dollar-for-dollar to ratepayers."[876]

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[873]Comments of DoD and FEAs, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 6.

[874]Response of NYCHA/CCTU, NY PSC Case No. 28961; March 4, 1987, p. 8.

[875]Brief of NYC, NY PSC Case No. 28961; March 27, 1987, p. 14.

[876]Comments of DoD and FEAs, WA UTC Docket No. 87-1320-SI; November 1987, p. 6.

To assure that ratepayers receive the appropriate level of shared excess profits under incentive regulation, additional financial reporting and monitoring may be necessary. The Federal Agencies asserted that "the burden of proof that a utility is entitled to keep any excess earnings should rest entirely with the utility."[877] The Agencies added that LECs should be required to respond to a show cause order by identifying causes of overearnings in the same detail that it would provide the causes of shortfalls.

Industry organizations also asserted that under incentive regulation, regulators would have to closely monitor service quality to ensure that LEC earnings are not increased at its expense. McCaw Communications stated that "the Commission would need to take on increased monitoring of monopoly providers to ensure that increased earnings came from improved performance, not from monopoly pricing or service degradation."[878] The Federal Agencies added that regulators would have to continue to "exercise judgement" as to depreciation rates, cost allocation, capital structure, cost of equity, and so forth on an ongoing basis.[879] However, monitoring earnings and establishing a threshold rate of return, according to the Federal Agencies, may not provide the sought-after improvement in LEC efficiency incentives.

The elimination or delay of the rate case and litigation process may, according to the organizations, severely reduce the ability of intervenors to provide input into the level and structure of rates for monopoly services. The Federal Agencies noted concern that the elimination of rate cases "would result in a Commission/Company process

[877]Comments of DoD and FEAs, WA UTC Docket No. 87-1320-SI; November 2, 1987, p 12.

[878]Comments of McCaw, WA UTC Docket No. 87-1320-SI; November 4, 1987, p. 2.

[879]Comments of DoD and FEAs, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 8.

which would effectively remove the affected users from protecting their valid interests and likewise remove the significant contribution of such user participation to the development of a full and meaningful body of evidence upon which the Commission can make a well-founded determination of wherein lies the public interest."[880] Similarly, the city of New York asserted that all interested parties should have a meaningful opportunity to participate in the review of LEC and staff filings regarding revenue requirements and rate structures. Telephone Answering Services of Utah, which asserted that LECs maintain a monopoly, added that "[t]he right to challenge the Telephone Company is imperative."[881] The right to challenge the LECs and provide input into a regulatory process is particularly important, according to the organizations, because LECs provide both competitive and monopoly services, and may be given some degree of pricing flexibility under incentive regulation. In conclusion, the New York Clearing House Association and the Committee of Corporate Telecommunications Users stated that "[p]ublic processes may be unwieldy, but in the long run they produce the soundest basis for Commission decisions."[882]

5.3.6. Consumer organizations

5.3.6.1. Weaknesses

Some consumer organizations and representatives also noted the potential lack of opportunity to participate in utility ratemaking decisions as a weakness of incentive regulation. Other weaknesses cited by consumer organizations were also similar to those cited by industry organizations. These included the alleged LEC monopoly control of the

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[880] Comments of DoD and FEAs, AL PSC Docket No. 19983; May 20, 1986, p. 2.

[881] Response to Issues by Telephone Answering Services of Utah, letter to Mountain Bell, ref. UT PSC Docket 88-999-02; April 29, 1988, p. 2.

[882] Response of NYCHA/CCTU, NY PSC Case No. 28961; March 4, 1987, p. 14.

local exchange market; the continued need under incentive regulation to establish an appropriate range of rate of return and to maintain financial and service quality monitoring; the lack of provisions to pass through to ratepayers the benefits of declining costs of providing service, including declines in the cost of equity; and the ability for a LEC to abuse its monopoly power and drive potential competitors from markets. As with their evaluations of social contract and price cap proposals, many participating consumer representatives asserted that an alternative to rate of return regulation is not unnecessary.

Providing a framework for consumer evaluations of incentive regulation (as well as other alternatives), the Illinois Citizens Utility Board stated that "the LECs must provide persuasive evidence to support their contention that competition exists in local exchange (intraMSA) markets before alternatives to rate of return regulation can be seriously considered."[883] The Utah Committee of Consumer Services similarly asserted that "the public will be best served by moving slowly in the area of telephone deregulation. Competition can replace regulation only in those markets supporting several strong companies providing true alternatives to telephone customers."[884]

According to many consumer organizations, that competition did not exist. The Citizens Utility Board, for example, stated that "there are considerable economic barriers to competition in Illinois' local telecommunications markets. It is inconceivable that a potential competitor could duplicate the billions of dollars that Illinois Bell has invested in its network."[885] The Alabama Association of Retired Persons added that providing a LEC with pricing flexibility under

[883]Reply Comments of CUB, IL CC Docket No. 87-NOI-3; April 26, 1988, p. 3.

[884]Comments of Committee of Consumer Services, UT PSC Case No. 88-999-02; May 4, 1988, p. 2.

[885]Comments of CUB, IL CC Docket No. 87-NOI-3; March 7, 1988, p. 1.

incentive regulation and the ability to automatically raise rates of monopoly services when return objectives are not met could "present the Company with a golden opportunity to drive competition with its affiliates out of the market."[886]

Given LECs' continued monopoly power, and the ability of rate of return regulation to adapt to individual instances of competition, some of the consumer organizations asserted that an alternative to rate of return regulation is not necessary. The Community Action for Fair Utility Practice (CAFFUP) noted that "[n]o problems with the present system have been shown and no benefits of the new systems have been demonstrated . . . . The present system seems to be responding to recent events and challenges."[887] The Washington Public Counsel also stated that "traditional regulation continues to serve us very well. We should be very careful not to make changes which will adversely effect the monopoly ratepayers."[888] In fact, while many consumer organizations noted the historical success of rate of return regulation and the development of the domestic telecommunications network, the Washington Public Counsel and the Alabama Consumers' Utility Counsel both noted that the LECs had met or exceeded authorized or competitive rates of return under rate of return regulation. According to the Washington Counsel, "[i]t is thus difficult to see why additional incentives in general are necessary."[889]

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[886]Comments of AARP, AL PSC Docket No. 19983; June 20, 1986, p. 8.

[887]Reply Comments of CAFFUP, IL CC Docket No. 87-NOI-3; April 22, 1988, p. 3.

[888]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 1987, p. 3.

[889]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 1987, p. 3.

Consumer organizations also noted the need to establish an appropriate range of return and set appropriate going-in rates -- issues upon which there is certain to be disagreement. According to CFA

> Key issues that emerge from incentive rates of return include the base rate of return and projections of costs. First, it can be said that the rate of return as currently set is supposed to include the incentive to work hard. If companies are not doing so, penalties, rather than rewards, might be appropriate.
>
> Second, establishing a basic fair rate of return and projections for costs independent of the incentive are also critical. If the base or projections of costs are too high, then companies will receive gifts rather than incentives.[890]

The CFA further asserted that existing LEC rates of return are three to four points higher than they have historically been, making them an inappropriate starting point for an incentive regulation proposal.[891] The Alabama Consumers' Utility Counsel asserted that the rates of return proposed in the Alabama rate stabilization plan proposal were "exorbitant, unconscionable and equitable only if one happens to be a stockholder in BellSouth." According to the Counsel, reductions in the prime rate and bond yields should make it "obvious to even the novice that rates of return on equity should also have declined."[892] The Washington Public Counsel added that the range of return "should be established to encourage certain specific goals such as increased efficiency or the introduction of new services."[893]

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[890] Divestiture Plus Four: Take the Money and Run, CFA; December 1987, pp. 12-13, 18.

[891] Ibid.

[892] Comments of Alabama Attorney General, Consumers' Utility Counsel, AL PSC Docket No. 19983; June 20, 1986, p. 6, 8.

[893] Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 1987, p. 4.

Other organizations added that not only must rates be made reasonable prior to implementing an incentive regulation plan, but that declining costs may lead to rate reductions under rate of return regulation. Noting that "[a]ny approach that rewards companies for improved efficiencies . . . can only be considered if rates of return are first set at appropriate levels," the people of Cook County Illinois (through the State's Attorney) questioned the desire of telecommunications carriers to change the method of regulation at the same time as rate of return regulation would produce lower rates. The people asserted that the impact of the Tax Reform Act of 1986, changing depreciation expenses, and favorable capital markets must be considered, and cross-subsidies from non-competitive to competitive services must be eliminated.[894] The Universal Service Alliance similarly asserted that New York Telephone's costs should be declining, and concluded that "[f]or years ratepayers have been told that when a utility's costs increase, rates must also increase. Symmetrical ratemaking requires that when a utility's costs decrease, rates must also decrease."[895] In conclusion, according to Community Action for Fair Utility Practice, "[a]lternatives to rate of return regulation cannot begin when rates are excessive."[896] However, the staff of the California PUC cautioned that broad incentives such as longer rate cycles "may result in windfall gains due to outside forces, such as unanticipated demand or changes in the economy."[897]

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[894]Reply Comments of the people of Cook County, IL CC Docket No. 87-NOI-3; May 4, 1988, pp. 1-2.

[895]Brief of Universal Service Alliance, NY PSC Case No. 28961; March 27, 1987, p. 4.

[896]Comments of CAFFUP, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 2.

[897]Comments of Public Staff, CA PUC En Banc Hearing on Regulatory Alternatives; September 11, 1987, p. 5.

Implementation of an incentive regulation proposal, according to the consumer organizations, may also result in the need for continued or additional financial and service quality monitoring. Stating that "without rigorous regulatory oversight, there simply can be no expectation that increased profits resulting from incentive regulation will benefit monopoly ratepayers," the Washington Public Counsel asserted that "[t]he use of a range of return should not be a substitute for the rigorous analysis of the actual rate of return for any given company, as well as its results of operations. Otherwise, range of return will simply transfer to a company's stockholders windfall profits which would have been denied it by traditional regulation."[898] The Counsel was also "very supportive" of establishing performance indices to assure continued quality of service.

As noted, another concern consumer organizations had with incentive regulation was the limited ability of parties to intervene in and participate in the ratemaking process. CFA cited the common trend in regulatory reform proposals to shift the burden of proof that rates are reasonable from the LEC to consumers ("or their representatives"). Noting that "[t]he Commission is well aware of the problems encountered by the Company's allocation policies," the Alabama Consumers' Utility Counsel asserted that the Alabama rate stabilization and equalization plan would "place an onerous burden on consumer representatives to verify the appropriateness of such allocations, if in fact such allocations could be verified."[899] The Washington Public Counsel added that "streamlining that reduces the opportunity to obtain adequate discovery effectively shifts the burden of proof from the company and

[898]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 1987, p. 4.

[899]Comments of Alabama Attorney General, Consumers' Utility Counsel, AL PSC Docket No. 19983; June 20, 1986, p. 18.

can only result in harm to ratepayers."[900] The Utah Committee of Consumer Services similarly asserted that "[a]ny change in regulation that allows rate and service changes to be made quickly and without public scrutiny has the potential of hurting ratepayers."[901]

The result, according to the consumer organizations, would be to discourage participation in the ratemaking process. The Alabama Consumers' Utility Counsel noted that reducing the need for the "extensive and time consuming" hearings will effectively remove the right of the ratepayers to "actively and meaningfully participate" in the hearing process."[902] However, as the Washington Public Counsel concluded, "[w]hile general rate cases can be arduous, complex and lengthy, they offer the only opportunity to review in detail the total financial picture of a company."[903] The Universal Service Alliance added that this open process must also apply to the negotiation of an incentive regulation agreement, rather than the limited negotiation process that has characterized many existing incentive regulation plans.

5.3.6.2. Support

Some consumer organizations, particularly those involved in the negotiation of incentive regulation proposals, supported the concept of incentive regulation. Strengths cited by the organizations have been incorporated into the proposals and include creation of efficiency incentives, rate reductions and stability, and protection against excessive LEC earnings. For example, according to the New York Consumer

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[900]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 1987, p. 1.

[901]Comments of the Committee of Consumer Services, UT PSC Case No. 88-999-02; May 4, 1988, p. 2.

[902]Comments of Alabama Attorney General, Consumers' Utility Counsel, AL PSC Docket No. 19983; June 20, 1986, p. 6.

[903]Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 1987, p. 2.

Protection Board, which participated in a negotiation process with the governor of New York and New York Telephone, the resulting rate moratorium and incentive regulation proposal "would serve as a strong incentive for [New York Telephone] to control operating and maintenance expenses and capital costs . . . [and] is a realistic and reasonable means of reducing and stabilizing [New York Telephone's] rates." The Board asserted that the plan would benefit residential and business customers and would "help attract new businesses to New York and encourage existing businesses to expand."[904]

5.3.7. Incentive regulation: summary

There was far more diversity of opinion within stakeholder groups on the perceived strengths and weaknesses of incentive regulation plans than in their evaluations of other regulatory alternatives. Strengths cited included rate stability, ratepayer sharing in the benefits of cost reductions, efficiency incentives, and potential administrative simplicity. However, corresponding weaknesses cited included the perpetuation of cost-rate discrepancies for monopoly services and the potential for anticompetitive monopoly abuses, the lack of incentives at the moment that sharing mechanisms become effective, and the potential administrative complexity of adding refund triggering and procedural burdens to those of rate of return regulation.

[904]Brief of CPB, NY PSC Case No. 28961; March 27, 1987, pp. 3-4.

Table 7

Framework for Evaluating Alternatives

Local Exchange Carriers (LECs)	**Regional Bell Operating Companies (RBOCs)**	– Protect universal service – Introduce new technology – Promote economic efficiency – Improve the U.S. international trade position – Provide LECs with the ability to compete in a timely manner and to respond to market changes and needs – Provide a transition to competition [6.3]
	Large Independents	– Protect universal service – Provide LECs greater flexibility in competitive markets – Retain regulatory oversight in non-competitive markets – Promote cost-based pricing – Provide a transition to competition [6.3]
	Small Independents	– Protect universal service – Preserve service area protection – Maintain rate averaging – Prevent duplication of facilities – Provide LECs with the flexibility to meet market needs [6.3]
Interexchange Carriers (IXCs)		– Protect consumers of monopoly services – Promote competition – Promote cost-based pricing – Prevent anti-competitive cross-subsidies – Promote service quality – Retain complaint procedures [6.4]
Other Industry[1]		– Protect consumers of monopoly services – Promote competition – Promote cost-based pricing – Prevent anti-competitive cross-subsidies – Promote rate stability and predictability – Promote service quality – Provide opportunity for participation in regulatory process – Improve complaint procedures [6.5]
Consumers		– Protect consumers of monopoly services – Promote universal, high quality service at just and reasonable rates – Prevent cross-subsidies of competitive services – Provide opportunity for public input in regulatory process – Retain complaint procedures [6.6]
Regulators	**Federal Communications Commission (FCC)**	– Provide a balance between consumer and investor interests – Restrict prices to a range bound at the lower end by confiscation and at the upper end by exorbitant rates – Correct dominant carrier business incentives [6.2.1]
	State Commissions and Commission Staff	– Promote universal, high quality service at just and reasonable rates – Correct inappropriate incentives – Protect monopoly ratepayers from potential abuses – Reduce regulatory costs – Prevent cross-subsidies [6.2.2]

[1] "Other Industry" represents positions of industries which may be large users of LEC services, LEC competitors, or both.

CHAPTER 6

FRAMEWORK FOR EVALUATING ALTERNATIVES

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FRAMEWORK FOR EVALUATING ALTERNATIVES

6.1. Overview

Stakeholder evaluations of alternative regulatory proposals reveal many common goals for alternatives. However, due to differing interpretations of the telecommunications environment and the impact regulatory reforms would have on stakeholders, their evaluations of alternatives as well as the overall goals of reforms varied (see Table 7).

6.2. Regulators

6.2.1. FCC

In its Notice of Proposed Rulemaking (NPRM) on price cap regulation, the FCC outlined its statutory responsibilities and goals when it proposed an alternative form of regulation for LEC and IXC interstate services. Within the mandate of the Communications Act, its goals are to protect universal service, foster technological advancement, protect ratepayers against a carrier's exercise of market power, and promote the efficient provision of interstate services at reasonable rates.[905] Citing legal precedent, the FCC added that it may implement any alternative to rate of return regulation that it finds would be "in the public interest" and would "result in a reasonable balance between consumer and investor interests."[906] In its evaluation of price cap

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[905]FCC NPRM, CC Docket No. 87-313; August 4, 1987, p. 2.

[906]FCC NPRM, CC Docket No. 87-313; August 4, 1987, pp. 4-5. The FCC cited Jersey Central Power and Light Co. v. FERC, 768 F 2d 1504 (DC Cir. 1985) to define a reasonable balance of consumer and investor interests as bounded at the upper end by exorbitant rates and at the

regulation, the FCC cited as its goal "to determine if the price cap model could be adapted so that it better protects and promotes consumer welfare and the public interest in an efficient and reasonably priced telecommunications network than does cost of service regulation."[907]

6.2.2. State regulators

State regulators frequently noted similar criteria they used for evaluating alternatives to rate of return regulation. The Washington UTC, for example, listed its general criteria: protection for monopoly ratepayers; maintenance of quality service, promotion of utility efficiency, and reduction of regulatory cost.[908] The Illinois Commerce Commission provided a similar list of criteria: reasonable rates, pricing efficiency, innovation and modernization, minimization of regulatory costs, and universal service.[909] The Maryland PSC cited "difficult and interrelated issues" that proposals for regulatory reform raise: how to best foster the public interest while the telecommunications industry is in substantial financial, technological, and competitive transition; protect consumers while giving LECs the opportunity to market price-competitive services; respond to competition in certain LEC service markets; encourage LEC investment in efficiency and innovation; permit LECs to respond to competition; assure that LECs do not subsidize competitive services with monopoly service revenues; and assure that LECs do not use their market power to gain an unfair advantage in competitive markets.[910] Overall, according to the Kentucky

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lower end by confiscatory rates.

[907]FCC NPRM, CC Docket No. 87-313; August 4, 1987, p. 1.

[908]WA UTC NOI Docket No. 87-1320-SI; September 16, 1987, p. 5.

[909]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 4.

[910]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 92.

PSC, regulators must "use the method of regulation that best balances the interests of both consumers and investors."[911]

While many state regulators noted that competition in telecommunications markets previously characterized as a natural monopoly necessitated changes in regulation and its goals, they frequently added that their primary objective remains to protect monopoly ratepayers and achieve universal service. Many regulators based this continued emphasis on the assertion that, as the Washington UTC stated, "[d]espite the development of competition for some services, many markets remain effective monopolies. For example, there is no effective competition for local exchange service."[912] As the Vermont PSB continued, "[o]ur first concern must be for the protection of basic exchange ratepayers, who will still be faced with a monopoly supplier."[913]

Regulators stated that maintaining "just and reasonable" rates and rate stability is key to protecting monopoly ratepayers. According to the Maryland PSC, "[t]he concept of just and reasonable rates is the cornerstone of regulation in Maryland and every other jurisdiction in the United States. . . . Any regulatory methods adopted by this Commission must result in just and reasonable rates."[914] The Commission also asserted that the C&P regulatory reform proposal filed in December 1987 contained "attractive features, foremost of which is the possibility of providing some rate stability for Maryland's business and residential customers." The Commission cited testimony provided in the regulatory reform proceeding in which many consumers indicated that they

[911]Comments of KY PSC, FCC CC Docket No. 87-313; October 16, 1987, p. 3.

[912]WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 1.

[913]VT PSB Order, Docket No. 5252; July 12, 1988, p. 46.

[914]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 42.

were risk-averse.[915] State regulatory reform plans frequently include rate reductions and periods of rate stability.[916]

Maintaining service quality was another key feature of any regulatory reform plan, according to many regulators. This feature is necessary to both protect the availability of universal, high quality service, and promote the introduction of innovative services. The Illinois Commerce Commission asserted that "any regulatory regime must continue to monitor, and be given leverage to enforce, the provision of universal, high quality service."[917] The West Virginia PSC similarly noted that "[a]ny type of regulation or deregulation must include the monitoring of service quality or the establishment of minimum service standards."[918] The Maryland PSC also noted the interrelationship between service quality and innovation incentives: "The marketing of new services often requires the installation of state-of-the-art technology. Thus, the [C&P] Regulatory Reform Proposal gives the Company an incentive to invest in modern equipment, which in turn will have the potential of benefiting all customers by improving the quality and reliability of service."[919]

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[915]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 55.

[916]For examples of approved regulatory reform plans, see Alabama Rate Stabilization and Equalization Plan (Docket No. 19983); New Jersey Rate Stability Plan (NJ BPU Docket No. TO 87050398); New York Rate Moratorium and Incentive Regulation Plans for AllTel (Case No. 29593), New York Telephone (Case No. 28961), and Rochester Telephone (Case No. 29551); West Virginia Flexible Regulation Plan (Case Nos. 83-259-T-SC, et al.); and Wisconsin Incentive Regulation Plan (Docket No. 6720-TI-102).

[917]Comments of IL CC, FCC CC Docket No. 87-313; October 15, 1987, p. 4.

[918]Comments of WV PSC, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[919]MD PSC Order No. 68115, Case No. 8106; June 30, 1988, p. 56.

Another objective frequently cited by regulators evaluating regulatory reform proposals was to provide efficiency incentives to the LECs. The Wisconsin PSC proposed an incentive regulation plan for Wisconsin Bell "with the goal of providing an incentive for [Wisconsin Bell] both to minimize operating costs and to provide continued high quality service more efficiently."[920] The Washington UTC similarly asserted that "in a time of increased change in the [telecommunications] industry," ratepayers might be better protected by "a system of regulation which retains the best attributes of the old system while improving it to provide incentives for companies to operate most efficiently."[921] The Michigan PSC also noted that regulatory reform plans "must be able to provide the regulated firm the most potent economic incentives to lower costs to a level of maximum efficiency."[922]

The goal of LEC efficiency may also help achieve regulators' goals of rate stability and reduced costs of regulation. According to the New York DPS, the New York Telephone rate moratorium plan "represents the latest restructuring of the rate case process in the New York Commission's continuing effort to alleviate the need for [New York Telephone] to file general rate cases every year. Its aim is to add stability to [New York Telephone's] telephone rates, reduce rate case expenses and provide the company with an incentive to operate efficiently."[923] The Alabama PSC similarly asserted that "[i]t is the intent of [the Rate Stabilization and Equalization plan] to avoid the large general rate increase requests so characteristic of recent

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[920] WI PSC Order, Docket No. 6720-TI-102; July 28, 1987, p. 13.

[921] WA UTC NOI, Docket No. 87-1320-SI; September 16, 1987, p. 3.

[922] Comments of MI PSC, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[923] Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. 6.

years."[924] The Washington UTC Staff Report on the Commission inquiry into incentive regulation noted that "[w]hile there are extremes of opinion which range from those who would replace traditional regulation altogether to those who would make little change, there was substantial consensus that the Commission was focusing on the correct issues by addressing the need to reduce regulatory costs and strive for positive incentives to efficiency and productivity."[925]

While striving to improve regulatory techniques that will protect consumers of LEC monopoly services, many commissions realized that they must also allow LECs to compete in many other markets. The New York PSC noted its "obligation to serve as a surrogate for the disciplines of the marketplace from which a monopoly would otherwise be free."[926] The New York DPS added that "the presence of effective competition . . . would obviate the need for any regulatory scheme."[927] However, though competition exists in some LEC markets, regulators (as well as other stakeholders) disagreed on the extent of that competition, and consequently on the amount of freedom required by LECs.

Further concerns were cited by many regulators over the potential for LECs to use revenues from monopoly markets to subsidize services in competitive markets where pricing flexibility has been granted. Given their goal of monopoly ratepayer protection and a desire to promote effective competition, the need to prevent cross-subsidies and predatory pricing was of concern to many regulators. The Vermont PSB frequently discussed the cross-subsidy issue in its order disapproving the New England Telephone social contract. According to the PSB, "[o]ne of the

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[924] AL PSC Order, Docket No. 19983; November 3, 1986, p. 7.

[925] WA UTC Staff Report, Docket No. 87-1320-SI; June 21, 1988, p. 2.

[926] Statement of NY PSC, Case No. 28961; March 19, 1986, p. 13.

[927] Comments of NY DPS, FCC CC Docket No. 87-313; October 16, 1987, p. 4.

basic premises of [the legislation authorizing a social contract, 30 V.S.A. 226a] is that there must be no significant pool of revenues (derived from NET's monopoly markets) available to off-set losses due to anti-competitive pricing in competitive sectors of NET's services."[928] The New York PSC, in its order extending the New York Telephone rate case moratorium, also noted its obligation "to prevent non-compensatory under-pricing."[929] The Washington UTC added that "as long as a regulated company insists on providing both competitive and non-competitive services, it is absolutely imperative that a regulatory body continue to oversee business and accounting practices that might allow regulated activities to subsidize competitive activities."[930] The Wisconsin PSC, noting that "a balance must be struck between the interest of monopoly ratepayers and the interests of the company and its customers who use competitive services," concluded that "superimposed upon any market-based price determination must be the avoidance of cross-subsidization."[931]

6.3. LECs

LECs also cited many common goals of regulatory reform, such as the continuation of traditional regulatory goals of universal high quality service, efficiency and innovation, and the continued development of the telecommunications infrastructure. LECs added that regulatory reforms should also seek to reduce the burdens associated with rate of return regulation and provide LECs sufficient flexibility to rival their unregulated competitors, while assisting in the transition to market regulation.

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[928] VT PSB Order, Docket No. 5252; July 12, 1988, p. 36.

[929] NY PSC Order, Case No. 28961; May 11, 1987, p. 43.

[930] Comments of WA UTC, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

[931] WI PSC Order, Docket No. 6720-TI-102; July 28, 1987, p. 19.

Many LECs provided a general summary of traditional regulatory goals that reforms should strive to achieve. As CP National stated, "modifications must . . . assure the maintenance of incentives assuring quality service, modern technology, and universal service."[932] Ameritech asserted that in comparing regulatory reforms with rate of return regulation, "[t]he comparative evaluation standards remain the Communications Act's public interest objectives: provide just and reasonable rates, preserve universal service, foster technology, promote efficiencies, and protect society against market power abuse."[933] NYNEX similarly stated that reforms should promote the development of "universal service; a high quality, feature-rich network that offers services required by large and small business users as well as by residential customers; and a pricing structure which is reasonable, economically efficient and avoids unreasonable discrimination."[934]

LECs frequently emphasized the importance placed on the goal of universal service. As Contel asserted, "perhaps it is time to change the shape of the regulatory tool; however, the preservation of universal service remains a primary concern to the industry and regulators alike."[935] Mountain Bell similarly stated that among "the public policy goals which [it] believes should guide any continued regulation of the industry" is that to "maintain the availability of access to telecommunications service at affordable rates, i.e., universal

[932]Comments of CP National, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

[933]Comments of Ameritech, FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[934]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, p. 7.

[935]Comments of Contel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 5.

service."[936] Illinois Bell also noted that "[a] regulatory system should ensure the continued high level of connectivity in the telecommunications industry. The world's highest level of penetration must not be sacrificed and continued attention must be given to maintenance of universal service."[937] USTA added that "the universal service goals, including the high cost support mechanisms and revenue streams . . . must be preserved."[938] According to the National Telephone Cooperative Association (NTCA), the goal of universal service "must not be abandoned or 'tainted' by efforts to impose another system of regulation"; NTCA concluded that "[t]he key goal of universal service must be and remain a fundamental touchstone" of any review of regulatory alternatives.[939]

LECs also asserted that providing high quality service should remain a goal under any alternative regulatory scheme. As Telephone and Data Systems (TDS) asserted, "maintaining high quality and affordable service for all TDS customers is TDS's paramount goal."[940] According to Illinois Bell, "[a]ny new regulatory process must promote high standards of efficiency and service." The company added that while marketplace forces can determine service quality levels for competitive services, "the regulatory process should continue to monitor service quality

[936] Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 2.

[937] Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 24.

[938] Comments of USTA, FCC CC Docket No. 87-313; October 19, 1987, p. ii.

[939] Comments of NTCA, NTIA Docket No. 61091-6191; December 15, 1986, pp. 3-4.

[940] Comments of TDS, NTIA Docket No. 61091-6191; December 15, 1986, p. 2.

levels of essential basic services."[941] GTE also maintained that "quality of service should be part of the Commission's evaluation" of alternative regulatory methods.[942] GTE added that the continued achievement of universal service requires the balancing of the complementary objectives of high quality service at reasonable rates.[943]

Corresponding to the weaknesses LECs cited in their evaluations of rate of return regulation, many stated that regulatory reforms should provide efficiency and innovation incentives, which will help continue to develop the nation's telecommunications infrastructure. For example, Centel asserted that "the current regulatory system should be changed to incorporate appropriate incentives which recognize well-managed companies and provide new and greater incentives for efficiencies."[944] Cincinnati Bell stated that it "would support regulatory reform to the extent that it encourages increased efficiency and innovation while lessening regulatory burdens and administrative costs."[945] Mountain Bell believes that maximizing the benefits of competition "by lowering costs and prices and facilitating the introduction of new products and services through innovation and new technology" should be a public policy goal that guides any continued regulation of LECs.[946]

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[941]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 25.

[942]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 39.

[943]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 10.

[944]Comments of Centel, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

[945]Reply Comments of Cincinnati Bell, FCC CC Docket No. 87-313; December 4, 1987, p. 1.

[946]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 3.

As Contel concluded, "[i]f the American public is to realize all of the benefits promised by the information age, carriers must have the incentive to operate efficiently and to introduce innovative technologies, and the ability to quickly respond to competitive market signals."[947] USTA added that "the Commission should seek to provide the utmost benefit to the broadest range of customers through the introduction of new services, as well as the lower prices, which could be realized through increased incentives for operational efficiency."[948] LECs further noted the domestic economy's increased dependency on telecommunications services. NYNEX discussed how Japan invested in a modern, feature-rich network to gain leadership in the financial and information services industries. The company concluded that "the result can be a staggering blow to the United States economy. . . . Therefore, development of a high quality, feature-rich network in this country is an important link in maintaining our international competitive position."[949] GTE added that "the success of the 'information age' is dependent on the provision of these innovative services through an efficient telecommunications infrastructure. At the same time, plain old telephone service (POTS) must be universally maintained."[950]

In addition to discussing traditional regulatory goals, many LECs emphasized the need for regulatory reform to satisfy additional goals, including reduced regulatory burdens, flexibility to compete, and movement towards a competitive market. Many LECs concluded that

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[947]Comments of Contel, FCC CC Docket No. 87-313; October 19, 1987, p. 22.

[948]Comments of USTA, FCC CC Docket No. 87-313; October 19, 1987, p. 8.

[949]Comments of NYNEX, FCC CC Docket No. 87-313; October 19, 1987, pp. 13-15.

[950]Comments of GTE, WA UTC Docket No. 87-1320-SI; November 4, 1987, p. 16.

regulation should be limited to those services where LECs maintain monopoly power.

As South Central Bell stated, there is a "need for new thinking on the role of regulation." South Central added that "the telecommunications industry requires a more flexible, less burdensome and more realistic regulatory regime."[951] Illinois Bell asserted that "[t]he regulatory process should be efficient. It should be administratively simple and expeditious, requiring a minimum amount of information, and rely, to the greatest extent possible, on the forces of competition and consumer judgement."[952] USTA similarly stated that "any new method of local exchange carrier regulation should reduce unnecessary administrative and other unwarranted regulatory burdens."[953]

Like many small companies, the Illinois Independent Telephone Association, noting that rate of return regulation creates "unique and disproportionately burdensome problems and costs for small local exchange carriers such as IITA member companies," asserted that the differences between large and small LECs must be considered when examining alternative regulatory proposals. According to the Association, "[a]ny and all actions to reduce regulatory burdens and costs will serve both the interests of IITA member companies and their customers." IITA added that "regulatory reform is necessary for small local exchange carriers if they are to survive with the ability to

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[951]Response of South Central Bell, KY PSC Case No. 10105; January 1988, p. 5.

[952]Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 25.

[953]Comments of USTA, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

provide universally available service at widely affordable rates in the areas they serve."[954]

Many LECs want regulation limited to those services where a monopoly still exists. In such markets, LECs continued, regulation should protect consumers of monopoly services from potential exploitation; in other markets, competition is the most efficient regulator. As Stanford Levin stated in his comments filed on behalf of Bell Atlantic, "[t]he major goal of telecommunications regulators should be to protect those customers who do not have reasonably priced and readily choices in the market."[955] GTE added that "from a public policy perspective, users lacking competitive alternatives need assurance that an altered regulatory mode will not subject them to inappropriate treatment."[956] The LECs asserted that those customers without competitive alternatives are the basic local service customers. As Contel noted, "[a]bsent competition, the pricing of the local loop should continue to be a regulated monopoly service."[957] Mountain Bell concluded that "[r]egulation should focus on the reasonableness of prices paid by consumers who have no other supplier options. These customers deserve stable rates, high quality service and continued availability of service. These customers should also receive the benefits of new, innovative services."[958]

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[954]Comments of IITA, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 2, 6.

[955]Statement of Dr. Stanford L. Levin, on behalf of Bell Atlantic, NTIA Docket No. 61091-6191; December 15, 1986, p. A4.

[956]Comments of GTE, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[957]Comments of Contel, Utah PSC Docket No. 88-999-02; April 29, 1988, p. 5.

[958]Position Statement of Mountain Bell, UT PSC Case No. 88-999-02; May 3, 1988, p. 30.

While focusing regulation on protecting monopoly consumers, LECs added that they should be given freedom to compete in other markets. Pacific Northwest Bell asserted that "[a] regulatory structure should inspire companies to perform as their free market counterparts, while protecting monopoly ratepayers from rate discrimination."[959] USTA similarly added that the "elimination of traditional rate of return regulation as soon as practical for all services where competition exists" would allow LECs to "match the business flexibility available to nonregulated businesses and continue to ensure that reliable service at a reasonable price is provided to customers who currently do not have alternatives."[960]

The need for the flexibility to meet competition from unregulated competitors was frequently the focal point of LEC comments on regulatory reforms. As Illinois Bell stated, "[n]ow that competition is a fact of life in telecommunications, it is essential that regulators insure that it occurs in a viable context, between competitors who are afforded the same opportunities. This cannot occur if some competitors must labor under the burdens of rate of return regulation while others do not."[961]

Noting that "[c]hanges in technology and the increase in competition necessitate regulatory reform," Centel also asserted that "[r]egulation must allow carriers to meet competition through a combination of market-based rates, new services, and new technologies."[962] Telephone Utilities of Washington, Inter-Island Telephone Corporation, and

[959] Comments of Pacific Northwest Bell, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

[960] Comments of USTA, NTIA Docket No. 61091-6191; December 15, 1986, p. 13.

[961] Comments of Illinois Bell, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 16.

[962] Comments of Centel, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 17, 12.

Peninsula Telephone Corporation similarly asserted that providers of non-essential services, including LECs, "must be allowed to package and price services to meet specific market conditions without the regulatory delay that accompanies general rate cases."[963] Southern Bell also asserted that "as technology and new firms entering the marketplace continue to produce alternatives to Southern Bell's service offerings . . . [i]t will become critical that the Company be able to react to these alternatives with similar alacrity to that which is available to its competitors."[964]

In conclusion, GTE, stating that "[t]he existence of a level playing field in the competitive marketplace is a critical and crucial environmental condition," asserted that many firms competing with LECs "are subject to little or no regulation," giving them the ability to establish market based prices. According to GTE, "[p]roviding LECs with this same advantage is essential if LECs are to remain viable in an increasingly competitive market."[965]

Finally, many LECs added that any regulation must assist in the transition to a competitive marketplace. Mountain Bell stated that it "supports, in the long term, the complete transition to market regulation of the telecommunications/information industry." According to Mountain Bell, this transition is being driven by "the implacable forces of technology." However, Mountain Bell added that "practical considerations necessitate a transitional mechanism . . . that will allow Mountain Bell the competitive flexibility required, yet protect

[963]Comments of Telephone Utilities of Washington, et al., WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 3.

[964]Petition of Southern Bell, FL PSC Docket No. 880069-TL; January 13, 1988, p. 11.

[965]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, pp. 11-14.

against monopoly pricing."[966] GTE similarly asserted that "the focus should be what aspects of the transition to competition are of potential harm to customers and/or firms and how these impacts can be mitigated. In other words, the question is not whether to remove regulation, but how to remove it."[967] GTE concluded that "regulation must smooth the transition toward a competitive environment while assuring affordable rates for users who have few alternatives."[968] Encompassing many goals of regulatory reform cited by LECs, Contel concluded that it "is open to analyzing any option that would relieve regulatory lag, provide carrier flexibility, reduce regulatory costs, and assist in a transition to a more competitive environment."[969]

6.4. IXCs

In sharp contrast to the LECs' positions, IXCs generally asserted that reduced regulation of LECs is simply inappropriate. According to IXCs, LECs remain natural monopolies, and full regulation is therefore necessary in order to protect against potential monopoly abuses. IXCs noted the LECs' unique position as both suppliers of essential monopoly services to IXCs and also as IXC competitors. Therefore, IXCs asserted that regulation -- either traditional or reformed -- must protect against potential anticompetitive pricing practices. If regulators implement regulatory reforms they must provide safeguards, according to IXCs, including the protection of monopoly service customers, promotion of cost-based stable rates, and prevention of cross-subsidies. IXCs

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[966]Comments of Mountain Bell, NM SCC Docket No. 87-54-TC; September 11, 1987, p. 3, 33.

[967]Comments of GTE, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 5.

[968]Comments of GTE, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

[969]Comments of Contel, UT PSC Docket No. 88-999-02; April 29, 1988, p. 9.

added that LECs must not be able to impair competition through the exploitation of their monopoly power.

According to AT&T, "any alternative framework . . . must balance the increases in efficiency and productivity with the increased potential for monopoly abuse." In a statement that summarized the position of many IXCs, AT&T added that its "overwhelming and unavoidable reliance on use of the local exchange carrier's monopoly access services to provide access to its customers makes it essential that the Commission's ability to ensure just and reasonable rates will not be jeopardized under any alternative regulatory framework. The Commission must ensure that no alternative plan it may adopt provides the LECs with the unwarranted ability to cross-subsidize competitive services through improper pricing or cost allocation mechanisms, or to discriminate in an anticompetitive fashion between different customer classes."[970] AT&T concluded that "[i]f an alternative form of regulation is determined to more satisfactorily ensure reasonable prices for monopoly service customers, its adoption could facilitate increased competition, provide customers alternatives, spur technological innovation, and produce increased efficiency in local exchange carrier networks."[971]

Many IXCs elaborated on the need for protection from potential abuses based on LECs' continued monopoly control over local exchange access. National Telecommunications Networks urged regulators "to devote substantial attention over the next several years to restraining the LECs from abusing their access bottleneck."[972] MCI cited LECs' current excessive access rates and increasing rates for other services provided

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[970]Comments of AT&T, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 7, 13.

[971]Comments of AT&T, CA PUC En Banc Hearing on Regulatory Alternatives; September 11, 1987, p. 12.

[972]Comments of NTN, FCC CC Docket No. 87-313; October 19, 1987, p. 35.

to captive customers, concluding that "[i]n these circumstances, more intense regulatory scrutiny of their pricing practices is required, not less."[973] MCI also asserted that "[p]roponents of radical departures from traditional regulation have not shown that these alternative regulatory approaches ensure just and reasonable rates of monopoly services. . . . Until an alternative to cost-of-service (rate-of-return) regulation has been proven to be effective, consumers of those monopoly services are completely justified in demanding regulatory controls over . . . rates, service quality and profits."[974] CompTel, which noted that "[t]he Commission's proper concern is preventing the LECs from charging exorbitant prices and discriminating among consumers of all of their services and who lack alternatives," concluded that "[t]he absence of competition demands effective Commission controls to ensure that the LECs charge reasonable and non-discriminatory rates and provide uniformly high quality service."[975]

A primary concern of IXCs was the potential for LECs to charge non-cost based rates for monopoly services. TS Communications asserted that it "is gravely concerned that an alternative regulatory framework would allow the costs of interexchange carrier access to rise dramatically." TS concluded that "any alternative framework must produce reasonable cost based charges for access service."[976] AT&T similarly asserted that "the paramount issue that must be addressed is establishment of some suitable mechanism to ensure just and reasonable rates for services that

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[973]Reply Comments of MCI, FCC CC Docket No. 87-313; December 4, 1987, p. iv.

[974]Position Statement of MCI, UT PSC Docket No. 88-999-02; April 13, 1988, pp. 2-3.

[975]Comments of CompTel, FCC CC Docket No. 87-313; October 19, 1987, p. 28; Reply Comments of CompTel, FCC CC Docket No. 87-313; December 4, 1987, p. 21.

[976]Comments of TS Communications, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 4.

are not subject to the constraints of competition." AT&T added that switched and many types of special access are not subject to effective competition.[977] Noting that "[f]or decades, tariffing has provided, and continues to provide, a framework for assuring that the LECs' rates are just and reasonable from the standpoint of the public interest," MCI asserted that "[t]ariffed rates must . . . be forced to correspond more closely to LEC costs."[978]

IXCs asserted that the need for cost-based, just and reasonable, and non-discriminatory rates would apply not only to the rates LECs charge IXC customers, but also to the rates LECs charge individual consumers. According to the IXCs, this important element of any regulatory reform would entail the establishment of safeguards against cross-subsidies. Among these safeguards, IXCs cited the imputation of access charges to LEC intraLATA toll services. According to AT&T, "[t]he specter of unfair competition resulting from the common provision of monopoly and competitive telecommunications services mandate that effective safeguards be established, so that the public interest in fostering a fully competitive marketplace and providing . . . consumers with the benefits of fair competition are protected." AT&T added that these safeguards include the imputation of access charges to LEC rates for competitive interexchange services "on the same basis and at equal levels as it charges its interexchange carrier competitors" and a cost allocation/separations process to protect against cross-subsidies of competitive LEC services.[979] AT&T also asserted that "[t]o protect against possible cross-subsidization AT&T believes that the features and

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[977]Comments of AT&T, CA PUC En Banc Hearing on Regulatory Alternatives; September 11, 1987, p. 13.

[978]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 9.

[979]Position Statement of AT&T, UT PSC Case No. 88-999-02; April 28, 1988, pp. 7-8.

functions of bottleneck aspects of services should be unbundled, priced separately, and subject to resale."[980]

Other IXCs also cited the need for safeguards against cross-subsidies, either under rate of return regulation or under alternative methods of regulation. MCI asserted that "[t]here are, of course, some dangers to be avoided in streamlining regulatory procedures. Great care should be taken to avoid relaxing standards and safeguards regarding service quality and cross-subsidization."[981] American Network also expressed concern over cross-subsidization of competitive services by monopoly services, asserting that "monopoly services should be broadly defined to include all services of a dominant carrier."[982]

According to MCI, the prevention of anticompetitive cross-subsidies is a critical element to achieving another goal of LEC regulation: promoting competition. MCI, like other IXCs, asserted that "any LEC ability to price its services flexibly will irreparably damage emerging competition by encouraging cross-subsidies of competitive services by captive monopoly ratepayers, including its competitors, as access customers."[983] MCI concluded that some regulatory change "may be appropriate, particularly if consumers of telecommunications services will be better protected and effective competition in the industry is further encouraged."[984] The Alternative Carrier Telecommunications

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[980]Comments of AT&T, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 3.

[981]Comments of MCI, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 2.

[982]Comments of AmNet, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 7.

[983]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 17.

[984]Position Statement of MCI, UT PSC Docket No. 88-999-02; April 13, 1988, p. 1.

Association similarly asserted that it is "important for the Commission to maintain such regulation as is necessary to assure that fair and equitable competition occurs."[985] AT&T added that "[m]easures to foster increased competition can only serve to expand customer options, stimulate vendor innovation, and increase the revenue base for the entire industry."[986]

In conclusion, as US Sprint asserted, "the Commission's paramount objective must, at all times, be to promote the public interest consistent with the intent of the framers of the Communications Act."[987] AT&T similarly stated that "[a]lternative regulation must create economic and competitive incentives which positively serve the public interest."[988] MCI asserted that "[u]nder any regulatory framework, the desired end is a market result that most closely approximates the competitive ideal. This is not to suggest that competition, in and of itself, is a goal. Rather, the ultimate objective is maximization of benefit to the public through the increased efficiencies and improvements in quality and productivity that are generated by effective competition." According to MCI, a regulatory framework should ensure that consumers enjoy "non-discriminatory cost-based rates; that revenues will maintain an appropriate relationship to costs; that all market participants will have the opportunity to recover reasonable costs and the incentive to provide efficient service; and that the quality and availability of service will be maintained at an acceptable level."[989]

[985]Comments of ACTA, FCC CC Docket No. 87-313; October 19, 1987, p. 10.

[986]Position Statement of AT&T, UT PSC Case No. 88-999-02; April 28, 1988, p. 16.

[987]Comments of US Sprint, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[988]Comments of AT&T, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 3.

[989]Comments of MCI, IL CC Docket No. 87-NOI-3; March 8, 1988, p.

6.5. Other Industry Organizations

Industry organizations, like the IXCs, considered the continuation of traditional regulatory goals, as well as goals tailored to prevent potential anticompetitive abuses such as cross-subsidies, as critical elements in their evaluations of potential regulatory reforms. The organizations asserted that regulation must continue to strive to benefit the public interest; it must protect monopoly ratepayers, including providing rate and service quality protection; it must protect against inappropriate cross-subsidization; and it must encourage competition.

Industry organizations emphasized the importance of the public interest standard in evaluating either regulatory reform or traditional regulation. As the Committee of Corporate Telecommunications Users (CCTU) stated, "[t]he public interest should be the hallmark of Commission action."[990] ADAPSO similarly asserted that "it is incumbent upon those parties advocating change to demonstrate that any new system of regulation will provide improved public benefit."[991] The promotion of the public interest, according to the industry organizations, entails the protection of monopoly ratepayers, the balancing of ratepayer and investor interests, and the promotion of just and reasonable, non-discriminatory rates.

Based on their assertion that LECs retain monopoly control over the local distribution network, industry organizations asserted the critical need to protect ratepayers from potential monopoly abuses. As the Tele-Communications Association asserted, regulatory initiatives should

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[990]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[991]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

"promote efficient and expanded use of the network while protecting ratepayers."[992] The Utilities Telecommunications Council similarly stated that it applauded Commission efforts to "examine regulatory alternatives that could better protect consumers of less competitive services."[993] According to Capital Cities/ABC, CBS and NBC, the ultimate goal of the FCC price cap proceeding "should be to devise a regulatory structure that promotes more efficient utilization of a dominant carrier's resources, provides the carrier the opportunity to earn sufficient revenue to cover its costs and compensate its shareholders fairly, while at the same time protecting users from excessive rates as contemplated by the Communications Act of 1934."[994]

Like the television networks, many organizations discussed the need to balance ratepayer and investor interests. However, while noting that shareowners should be given the opportunity to earn a just and reasonable return on their investment, the organizations asserted that monopoly ratepayers' interest in just and reasonable rates must have first priority. As ADAPSO stated, "[t]wo primary objectives of rate of return regulation, allowing carriers to recover their costs along with a fair rate of return on equity and protecting consumers from monopoly pricing, should not be significantly altered under a price cap or any other regulatory scheme."[995]

However, CCTU added that while providing for a favorable return to LEC shareowners "is a legitimate interest when the Commission is setting

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[992]Comments of TCA, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

[993]Comments of UTC, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

[994]Comments of Capital Cities/ABC, et al., FCC CC Docket No. 87-313; October 19, 1987, p. 6.

[995]Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

rates," it is not the primary interest. According to CCTU, the primary interest is "in setting rates that are 'just and reasonable,' given the carrier's costs of providing the service." CCTU added that "[a]ssuming benefits flow from a relaxed form of rate regulation, the ratepayer should benefit first and foremost."[996] IBM similarly asserted that "public interest requires that any [regulatory alternative] proposal include some mechanism to ensure that ratepayers share in any cost savings produced. If . . . ratepayers have been paying higher prices because carriers have inflated their investments and expenses, then ratepayers should receive, in the form of lower prices, a substantial portion of the cost savings that any alternative regulatory scheme is designed to achieve."[997]

Many of the organizations, reflecting their concerns over strategic or predatory pricing and rate churn, also focused on the need for equitable rates, based on economic cost, that are stable and predictable. As ICA asserted, the business community will not support regulatory reform "until the Commission devotes the resources needed to make substantial progress toward cost-based, stable and predictable rates for the interexchange and exchange access services upon which business ratepayers depend."[998] The Department of Defense added that "the need for rates that are equitable in both a social and economic sense remains the most appropriate criteria for judging the appropriateness of a regulatory format."[999]

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[996]Reply Comments of CCTU, FCC CC Docket No. 87-313; December 4, 1987, p. 17.

[997]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

[998]Reply Comments of ICA, FCC CC Docket No. 87-313; December 4, 1987, p. 6.

[999]Comments of DoD, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 1.

The assurance of economically equitable rates, as the Ad Hoc Users Committee asserted, means that "the procedures designed by the Commission must ensure that rates continue to bear some reasonable relation to the carriers' underlying costs." The Committee added that before any reforms are considered, the major issues of strategic pricing and joint costs must be resolved.[1000] IDCMA similarly asserted that "[a]ny regulatory system that the Commission prescribes must assure that dominant carriers do not abuse their dominant position by charging unjust or unreasonable rates for their regulated transmission services."[1001] As the Tele-Communications Association concluded, "[w]hatever form of regulation the Commission uses, its statutory responsibilities remain the same -- to ensure just, reasonable and non-discriminatory rates. To meet these responsibilities, the Commission must have in place (1) monitoring procedures, to detect the existence of unlawful rates, and (2) refund procedures, to protect ratepayers against unlawful rates that escape detection."[1002]

Of key importance in the assurance of just and reasonable rates, the organizations continued, is the transition from strategic and predatory pricing to pricing based on economic cost. As ICA asserted, "the proper focus of access pricing should be on whether services are priced according to costs, not whether they are 'competitively' priced."[1003] The Department of Defense similarly asserted that "[r]ates for . . . telecommunications services, over which a firm may exercise monopoly powers, should be based on the cost of providing these services

[1000]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 5.

[1001]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. ii.

[1002]Reply Comments of TCA, FCC CC Docket No. 87-313; December 4, 1987, p. 18.

[1003]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 13.

including the cost of capital under efficient and economic management."[1004] The Ad Hoc Users Committee added that "[t]he Commission has some discretion as to the procedures it employs, but it has no discretion to change the ultimate test that rates must be just and reasonable vis-a-vis costs."[1005]

According to many of the organizations, LEC costs are declining, and would decline further if regulatory administrative costs are reduced. The organizations added that the public interest standard, as well as the need for cost-based pricing, dictates commensurate rate reductions. According to CCTU and the New York Clearing House Association, "[c]urrent and projected costs are now (finally) declining, and ratepayers should enjoy the benefits of those declines in the form of lower prices."[1006] ICA asserted that regulatory reforms "must be demonstrated to ensure that ratepayers will benefit from flow-throughs that reflect every item that would serve to reduce telephone rates in the future." ICA specifically noted that "[r]atepayers ultimately should enjoy the benefits of eliminating any portion of the estimated $1.1 billion in annual regulatory costs that NTIA has estimated would be realized."[1007]

The Department of Defense added that excess earnings caused by external cost reductions "should be passed through dollar-for-dollar to ratepayers."[1008] IBM, discussing cost savings that carriers may realize

[1004]Comments of DoD, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 9.

[1005]Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 16.

[1006]Brief of NYCHA/CCTU, NY PSC Case 28961; March 30, 1987, p. 8.

[1007]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 22.

[1008]Comments of DoD, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 6.

under alternative forms of regulation, also asserted that reforms should "include methods of ensuring that ratepayers do share in such cost savings."[1009] Organizations added that to the extent that any inefficiencies due to rate of return regulation have been incorporated into existing rates, adjustments would be necessary in order to set appropriate rates under an alternative regulatory framework.

Industry organizations, such as the Utilities Telecommunications Council, added that it is imperative that their members "have access to common carrier services at prices that are stable and predictable." The Council added that it "places a paramount importance on pricing stability."[1010] ICA asserted that "the Commission should not even consider the implementation of price cap regulation for local exchange carriers . . . unless and until it can demonstrate that any such plan will alleviate user concerns with frequent and disruptive rate increases (the 'rate churn' phenomenon)."[1011]

Another cost/rate related issue of paramount importance to industry organizations was the need to incorporate safeguards to protect against cross-subsidies and the inappropriate leveraging of monopoly power. As the American Newspaper Publishers Association stated, "cross-subsidization remains a potent threat wherever companies monopolize regulated services while participating, and seeking to participate, in competitive services."[1012] IDCMA, asserting that an effective regulatory system is necessary to prevent LECs from engaging in anticompetitive

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[1009]Reply Comments of IBM, FCC CC Docket No. 87-313; December 4, 1987, p. 3.

[1010]Comments of UTC, FCC CC Docket No. 87-313; October 19, 1987, p. i, 5. UTC represents electric, gas, water and steam utilities.

[1011]Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. ii.

[1012]Reply Comments of ANPA, FCC CC Docket No. 87-313; December 4, 1987, p. 5.

conduct that would foreclose any significant competition, asserted that an accounting system that tracks costs is necessary. IDCMA added that "[t]he Commission should continue to require that regulated services be provided in a non-discriminatory manner."[1013] IBM also asserted that "[p]ending the development of a fully competitive marketplace, nonstructural safeguards against improper cross-subsidization and discrimination will remain essential and should be retained."[1014] The Department of Defense, noting that "regulated carriers must be prevented from predatory pricing of competitive services through use of excess profits from service areas in which it has monopoly power," similarly concluded that "[u]tility firms that offer both competitive and non-competitive services should be organized in a manner that requires, as a matter of practice, accurate identification of the costs of providing non-competitive services."[1015]

The prevention of anticompetitive monopoly abuses by LECs, industry organizations continued, would encourage the development of competition, another fundamental objective they asserted any regulatory reform should strive for. IDCMA asserted that any regulatory system prescribed must assure that dominant carriers do not abuse their monopoly position by "foreclosing competition in markets that are dependent on the use of regulated transmission services."[1016] The American Petroleum Institute stated that its "fundamental position on common carrier telecommunications regulatory issues is that Commission policies which encourage competition through decreased regulation and the removal of barriers to

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[1013]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 11, 32, 34.

[1014]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 11.

[1015]Comments of DoD, IL CC Docket No. 87-NOI-3; March 8, 1988, p. 5, 9.

[1016]Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. ii.

entry provide the maximum benefit for the greatest number of users."[1017] IBM added that "[i]f the [FCC] adopts an alternative regulatory approach, it should implement the new approach in a way that facilitates the transition to an effectively competitive marketplace." IBM also asserted that it is essential that any regulatory scheme facilitate the development of competition and provide for the total deregulation of services as they become competitive.[1018] As CCTU concluded, "[c]ompetition in the telecommunications marketplace should be facilitated wherever possible; however, it should not come at the expense of the public interest."[1019]

Other, more traditional, regulatory goals cited by industry organizations as critical elements of any system of regulation included incentives for efficiency and innovation and for the maintenance of service quality. As the Computer and Communications Industry Association stated, "[a]ny alternative form of regulation should create a better economic incentive system that promotes more efficient management of the utility and its resources, while at the same time fully and fairly compensating the shareholders of the firm for the capital they have committed to the provision of telecommunications services."[1020] The Tele-Communications Association similarly asserted that it supports initiatives "that promote efficient and expanded use of

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[1017]Comments of API, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[1018]Comments of IBM, FCC CC Docket No. 87-313; October 19, 1987, p. 11, 3. See also Comments of IBM, CA PUC En Banc Hearings on Regulatory Alternatives; September 11, 1987, p. 2.

[1019]Comments of CCTU, FCC CC Docket No. 87-313; October 19, 1987, p. 2.

[1020]Comments of CCIA, FCC CC Docket No. 87-313; October 20, 1987, p. 9.

the network while protecting ratepayers."[1021] ADAPSO added that "[a]ny proposal considered by the Commission should have as a key objective the unencumbered and expedited delivery of new and improved service offerings to the user community."[1022]

Many organizations noted the need for continued regulatory oversight to ensure high levels of service quality. As the Telecommunications Ratepayers Association for Cost-Based and Equitable Rates (TRACER) stated, new regulatory schemes should ensure "that cost reductions are not the result of a reduction in the quality of service or of the failure to make investments required to ensure reasonable levels of service in the future."[1023] The Ad Hoc Users also asserted that because price regulation could provide carriers with incentives to cut costs in any way possible, "the Commission must adopt monitoring and surveying techniques to detect any such deterioration and must develop policies designed to ensure that quality does not slip to unacceptable levels."[1024] ICA similarly asserted that the Commission must monitor service quality under price regulation "to insure that carrier cost-cutting measures do not adversely affect the reliability and overall quality of communications services provided to ratepayers."[1025]

In conclusion, industry organizations asserted that any regulatory reform must balance the needs for monopoly ratepayer protection with the

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[1021] Comments of TCA, FCC CC Docket No. 87-313; October 19, 1987, p. 1.

[1022] Reply Comments of ADAPSO, FCC CC Docket No. 87-313; December 4, 1987, p. 4.

[1023] Comments of TRACER, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 3.

[1024] Comments of Ad Hoc Users, FCC CC Docket No. 87-313; October 19, 1987, p. 40.

[1025] Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 26.

promotion of competition in the telecommunications marketplace. As IDCMA stated, it has not been shown that price regulation "will perform as well or better than the present cost of service regulation in protecting and promoting consumer welfare as well as protecting the public interest in an efficient and reasonably priced telecommunications system and preserving and promoting competition in the telecommunications market."[1026] ADAPSO stated that it would be prepared to support regulatory reforms if they would lead to just and reasonable rates at a lower cost to society without a degradation in service quality. CCTU asserted that "comprehensive regulation must be retained to ensure at least on an interim basis that the public interest in 'just and reasonable' rates, quality service, and a diversity of suppliers is safeguarded."[1027] ICA added that while LEC shareowners may benefit from "stimulated cost-cutting and increased productivity . . . these gains should not take precedence over the rights of ratepayers."[1028] The general consensus of the organizations was, as the Utilities Telecommunications Council stated, to applaud "the Commission's effort to examine regulatory alternatives that could better protect consumers of less competitive services from exorbitant rates while encouraging the growth of competition in those market segments where it has already taken hold."[1029] Those services subject to effective competition, organizations added, should be deregulated. However, the organizations emphasized that LECs maintain monopoly control over basic local services, necessitating continued regulatory scrutiny.

[1026] Reply Comments of IDCMA, FCC CC Docket No. 87-313; December 4, 1987, p. 2.

[1027] Reply Comments of CCTU, FCC CC Docket No. 87-313; December 4, 1987, p. 2.

[1028] Comments of ICA, FCC CC Docket No. 87-313; October 19, 1987, p. 31.

[1029] Comments of UTC, FCC CC Docket No. 87-313; October 19, 1987, p. 4.

6.6. Consumer Representatives

Consumer representatives, like IXCs and industry organizations, focused on LECs' alleged continued monopoly over basic local services and the resulting need for regulation to protect consumers from potential monopoly abuses. Basing their recommendations on this perception of the local exchange market as a monopoly, consumer representatives generally supported the continued application of rate of return regulation and the continued support of traditional regulatory goals such as universal high quality service, just and reasonable rates, and carrier efficiency. According to the representatives, these goals may take on additional importance where regulated monopolists jointly provide competitive services.

Stating its support for traditional regulatory goals, the Citizens Utility Board of Illinois asserted that "[t]he proper goals of regulation are . . . universal service; economic efficiency; just, reasonable and affordable rates; and reliability and maintenance of the network."[1030] The Consumer Federation of America (CFA), discussing the continued applicability of the Communications Act in guiding telecommunications regulation, added that "[t]he requirement of fair rates, neither confiscatory nor inordinately profitable, is the cornerstone of the Communication Act's universal service goal." According to CFA, any regulatory scheme must incorporate an adequate evaluation of carriers' costs and earnings in order for the FCC to meet its statutory obligations under the Act. CFA concluded that "[t]he goals of the Act have been well served and alternatives to rate of

[1030]Reply Comments of CUB, IL CC Docket No. 87-NOI-3; April 26, 1988, p. 1. See also Reply Comments of CAFFUP, IL CC Docket No. 87-NOI-3; April 22, 1988, p. 4.

return regulation must clearly demonstrate that they can do a better job."[1031]

The mandate of just and reasonable rates, the representatives added, also requires that declining LEC costs be reflected in rate reductions and that cross-subsidies of competitive ventures with monopoly service revenues be prevented. The representatives cited concerns with regulatory proposals to freeze rates or establish pre-determined rate increases, asserting that LECs are facing declining cost curves. As CFA stated, "[g]uaranteed price increases or even decreases cannot prevent excess profits. . . . [A]ny guaranteed change in rates may result in rates that are too high -- because the industry is a declining cost industry."[1032] The citizens of Florida similarly asserted that rates must be reduced to reflect the expiration of accelerated amortization schedules, or else "the ratepayer will never see the turn around point or benefit from amortization schedules underlying present rates."[1033] As the Universal Service Alliance concluded, "[f]or years ratepayers have been told that when a utility's costs increase, rates must also increase. Symmetrical ratemaking requires that when a utility's costs decrease, rates must also decrease."[1034]

Consumer representatives asserted that to permit LECs to retain excess earnings generated during a period of falling costs could exacerbate another major concern: the potential for cross-subsidies of LEC competitive services with monopoly service revenues. According to CFA, LECs (and RBOCs in particular) are funneling excess cash out of

[1031]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 6, 2, 21.

[1032]Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 10.

[1033]Comments of Citizens of Florida, FCC CC Docket No. 87-313; October 19, 1987, p. 9.

[1034]Brief of USA, NY PSC Case No. 28961; March 27, 1987, p. 4.

their telecommunications business; CFA asserted that "[t]he companies were likely neglecting their basic function and using monopoly revenues to cross-subsidize competitive activity."[1035] Citing the potential abuses of monopoly power to disadvantage competitors under price regulation, the Office of the Consumers' Counsel of Ohio asserted that "[t]his sort of pricing calls out for [rate of return regulation], but at least calls for a cap on individual rate elements as opposed to a bundle of rates."[1036] The Maryland People's Counsel reached a conclusion common among the consumer representatives, stating that "profit containment measures are required in order to limit cross-subsidy." The Counsel added that "strengthened measures against cross-subsidy within a rate of return framework are needed."[1037]

Overall, consumer representatives asserted the need to focus on the protection of captive monopoly ratepayers. The statutory obligations of the FCC to promote just and reasonable rates, efficiency and innovation, and high quality service, according to the representatives, form an integral component in the protection of captive monopoly ratepayers. Consumer representatives also asserted the need for public participation in the regulatory process. As the Washington Public Counsel stated, it "supports the concept of regulatory streamlining, provided that the interests of ratepayers are protected and that the process allows for informed participation by all parties."[1038] The people of Cook County added that prior to adopting an alternative to rate of return

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[1035] Divestiture Plus Four: Take the Money and Run, CFA; December 1987, p. 6.

[1036] Reply Comments of OCCO, FCC CC Docket No. 87-313; December 4, 1987, p. 10.

[1037] Reply Comments of MPC, FCC CC Docket No. 87-313; December 4, 1987, p. 15, 18.

[1038] Comments of Public Counsel, WA UTC Docket No. 87-1320-SI; November 2, 1987, p. 1.

regulation, regulators must "further investigate ways to best protect the captive, residential customer in any transition."[1039]

CFA asserted that in addition to retaining earnings regulation, if the FCC experiments with price regulation, it must "include mechanisms which provide at least as much protection against discriminatory and unreasonable rates as the Commission's current method of regulation." Refuting claims of administrative savings, CFA added that reformed regulation that does a good job of protecting "captive residential consumers is not likely to save much of the administrative costs of regulation."[1040] As the Maryland People's Counsel concluded, "[s]o long as the predominant characteristic of the industry remains that of a monopoly, the need for substantial regulation to protect the public interest will be unavoidable."[1041]

In conclusion, consumer advocates asserted that any reforms to rate of return regulation must improve upon a method of regulation that they assert has a proven successful record at meeting a multitude of goals. As the New York City Energy and Telecommunications Office concluded, it could support the adoption of an alternative to rate of return regulation "if that new approach provides for the following: (1) protects the concept of and promotes universal service; (2) ensures that consumers of less competitive services will not be victimized by excessive rates; (3) encourages continued growth and competition especially in those market segments where it has already taken hold; (4) encourages service efficiency and technological innovation; and

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[1039]Reply Comments of People of Cook County, IL CC Docket No. 87-NOI-3; May 4, 1988, p. 3.

[1040]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 3, 36.

[1041]Comments of MPC, FCC CC Docket No. 87-313; October 19, 1987, p. 3.

(5) accomplishes all of this at a lower cost to society than is incurred under the current regulatory scheme."[1042]

Consumer representatives, frequently extolling the many virtues of rate of return regulation and asserting that its detractors have not been able to substantially prove any significant weaknesses, would generally agree with the CFA assertion that any "alternatives to rate of return regulation must clearly demonstrate that they can do a better job" of serving the goals of the Communications Act.[1043]

6.7. Summary

While all the stakeholders supported continuation of traditional regulatory goals, such as universal high quality service as well as just, reasonable, and non-discriminatory rates, differing views on the nature of the current telecommunications marketplace led to differing views on how best to meet these goals and protect the public interest. Whereas LECs asserted that rapidly emerging competition (entering previously protected monopoly markets) makes necessary the reduction of regulatory burdens and the provision of flexibility to compete with unregulated competitors who may use the regulatory process to their competitive advantage, LEC competitors and consumers refuted claims that effective competition exists in many telecommunications markets. These stakeholders asserted that LECs maintain a virtual monopoly over virtually all services, and that strict enforcement of regulatory safeguards is necessary to protect captive monopoly ratepayers and to promote competition. In fact, these stakeholders added that LEC diversification into competitive markets has increased the need for effective regulatory oversight to prevent anticompetitive and

[1042]Comments of ENERTEL, FCC CC Docket No. 87-313; October 19, 1987, p. 25.

[1043]Comments of CFA, FCC CC Docket No. 87-313; October 19, 1987, p. 21.

discriminatory monopoly pricing and cross-subsidies that could deter competition and ultimately lead to higher prices and fewer choices.

Thus, many LECs asserted the need to provide a regulatory transition toward market regulation, while competitors/consumers asserted the need to provide a variety of protections to assure that competition is able to develop. Again in the position of balancing stakeholder positions and attempting to reach the conclusions that will best serve the public interest in accordance with their statutory obligations, regulators frequently acknowledged the presence of competition in LEC markets.

However, while some regulators noted their inability to control the forces of technology or competition (and the resulting inability to continue to provide franchise protection to LECs), they also acknowledged continued LEC monopoly control over basic access services for most users. Many regulators concluded that any regulatory alternatives must result in providing greater protection to monopoly ratepayers, while continuing to promote traditional regulatory goals.

CHAPTER 7

SUMMARY OF POSITIONS

between consumer and investor interests, serving as a substitute for competitive market constraints not present in a monopoly industry market. Many stakeholders also agreed that where emerging competition is technologically feasible, it can provide a host of benefits to consumers. The stakeholders asserted that in those markets, competition should be promoted, and that where there is effective competition market forces should replace regulation.

Even though they agree on the benefits of competition, stakeholder groups hold varying perceptions of the nature and extent of competition in the telecommunications market. These differing positions on competition resulted in differing conclusions on the appropriate scope of regulation.

According to many LEC competitors and consumers, LECs continue to maintain a natural monopoly in the provision of bottleneck basic network access. LEC competitors asserted that traditional rate of return profit regulation is necessary to curb potential monopoly abuses that could thwart potential competition. These potential abuses include the use of predatory pricing, the discriminatory provision of monopoly services required as inputs to competitive services, and the cross-subsidization of LEC competitive services with monopoly service revenues. Some competitors asserted that their entire existence is controlled by the LECs, who may find the presence of limited competition useful to secure sympathetic regulatory treatment from regulators.

However, these stakeholders asserted, regulatory flexibility that reduces oversight of LECs is particularly inappropriate given the potential abuses present in mixed competitive/monopoly markets. These potential abuses could be magnified, competitors asserted, as LECs introduce new services which actually could be repackaged existing services provided in an anticompetitive fashion, or services, such as Open Network Architecture Basic Service Elements, that may be critical to the provision of competitive services. Based on the many potential

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SUMMARY OF POSITIONS

Technological, legal, and regulatory changes have radically altered the nature of the telecommunications industry since the regulation of LECs was introduced in the early twentieth century. Changes continue to occur at a rapidly increasing pace. A fundamental issue that will be at the forefront of telecommunications policymaking into the 1990s and beyond is whether traditional regulation is accommodating and will be able to accommodate to the changes in demands placed upon it in the changed environment.

Many diverse stakeholders will continue to participate in the debate and decision-making process, at both the state and federal levels, to determine an appropriate regulatory response to changes in the telecommunications environment. An examination of stakeholder positions on LEC regulation reveals agreement on many traditional goals of regulation, such as universal service and just and reasonable rates. However, largely as a result of differing perceptions of changes that have occurred in the telecommunications environment, stakeholders have placed additional emphasis on certain regulatory goals. The result is that stakeholder groups have reached vastly different conclusions on the ability of rate base/rate of return regulation to meet regulatory goals and on the need to implement regulatory alternatives.

Among the regulatory goals supported by the great majority of the stakeholders studied are the following: promoting universal high quality service at just and reasonable, non-discriminatory rates; providing LECs with incentives to be efficient and innovative; and providing the opportunity for LECs to earn a fair rate of return. As many stakeholders asserted, regulators must strive to achieve a balance

LEC abuses, many of these stakeholders asserted that if any regulatory revisions are necessary, they should involve a stronger commitment of regulators to more effectively administer traditional regulation and greater opportunity for stakeholders to participate in the regulatory process.

LEC consumers, including residential and business consumers and potential competitors, similarly asserted that LECs are natural monopoly providers of many basic network access services. These stakeholders also asserted that traditional regulation has been successful at meeting regulatory goals, and that any weaknesses -- which some consumers asserted have not been proven -- may be corrected through more effective and stricter regulatory oversight. While the consumer stakeholders agreed that cross-subsidies of competitive services with regulated monopoly revenues is a major concern, large users further asserted that rates should be cost-based to assure that no group of consumers subsidizes another. Consumers also asserted that a lack of effective regulatory oversight -- including an examination of costs, revenues, and profits, as well as the opportunity for intervenor participation -- could result in shifting the balance of interests from ratepayers to shareowners. Such shareowners would be able to enrich themselves with windfall profits generated from new service revenues and cost reductions made possible by investments of monopoly ratepayer revenues.

The world appears different when viewed from the LECs' perspective. LECs maintain that a combination of technology with regulatory and legal changes has resulted in virtually all of their markets being subject to some level of competition. LECs asserted that many of their vulnerable services, such as those characterized by concentrated revenues and profit potential, are particularly vulnerable: they have been priced to provide contributions to basic services, and competitors can use the regulatory process to gain strategic information and delay LEC market responses to competition.[1044] Competitive losses in these markets result in a pricing spiral, LECs asserted, when the regulatory process shifts additional revenue requirements to other competitive services, making theie services more vulnerable to competitive threats. Ultimately, this pricing spiral could threaten universal service, according to some LECs. LECs also asserted that actual or potential competition (market contestability) can sufficiently constrain them from engaging in potential monopoly abuses, and that focusing regulation on the protection of those consumers who do not have alternatives can protect them more efficiently and effectively. Finally, LECs asserted that while traditional rate of return has been historically successful <u>in the past environment</u> at meeting regulatory goals, its direct and indirect costs increase and are no longer balanced by offsetting benefits in a competitive environment. In fact, many LECs asserted that traditional rate of return regulation may be counterproductive in the presence of competition.

Regardless of the level of competition, LECs also uniformly cited the need for a more efficient form of regulation. However, the consensus of positions among consumer/competitors was the need for adequate safeguards to protect against potential monopoly abuses -- which could make many proposed regulatory alternatives as complex, burdensome, and subjective as critics of traditional rate of return regulation accuse it of being.

Regulators are responsible for the difficult task of evaluating stakeholder positions and environmental conditions in order to reach a decision that will balance consumer and investor interests. While many commissions asserted that <u>competitive</u> services should be or have been deregulated, there were again differing positions on the nature and

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[1044] Pacific Bell cited its annual subsidy flow as $3.3 billion. Comments of Pacific Bell, CA PUC En Banc Hearing on Regulatory Alternatives; September 11, 1987, p. 7.

extent of competition and the need to provide LECs with flexibility to compete. While many commissions noted the administrative complexity of difficult and subjective cost allocation procedures, many also asserted that such allocations are necessary in order to assure just and reasonable rates. Some regulators asserted that given adequate proof of competitive inroads into monopoly markets, regulatory forbearance may be appropriate. However, others noted that they are no longer able to control the availability of competitive alternatives, and are therefore no longer able to live up to the original social contract between regulators and the LECs. Some regulators also asserted that requiring proof of competition before providing LECs with the ability to compete may unfairly restrict the LECs' ability to respond to competition until it is too late to recapture lost business and replace lost subsidies used to support basic services. Overall, regulators must seek to reach the decision that will maximize the public interest and most effectively balance ratepayer and shareowner interests.

In conclusion, the most critical questions stakeholders must address when evaluating regulatory alternatives focus on the issue of competition. Can regulators control competition? Is competition beneficial in all markets? Where is competition effective and where is it only emerging? At what point is competition sufficiently developed to better promote the public interest than regulation? And what form of regulation will best be able to promote traditional regulatory goals as well as facilitate the transition to fully competitive markets? How will the success or failure of any regulatory alternative be judged? The answers to these complex questions will determine the future structure and global competitiveness of the US telecommunications industry, and, like the resolution of regulatory issues in other industries, continue to be evaluated and debated by stakeholders well into the next century.

CHAPTER 8

OBSERVATIONS

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OBSERVATIONS

A review of stakeholder positions on rate of return regulation and alternatives to it quickly reveals that -- with the exception of regulators who must consider all stakeholder positions and render a decision consistent with their statutory mandate -- it may be the LECs vs. the others in a battle over the appropriate treatment of LECs.

LECs are frequently the initiators and/or supporters of regulatory reforms. Despite their assertions that regulatory reform proposals amount to more efficient regulation, regardless of competitive activities, LECs frequently focus arguments in support of regulatory reform on the onslaught of competition made possible by technological, legal, and regulatory changes. Given a competitive environment, LECs assert that they must be free from many constraints of rate of return regulation. They frequently argue the need for pricing flexibility and the ability to offer new services without the burden of regulatory proceedings open to all intervenors, including potential competitors, as necessary in order for them to compete. While many other stakeholders assert that LECs remain the monopoly provider in virtually all of their markets, LECs describe the crumbling of technological and regulatory barriers barring entry to markets, violating what they consider the social contract between regulators and LECs. They fear being left as the rail industry of the 1990s: a low-growth, low-profit network lacking the advanced information services features available on private large-user networks.

However, LECs are seeking more than flexibility to compete; many reform proposals seek to disconnect the tie between rate base and profits. According to LECs, rate of return regulation does not provide incentives for efficiency or innovation. As long as profits are tied to the rate base, a LEC may increase its returns to shareowners only by expanding its rate base. However, the deployment of new technologies, although causing risk for the investor, frequently does not result in rate base expansion. In fact, many new, efficient technologies may result in reductions to the rate base, and could reduce LEC earnings under rate of return regulation. Not only could this incentive structure further exacerbate the divide between the public ("have not") and private ("have") networks, but it could cause a dramatic decline in LEC profitability.

IXCs and industry organizations, on the other hand, focus on the monopoly they allege LECs continue to control over basic access services, and on the forays of LECs into competitive ventures. It is not coincidental that these LEC ventures frequently compete with IXC and industry services. The concern among IXCs and industries is that, contrary to LEC concerns over the continued subsidy of basic services by competitive services, the subsidy actually goes the other way. Many organizations note that as long as any firm provides both monopoly and competitive services, at a minimum there will be concern over cost allocation -- the mechanism for a more subtle form of subsidy.

The fear of the IXCs and industries is that the price of monopoly services, including inputs, can be kept anticompetitively high (significantly above cost), permitting the below-cost anticompetitive pricing of competitive services. Their response has been to raise numerous costing and pricing issues before regulators considering reform proposals. The majority of comments from these stakeholders is on pricing issues. The current regime of rate base/rate of return regulation provides these LEC customers/competitors what they want: the opportunity to participate in the pricing process in order to keep input prices as low as possible, and the ability to publicly debate the introduction of competitive LEC services (which may delay the services sufficiently enough to provide competitors with the opportunity to gain market strength).

The opportunity for public input provided under rate of return regulation is also of key importance to consumer organizations. These organizations, like the IXCs and industry organizations, frequently focus on the prices and availability of services. Again, they cite LECs' monopoly status as a provider of essential services to their constituency. And again, they assert the importance of the rate of return regulatory process in order to challenge rate and service requests proposed by LECs. Like the IXCs and industry organizations, consumer organizations voice concern that monopoly service revenues may be used to subsidize competitive ventures of LECs. While a price commitment (including freezes or decreases) and continued service quality commitments and monitoring may be considered as adequate protection for LEC consumers, the consumer organizations fear being left without proceedings in which to bring their challenges.

LECs assert that the adversarial rate of return regulatory process provides the benefit to opposing intervenors, who may indefinitely delay the introduction of new products or services. The same is true of regulatory reform proceedings. Lack of consensus on regulatory action results in a decision actually being made: the continued use of rate base/rate of return regulation. The compromises that have been reached frequently fall short of the LEC desire to disconnect rate base and return. Social contract and price cap regulation, which would most divorce the marriage of rate base and returns, have proven the most difficult to achieve. Incentive regulation, the most commonly implemented alternative to rate base/rate of return regulation, is also the most closely related to it. In fact, incentive regulation does not separate return from rate base, but gives the LEC some flexibility in allowable returns and pricing. Even where more radical departure from rate of return regulation has been approved, it appears that the test for success of the plan will be an analysis based on rate of return on rate base. Many of the compromises result in blurred distinction among the various reform plans, with the common elements of price regulation of basic services and flexibility for non-basic or competitive services considered or granted. Absent legislative changes, many regulators consider themselves to be compelled to reach this conclusion, based on the interpretation of "just and reasonable" rates.

As the technological, legal, and regulatory barriers to market entry continue to fall, further weakening the original understandings between LECs and regulators, further proposals for regulatory alternatives may well come forth. Stakeholders' positions will continue to evolve and adjust to changing conditions, but the fundamental philosophy guiding the formulation of their positions may remain constant. An understanding of stakeholder goals should continue to clarify the positions they may take on future regulatory proposals.

ACRONYMS

Regulatory Commissions

BPU	Board of Public Utilities
CC	Commerce Commission
CPUC	California Public Utilities Commission
DPU	Department of Public Utilities
DPUC	Department of Public Utility Control
FCC	Federal Communications Commission
PSB	Public Service Board
PSC	Public Service Commission
PUC	Public Utilities Commission
SCC	State Corporation Commission
URC	Utility Regulatory Commission
UTC	Utilities and Transportation Commission

Other Acronyms

ANPA	American Newspaper Publishers Association
ADAPSO	Association of Data Processing Service Organizations
BOC	Bell Operating Company
CAFUP	Community Action for Fair Utility Practice
CCIA	Computer and Communications Industry Association
CCTU	Committee of Corporate Telecommunications Users
CFA	Consumer Federation of America
CPI	consumer price index
DPS	Department of Public Service
FEA	Federal Executive Agency
FX	foreign exchange
ICA	International Communications Association
IDCMA	Independent Data Communications Manufacturers Association
IXC	interexchange carrier
LATA	local access and transport area
LEC	local exchange carrier
MSA	metropolitan service area
MTS	message telephone service
NASUCA	National Association of State Utility Consumer Advocates
NOI	Notice of Inquiry
NPRM	Notice of Proposed Rulemaking
NTCA	National Telephone Cooperative Association
NTIA	National Technical Information Agency
NTN	National Telecommunications Network
NTRA	National Rural Telephone Association
NTS	non-traffic sensitive
OCCO	Office of the Consumers' Counsel of Ohio

OPASTCO	Organization for the Protection and Advancement of Small Telephone Companies
RBOC	Regional Bell Operating Company
TCA	Tele-Communications Association
TDS	Telephone and Data Systems
USTS	U.S. Transmission Systems