

Summary Version

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

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Program on Information Resources Policy

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Introduction

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 telephone stakeholders, including the companies themselves, governments, users, and competitors.

This report is available in two versions:

- **Full-length 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*.

and

- **Summary version (this version)**

This report 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 full-length research report 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.

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

*Regulatory change...
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Regulatory change in the telephone business is a political stakeholder game in which parties with diverse interests and strengths compete. The government forums have their own rules and charters, which not only moderate the game but also make it more complex.

Stakeholders who participate in state and federal regulatory debates generally agree on the goals of regulation, which include achieving universal, high-quality service at just, reasonable, and non-discriminatory rates; providing service with efficiency and innovation; and assuring that local exchange carriers have the opportunity to earn a fair rate of return. Regulators, they agree, must strive to balance consumer and investor interests, serving as a substitute for competitive market forces and constraints not present in a monopoly environment.

*LECs claim the slow
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Most further agree that effective competition would benefit consumers and should be promoted. In markets with effective competition, market forces should replace regulation.

But although they agree on regulatory goals, stakeholders take dramatically different positions on the best means by which to achieve them, based on their perception of competition in their own markets or simply on self-interest.

LECs focus on the continued erosion of barriers that prevent entry into their markets, and on the historically proven inability of regulators to thwart such entry. They claim the slow and often abused regulatory process prevents regulation from keeping pace with technological and market developments, as new entrants often delay the process while they gain market share. Regulatory compromise frequently requires LECs to perform burdensome accounting procedures,

including detailed subjective cost allocations. Here again, the regulatory process allows competitors to delay decision-making, gain competitive market and cost data, and influence the allocation of LECs' costs. LECs claim, therefore, that they cannot compete effectively, the introduction of new services to consumers is denied or delayed, and competitive LEC services may be priced artificially high to ensure that they are not cross-subsidized by monopoly services (or in fact provide a subsidy to those services), while services used as inputs by competitors are priced artificially low.

If they cannot compete, LECs argue, then consumers of basic services ultimately will face a pricing spiral as LECs lose market share to competitors who target profitable market segments. As contributions from competitive services are reduced, upward pressure placed on remaining services could result in two telecommunications networks: a public ("have not") network, and private ("have") networks. LECs conclude that although rate of return regulation has met regulatory and social goals successfully *in the past environment*, its direct and indirect costs are increasing and are no longer balanced by offsetting benefits in a competitive environment.

Users are particularly concerned about the price and provision of services they purchase.

Many other stakeholders — mostly competitors, users, and consumer groups — focus on the monopoly control that LECs retain in basic service markets. They claim that effective controls, such as cost allocation and public debate procedures, are needed to curb potential monopoly abuses. Such controls, they argue, are necessary to monitor LEC expansion into unregulated lines of business, including non-regulated non-telephone businesses, and control the resulting potential to subsidize such ventures with monopoly service revenues. They frequently request specific procedural outcomes, such as cost allocations, that favor them.

Users, including interexchange carriers and information service providers, are particularly concerned about the price and provision of services they purchase (input services). They seek the non-discriminatory provision of access services, open network architecture basic service elements, and other services at "cost-based" rates to non-LEC service providers. Users claim

that their very existence is controlled by the pricing and availability of LEC input services as well as the pricing of competitive LEC services.

Many stakeholders maintain that new, innovative, and competitive services may be jeopardized without the regulatory process to thwart anticompetitive activity.

Consumer groups, too, focus on pricing issues and the underlying cost allocations. Like competitors and users, they cite fear of inappropriate subsidies of LEC competitive ventures and claim that the rate of return regulatory process is needed to prevent them. In direct contrast to LEC positions, many industry and consumer stakeholders maintain that the availability of new, innovative, and competitive services may be jeopardized without the regulatory process to thwart anticompetitive activity. They conclude that the costs associated with such regulation are inconsequential compared to the costs to ratepayers of an unfettered monopolist. Many of these stakeholders focus on the historical success of rate of return regulation and its adaptability to past changes.

LECs therefore often find themselves defending regulatory alternatives from a barrage of attacks by stakeholders who support the status quo and/or outright oppose the alternatives. In an effort to seek common ground, LECs have introduced or supported many regulatory reform proposals that contain common elements designed to appease.

They claim that price commitments and disconnection of rate base from ROR may not only lock in any previous pricing distortions but also produce excessive profits.

One such element is to provide safeguards for consumers who do not have alternative suppliers. LECs argue that the marketplace (and the legal process, if necessary) is the most efficient regulator where competition exists. Where it does not exist, however, LECs have offered price commitments (freezes or limited increases) for basic services. Other safeguard elements include network investment and service quality commitments.

However, many — including industry and consumer stakeholders — counter that price commitments and disconnection of rate base from rate of return may not only lock in any previous pricing distortions but also produce excessive profits generated from declining costs due to ratepayer-funded investments in efficient technologies. This motive, they argue, may be the critical reason LECs are seeking alternatives at all.

LECs admit that the deployment of new, efficient technologies may actually reduce the rate base, hence profits. The introduction of new technologies and services, they argue, is therefore essential to offset the limited growth potential in basic exchange and access services. Without the incentives or ability to introduce these services, LECs may become the rail industry of the 1990s — a low-growth, low-profit network backbone lacking the advanced information services features available on private large-user networks.

Proposed social contract alternatives are a modification of the original contract.

LECs urge that the transition from profit to price regulation should also be a transition from micro- to macro-regulation. Under the macro-regulation concept, regulators would dedicate fewer resources to detailed examinations of individual service rate elements and returns, while focusing on certain criteria for targeted services. While the frequency and complexity of the contentious hearings process ultimately could be reduced, this concept requires initial agreement on targeted services and goals, probably accomplished through a contentious hearings process. Regulators and stakeholders have to define services for which minimum standards should be required, and then define those standards. Many regulatory reform plans take an initial step towards this outcome by categorizing services.

The various regulatory alternatives are distinguished by the actual level of pricing commitments and freedoms, and the extent of disconnecting the rate base rate of return link. Three major categories of alternatives are social contracts, price cap regulation, and incentive (range of rate of return) regulation.

Where rate of return regulation may be considered an existing "social contract" between regulators and the regulated firm, which defines the rights and obligations of each, proposed social contract alternatives are a modification of the original contract. These alternatives provide LECs with the greatest overall degree of pricing and profit regulation short of deregulation. *Social contract regulation* protects consumers of basic services with price commitments (freezes or limited increases). LECs are granted pricing and earnings freedom for non-basic or competitive services; LEC profits are not

monitored. Specific social contract proposals may modify the definition of basic price-regulated services, the nature of price adjustment factors or triggering mechanisms, and the duration of the agreement.

Under price cap regulation, LEC prices would be regulated based on "going-in" rates.

Under *price cap regulation*, LEC prices would be regulated based on "going-in" rates for a category of services adjusted periodically by agreed-upon factors. Rate proceedings would be needed to increase service category price caps, and price floors could be established to prevent discriminatory pricing. Profits would be decontrolled. Variations among price cap proposals involve adjustment factors, frequency, and formulas; individual service or service category price commitments; and the level of service category aggregation.

Retaining the greatest number of rate of return attributes, *incentive regulation* plans are actually a continuation of rate of return monitoring of LEC profits. They divide returns above specified levels between the ratepayers and the shareholders. Unlike price regulation proposals, these plans do not separate agreed-upon pricing and earnings flexibility within the established range of rate of return. Price commitments for basic services, refund mechanisms, and the range of return itself are areas that may be tailored to meet the environment and requirements in individual states.

Incentive regulation plans are actually a continuation of rate of return monitoring of LEC profits.

While each alternative represents a move towards market regulation on the regulatory continuum, alternatives actually approved and implemented by 1/1/90 frequently have fallen short of LEC expectations. The most commonly implemented alternative framework, incentive regulation, provides limited earnings and service flexibility to LECs while retaining most aspects of rate of return regulation. Social contract and price cap regulation, which would disconnect the rate base rate of return link, have proven the most difficult to achieve. Most enacted plans contain elements of all three alternatives, and an ongoing process of reviewing the regulatory structure. Even where the most radical departures from rate of return regulation have been approved, rate of return performance measurements are the most frequently cited benchmarks used

to evaluate the alternatives upon conclusion of their limited terms. Cost allocation and the establishment of "going-in" rates continue to be a source of heated debate among stakeholders.

Most enacted plans contain elements of all three alternatives, and an ongoing process of reviewing the regulatory structure.

Most regulators are charged by their charters with the difficult task of evaluating stakeholder positions and environmental conditions in order to balance consumer and investor interests. Bound by legislated statutes or constitutional mandates, many regulators feel compelled by the rate of return standard. Others must attempt compromise among many interveners, which often adds additional layers to existing regulation. Meanwhile, stakeholders who oppose regulatory reforms may use the existing regulatory process to delay a decision on changing the process itself — no decision is actually a vote to maintain existing regulation.

Regulators must also determine the appropriate benchmark to evaluate the success of rate of return regulation or its alternatives. Virtually all stakeholders agree that any government-imposed regulation has its costs; using a theoretical rate of return benchmark compares alternatives to an imperfect form of regulation and involves numerous detailed and subjective judgments. Potential evaluation benchmarks include a definition and determination of basic service penetration, prices for targeted services or customer groups, service quality, and the availability of new, innovative services. However, each benchmark adds a further layer of complexity to the already detailed consideration of regulatory alternatives, and requires regulators to further define existing goals of regulation.

Each benchmark adds a further layer of complexity to the already detailed consideration of regulatory alternatives.

As the technological, legal, and regulatory barriers to market entry continue to fall, new regulatory alternatives may be proposed. Although stakeholders' positions (including their market positions) will continue to evolve and adjust to changing conditions, the basic philosophy that helps formulate them may remain intact; stakeholders will base actual and/or stated positions on their self-interests. A successful intervener may identify other stakeholder groups, communicate with them, address their interests and concerns, and build partnerships. While distinctions between customer and

competitor groups have blurred, making it more difficult to develop a compromise, most interveners seek one or two basic objectives: inexpensive, high-quality inputs, and a market playing field favorable to their industry. Stakeholders will support these objectives; their basic interests, and positions, do not change over time.