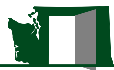 Washington Research Council

Policy Brief

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Legislature Considers Changes in Telecom Regulation

Washington's economic future is tied to telecommunications.

Telecom networks enable "the integration of business activities on a global scale in ways unanticipated 20 years ago," the Washington Research Council said previously in *Unscrambling Telecommunications Policy* (November 7, 1997). "If Washington is to prosper in the twenty-first century, it must have a state-of-the-art telecommunications infrastructure."

Such infrastructure will require investment and public policies to stimulate it. Legislation now before lawmakers in Olympia proposes changes in regulatory policy designed to improve investment incentives.

Reflected in the legislative discussions are the issues that have plagued the national effort at telecommunications deregulation. Congress tried to resolve these issues with passage of the Telecommunications Act of 1996.

At the time, Congress attempted to reconcile several challenges facing telecommunications firms and those who would regulate them. Rapidly changing technologies had blurred distinctions between services. As computer, television, cable, and telephone technologies converged, opportunities for competition increased. Congress recognized that in a dynamic marketplace, competition should supplant regulation and should be encouraged. For this reason, the Telecommunications Act of 1996 established a national policy to replace regulated monopoly with competition in local telecommunication markets.

Traditionally, local markets were dominated by a single telephone company whose service prices and allowed rate of return were set by state regulators. Congress understood that such rate-of-return regulation is particularly inappropriate in emerging competitive markets.

Full-fledged competition will not develop immediately, however. "During the transition," the Research Council urged, "regulators must be sensitive to the incentive opportunities provided by alternative forms of regulation."

Local phone companies contend that the way Washington has regulated their prices gives them little incentive to invest in advanced services. The Washington Utilities and Transportation Commission sets the prices to limit the return they earn on their investment in plant and equipment.

Many states have adopted an alternative known as "price-cap" regulation. Telecom companies are free to earn as big a rate of return as they can, but the state continues to regulate prices for services absent enough competing vendors to let the market determine prices.

The logic of price-cap regulation is this:

Rate-of-return regulation puts a lid on a company's rate of profit. If the company introduces an innovation that increases revenues or lowers costs, regulators will take these into account when setting the prices the company may charge. So innovation results in lower prices rather than higher profits. In contrast, when unregulated companies innovate, reduced costs or enhanced revenues result in higher profits.

Under price-cap regulation, regulators set a ceiling on the price. A company may charge any price it chooses as long as it does not exceed the cap.

This form of regulation was introduced in the United Kingdom in 1984 and applied to the newly privatized British Telecom. In 1989, the Federal Communications Commission applied price cap regulation to AT&T. Today, the vast majority of states use price caps in some way in regulating their telecommunications companies.

Price caps break the linkage between innovation and regulated prices, creating an incentive to innovate. When companies market new services, they are free to earn as much as they can.

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Three bills now before the legislature would allow price-cap regulation. The most prominent is HB 1436, “An Act Relating to Promoting the Deployment of Advanced Telecommunications Services and High Bandwidth Infrastructure.” (SB 5752 is the companion bill in the Senate.)

HB 1436 would allow “incumbent” local phone companies such as U S West or GTE to opt for a new regulatory regime that would deregulate the prices of certain telecommunication services and replace rate-of-return regulation with price caps on the remainder. The bill identifies three classes of services:

- Basic services, which would continue to fall under price regulation.
- Other existing services, which would be freed of price regulation after three years.
- New services, which would be free of price regulation.

“Basic service” is defined as voice grade touch-tone connection to the public switched network via a single party line, with access to 911, operator services, interexchange services, and directory assistance. “Other existing services” include such enhancements as call waiting, voice messaging and caller ID, as well as services like T-1 lines through which businesses gain high-speed access to the Internet.

DSL, a high-speed Internet access service, now operates in only a few telephone exchanges. HB 1436 would classify DSL as a new service in areas where it had not yet been deployed. Telecom companies could set their DSL prices as they see fit.

The bundling of existing services into new offerings would also qualify as new services for which companies could determine the prices.

U S West Communications Inc. is prominently lobbying for HB 1436. The company argues that freedom from price-regulation is necessary for the rollout of advanced telecom services.

The company says that eight states in its 14-state territory now permit price-cap regulation, and only three states in the rest of the nation still stick with rate-of-return regulation. The rest have adopted some form of price-cap regulation.

In the company’s view, the setting of service prices and overall rates of return by state regulators suited a time when monopoly companies provided little more than basic phone service, and regulators adjusted rates to subsidize urban residential and rural customers.

New services, supported by expensive new technology, are a different matter, U S West claims. Investing to market high-speed Internet access, for instance, is risky. Regulators would set the price U S West could charge, but the company could face competition from other vendors. If the new service failed to make money, U S West would eat the loss. So the company figures today’s state-dictated ceiling of a 9.36 percent rate of return is too low to risk new investment.

In a recent hearing on the bill, Utilities Commission officials testified that price-cap regulation potentially could benefit both consumers and regulated companies. But they argued that lack of demand, not current regulations, explains the lack of advanced services such as DSL outside of densely populated areas. Freeing the companies from price regulation would not lead them to invest in new services if not enough customers want them.

Indeed, commission officials suggested that rate-of-return regulation may promote investment in rural areas better than price caps could, since telecom-company revenue is set to cover costs. If a company lost money on rural customers, the commission could compensate by allowing higher prices to be charged to urban customers.

The commission has other reservations about the bill:

The bill does not provide the commission with a mechanism to enforce quality standards. Under the current rate-of-return regime, the commission has held down U S West’s prices as punishment for shortfalls in service quality. With a shift to price cap regulation, the commission would lose this tool.

The commission believes the prices of all non-competitive services should be capped, not just the prices of basic services, as called for in HB 1436.

A number of companies seeking to compete in the local exchange market – including, AT&T, MCI and Electric Light Wave –oppose this bill. They do not object to price-cap regulation as such, but maintain this bill prematurely would deregulate US West’s prices before if faces competition from other vendors. As a result, the incumbent carriers could price services at a loss to deter potential competitors.

Further background on the choices facing the state can be found in the Research Council’s Special Report *Unscrambling Telecommunications Policy* and in the Policy Brief, *New Role for Regulators as Competition Comes to Utility Industries* (PB 97:6). Both are available on our web site <<www.researchcouncil.org>>.