

Final Pricing Strategies

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I AGREE WITH MANY OF THE EXPERTS THAT ARGUE THAT THE FORCES OF TECHNOLOGY AND COMPETITION HAVE COMPELLED STATE REGULATORS TO REEVALUATE AND REASSESS THE STRUCTURE OF TELECOMMUNICATION SERVICE MARKETS. SOME IN THE INDUSTRY BELIEVE THAT IN A TECHNOLOGY-FUELED COMPETITIVE MARKET PLACE, REGULATION, MORE PARTICULARLY, RATE OF RETURN REGULATION, IS OF LITTLE BENEFIT AND IN MANY WAYS A MAJOR DETERRENT TO SUBSTANTIVE PROGRESS. WHERE I BEGIN TO DEVIATE FROM THESE VIEWS IS IN MY ASSESSMENT OF THE EXISTING TELECOMMUNICATIONS MARKET VIZ A VIZ COMPETITION AND IN THE ROLE THAT STATE REGULATION HAS PLAYED DURING THIS TRANSITIONAL PERIOD. IT IS MY OPINION THAT DESPITE THE GREAT STRIDES THAT HAVE BEEN ACHIEVED IN TELECOMMUNICATIONS TECHNOLOGY, TELEPHONE COMPANIES WILL RETAIN SUBSTANTIAL MARKET POWER IN THE SUPPLY OF LOCAL SERVICE, WHILE AT THE SAME TIME, BECOMING INCREASINGLY MORE INVOLVED IN COMPETITIVE MARKETS. CONSEQUENTLY, REGULATORS MUST RESPOND TO THE DUAL BURDEN OF ASSURING THAT TELEPHONE COMPANIES DERIVE NO UNDUE ANTI-COMPETITIVE ADVANTAGES, AND THAT CAPTIVE RATEPAYERS ARE NOT INAPPROPRIATELY BURDENED WITH COSTS OF COMPETITIVE VENTURES.

I ALSO DISAGREE WITH THE RECENT CRITICS OF REGULATION THAT ASSERT THAT STATE REGULATORS ARE "OPPOSED TO ANY COMPETITION WHICH APPEARS TO THREATEN THE REVENUE BASE OF THE LOCAL EXCHANGE COMPANIES."* INTERLATA COMPETITION IS PRESENT IN NEARLY ALL OF

*Telephone Competition and Deregulation: A Survey of the States, NTIA, October 1986, at p.4.

THE MULTI-LATA STATES. THIRTY-SIX (36) OF THE THIRTY-EIGHT (38) MULTI-LATA JURISDICTIONS HAVE AUTHORIZED FACILITIES-BASED CARRIERS TO OPERATE IN THEIR RESPECTIVE STATES. WHILE NON-FACILITIES BASED COMPETITION IS PERMITTED IN ALL MULTI-LATA JURISDICTIONS. A NUMBER OF STATES HAVE ALSO TAKEN STEPS TO REDUCE THE REGULATORY RESTRICTIONS ON INTERLATA COMPETITION BY ADOPTING SOME FORM OF PRICE FLEXIBILITY. COMMISSIONS IN APPROXIMATELY THIRTY (30) STATES HAVE ADOPTED "BANDED RATES" FOR INTEREXCHANGE CARRIERS, INCLUDING AT&T. STATE COMMISSIONS IN TWENTY (20) JURISDICTIONS HAVE ALSO AUTHORIZED FACILITIES-BASED COMPETITION IN THE INTRALATA TOLL MARKETS. AND THE STATE OF FLORIDA PERMITS INTRALATA TOLL COMPETITION BETWEEN EQUAL ACCESS EXCHANGE AREAS AND THROUGH RESOLD FACILITIES. STATE OFFICIALS HAVE ALSO EXTENDED THE CONCEPT OF PRICE-FLEXIBILITY TO THE LOCAL EXCHANGE MARKETS INCLUDING BANDED RATES, DETARIFFED SERVICES* AND PRIVATE CONTRACTS.

THESE FACTS WOULD SEEM TO DISPEL THE ASSERTIONS THAT STATE REGULATORS ARE PROTECTIONISTS AND ARE THEREFORE OPPOSED TO COMPETITION. I WILL CONCEDE, HOWEVER, THAT THE STATES HAVE PROCEEDED DOWN THE PATH OF DEREGULATION WITH FAR GREATER CAUTION THAN HAS BEEN DEMONSTRATED AT THE FEDERAL LEVEL BY EITHER THE DEPARTMENT OF JUSTICE (DOJ) OR THE FEDERAL COMMUNICATIONS COMMISSION (FCC). THE REASONS FOR SUCH DIFFERING APPROACHES UPON CAREFUL ANALYSIS BECOME SOMEWHAT CLEAR; THE STATES HAVE BEEN

**Such services as Centrex/Centron, coin telephone, mobile services personal signaling, private lines, pagers, MTS/WATS, and wire/DIGICOM.

FORCED TO RESPOND IN A REGULATORY FRAMEWORK TO DECISIONS RENDERED BY THE FCC. THESE DECISIONS HAVE HAD DIRECT REVENUE IMPACT ON LOCAL OPERATING COMPANIES. DECISIONS RELATING TO SUCH MATTERS AS DEPRECIATION, STRUCTURAL SEPARATIONS, ACCOUNTING, COST ALLOCATIONS, AND THE LIFTING OF BUSINESS RESTRICTIONS AND THE LIKE HAVE HAD AND WILL HAVE IMMEDIATE AND DEVASTATING EFFECTS ON LOCAL TELEPHONE RATES AND LOCAL TELEPHONE ISSUES. THE STATE COMMISSIONS, UNLIKE THE DOJ (WITH ITS NARROW ANTI-TRUST FOCUS) AND THE FCC (WITH ITS LEGISLATIVE MANDATE TO ENCOURAGE THE PROVISION OF NEW TECHNOLOGIES AND SERVICES) HAVE BROADER LEGISLATIVE RESPONSIBILITIES THAT REQUIRE REGULATORY DECISIONS THAT ARE DEEMED IN THE PUBLIC INTEREST. WE ARE REQUIRED, BY LAW, TO BALANCE THE INTEREST OF THE REGULATED AND THE CAPTIVE CONSUMER. MORE IMPORTANTLY, EVEN THOUGH THE FCC HAS A LEGISLATIVE DIRECTIVE TO ENSURE "UNIVERSAL SERVICE," IT HAS BEEN AT THE STATE LEVEL THAT THESE WORDS HAVE ACTUALLY BEEN EMBRACED AND ENFORCED IN REGULATORY DECISIONS.

THIS MORNING I WILL DISCUSS HOW THESE RESPECTIVE PERCEPTIONS OF REGULATORY RESPONSIBILITIES HAVE COMPELLED STATE REGULATORS TO APPROACH SUCH ISSUES AS PRICE AND COSTING QUITE DIFFERENTLY FROM OUR FEDERAL COUNTERPARTS. I WILL SPECIFICALLY ADDRESS THE AREAS OF NETWORK MODERNIZATION, ONA, DIVERSIFICATION AND AFFILIATE TRANSACTIONS.

AT THE STATE LEVEL, REGULATORS, IN DETERMINING PRICE, WILL CONSIDER SUCH FACTORS AS 1) RATES WHICH WILL GENERATE THE ESTABLISHED REVENUE REQUIREMENTS, 2) INCREMENTAL COSTS, 3) COST-CAUSER, 4) FAIRNESS AND EQUITY, 5) UNIVERSAL SERVICE, 6) EFFICIENCY, 7) RATE CONTINUITY, 8) CROSS-SUBSIDIZATION, 9) COMPETITION, AND 10) POLITICAL REALITIES. BUT NOT NECESSARILY IN THAT ORDER.

HISTORICALLY, TELEPHONE COSTING AND PRICING AT THE LOCAL LEVEL WAS DONE RESIDUALLY. CERTAIN SERVICES WERE SEPARATELY COSTED AND PRICED, AND THE REVENUE REQUIREMENTS OVER AND ABOVE THE REVENUES GENERATED BY THOSE SERVICES WERE RECOVERED FROM LOCAL SERVICE RATES. GIVEN THE BENT OF TELEPHONE COMPANY MANAGEMENT TOWARD COMPETITIVE MARKETS AND DIVERSIFIED BUSINESS VENTURES, IT SEEMS ABUNDANTLY CLEAR THAT REGULATORS ARE NOW FACED WITH THE OBLIGATION AND RESPONSIBILITY TO REEVALUATE PRESENT COSTING METHODOLOGIES. GIVEN THE LARGE PROPORTION OF JOINTLY USED PLANTS UTILIZED IN PROVISION OF TELEPHONE SERVICE, AND THE "ARBITRARINESS" OF ANY ALLOCATION OF THOSE COSTS AMONG SERVICES, DISPUTES OVER COST OF SERVICE WILL ESCALATE SUBSTANTIALLY OVER THE NEXT FEW YEARS. THERE WILL BE LARGE DISPARITIES BETWEEN COSTS OF A SERVICE AS DEVELOPED BY THE VARIOUS PARTIES IN A RATE PROCEEDING. BOTH DEFINITION AND ALLOCATION OF COSTS MUST BE EVALUATED CLOSELY AND STATE REGULATORS CAN NO LONGER ACCEPT TELEPHONE COMPANY DEFINITIONS AND ALLOCATIONS WITHOUT

UNDERSTANDING THAT STRATEGIC PRICING TO RETAIN OR EXPAND MARKET DOMINANCE IN BOTH EXISTING AND DEVELOPING MARKETS AT THE EXPENSE OF MONOPOLISTICALLY-SUPPLIED CUSTOMERS IS A POTENTIAL REALITY BROUGHT ABOUT BY THE PRESSURE OF COMPETITIVE MARKETS. AND THE ADDITIONAL REALITY OF THE RELATIONSHIP BETWEEN PRODUCT PRICING, PRODUCT DEMAND DETERMINANTS, MARKET SHARE, PROFITS AND MANAGEMENT/SHAREHOLDER INCENTIVES MUST BE KEPT EVER-MINDFUL IN OUR EVALUATION OF PRICING PROPOSALS. THESE PRICING STRATEGIES OR COST SHIFTS CAN BE SUBTLE, AND NOT READILY DETECTED USING TRADITIONAL ACCOUNTING METHODS, BUT THIS MAKES THE SHIFT NO LESS DAMAGING FROM THE PROSPECTIVE OF THE MONOPOLY RATEPAYERS OR COMPETITORS.

INVESTMENT PRACTICES MUST ALSO BE MORE CLOSELY SCRUTINIZED, SUCH AS ACCELERATED MODERNIZATION OR THE NEWLY PROPOSED MOVE TO OPEN NETWORK ARCHITECTURE (ONA). THESE BUSINESS DECISIONS MAY IMPOSE COSTS ON MONOPOLY RATEPAYERS FROM WHICH LITTLE OR NO BENEFIT IS DERIVED. MODERNIZATION TO DIGITAL TECHNOLOGY WHICH ALLOWS FOR THE ACCOMMODATION OF COMPUTER APPLICATION IS OCCURRING AT AN ALARMING RATE DESPITE THE FACT THAT THE PRESENT NETWORK IS USED PRIMARILY FOR VOICE COMMUNICATIONS FOR WHICH THE OLDER NETWORK HAD WORKED ADEQUATELY. AND AT THIS POINT THE DEMAND FOR MANY OF THE SERVICES FOR WHICH THE DIGITAL NETWORK IS BEING DESIGNED HAS EITHER NOT MATERIALIZED OR IS ISOLATED TO A RELATIVELY FEW LARGE USERS.

GIVEN THE EFFECTS OF MODERNIZATION ON RATE BASE, DEPRECIATION RATES AND DEPRECIATION RESERVES, IT BECOMES PROBLEMATIC FOR REGULATORS IF THE DECISION TO MODERNIZE HAS BEEN DRIVEN SOLELY BY COMPETITIVE GOALS BUT PAID FOR SOLELY BY MONOPOLY RATEPAYERS.

THE PROJECTED COST OF ONA IS \$3.5-3.8 BILLION AND HAS BEEN PROPOSED BY THE FCC TO ENSURE COMPETITION AMONG ENHANCED SERVICE PROVIDERS. DOESN'T EQUITY AND FAIRNESS REQUIRE THAT THESE COSTS BE ISOLATED AND ASSIGNED TO ENHANCE SERVICE USERS AND PROVIDERS. THE CALIFORNIA PUBLIC UTILITIES COMMISSION ARGUES THAT TO THE EXTENT THAT ONA RESULTS IN SIGNIFICANT CURRENT EXPENSES, THEY SHOULD BE CAPITALIZED AS "ORGANIZATIONAL" COSTS FOR THE NEW ENTERPRISE, AND RECOVERED AS REVENUE STREAMS DEVELOP.*

IT HAS RECENTLY BEEN SUGGESTED THAT THE STAND-ALONE COSTING METHODOLOGY IS AN APPROPRIATE WAY TO ALLOCATE COSTS BETWEEN REGULATED AND UNREGULATED SERVICES. UNDER THE STAND-ALONE CONCEPT, SEPARATE NETWORKS ARE COSTED FOR EACH OF SEVERAL DIFFERENT SERVICE CATEGORIES SUCH AS LOCAL SERVICE, TOLL SERVICE, PRIVATE LINE SERVICE, AND SPECIAL OR ENHANCED SERVICES. THIS COSTING WOULD BE BASED ON ANALYSIS OF ACTUAL USE OF FACILITIES, TRAFFIC, AND ACTUAL BOOKED COSTS. OPERATING EXPENSES FOR EACH CATEGORY WOULD ALSO BE CALCULATED OR ALLOCATED ON THE BASIS OF COST-CAUSATION. AGGREGATING THE EXPENSE AND CAPITAL COSTS BY

*California ONA concerns.

CATEGORY WOULD YIELD THE STAND-ALONE COST OF PROVIDING EACH CATEGORY OF SERVICE. 1/

IT HAS BEEN ARGUED THAT THIS METHOD SHOULD BE APPLIED TO TELECOMMUNICATIONS SERVICES^{2/} BECAUSE THERE WILL ALWAYS BE A PORTION OF COSTS THAT ARE COMMON TO MULTIPLE SERVICES^{3/} AND THE APPROPRIATE METHOD FOR COMMON COST ALLOCATION AMONG THESE SERVICES IS SHARING OF THE BENEFITS OF COMMON SUPPLY IN PROPORTION TO THE STAND-ALONE COST OF SEPARATE SUPPLY. 4/

ILLUSTRATION; ASSUME THAT THE STAND-ALONE COSTS OF THE COMMON COMPONENT OF LOCAL SERVICE, LONG DISTANCE SERVICE AND ENHANCED SERVICES ARE \$50, \$75 AND \$100, RESPECTIVELY. IF THEY ARE SUPPLIED IN COMMON, THE TOTAL COST IS \$150, PROVIDING A \$75 SAVING OVER SEPARATE PRICING. THIS SAVING IS 33% OF THE SUM OF THE STAND-ALONE COSTS. IF EACH SERVICE RECEIVES A 33% SAVING FROM ITS STAND-ALONE COSTS, THE COMMON COST ALLOCATION WOULD BE: LOCAL SERVICE, \$33; LONG DISTANCE, \$50; AND ENHANCED SERVICES, \$67. EACH SERVICE BENEFITS PROPORTIONATELY IN DIRECT REFERENCE TO ITS BEST ALTERNATIVE STAND-ALONE COSTS. 5/

SUPPORTERS OF STAND-ALONE COSTING DEFEND IT AS AN IMPORTANT REGULATORY TOOL WHICH IS DESIGNED TO IDENTIFY CROSS-SUBSIDIZATION, ALLOCATE COSTS ON A COST-CAUSATIVE BASIS, AND DISTRIBUTE THE BENEFITS OF JOINT PRODUCTION. THEY POINT OUT

THAT TELEPHONE COMPANIES WHICH CRITICIZE THE METHODOLOGY AS TOO VAGUE AND HYPOTHETICAL DO NOT HESITATE TO EMPLOY HYPOTHETICAL BYPASS SITUATIONS IN THEIR RATEMAKING ARGUMENTS. FURTHER, THOSE WHO URGE THAT STAND-ALONE COSTING IS NOT APPROPRIATE BECAUSE IT DOES NOT ADDRESS INDIVIDUAL CUSTOMER SITUATIONS SIMPLY DO NOT UNDERSTAND THE PROCESS. PROPONENTS OF THE METHODOLOGY STATE THAT SINCE THE PURPOSE OF STAND-ALONE COSTING IS TO ATTRIBUTE A REVENUE REQUIREMENT TO VARIOUS SERVICES, IT WOULD NOT BE APPROPRIATE TO ADDRESS INDIVIDUAL CUSTOMER SITUATIONS. 6 /

TELEPHONE COMPANIES, AS YOU WOULD EXPECT, HAVE NOT FAVORED IMPLEMENTATION OF STAND-ALONE COSTING METHODOLOGIES. IN THE D.C. PUBLIC SERVICE COMMISSION'S LAST RATE PROCEEDING, THE C&P TELEPHONE COMPANY CONDEMNED IT AS PROMOTING "ECONOMICALLY INEFFICIENT PRICE STRUCTURES AND DENYING THE BENEFITS OF JOINT AND MULTIPLE PRODUCTION TO CONSUMERS." 7 / WHEN THE KANSAS CORPORATION COMMISSION CALLED FOR COMMENTS ON THIS TOPIC IN 1986, SOUTHWESTERN BELL WENT ON THE RECORD IN OPPOSITION BECAUSE SUCH COSTING, IN ITS VIEW, WAS NOT REALISTIC BECAUSE IT ASSUMED A RELATIONSHIP BETWEEN AN EXISTING NETWORK AND A HYPOTHETICAL NETWORK AND THE COMPANY BELIEVED THAT THE QUANTITY OF ASSUMPTIONS NECESSARY TO FORMULATE THIS TYPE OF PROJECT WOULD BE ENORMOUS. FURTHER, A STAND-ALONE COST STUDY WOULD PRODUCE VASTLY DIFFERENT RESULTS DUE TO ITS DEPENDENCY ON THE NUMBER OF SERVICE CATEGORIES. 8 /

STATE REGULATORY COMMISSIONS, FOR THE MOST PART, HAVE ADOPTED A "WAIT AND SEE" ATTITUDE ON THIS ISSUE. FOR EXAMPLE, THE KANSAS CORPORATION COMMISSION PERFORMED THE FIRST STAND-ALONE COSTING STUDY IN 1983, BUT HAS YET TO ACTUALLY ADOPT THE METHODOLOGY. THE SAME IS TRUE FOR STATE COMMISSIONS IN WISCONSIN, SOUTH DAKOTA AND OHIO. PENNSYLVANIA HAS A STATUTE WHICH REQUIRES A TELEPHONE COMPANY TO SUBMIT STAND-ALONE COST STUDIES, BUT ONLY WHEN THE REQUESTED PERCENTAGE INCREASE IN LOCAL RATES EXCEEDS THE OVERALL REQUESTED PERCENTAGE INCREASE. 9/

THE DISTRICT OF COLUMBIA HAS NEVER REQUIRED THAT A STAND-ALONE STUDY BE DONE. IN FACT, WE HAVE CONSISTENTLY REJECTED ASSERTIONS THAT SUCH A STUDY SHOULD BE PERFORMED. THE MOST RECENT REJECTION OCCURRED IN FORMAL CASE 828, OUR CENTREX DOCKET.

IN THAT CASE, THE OFFICE OF THE PEOPLE'S COUNSEL URGED US TO PLACE CENTREX IN ITS OWN SERVICE CATEGORY AND TO ALLOCATE ITS COSTS ON A STAND-ALONE BASIS. THE COMMISSION REJECTED THIS BECAUSE WE WERE NOT CONVINCED OF THE USEFULNESS OF THE STAND-ALONE COST METHODOLOGY SINCE IT DID NOT CONSIDER THE ROLE OF COMPETITIVE MARKET FORCES AND DEMAND ELASTICITIES IN THE FORMATION OF EFFICIENT RATES; RATHER, THIS METHOD WOULD TEND TO ASSIGN COSTS TO SERVICES BASED UPON "SUPPLY SIDE" CONSIDERATIONS ONLY. SUCH A NARROW VIEW OF PRICING POLICY COULD LEAD TO