

PREPARED REMARKS OF
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PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

FOR

WESTERN CONFERENCE OF
PUBLIC SERVICE COMMISSIONERS
"CONFOUNDING ENIGMA IN
THE MILLENNIALIST DECADE"
JUNE 12, 1990

GOOD MORNING COLLEAGUES. IT IS A PLEASURE TO BE HERE AND TO HAVE THE OPPORTUNITY TO DISCUSS MY VIEWS CONCERNING THE NEW REGULATORY ENVIRONMENT. IT IS A PARTICULAR PLEASURE TO BE BEFORE A NUMBER OF MY FELLOW COMMISSIONERS, STAFF AND FRIENDS. I SHOULD NOTE THAT I AM HERE IN MY CAPACITY AS CHAIRMAN OF THE PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA, AND THAT MY REMARKS ARE PRESENTED ON THAT BASIS.

AS REGULATORS, WE ARE CONFRONTED WITH AN ENORMOUS CHALLENGE. THAT CHALLENGE IS TO OVERSEE THE VARIOUS REGULATED INDUSTRIES UNDER OUR JURISDICTION, AS WE PROCEED TOWARD THE TWENTY-FIRST CENTURY. ONE OF THOSE INDUSTRIES, TELECOMMUNICATIONS, HAS BECOME THE FOCAL POINT OF MANY HEATED DEBATES. SUCH DEBATES INCLUDE, AMONG OTHERS, CONCERNS ABOUT THE UNITED STATES LOSING ITS POSITION AS THE LEADER OF THE INFORMATION AGE AND CONCERNS REGARDING THE NEED FOR INFRASTRUCTURE DEVELOPMENT TO ENSURE CONTINUANCE OF THE UNITED STATES' PREEMINENT POSITION IN THE WORLD'S TELECOMMUNICATIONS MARKETPLACE.

IF I HAD BEEN TOLD THAT, BY THE END OF MY FIRST DECADE AS A STATE COMMISSIONER, I WOULD BE CONVERSANT IN SUCH TERMS AS "ECONOMIES OF SCALE AND SCOPE", "SLCs," "AUTOMATIC STABILIZERS," "SS7," AND "ISDN," JUST TO NAME A FEW, I MAY HAVE DECIDED TO EMBARK ON OTHER, LESS DYNAMIC, PROFESSIONAL INTERESTS. BUT I FIND THE LANGUAGE AND THE MYRIAD OF ACRONYMS SYMBOLIC OF THE CHALLENGES AHEAD, AND THE NECESSITY FOR US TO MEET THAT CHALLENGE.

ONE SUCH CHALLENGE THAT HAS BECOME QUITE TOPICAL OF LATE IS "REGULATORY REFORM." THAT SEEMS TO BE THE BUZZ WORD FOR THE NINETIES. AS THE EXPERIENCES OF THE EIGHTIES ARE EVALUATED, THE ROLE OF REGULATION IS BEING REEXAMINED IN LIGHT OF THESE EXPERIENCES, IN AN EFFORT TO BETTER EMULATE THE "FREE MARKET." THE METHODS PROFFERED BY MANY TO REACH THIS GOAL ARE PRICE CAPS, INCENTIVE REGULATION, BANDED PRICING AND DEREGULATION. I SUGGEST TO YOU, HOWEVER, THAT A CAUTIOUS, GUARDED SKEPTICISM MAY BE NECESSARY, REQUIRING A THOROUGH EXAMINATION OF THE UNDERLYING PRECEPTS OF ANY ALTERNATIVES TO RATE OF RETURN REGULATION, TO

ASSURE THAT THE BENEFITS PROMISED ARE REALIZED AND SUSTAINED. LET US NOT FORGET THAT WE ARE EXAMINING REQUESTS BY VIRTUAL MONOPOLIES FOR REGULATORY ALTERNATIVES, WHILE STILL GOVERNED BY OUR "PUBLIC INTEREST" MANDATE, AND THE NEED TO FASHION REGULATORY RESPONSES WHICH BALANCE THE INTERESTS OF THOSE MONOPOLIES WITH THE INTERESTS OF CAPTIVE RATEPAYERS.

IN GENERAL, ALL REGULATORS ARE GOVERNED BY SOME FORM OF THE "JUST AND REASONABLE RATES" STANDARD. FOR EXAMPLE, AS A D.C. COMMISSIONER, MY MISSION IS TO "INSURE THAT EVERY PUBLIC UTILITY DOING BUSINESS WITHIN THE DISTRICT OF COLUMBIA ... [IS FURNISHING] SERVICE AND FACILITIES REASONABLY SAFE AND ADEQUATE AND IN ALL RESPECTS JUST AND REASONABLE."1/ MOREOVER, I MUST ASSURE MYSELF THAT "THE CHARGE MADE BY ANY SUCH PUBLIC UTILITY FOR ANY FACILITY OR SERVICES FURNISHED, OR RENDERED, OR TO BE FURNISHED OR RENDERED, SHALL BE REASONABLE, JUST, AND NONDISCRIMINATORY."2/ THUS, FROM

1/ D.C. Code §43-402.

2/ Id.

MY PERSPECTIVE, IT IS AGAINST THIS "JUST AND REASONABLE" STANDARD THAT ALL REGULATORY PROGRAMS, BOTH RATE OF RETURN AND "INCENTIVE" ALTERNATIVES, MUST BE EXAMINED, AND AGAINST WHICH THE DELICATE BALANCE CALLED THE "PUBLIC INTEREST" MUST BE STRUCK.

AS I INDICATED EARLIER, INCENTIVE REGULATION, OR ALTERNATIVES TO TRADITIONAL RATE OF RETURN REGULATION, HAS BEEN ONE OF THE MOST CHALLENGING DEVELOPMENTS AT THE STATE LEVEL IN THE LATTER PART OF THE 1980s. IN JANUARY OF THIS YEAR, THE MISSOURI OFFICE OF THE PEOPLE'S COUNSEL RELEASED A SUMMARY REPORT CONCERNING STATE INCENTIVE REGULATION PLANS, WHICH INDICATES THAT WELL OVER TWENTY STATES HAVE EITHER INSTITUTED SUCH PLANS OR ARE CONSIDERING INCENTIVE REGULATION, WITH A SIMILAR NUMBER OF STATES ENACTING LEGISLATION WHICH HAS AT LEAST ESTABLISHED THE FRAMEWORK FOR ALTERNATIVE REGULATION.^{3/} MY REVIEW OF THE MISSOURI REPORT SUGGESTS THAT THE INCENTIVE REGULATION PROPOSALS TO DATE POSSESS

^{3/} See Schmitz, Drainer, "Report on Telecommunications Alternative Regulation Plans by State," Missouri Office of the Public Counsel (Jan. 1990) (Missouri Report).

THREE COMMON FACTORS:

- (1) THE PLAN PROPOSES A FREEZE ON "BASIC RATES" IN EXCHANGE FOR RELIEF FROM TRADITIONAL RATE OF RETURN REGULATION FOR OTHER SERVICES;
- (2) THE PLAN PROVIDES FOR SOME FORM OF "SHARING" OF PROFITS ABOVE A TARGETED RETURN BETWEEN THE TELEPHONE COMPANY AND THE RATEPAYERS; AND
- (3) THE PLAN IS PROPOSED FOR A SPECIFIC TIME PERIOD AFTER WHICH A REEXAMINATION OF THE PROPOSAL PRESUMABLY WILL OCCUR.

I SHOULD NOTE THAT THESE THREE FACTORS ARE NOT MUTUALLY EXCLUSIVE;

SOME STATE PLANS INCLUDE MORE THAN ONE.

FOR EXAMPLE, WHEREAS DELAWARE HAS ESTABLISHED A PLAN WHEREBY BASIC RATES WILL BE FROZEN UNTIL AUGUST, 1990,^{4/} ALABAMA'S PLAN FALLS WITHIN CATEGORIES 2 AND 3, WITH A TRIAL PERIOD OF THREE YEARS AND A SHARING MECHANISM WHEREBY 50% OF THE EXCESS EARNINGS WILL BE SHARED BY END-USERS BASED ON AN ESTABLISHED FORMULA.^{5/} IN FLORIDA, THE COMMISSION HAS ESTABLISHED A PROPOSAL IN WHICH EACH OF THE THREE FACTORS IS REPRESENTED.

^{4/} Id., Section III: Outlines of Alternative Regulation Plans by State, at 2.

^{5/} Id. at 1.

THE MISSOURI REPORT INDICATES THAT, UNDER THE FLORIDA PROPOSAL, BASIC RATES ARE CAPPED UNTIL DECEMBER, 1990, THE TRIAL PERIOD FOR THE PLAN RUNS FROM OCTOBER, 1988 THROUGH DECEMBER, 1990, AND A THREE LEVEL SHARING MECHANISM WAS APPROVED. UNDER THE FLORIDA MECHANISM, THE COMPANY RETAINS ALL EARNINGS BETWEEN 13.25% TO 14.00%, THE RATEPAYERS SHARE 60% OF THE EARNINGS BETWEEN 14.00% AND 16.00%, AND THE RATEPAYERS RECEIVE 100% OF THE EARNINGS OF THE COMPANY IN EXCESS OF 16.00%.6/ SIMILAR PLANS THAT HAVE ASPECTS WITHIN ALL THREE CATEGORIES ARE THOSE WHICH HAVE BEEN APPROVED BY THE KENTUCKY COMMISSION^{7/} AND THE WISCONSIN COMMISSION.^{8/} THIS WIDE VARIANCE OF PLANS SUGGESTS THAT EACH STATE COMMISSION MUST GRAPPLE WITH THE SPECIAL CIRCUMSTANCES OF THEIR RESPECTIVE JURISDICTIONS, AS THE REGULATORS ATTEMPT TO STRIKE THE "PUBLIC INTEREST" BALANCE.

6/ Id. at 2.

7/ Id. at 3.

8/ Id. at 9.

WHILE IT HAS BEEN SAID THAT THE STATES ARE THE LABORATORIES FOR TESTING GOVERNMENTAL POLICIES, THE FEDS HAVE ALSO BEEN CONDUCTING THEIR OWN FORAY INTO INCENTIVE REGULATION AT THE FCC THROUGH THE IMPOSITION OF "PRICE CAPS" FOR AT&T AND THE LECs.

WITH THE REPORT AND ORDER, THE FCC INSTITUTED PRICE CAPS FOR AT&T BEGINNING ON JULY 1, 1989. THIS DECISION IS PENDING RECONSIDERATION.

WITH REGARD TO THE LOCAL EXCHANGE CARRIERS (LECs), THE FCC SIMILARLY PROPOSED A PRICE CAP PLAN, BUT AUGMENTED THE ONE ADOPTED FOR AT&T BY THE ADDITION OF AN "AUTOMATIC STABILIZER." IN RESPONSE TO THE COMMENTS CONCERNING THE LEC PRICE CAP PROPOSAL, AND THE CONTROVERSY OVER THE CORRECT LEVEL OF LEC PRODUCTIVITY AND THE AUTOMATIC STABILIZER, THE FCC RELEASED THE MOST RECENT SUPPLEMENTAL NOTICE.

IN ORDER TO FOCUS MY COMMENTS ON THE FCC PRICE CAP PROPOSAL, LET ME NOTE CERTAIN CONCERNS WITH RESPECT THE FCC PROPOSAL FOR THE LECs, WHICH WERE EXPRESSED BY THE D.C. COMMISSION IN OUR COMMENTS

WITH THE FCC ON THE RECENT SUPPLEMENTAL NOTICE.

FIRST, ONE OF THE MORE CONTENTIOUS PROPOSITIONS SET FORTH BY THE FCC WAS ITS TENTATIVE CONCLUSION THAT THE PRODUCTIVITY OFFSET FOR LEC PRICE CAPS SHOULD BE 2.5%. AS THE FCC HAS STATED

AT THE MOST BASIC LEVEL, PRODUCTIVITY MAY BE CONSIDERED AS OUTPUT PER UNIT OF INPUT. THAT IS, PRODUCTIVITY ADVANCES IN A BUSINESS ARE MANIFESTED BY INCREASED OUTPUT FROM THE SAME AMOUNT OF RESOURCES, I.E., LAND, LABOR OR CAPITAL (SOMETIMES REFERRED TO AS "FACTORS"). PRODUCTIVITY ADVANCES CAN ALSO BE MANIFESTED BY THE SAME AMOUNT OF OUTPUT FROM DECREASED USE OF RESOURCES. WHETHER FROM INCREASED OUTPUT OR REDUCED USE OF RESOURCES, WHEN A BUSINESS IS PRODUCTIVE, THE DOLLAR COST OF A UNIT OF OUTPUT DECLINES DUE TO THE DIMINISHED RESOURCE REQUIREMENT PER UNIT OF OUTPUT.^{9/}

THE FCC, RELYING ON TWO STUDIES CONDUCTED BY ITS STAFF, TENTATIVELY CONCLUDED THAT ITS PROPOSED 2.5% LEVEL WAS JUSTIFIED. I NOTE, HOWEVER, THAT THE STUDIES WHICH THE FCC RELIES ON ARE "INDIRECT" ANALYSES OF PRODUCTIVITY. FURTHER, AND AS ARGUED BY THE D.C. COMMISSION, THE DATA WHICH THE STUDIES USED SUGGEST THAT PRODUCTIVITY MAY BE UNDERSTATED, IN THAT THE DATA DOES NOT TAKE INTO ACCOUNT THE EFFECTS OF DIVESTITURE, THE EFFECTS OF ACCESS

^{9/} See Supplemental Notice at para. 67 (footnotes omitted).

CHARGES, THE RATE OF TECHNOLOGICAL INNOVATION, AND AMORTIZATION OF DEPRECIATION RESERVE DEFICIENCIES.^{10/}

I WANT TO BRIEFLY NOTE ONE ADDITIONAL FEDERAL FORUM IN WHICH THE ISSUE OF INCENTIVE REGULATION HAS BEEN RAISED. SPECIFICALLY, THE NATIONAL TELECOMMUNICATIONS AND INFORMATION ADMINISTRATION (NTIA) RAISED THE ISSUE OF INCENTIVE REGULATION IN ITS RECENT "NOTICE OF INQUIRY" CONCERNING THE UNITED STATES' TELECOMMUNICATIONS INFRASTRUCTURE.^{11/} I HIGHLIGHT THIS PROCEEDING BECAUSE IT QUESTIONS THE EFFICACY OF RATE OF RETURN REGULATION ON THE BASIS OF DEPRECIATION PRACTICES.

THE NTIA NOTICE APPEARS TO SUGGEST THAT CURRENT DEPRECIATION PRACTICES ARE INCONSISTENT WITH THE "ECONOMIC" AND "TRUE" USEFUL LIFE OF EQUIPMENT, AND THAT THE DECISION IN LOUISIANA PUBLIC SERVICE COMMISSION V. FCC^{12/} HAS IMPROPERLY PREVENTED THE FCC FROM

^{10/} See Comments of the [D.C. Commission], CC Docket No. 89-313, filed May 7, 1990 at 6-7.

^{11/} Comprehensive Study of Domestic Telecommunications Infrastructure, Notice of Inquiry, 55 F.R. 800 (Jan. 9, 1990) (NTIA Notice).

^{12/} 476 U.S. 355 (1986).

REQUIRING STATES TO ACCELERATE DEPRECIATION SCHEDULES FOR MOST LEC INVESTMENT.^{13/} OF COURSE I DISAGREE.

IN MY VIEW, THE DEPRECIATION PRACTICES OF THE STATES HAVE RESULTED IN DRAMATIC INCREASES IN DEPRECIATION RATES OVER THE LAST TEN YEARS. IN ADDITION, WITH THE RAPID AMORTIZATION OF DEPRECIATION RESERVE DEFICIENCIES, THE CURRENT SYSTEM HAS RESPONDED TO THE PACE OF TECHNOLOGICAL CHANGE. WHAT THIS SUGGESTS TO ME IS THAT THE ARGUMENTS THAT RATE OF RETURN REGULATION WILL IMPEDE TECHNOLOGICAL ADVANCEMENT ARE SPURIOUS AND SHOULD NOT BE USED AS THE SOLE BASIS TO JUSTIFY EMBRACING ALTERNATIVES TO RATE OF RETURN REGULATION.

AS THE ABOVE OVERVIEW SUGGESTS, THE INQUIRY CONCERNING ALTERNATIVES TO RATE OF RETURN REGULATION IS WIDESPREAD. BUT IN MY VIEW THAT DOES NOT MEAN THAT PRICE CAPS, BANDED PRICING, DEREGULATION OR INCENTIVE REGULATION PRESENTS THE PERFECT COMPROMISE. RATHER, THESE NEW REGULATORY APPROACHES RAISE THEIR

^{13/} See NTIA Notice at paras. 83-84.

OWN VERY PARTICULAR CHALLENGING CONCERNS. LET ME QUICKLY DISCUSS SEVERAL OF THOSE CONCERNS WITH YOU.

FIRST, I FEAR THAT RATEPAYERS MAY BE BEARING TOO MUCH OF THE RISK. MY CONCERN FOCUSES ON THE ABILITY OF THE LEC TO SEEK FLEXIBILITY BUT RETAINING THE RIGHT TO RETURN TO TRADITIONAL RATE OF RETURN REGULATION SHOULD THE PROJECTIONS FOR FINANCIAL SUCCESS FALTER.

SECOND, AND WITH REGARD TO THE FREEZING OF RATES, THE GENERAL PERCEPTION ABOUT THE TELEPHONE INDUSTRY IS THAT IT IS ENTERING A PERIOD OF DECLINING COSTS. WITH A FREEZE, THE COMPANIES COULD EXPERIENCE A WINDFALL. MOREOVER, I DO NOT BELIEVE THAT FREEZING BASIC RATES FOR SOME PERIOD OF TIME NECESSARILY IS THE ANSWER TO MY CONCERN VIZ A VIZ RATEPAYER RISK. WHILE POLITICALLY, THE CONCEPT OF "FREEZING RATES" IS COMFORTABLE, THE CHALLENGE CONFRONTING REGULATORS IS THE "JUST AND REASONABLENESS" OF THE LEVEL OF THE RATES PRIOR TO THE IMPOSITION OF THE FREEZE. MOREOVER, THE VALUE OF THE FREEZE CAN BE NULLIFIED ONCE THE PERIOD

OF THE FREEZE HAS ENDED IF RATES BEGIN TO RISE PRECIPITOUSLY. THEREFORE, CONSIDERATION SHOULD BE GIVEN TO DETERMINING BOTH THE "JUST AND REASONABLENESS" OF THE LEVEL OF THE RATES PRIOR TO THE FREEZE, AS WELL AS THE AMOUNT OF INCREASE IN RATES, IF NECESSARY, WHICH WOULD BE PERMISSIBLE IN THE YEAR OR YEARS AFTER THE FREEZE HAS EXPIRED.

THIRD, AN LEC MAY BE TEMPTED TO UTILIZE THIS PERIOD OF FLEXIBILITY IN ORDER TO MODERNIZE THE NETWORK WITHOUT REGARD TO COST, PARTICULARLY IF THE ABILITY EXISTS, AS SUGGESTED EARLIER, TO RETURN TO TRADITIONAL RATE OF RETURN REGULATION. AT RISK AGAIN IS THE CAPTIVE RATEPAYER WHO MAY BE ASKED TO BEAR A DISPROPORTIONATE SHARE OF THAT INVESTMENT.

FOURTH, I AM CONCERNED THAT THE USE OF A "SHARING MECHANISM," WHILE AN INTERESTING THEORY MAY NOT BE A REALITY. FIRST, I AM NOT AWARE OF ANY STATE (OTHER THAN THE IDAHO EXPERIENCE), WHICH HAS INCLUDED A SHARING MECHANISM IN ITS NEW REGULATORY REGIME, WHERE THE CONSUMERS HAVE ACTUALLY SHARED IN EXCESS EARNINGS. WHILE SOME

MAY ARGUE THAT THIS IS DUE TO THE COMPROMISE REACHED IN SETTING THE SHARING THRESHOLDS, I QUERY WHETHER THIS ALSO COULD BE THE RESULT OF THE COMPANY'S TOTAL CONTROL OVER ITS NETWORK INVESTMENT AND ITS FINANCIAL PLANNING.

FIFTH, IN EVALUATING ANY ALTERNATIVE REGULATORY PROPOSAL, I BELIEVE ONE MUST ALSO EVALUATE THE NEED FOR DETAILED REPORTING REQUIREMENTS, INCLUDING THE REPORTING OF COSTS IN ORDER TO HAVE A HISTORICAL RECORD SHOULD THE LEC SEEK TO RETURN TO RATE OF RETURN REGULATION, AND IN ORDER TO ASSURE THAT THE LEC IS NOT ENGAGING IN ANTICOMPETITIVE BEHAVIOR SUCH AS CROSS SUBSIDIZATION AND PREDATORY PRICING. LET US NOT FORGET THAT THE UNDERLYING INCENTIVE FOR SUCH ACTIVITY, I.E., THE MAINTENANCE OF MARKET SHARE, IS STILL PRESENT REGARDLESS OF THE REGULATORY REGIME.

LAST, BUT BY NO MEANS LEAST, IS MY OVERRIDING CONCERN REGARDING THE QUALITY OF SERVICE. MY CONCERN IS SIMPLY THIS: ALTERNATIVE REGULATORY MECHANISMS MAY CREATE THE INCENTIVE TO REALIZE SHORT TERM PROFITS AT THE EXPENSE OF SERVICE QUALITY. THIS

CONCERN CROSSES JURISDICTIONAL BOUNDARIES IN THAT DETERIORATING SERVICE AFFECTS ALL RATEPAYERS. THEREFORE, I SUGGEST TO YOU THAT ANY ALTERNATIVE REGULATORY MECHANISM SHOULD INCLUDE A PROCESS OF ESTABLISHING AND EFFECTIVELY MONITORING QUALITY OF SERVICE STANDARDS.

IN LIGHT OF MY REMARKS OF THE PAST FEW MINUTES, IT MAY SURPRISE YOU TO KNOW THAT I AM NOT OPPOSED TO REGULATORY REFORM. I AM COGNIZANT OF THE ECONOMIC AND TECHNOLOGICAL CHANGES OCCURRING IN THE INDUSTRY. I BELIEVE, HOWEVER, THAT CHANGE FOR CHANGE'S SAKE IS NOT PROGRESS: IT IS MERELY THE REPLACEMENT OF ONE FORM OF REGULATION FOR ANOTHER. BEFORE I THINK WE SHOULD SUBSCRIBE TO A PARTICULAR ALTERNATIVE APPROACH, IT SHOULD BE PROVEN THAT THE CHOSEN METHOD OF RE-REGULATION WILL IMPROVE THE OVERALL STATE OF TELECOMMUNICATIONS, THAT IT WILL INCREASE EFFICIENCIES, YIELD TECHNOLOGICAL INNOVATIONS, CREATE, WHERE APPROPRIATE, SUSTAINED PRICE REDUCTIONS, AND THAT BENEFITS WILL APPRECIABLY EXCEED RISKS. LET US NOT PROCEED WITH RADICAL REVISIONS TO LONG-STANDING

REGULATORY METHODS, WITHOUT ASSURANCES THAT THE DEVIL WE KNOW IS NOT BETTER THAN THE ONE WE DON'T. I BELIEVE THAT ANY CHANGE SHOULD PROCEED SLOWLY, CAUTIOUSLY, ON A SERVICE-BY-SERVICE BASIS, AND ONLY AFTER A CLEAR AND CONVINCING SHOWING THAT IT IS IN THE PUBLIC INTEREST TO ADOPT CHANGE, SAID A DIFFERENT WAY - THAT IT WILL BE IN THE BEST INTEREST OF THE CONSUMER AND THE COMPANY ALIKE.

I THANK YOU AGAIN FOR THIS OPPORTUNITY TO BE HERE WITH YOU IN TUCSON. I LOOK FORWARD TO ANSWERING ANY QUESTIONS YOU MAY HAVE.