Price Cap Regulation and Cross Subsidization

by

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<u>Introduction</u>: Cross-subsidization is the support of one service by other services. Throughout the history of telephony there have been many claims that cross-subsidies are used to support universal service or suppress competition. Local Exchange Carriers (LECs) currently face the threat of loss of access markets to alternative access providers (ALTS).[2] The transport market is the first market that the ALTs enter. Clearly, the LECs have an incentive to cross-subsidize their transport access service in order to diminish or demolish this threat to their long term dominance of the industry. The purpose of this paper is to investigate if, under the regime of price cap regulation, LECs have the ability to cross-subsidize the transport market.

It is claimed that price cap regulation, because it allegedly eliminates the incentive to shift costs among services, reduces the possibility of cross subsidization. The FCC has also determined "that the adoption of price cap regulation for the LECs constitutes an effective complement to cost allocation, reporting and enforcement safeguards, to reduce BOC incentives to cross-subsidize."[3]

This paper will examine (1) whether the theoretical arguments in favor of price cap regulation for the purpose of limiting cross-subsidization are reasonable; (2) whether price cap regulation as it has been established by the FCC can eliminate cross-subsidization in practice; and (3) is price cap regulation useful once alternative firms are allowed to enter selective markets.

<u>Price Caps and the Incentive to Cross-Subsidize</u>: Under price cap regulation, individual service prices are no longer tied to cost of service studies. Instead, prices are allowed to rise with

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[1] The views expressed in this paper are those of the author and do not necessarily represent the views of the Public Service Commission of the District of Columbia or its Staff.

[2] The term, ALTS, refers to alternative access providers. The term, CAPS refers to competitive access providers. The term, ALTS, is preferred to the term, CAPS, because it is not clear when or if the alternative providers will become effective competitors.

[3] Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards, Report and Order, CC Docket No. 90-623, released December 20, 1991, para. 13.