How should we judge whether states' telecommunications policies are deregulatory and pro-competitive?

A Free-Market Scorecard

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Much of the United States' communications infrastructure is used to carry both interstate and intrastate communications services. Even before the passage of the Communications Act of 1934, it was clear that the states and the federal government were determined to share responsibility for regulating communications services offered over the same physical facilities. The 1934 Act codified the sharing of jurisdictional authority, granting the Federal Communications Commission authority over interstate services while giving the states much of the authority to regulate the rates, terms, and conditions of intrastate offerings.

In some important respects, the Telecommunications Act of 1996 enhanced the regulatory authority of the FCC vis-à-vis the states. For example, the act gave the FCC greater authority to preempt state or local laws that impede the provision of intrastate service. The act also gave the FCC primary authority to implement several local telephone competition provisions contained in the legislation, including the issuance of rules governing the availability and pricing of unbundled pieces of the incumbent telephone companies' local networks.

In the main, however, Congress recognized the continued important role of the states in maintaining and fostering the evolution of a modern communications infrastructure. Indeed, the 1996 Act charged not only the FCC but also "each State commission" with the responsibility to encourage the timely deployment of advanced telecommunications capability. At the same time, Congress envisioned a presumptively "pro-competitive, de-regulatory" policy framework as the best means of achieving widespread deployment of advanced communications and information services.

A large number of state communications policymakers appreciate the desirability of implementing pro-competitive, deregulatory policies. They recognize that, as competition in all communications sectors continues to develop, consumers will benefit from allowing marketplace forces to supplant traditional "utility-style" regulation. There is agreement among an increasing number of state policymakers with the assessment of FCC Chairman Michael Powell that free markets "are far superior devices than central planning models for controlling prices, spurring innovation, enhancing quality, and producing consumer choice." Indeed, in the past, a few states such as New York have been leaders in adopting various deregulatory policies that have promoted a more competitive environment in their jurisdictions and that subsequently have been adopted by the FCC.

Unfortunately, many telecommunications-related state policies and actions that are lauded as "pro-competitive" and "deregulatory" are little different from traditional, utility-style command-and-control regulation that erects barriers to entry and suppresses competitive marketplace responses. To identify true, innovative, free-market state policies, I offer the following criteria, which are meant to provide a guide for determining whether a state's telecommunications policies are, in the main, "deregulatory" and "pro-competitive."

1. Has the state replaced rate-of-return regulation with true price caps?

Under traditional rate-of-return or "cost-plus" regulation, a telephone company lacks the incentive to operate in an efficient manner because regulators only allow it to recover a specified return on its investment. Expenses are recovered on a dollar-for-dollar basis. By capping rates and not profits, true price-cap regulation provides an incentive for the telephone company to

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operate efficiently because cost savings accrue to the stockholders. And under price-cap regulation, the regulatory authority no longer is required to conduct interminable and highly conjectural rate cases in an attempt to determine the "reasonableness" of the telephone company's capital investment and all its various expenditures.

Some plans that are labeled "price-cap" regulation actually employ mixed traditional and price-cap elements. Under those plans, regulators place a cap on the company's earnings by requiring that profits exceeding a specified level be "shared" with ratepayers. That is not true price-cap regulation and should not be classified as deregulatory.

2. Has the state undertaken meaningful rate-rebalancing?

State regulators historically have required the incumbent local exchange carriers to provide local residential dial tone service on a heavily subsidized basis in order to promote "universal service." The subsidies to local residential service have been generated principally by inter- and intrastate long distance services that were priced above cost as well as intrastate business services and vertical ("custom calling") features priced above cost. Without rate rebalancing that brings the basic residential rate closer to the cost of providing the service, it is considerably more difficult for local competition to develop in the residential market. New entrants find it more difficult to compete against the incumbent's below-cost service, and overpricing of contributory services leads to wasteful reductions in usage.

Some states like Colorado have capped local residential rates by statute, making rate rebalancing virtually impossible. In a March 2002 opinion, Colorado Public Utilities Commission chairman Ray Gifford took note of the anti-competitive impact of below-cost residential rates: "The lack of CLEC [competitive local exchange carrier] entry into the residential market can be explained by only one thing: The residential retail rates make entry either unattractive relative to other markets or unprofitable altogether." Regrettably, in April 2002, Florida Governor Jeb Bush vetoed a bill that would have implemented some degree of rate rebalancing by lowering intrastate long distance rates and increasing local residential rates. On the other hand, a few states like Massachusetts and Illinois have taken significant steps to implement more cost-based rate structures by allowing the increase of residential rates.

In order to be classified as pro-competitive and deregulatory, a state's pricing regime must achieve a substantial measure of rate rebalancing that allows local residential rates to move close to the cost of providing the service.

3. Does the state require additional unbundling and sharing of the incumbent's facilities?

In implementing the Telecommunications Act of 1996, the FCC has issued rules that define the extent to which the incumbent's local exchange network must be unbundled and shared with competitors. Rules that require unbundling and sharing of network elements in excess of the minimum required under the 1996 Act deter facilities investment on the part of incumbents as well as new entrants.

A good case can be made that the FCC's rules have required an excessive amount of unbundling and sharing of incumbent network facilities. Now, some states are asserting that they should require more sharing than mandated by the FCC. For

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example, in April 2002 the Texas Public Utility Commission voted to require Southwestern Bell Telephone Company to offer unrestricted local switching to CLECs, even though the FCC has allowed the incumbent to discontinue mandatory sharing of that service. To the extent that a state requires any level of unbundling and sharing in addition to the amount already mandated by the FCC, its actions hinder the development of local competition and are not deregulatory.

4. Does the state require prices lower than TELRIC?

This criterion should be considered in conjunction with Criterion No. 3 because the extent to which elements are required to be shared is related to the price at which unbundled network elements are required to be made available. If the price at which network elements are required to be made available is set too low, then a greater degree of inefficient non-facilities-based entry is encouraged. New competitors find it less costly to lease the facilities of the incumbent rather than build their own. And the incumbents are discouraged from making investments in new facilities when they know that any competitive advantage derived from their own investments will be dissipated by the requirement to share at prices that are set too low. The FCC has required that states implement a particular form of forward-looking pricing methodology called TELRIC—Total Element Long Run Incremental Cost. If a state prices network elements lower than the minimum prices required by the FCC's methodology, then the state's action is anti-competitive and not deregulatory.

5. Does the state evaluate Bell company applications in a rational and timely manner?

Under the 1996 Telecommunications Act, the FCC is required to consult with the state commission before deciding whether to grant a petitioning Bell company's application seeking authority to provide "interLATA" long distance services within a state. As a practical matter, it is unlikely that any Bell application will go forward at the FCC unless the state commission at least has made fairly substantial progress in evaluating whether the company has complied with the 14-point "competitive checklist" contained in the legislation. In order for the state's consumers to benefit from the additional competition in the (increasingly less distinct) long distance and local marketplaces, the state must have a process in place that facilitates timely and rational consideration of the application. To be timely and rational, the state's process should focus on defining the core elements necessary for compliance, rather than engaging in exercises seemingly designed to see how many hundreds or thousands of disaggregated and discrete "performance standards" can be separately stated.

The state should also incorporate into its evaluation and enforcement process the notion of "substantial compliance" that is common in many other regulatory and legal settings. Under that evaluation standard, a Bell company's failure to comply in some less consequential technical sense with even a core requirement would not be deemed fatal to a positive evaluation. And certainly, the failure to comply on an infrequent or inadvertent basis with non-core elements would not be a reason for negative treatment. Moreover, if a state process produces requirements or performance standards that are not harmonious with those of other states in the petitioning Bell's region, or that are measurably more onerous than the FCC's already detailed requirements, that would be a cause for serious concern. In sum, in order to be considered pro-competitive and deregulatory, the state commission's process for evaluating applications must facilitate timely consideration in a rational and harmonious common-sense manner.

6. Is the incumbent to be split into wholesale and retail entities?

AT&T, WorldCom, and other CLECs have filed petitions or submitted legislative proposals in many states seeking to have the incumbent LECs broken up into separate "wholesale" and "retail" companies. They claim that such a drastic measure is the only way to prevent the incumbent from favoring its own retail operations vis-à-vis competitors to whom it is obligated to provide unbundled network elements on a wholesale basis. Such "structural separation" is an even-more-extreme form of regulation than that which generally occurs under so-called "functional" non-structural safeguards that establish a plethora of non-discrimination obligations.

In rejecting proposals to break up Verizon-Pennsylvania, the Pennsylvania Public Utilities Commission in March 2001 stated that consumers would not benefit from "a physical structural division resulting in the likelihood of additional and prolonged litigation and regulatory micromanagement which even the competitors do not view as a successful formula for bringing telephone local competition to Pennsylvania." And, in an opinion rejecting structural separation issued in November 2001, the Florida Public Service Commission observed that the requested relief was "so draconian that, of the states that have examined the issue, all have rejected it." The Florida Commission commendably added, "This is an inefficient way to encourage competition," and, "Each additional regulation imposed on BellSouth creates costs and inefficiencies." Any proposal to adopt structural separation is not deregulatory; that is also true of proposals to increase the already burdensome forms of functional separation.

7. Is the state trying to regulate broadband?

As distinct from traditional narrowband voice service, broadband service has never been offered on a monopoly basis. Rather, it is a new advanced service offered on a competitive basis. The FCC has stated, "Service providers are deploying a variety of networks that rely on different network architectures and transmission paths, including copper wire, cable, terrestrial wireless radio spectrum, satellite radio spectrum, or a combination of these and other media, to provide high-speed services." Unfortunately, despite its determinations that broadband services are being offered on a competitive basis, the FCC nevertheless has continued to regulate aspects of telephone company offerings such as DSL.

So far, many states have resisted entreaties to regulate broadband, but others appear ready to jump in. In March 2002, the California Public Utilities Commission announced it would entertain complaints that Pacific Bell is offering DSL service on a

discriminatory basis and at an unacceptable service quality level.

States applying utility-style rate regulation, sharing, and nondiscrimination obligations to broadband services will deter facilities investment by the incumbent carriers and new CLEC entrants. Those states also discourage investment by providers using other technology platforms such as cable. Competition in the broadband marketplace will be forestalled, and such actions certainly will not be classified as deregulatory or pro-competitive.

8. Does the state prohibit or substantially limit governmental provision of telecommunications services?

At a time when there is growing recognition on a worldwide basis concerning the inefficiencies of government-operated businesses, there also is a growing trend among state and local governments to get into the telecommunications business. Typically, the government-owned and -operated networks not only provide services to government offices, but also to a wider circle of private "authorized users," if not to the public-at-large. For example, New Mexico announced in April 2002 that it is requesting bids to establish a public fiber-optic network linking state agencies, schools, and local governments in 35 cities across the state. The plan contemplates allowing private companies to buy excess capacity from the network.

The existence of government providers leads to an inefficient allocation of resources and hinders the development of a competitive communications marketplace. Experience has shown that such networks often receive large subsidies that disadvantage private service providers. By virtue of their position, particularly as the circle of users to whom they may provide service widens, governments are tempted to — and often do — engage in activities that hinder private sector competition by raising the costs competitors face (e.g., imposition of unreasonable permitting requirements or non-cost-based rights-of-way fees on private sector providers).

Some states generally restrict their municipalities from providing communications services. That type of restriction is a positive step. States that act as service providers — or allow their local governments to act as service providers — are acting in an anticompetitive and regulatory manner rather than being pro-competitive and deregulatory.

9. Does the state's licensing, permitting, or related policies act as barriers to entry?

In order for competition to flourish, the states must not impose, or allow their municipalities to impose, unnecessary restrictions or unreasonable fees that increase telecom firms' costs of entry or existing service. Such unnecessary restrictions include non-cost-based licensing, permitting, and application fees; rights-of-way access, tower siting and zoning restrictions; unreasonable applications processing hurdles; and the like.

Both Kansas and Michigan recently passed legislation that limits the franchise fees that municipalities may charge telecommunications companies. On the other hand, Oregon allows Portland to impose a seven-percent gross revenue "privilege tax" on telecommunications companies that want to use the city's rights-of-way. States that impose unnecessary restrictions and/or unreasonable fees, or allow their local governments to do so, curtail competition and injure consumers by raising the cost of doing business. States that allow and engage in such practices are acting in an anti-competitive manner that is not deregulatory.

10. Does the state limit taxes and regulatory fees imposed on telecommunications services?

Studies have shown that states and municipalities impose an incredible range of taxes and fees on telecommunications services under a wide variety of denominations. The taxes and fees range from franchise taxes and sales taxes to gross receipts taxes, excise taxes, business and occupation taxes, 911 fees, infrastructure maintenance fees, poison control fees, and on and on. While estimates are necessarily rough in light of the multiplicity and variety of state and local telecommunications taxes and fees, one study determined that their combination amounted to about eight percent of total telecommunications revenue in 2000. And the tax burden appears to be growing steadily.

Telecommunications taxes might have been a relatively efficient way to collect revenue when telephone service was a monopoly. But in today's competitive environment, the mishmash of taxes and fees, and their cumulative burden, is more likely to distort the marketplace and suppress demand for new services such as broadband and wireless. Thus, states with higher-than-average tax burdens or overly complex tax and fee regimes should be classified as acting in a manner that is not consistent with a pro-competitive, deregulatory policy.

CONCLUSION

In closing, I want to note that my intention in creating this list is not to establish a numerical or objective scoring system of states' telecommunications policies. Rather, it is to provide guideposts for evaluating whether state policies, in 10 different telecommunications-related areas, tilt more or less in a pro-competitive and deregulatory direction. To the extent that a state's policies lean in such a pro-competitive and deregulatory direction, it is much more likely that, in today's rapidly changing telecommunications environment, the state will enjoy greater economic and social benefits than if it takes the opposite path.

READINGS

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