

New approaches to regulation: The Vermont Telecommunications Agreement

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The dramatic changes in telecommunications in the past decade have caused many states to try new approaches to the regulation of local telephone companies. The "Vermont Telecommunications Agreement" was one of the earliest attempts at such innovative regulatory approaches. To learn more about that experience, the PURE '93 conference and MPR invited representatives with three different perspectives on the Vermont experience to share their observations.

The Vermont Telecommunications Agreement

by Thomas Aulisio, New England Telephone Co.

Let me begin my assessment of the Vermont Telecommunications Agreement by explaining not only the original goals of the VTA, but also public expectations of this form of regulation, and how well we have or have not met these expectations. Secondly, I would like to discuss the VTA as a process, because the process is just as important as the form when it comes to evaluating the VTA.

The original goal of the VTA was based on the assumption that competition was inevitable, and ultimately in the best interest of the public. The goal, therefore, was to introduce competition, while establishing protections for the monopoly ratepayer. The solution, or the basis for agreement, was pretty simple. New England Telephone (NET) was given additional earnings, marketing and operational flexibility to deal with its new competition. In return, NET agreed to a schedule of basic rates, service and investment commitments. These commitments by NET were designed to assure regulators that NET could not offset competitive losses by simply increasing the price to monopoly customers or by degrading service and the quality of the infrastructure.

The VTA and 'TANSTAFL'

In the first contract, there were no increases in basic rates. Naturally everybody loved the first contract. Furthermore, everybody fell asleep during the course of the first contract, as Commissioner Sedano indicated in his comments. Subscribers thought that they were getting a modern network, better service, and lower prices in the toll market due to competition. There was no cost to them for all of this. To subscribers, this deal was almost too good to be true.

Unfortunately, the most famous of all economic principles arose when we tried to implement the second VTA. It's called the "TANSTAFL" principle which is an acronym for, "there ain't no such thing as a free lunch." Faced with a \$1.85 increase in basic rates in the one-year extension, people found out that there was no free lunch. They began to look for the reasons why there was not a free lunch. For example, one consultant in the case concluded that NET has gold-plated the network during the course of the VTA. This simply is not true: The average net investment per access line actually declined, even though NET spent \$284 million over that period. Because NET had control over depreciation expenses, NET depreciated the costs of the plan in the fashion

that reduced the revenue requirement per access line over the course of the VTA by 50-cents per line per month. In addition, there are maintenance savings from the investments that could amount to \$1 to \$2 per line per month.

The real pressures on local rates are toll competition and changes in federal regulation. Interstate toll competition is causing prices to conform to costs. Where historically local carriers recovered a large fraction of the revenue requirement from the interstate jurisdiction without regard to actual costs, that is no longer possible. The Federal Communications Commission (FCC) is shifting costs back to the state jurisdictions. This will continue as interconnection policies expand in the federal arena. In Vermont, since 1986, costs have been shifted back to the state jurisdiction in the amount of \$6 per line per month. But the rates only went up \$1.85 at the conclusion of the agreement and Vermont obtained a very modern network, so the state did receive a very good deal. Unfortunately, and this is largely New England Telephone's fault, the contract had no basic rate increases even though the underlying economics were inconsistent with that freeze. Based on this experience, it is fair to say that New England Telephone will never again enter into an agreement that does not move basic rates closer to costs. The economics dictate this position. Furthermore, continuing the basic rate subsidy is misleading to consumers.

Evaluation of VTA

Two very good things have come out of the VTA. First, the State of Vermont should be commended for not debating the VTA endlessly. NET really accepted the contract with no basic rate increase because the company wanted to get this ball rolling someplace. In retrospect, NET agreed to a poor bargain. The State of Vermont should be commended for that. Commissioner Sedano once referred to this as a marriage. I think in a broader sense it is not only like a marriage but also like raising a child. You go along. There are some bumps in the road. At some times, like age two and thirteen it's a little tough. This is the way it is with this contract process. We are trying to resolve some of the bumps in the road right now.

The state's development of goals and policies was very important to both the initial VTA process and the second VTA process. The Vermont Department of Public Service has issued a ten-year plan. That will make progress easier in the future. With a plan, anyone with a proposal must explain how that will meet the goals of the ten-year plan. I think that's excellent. For any state considering a contract, the first step should be development of such a plan. Without a plan, the negotiations will degenerate into a debate of self-interests.

There have been problems with the VTA. One of the bumps in the road is the contract concept itself. Personally, I do not believe that contracts necessarily lead to a fair conclusion. With a contract, the party with the most negotiating leverage wins. In the first VTA, where NET wanted this form of regulation some place, the state understood that and they obtained a good contract. That was ultimately to everybody's detriment, because it was not sustainable.

The Commissioner of the Department of Public Service normally plays the role of the public advocate in the State of Vermont. The public does not understand his role, nor should we expect them to understand that role in this process. It would probably be better if the commissioner were not the other party to this contract process when it is reviewed. The commissioner should probably fill his traditional role, while somebody else negotiates with the company. Because the

public may misinterpret the commissioner's role in the contract process, it may damage the credibility of the department. This is very unfair, because the commissioner and his staff are very competent and hard-working people.

Direct legislative involvement has also been a problem. Legislators face clear political pressures and challenges. Regulation was moved from legislators specifically to moderate these political pressures. Regulators are very good at regulation, and we should let them regulate. There has been too much legislative involvement in the State of Vermont in these contract processes. I would advise any state considering alternative regulation to let its regulators manage it.

Overall, I think that the FCC price cap method is far superior to the contract form. In the FCC price cap formula, the utility is given a productivity objective. If the utility meets that productivity objective, it earns about what it would under rate of return regulation. If it beats the productivity objective, the utility might earn a little more. If it fails to meet it, the utility will earn less than what it would have under rate of return regulation. Although the determination of productivity standards is not a science, it is comparable to the judgments that determine return on equity under rate of return regulation. Reasonable debate is likely to lead to mutually acceptable standards.

Under a contract, I do not believe that similar results can be achieved. Contract regulation is really rate of return of regulation with a forward-looking test period.

There does need to be more pricing flexibility in future contracts. There is a lot more competition today than there was four or five years ago. If public policy is to promote competition, price must move toward costs. Five years ago, there was general consensus that, for most customers, there was no viable alternative to a local monopoly. Today, people are not so sure. Peter Huber has argued that the natural monopoly may be in the interexchange market, not the local exchange market. The barriers to local exchange competition may now be more regulatory than technical. One of these regulatory barriers is the low price of basic service. We do have to find better ways to keep low income subscribers on the network, but it does not make much sense to protect the entire market from competitive alternatives.

Conclusion

In conclusion, I would offer these observations: First, prices are going to change. Second, a price cap mechanism for incentive regulation is better than the contract approach. Lastly, the experience in Vermont demonstrates that it is very important to have a broad telecommunications plan in effect at the outset of the contract process.

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