THE INTEREXCHANGE TELECOMMUNICATIONS INDUSTRY:

SHOULD REGULATION

DEPEND ON THE ABSENCE OF COMPETITION?

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Government interference or regulation affixes itself to an industry at that point where industry fails or refuses to conduct its affairs in a fashion which will protect the individual and social interests * * *.

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[Regulatory] standards are seldom formulated until there is a dominant need for protection which the industry is unable or unwilling to provide; which society is unable to provide for itself; and which it insists that government provide.[1]

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[1] Horack and Cohen, "After the Nebbia Case: The Administration of Price Regulation," 8 University of Cincinnati Law Review 219, 222, 226 (1934).

INTRODUCTION

Substantial effort is being devoted today to answering the question: does workable competition exist in the interexchange telecommunications industry.[2] The argument presented is that, given the presence of such competition, no need exists for regulation to enforce just and reasonable rates, non-discrimination, efficient industry operation, and the like. "The market" in a workably competitive setting will accomplish these goals, the argument goes, and accomplish it with a greater efficiency and effectiveness than present means of economic regulation.

In contrast to this argument, the thesis of this report is that whether or not the interexchange telecommunications industry should be regulated does <u>not</u> depend on whether the industry is "workably competitive." An industry may be workably competitive but nevertheless still be necessarily subject to public control for the public good. Clearly, of course, competition is not irrelevant to the issue of regulation versus deregulation. Just as clearly, it is not determinative.

The notion that competition can and should displace direct governmental intervention in economic affairs has some facial attractiveness. Since time

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[2] See, Horning, et al., <u>Evaluating Competitiveness of Telecommunications Markets: A Guide for Regulators</u>, National Regulatory Research Institute (January 1988); see also, Rowe, <u>Breaching the Social Contract: A Summary of State Telephone Deregulation Efforts</u>, National Consumer Law Center (December 1989).

immemorial, the doctrine that competition is the "life of trade" and that competition is the proper method and means of allocating resources --financial and natural-- has been taught.[3] Substantial effort, both public and private, is devoted to ensuring and promoting robust competition in the marketplace.[4]

Question exists, however, whether "the market" will indeed be able to substitute for regulation in the interexchange telecommunications industry. Some industry analysts argue that the interexchange markets are, indeed, not workably competitive at all.[5] These analysts observe that the interexchange industry is highly concentrated, is populated by firms that wield considerable market power, and has both the opportunity and the incentive to engage in monopolistic pricing.[6] Other industry analysts argue that, whatever the structure-conduct-performance evaluation of the interexchange industry, consumers in the telecommunications industry have attributes that will interfere with, if not prevent, the operation of workable competition.[7] Still other analysts argue that, given the nature of interexchange service, inadequate

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[3] See, e.g., Cabot, "Competition is the Life of Trade," 3 Harvard Business Review 385 (1925).

[4] See, e.g., Colton, Identifying Consumer Characteristics Which are Important To Determining the Existence of Workable Competition In the Interexchange Telecommunications Industry, at 87 - 96, National Consumer Law Center (December 1989). (hereafter Colton).

[5] See, e.g., Shepherd, "Effective Competition, Deregulation, and 'Price Caps'" (Oct. 1988). (Paper presented at Conference on Competition and the Regulation of Telecommunications Services, Public Service Commission of the District of Columbia).

[6] See, Racster, Issues in Regulating Imperfectly Competitive Telecommunications Markets, National Regulatory Research Institute (1986).

[7] See, Colton, supra.

information exists (absent some regulatory or legislative response) for the free operation of workable competition.[8]

This evaluation examines the debate concerning regulation versus deregulation of the interexchange telecommunications industry in yet a different context. The evaluation differs from most in that, for purposes of analysis, the presence of workable competition is assumed. (It is important to note, however, that the assumption of competition is made solely for the purposes of analysis.) The objective here is to obtain an understanding of whether, even given the presence of workable competition, reasons exist to exert state regulatory authority.[9]

In pursuit of this understanding, the following analysis will be undertaken in three parts. Part I will articulate the basis which underlies the economic regulation of a variety of industries. Part II will look at the goals that regulation seeks to serve. Part III will examine the situations in which competition is found to be insufficient to fulfill socially-demanded tasks.

The process of deciding whether the interexchange industry should be regulated involves two fundamental steps. First, if workable competition does

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[8] See, Rowe, Consumer Information in Telephone Pricing, National Consumer Law Center (December 1989). (hereafter Rowe).

[9] In this sense, "regulation" is intended to refer to what historically has been considered "economic regulation." It excludes, for example, much environmental regulation, workplace safety regulation, securities regulation, and the like.

not exist in today's interexchange markets, the inquiry goes no further. Regulation is necessary, much the same as it is necessary for electricity, natural gas and other monopolistic public utilities and common carriers.[10] If competition does exist, however, it is necessary next to determine whether that competition is of the type and extent to achieve the objectives that would be sought through regulation. If it is not, competition cannot displace governmental control as a means of protecting the public's interest and regulation is necessary. In the event workable competition is found to exist, both steps of the analysis must be completed.

In sum, any evaluation of the ultimate decision to regulate or not to regulate must look first at whether or not competition is present; if it is, the decision to regulate or deregulate should then depend on whether there is a need for public regulation, notwithstanding the presence of workable competition.

[10] In this sense, this report categorically rejects the extreme assertion that there is no need to regulate even a monopolistic industry providing a public necessity.

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PART I: THE BASIS OF REGULATION.

Lord Hale, of Seventeenth Century England, did not frequently consider digital switches and fiber optic wires in 1670. Still, his advice on public regulation should serve as the starting point for examining what role government regulation should play in the interexchange telecommunications markets today. Lord Hale's comments have guided U.S. policymakers through all of its prior regulation and deregulation cycles.[11] Indeed, the basic foundation for government control of business in Anglo-American jurisprudence can be traced directly to his commentaries. In his treatise De Portibus Maris, Lord Hale declared that when private property becomes "affected with a public interest," it "ceases to be juris privati only."[12]

The United States Supreme Court recognized the truth of this declaration when, as early as 1876, in Munn v. Illinois,[13] the Supreme Court held that it was upon Lord Hale's principle that the right of regulation rested in

[11] While perhaps it would be nice to think that the telecommunications industry presents unique issues today, that is not so. The United States historically has gone through regulation cycles, such as the years associated with the Granger Movement and regulation of the railroads; state regulation after the public utility holding company abuses of Samuel Insull is another "regulation" cycle. So, too, has the country gone through periods of deregulation or aggressive laissez faire such as occurred in the early 1800s and has again become apparent in the 1980s. Cycles can overlap as well. While there is growing sentiment for deregulation generally today, there is a counter pressure in the prescription drug industry; moreover, there is the first glimmer of sentiment for re-regulation of the airline industry.

[12] See, generally, McAlister, "Lord Hale and Business Affected with a Public Interest," 43 Harvard Law Review 759 (1930).

[13] 94 U.S. 113 (1876).

the United States.[14] Without question, the Munn court addressed only the power of the state to exercise jurisdiction, a power that is no longer questioned. Today the issue is not whether the state may exercise regulation, but rather whether the state should exercise it.

The issues have similar conceptual groundings. The answers to each question ("may" and "should") are founded in the role that regulation serves in our economic system. Regulation of industry by government is as old as the fundamental democratic precepts which underlie this nation. Regulation can be traced to when government first declared that prices charged for particular "public" products must be "just and reasonable."[15] In short, regulation is not a recent invention, flowing out of institutions associated with the New Deal. So long as private and public interests have diverged, government has retained the authority to step in and control private activities.[16]

Importantly, no single set of circumstances adequately explains each and every instance of the rise of economic regulation. Three factors, however, stand out:[17]

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[14] 94 U.S. at 125, 126.

[15] Indeed, economic regulation can be traced back to medieval Europe. See, generally, Schumpeter, History of Economic Analysis, at 60 - 61, 98 - 99, 359 - 360 (1954).

[16] Regulation over the years has included most industries that have stood in the gateway of commerce, including the provision of financial services, transportation, energy and communication. Indeed, few (if any) industries that substantially affect commerce today escape price, earnings or disclosure regulation. See, e.g., Rowe, supra, at Appendix B.

[17] Other factors exist. See, generally, Hall, The Concept of a Business Affected with a Public Interest

- The presence of monopoly power
- The grant of public perquisites
- The potential for public harm

Each will be examined separately. In so doing, however, one must remember that these factors may be present individually or collectively. Like so much else, they are dynamic and interdependent.

A. <u>MONOPOLY CONTROL</u>.[18]

One of the primary foundations for state economic regulation was the presence of monopoly power over the offer of essential services.[19] In the terms of the times, regulation was undertaken for the "business affected with a public interest." Some of these were monopolies, and were regulated as such. The railroads and the grain elevators in the 1800s are examples, as are the electric and natural gas companies of more recent years. Under this theory of regulation, the law was necessary to stand between the provider of services and the abuse that unfettered monopoly power might portend.[20]

(1940).

[18] For purposes of this paper, no distinction is made between "monopoly" and "oligopoly" power.

[19] See, generally, Wyman, "The Law of the Public Callings as a Solution of the Trust Problem (Part I)," 17 <u>Harvard Law Review</u> 156 (1904); see also, Wyman, "The Law of the Public Callings as a Solution of the Trust Problem (Part II)," 17 <u>Harvard Law Review</u> 217 (1904).

[20] This theory is generally advanced to explain the rise of the "public utility" and "common carrier." For these special industries, the law has imposed special duties. These duties include the obligation to provide reasonably adequate service to all who apply for it; to provide that service at just and reasonable rates; and to provide that service in a non-discriminatory fashion. However, the "public utility," with its special obligations, and the "business affected with a public interest," with its public regulation, are two distinctly different business entities.

Clearly, however, the lack of competition alone is not now and never has been the <u>sole</u> determinant of whether public control was to be exerted over a business. Neither is the monopoly control of an essential service necessarily sufficient, standing alone, to justify regulation. The monopoly provider of coal, for example, has never been subjected to regulation. Nor would a community's sole physician be subject to regulation because of her monopoly status.

The courts have recognized that regulation <u>may</u> turn on monopoly control of an essential good but generally has "something more" involved. In <u>German Alliance Insurance Company v. Lewis</u>,[21] for example, the U.S. Supreme Court relied simply on the facts that fire insurance was an important industry and that many people were affected to justify regulation.[22] So, too, in both <u>Budd v. New York</u>[23] and <u>Brass v. North Dakota</u>[24] did the U.S. Supreme Court expressly hold that monopoly control, unto itself, was neither necessary nor sufficient to justify the public control of business. Not even in <u>Munn v. Illinois</u>, the case in which economic regulation in the United States was first judicially approved, did the Supreme Court specially predicate the power to regulate on the existence of a monopoly by the affected industry. Indeed, the Supreme Court held in words still applicable today that it was the public nature, and not the monopolistic character, of the grain industry that justified its

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[21] 233 U.S. 389 (1914).

[22] 233 U.S. at 430.

[23] 143 U.S. 517 (1891).

[24] 153 U.S. 391 (1894).

regulation at that time.[25]

Monopoly control of essential services is a factor to consider in deciding whether or not to regulate an industry. It <u>may</u> be sufficient by itself to impose regulatory economic constraints. Nevertheless, monopoly control does not serve as the basis for <u>all</u> regulation.

B. PUBLIC PERQUISITES.

The grant of special privileges to a private corporation yields corresponding public obligations.[26] Among those public obligations is submission to economic regulation in the public interest. This regulation might involve controls over price setting and disclosure, service quality, and long-term planning.

A corporation or industry that has been granted the right of eminent domain is the best example of an industry that is accordingly subject to public control. Private land, of course, cannot involuntarily be taken for private use. By definition, therefore, the exercise of the power of eminent domain must be for a "public use." The public thus has a right to ensure that property so taken, or the industry so supported, is not operated strictly for private gain, with "the

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[25] For a superb critique of the "monopoly theory," see Rottschaefer, "The Field of Governmental Price Control," 35 Yale Law Journal 438, 451 - 566 (1926).

[26] See, generally, Hall, The Concept of a Business Affect with a Public Interest (1940).

public good" flowing only as an incident therefrom. The industry, in other words, having been granted a right that can only be exercised for the public use must subject itself to supervision in enforcement of that responsibility.

Moreover, if an industry is granted the right to acquire property over the objection of the current title holder, that grant is a delegation of the power of the state itself; only the state may take private property.\27\ Being the delegee of the power of the state, an industry carrier with it certain responsibilities as well. For example, just as the state may not deny the use of streets, the availability of fire and police protection, and the offer of public education on ability to pay, a corporation, whose existence and prosperity depends in large part on the private exercise of the power of the state, may not deny its service based on inability to pay. The delegation of some aspect of the power of the state, itself, carries with it the obligation of regulatory oversight to ensure that the power of the government is wielded for the entire public and not merely some small fraction of the public.

Other public perquisites have been held, also, to justify public oversight. The grant of certain tax benefits, the grant of antitrust immunities, and the grant of public funds are public amenities which have been found to constitute a sufficient basis upon which to conclude that the benefitted company has "a public duty to discharge" and "owes a duty to the community" enforceable by

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\27\Other powers that carry similar restrictions include the right to obtain credit secured by a pledge of the general taxing power of the state.

public oversight and regulation.

C. <u>PUBLIC HARM</u>.

The sheer magnitude of public harm should particular industries <u>not</u> be subject to governmental control has served as the basis for public regulation.[28] Certain industries are seen to hold a "special relationship" to the public. Because of their "unique public position," should abuses arise in these industries, the public would suffer disproportionate harm. The proposition is stated differently at different times. Tugwell stated as early as 1922:

"there might conceivably be a clear monopoly in the business of supplying the public with watch cases for instance but that business might not be regulated because it was not sufficiently important to the public interest."[29]

The U.S. Supreme Court stated it like this:

"In some degree the public interest is concerned in every transaction between men, the sum of the transactions constituting the activities of life. But there is something more special than this, something of more definite consequence which makes the public interest that justifies regulatory legislation."[30]

The "something more" was found to be the power and opportunity for an

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[28] See, generally, Tugwell, <u>The Economic Basis of Public Interest</u> (1922).

[29] Tugwell, supra, at 65.

[30] <u>German Alliance Insurance Co. v. Lewis</u>, 233 U.S. 389 (1914).

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industry to engage in "imposition and oppression."

Unquestionably, government not only may, but must, regulate to protect the public's health, safety and comfort. In addition, if an industry is such that the public can be subjected to economic imposition and oppression, that industry is subject to public control through economic regulation. Under this approach, the opportunity and ability of the industry may arise because of the number of people affected, because of the magnitude of the payments made by the public to the industry, because of the high proportion of individual household income devoted to paying the industry, because of the life-sustaining necessity of the industry, or because of some similar factor. These factors, however, are evidentiary. They reveal the conditions which justify regulation; they are not the justification themselves. The justification is the "imposition and oppression" that cannot be stopped without public regulation.

The provision of banking and financial services, insurance, energy, water and communications all are among these industries with a special relationship to the public.[31] A number of characteristics mark these industries. First, they often involve household necessities with few close substitutes. Their loss can destroy a life in all of its social, economic and physical well-being senses. Second, they are often extremely complex, either

[31] At times and in places, housing, too, has been considered such a public necessity. In Florida, for example, mobile home parks are extensively regulated as discussed in detail below.

in the nature of the product or in the nature of the pricing. Third, because they are often public necessities, the interruption or abuse of which would cause substantial public disruption, society cannot afford to allow them to fail, to be mismanaged, or to be marked by consumer abuses.

D. SUMMARY.

Each basis for regulation discussed above offers assistance to a determination of whether to regulate or deregulate the interexchange telecommunications industry. The monopoly theory, while incomplete, offers the "clear choice." If workable competition does not exist in the interexchange industry, regulation must follow. The remaining two theories require a more extended analysis. Nevertheless, in each instance, continued regulation is called for even though a workably competitive industry may exist.

The theory of public harm seems best suited to an evaluation of the interexchange industry. It does not focus the sole attention of policymakers on the business. Rather, it considers also the social setting of the business, its market, and the spread of the consequences of non-regulation.[32] It considers the extent of the consumer's disadvantage should the postulated abuses from non-regulation actually arise. These factors should be given considerable weight in a deregulation debate.

[32] See, Tugwell, supra, at 70.

PART II: GOALS OF REGULATION.

Regulation of American industry has historically served numerous goals: economic, social and political. No single set of goals is common to every industry. However, some commonalities can be identified. They are, if not overlapping, nevertheless interdependent and mutually supportive. Common goals include oversight over rates and charges, over the provision of service, over external impacts, over long-term planning and over the stability of the industry among others. In each instance, it is important to bear in mind the reasons which gave rise to public control in the first place. The fact that there might be a monopoly provision of service, the fact that there are underlying publicly-provided perquisites, the fact that the service is of essential public importance, individually or collectively, all give additional meaning to the regulatory goals discussed below.

A compendium of regulatory goals is presented below. These "goals" (or objectives or purposes) have been compiled from an examination of 150 years of economic, legal, political and public policy literature. The list is not intended to be comprehensive. No list could be. The list <u>is</u> intended to provide a relatively complete overview of the <u>types</u> of objectives which economic regulation is designed to pursue.

In reviewing any list such as presented below, it is important to bear in mind several things. First, the reasons for public regulation might change or disappear over time. Accordingly, there must be a constant reevaluation of regulation. Some industries might newly enter the realm of the regulated while others might exit. Second, the goals of regulation may not be entirely consistent one with another. It is up to regulators in any given instance how to weigh those goals and which goals should predominate when conflicts arise. Third, there is no hierarchy of goals. The list presented below, for example, is presented in no order of priority.

A. CONTROL OF PRICES AND EARNINGS.

The most public areas of regulatory control are the areas of prices and earnings. Pricing is one of the primary areas for potential abuse by non-regulated companies. It involves the potential for significant income redistribution as well as the potential for making goods and services unavailable to a large portion of the population. The goals of price and earnings controls include:

1. **JUST AND REASONABLE RATES:** Rates must be "just and reasonable" for all consumers. Just and reasonable rates often are found to incorporate three elements.[33] First, service is to be provided at "least-cost." If two alternative means of providing the same service are available, Alternative A which costs $10 and Alternative B which costs $15, the obligation is to provide Alternative A. Second, service is to be provided consistent with earning a reasonable, but only a reasonable, return on equity.

[33] In addition, "just and reasonable" can be said to incorporate the elements of "equity" and "non-discrimination" discussed below.

Investors should be permitted to profit to the extent, but only to the extent, of their exposure to risk. Moreover, no unreasonable profit, either in terms of rate or magnitude, should arise from the control of an essential public service. Third, rates are to presume efficient and economical management. Managerial imprudence, negligence, or outright incompetence, is not to be compensated.

2.<u>NON-DISCRIMINATION</u>: Rates and charges for services are to be provided on an equal basis to all who seek service, pay for it, and comply with the reasonable rules of the service provider. Non-discrimination prohibitions largely arose out of the abuses of the 19th Century, where railroads offered advantages to one shipper over another based solely on favoritism and caprice. The U.S. Supreme Court eventually held that, considering the public support of the railroads in the form of land grants, tax advantages, and the right of eminent domain, and considering the essential nature of the service, the railroads owed an equal duty to the <u>entire</u> public. So, too, have Rural Electric Cooperatives (RECs) been found to have such a duty because of the extensive federal funding devoted to bring electrification to Rural America. Similar duties, based on similar grounds, can be found for other industries subject to public control.

3.<u>EQUITY</u>: Equity is equally important to the goals of "reasonableness" and "non-discrimination." The equity goal flows from three basic sources. First, the importance of the goods and services subject to public control dictates that they be available to all who seek them. Members of the public should not be denied access to essential life services such as energy or water, or to essential economic and social services such as communications and finance, because of an inability to pay. Second, by accepting public benefits, an industry accepts the responsibility to ensure that the goods and services assisted by the public will be made available to the entire public. When a telephone company converts part of a public street to its own use, the conversion must be for the <u>entire</u> public and not merely for that part of the public which is able to pay the privately established rates. Finally, to the extent that the industry is monopoly dominated, by definition, no alternative exists for those households who are priced out of the market. Since the loss of service can be life-threatening, in that situation, the requirement that rates and charges be "equitable" is particularly important.

4.<u>CROSS-SUBSIDIZATION</u>: Outside the context of non-discrimination, the issue of cross-subsidization arises primarily as between regulated and unregulated services provided by the same corporation. Speculative ventures, supported by ratepayer-provided compensation, are not to be condoned. Moreover, customers of a publicly-supported essential service should not be forced to subsidize less essential services in a more competitive market. Unfortunately, when a firm participates in both a competitive market and a non-competitive market, and has substantial common costs, that firm has both the incentive and the opportunity to provide subsidies flowing to support its competitive position. Ratepayers of the monopoly service have no choice but to take service from the monopoly provider. Their only choices are to pay or to do without. Accounting separation is generally insufficient to prevent the industry practices which tend to dump unjustified costs on most customers. As a result, regulation is necessary.

B. <u>REVIEW OF SERVICE QUALITY</u>.

Aside from the regulation of rates and charges, regulators oversee the quality of service as well. The objective is to ensure the maintenance of reasonably adequate service. Adequacy of service concerns issues such as the following:

5.<u>RELIABILITY</u>: When the light-switch is flipped, the lights should go on. When the receiver is picked up, a dial tone should be present. That is the essence of reliable service. Reliability means that service will be available at the time and to the extent that it is reasonably demanded. Regulation of reliability often takes the form of ensuring that investment is adequate to maintain the facilities necessary to meet peak demand and to provide against contingencies.

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6.**<u>RUINOUS COMPETITION</u>:** Ruinous competition occurs in situations where firms compete so aggressively as to threaten their long-term financial stability. Ruinous competition can be prevented by entry regulation, by price regulation, by capital investment regulation, and the like. To pr*20 ruinous competition is to <u>preserve</u> short-term reliability and to <u>foster</u> long-term reliability.

7.**<u>SAFETY AND SOUNDNESS</u>:** Ensuring the safety and soundness of an industry protects the customers of that business from external risks. Concerns over safety and soundness in the banking industry, for example, arise from the involvement of banks in risky endeavors such as insurance and securities. The collapse of the heavily leveraged utility holding company structures of Samuel Insull in the early 20th Century gave rise to efforts to protect the safety and soundness of regulated utilities. The collapse of the savings and loan industry, and the threat to commercial banking due to oil and Third World loans, are of similar moment today. Given the increasingly broad geographic interdependence of even seemingly small "neighborhood" businesses, the preservation of the safety and soundness of communication links is essential.

8.**<u>STABILITY</u>:** There is a need, with some industries, to cushion against the impacts of substantial swings in economic conditions. With industries that have an obligation to serve, in particular, there is a substantial exposure to the vicissitudes of the economy. The obligation to serve generally requires a significant capital investment in facilities. Economic downswings are thus likely to result in a substantial under-utilization of these facilities, jeopardizing the financial viability of the firm. The public thus has an interest in foreseeing and forestalling or cushioning swings which might threaten the stability of the industry.

C. <u>CONTROL OF EXTERNAL IMPACTS</u>.

Regulation is designed in many instances either to obtain or to prevent certain external impacts, either positive or negative. These are impacts that might not be of direct concern to business investors, since the business investor does not pay the cost or receive the benefit. These are impacts that might have no easily quantifiable economic value. They can be of substantial social concern, however. External impacts might include:

9.<u>UNIVERSAL SERVICE</u>: The provision of service to each household is a social goal for essential public services. As a reasonably affluent society, the determination has been made that every household should have services such as housing, telephones, energy, water, banking and insurance. Moreover, there is a value to society as a whole by ensuring universal service. The failure to have insurance\34\ or telephones,\35\ for example,

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\34\Insurance is a product with such external benefits. Because of the adverse effect on remaining consumers if any one consumer fails to purchase insurance, state governments often require both the purchase of insurance and/or the purchase of minimum amounts of insurance. See, J. Hanson, et al., <u>Monitoring Competition: A Means of Regulating the Property and Liability Insurance Business</u>, at 124 - 125 (1974).

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imposes a cost on the public unrelated to the service itself. A competitive firm will not ipso facto seek to ensure universal service.

10. **ENVIRONMENTAL IMPACTS:** Environmental impacts are often public costs that cannot reasonably be expected to be accounted for in the decisionmaking of a competitive firm. To the extent that the clean-up or mitigation of environmental degradation is mandated by statute or regulation, the environmental costs are internalized. To the extent, however, that the environmental costs are not subject to clean-up or mitigation, they cannot or will not be considered in a competitive environment. In addition, aesthetic impacts are often found to have little or no economic value. Regulation is designed to account for, or control, these otherwise ignored environmental impacts.

11. **CUMULATIVE IMPACTS:** The cost to society of any particular industry is not the cost of each firm standing alone. Nor, for that matter, is the societal cost that of each individual firm summed. One goal of regulation is to consider the synergistic and cumulative

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[35] For example, in a 1988 study of winter-heating disconnections in Maine, the National Consumer Law Center found that 70 percent of the households for whom a winter disconnection was sought, and 80 percent of the households for whom a winter disconnection was granted, lacked telephone service. The Center found that the lack of telephone service directly contributed to the loss of heating during the winter. Households without telephone service, the Center concluded, were less able to respond to their inability-to-pay situations, either by making payment arrangements or by obtaining public assistance. See, National Consumer Law Center, An Evaluation of Low-Income Utility Protections in Maine: Winter Requests for Disconnect Permission, at 16 - 18 (July 1988).

impacts of all firms acting together. One impact of a multi-billion investment, for example, is to reduce available capital for remaining societal needs. One impact of central station generation is to increase reliance on demonstrably fragile transmission and distribution networks. Competition, standing alone, provides no mechanism for considering the social impacts of an industry as a whole. Regulation does.

12.<u>CONCENTRATIONS OF POWER</u>: Concentrations of power, political and economic, have always been inimical to the American conscience. Based on this philosophy, for example, there has been a mandatory separation of banking and commerce. The federal Public Utility Holding Company Act (PUHCA) served the same purpose for that industry. Arising from the trust challenges in the late 19th Century, American policy has sought to discourage, inhibit or outright proscribe the ability of single corporations or individuals to wield excessive control over essential public facilities. Regulatory policy dictates that control of financial and energy resources, or communication facilities, should be diversified.

D. <u>SYSTEM IMPROVEMENTS</u>.

Regulation often serves to bring about necessary improvements in the <u>process</u> of decisionmaking. The underlying philosophy is that if the process is made better, the results of the process are made better as well. These process-oriented goals often have little to do with economic issues, but relate instead to social and political mores.

13. <u>CONSUMER INPUT</u>: One goal of regulation is to help democratize the decisionmaking process regarding the provision of essential public services and regarding the allocation of substantial public resources. The need for public participation has become even greater as the stakes in this decisionmaking have increased: the offer of services to entire segments of the population; the commitment of billions of dollars to one economic endeavor rather than another. The decisions made by the interexchange industry affect all of society, including all of its diverse constituent parts. Consumers <u>qua</u> consumers, environmental interests, poverty interests, business interests, low-income housing interests. The board of directors of a private corporation has neither the incentive nor the ability to consider these diverse interests. For the various interests to be represented, a broad spectrum of participation is necessary. That participation can occur through the regulatory process. Whether "economic efficiency" should be sacrificed to some extent (or to what extent) in order to provide high quality rural telephone service in the Florida panhandle is <u>not</u> best left to middle class white executives sitting in New York or Atlanta.

Regulation allows for the type of public participation dictated by the magnitude of the decisions made today by national and multinational corporations whose single group of directors make policy affecting entire populations.

14.<u>LONG-TERM PLANNING</u>: Given the obligation to serve, and the capital intensity of most industries subject to this obligation, it is often not possible for appropriate long-term planning to occur within a competitive context. Taking fixed capital investment as "a given," prices are often set at any level above short-run marginal costs. While this obtains some contribution toward fixed system costs in the short-run, it does not permit for the long-term financial viability of the firm. This has been the plague of the airline industry in recent years. Moreover, given investor expectations for short-run profits, long-term planning is generally subordinated to meeting these short-run expectations. In such circumstances, consistent with the need to provide reasonably adequate service, ensure reliability, and prevent threats to safety and soundness, public oversight of planning is implemented.

15.<u>SOCIALIZED COST OF REGULATION</u>: The elimination of governmental control of business does not necessarily eliminate "regulation." It instead may merely substitute private regulation for public. For a competitive industry, for example, if the market is expected to provide price discipline, each individual consumer must seek out price information. If there is no public control of unfair or discriminatory practices, individual enforcement actions must substitute for the public control.

There is, however, a cost to the private control of business. There is a search cost to individual consumers for discovering price information. There is a cost, as well, for each action challenging discrimination. Clearly, also, there is a "cost" in lost consumer welfare when individuals do <u>not</u> engage in private regulation.

The public control of business often simply recognizes these private costs of regulation. It recognizes that the cost of regulation is often too great --if not in absolute terms, in terms relative to the benefits to be obtained-- for any given individual for private action to occur. This prevents <u>any</u> regulation even though in the aggregate the societal cost of the lack of oversight is substantial. The public control of business, therefore, is designed to socialize the costs of regulation to attain the substantial public good.

16.<u>FUNDAMENTALLY FAIR PROCEDURES</u>: Providing that the actions of private companies comply with fundamentally fair procedures in the denial or termination of service is one objective of public regulation. This regulation imputes to private corporations those processes which, if action is taken by the government, would be required by Constitutional Due Process principles. Providing adequate and timely notice prior to the denial of service, ensuring an opportunity to contest a denial of service as unjustified, and requiring a rational nexus between the reason for denial and the service itself are all examples of these "fair" procedures. The need for such procedures lies in the political mores of "fair dealing" in this country and not in any notion of economic efficiency.

17. **<u>CONSUMER PROTECTIONS</u>:** Public protections against unfair and abusive practices is one example of regulation undertaken in a competitive industry. Ensuring that consumers can gain access to check deposits in a timely fashion, prohibiting the denial of services for nonpayment of a bill owed by a third party, and ensuring that mobile home park owners or operators do not unreasonably tie the sale of fuel oil to the rental of mobile park space, and the like, are all examples of protections against potential consumer abuses. Moreover, regulation can seek to provide added protections to ensure consumers an ability to maintain essential services. Mandating deferred payment agreements for arrears and minimum notice to tenants prior to the conversion of rental property or mobile

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home park space to other land uses are examples of this type of consumer protection.

E. SPECIAL PROTECTIONS.

Regulation often stands as a barrier between an industry and the oppression of particularly vulnerable customer classes. The vulnerability of the class may arise because of attributes of the customers, because of attributes of the industry, or because of market failures.

18.RESIDUAL MARKETS: Residual markets are those markets for which little or no effective competition exists. In these markets, consumers are "rationed": their demand for services exceeds the supply available to them. In such circumstances, it is not possible for their market sector to control or "regulate" the supplier. Consumers take what is available.

In the telecommunications industry, for example, the residual market is the rural residential market. In the insurance industry, the residual market encompasses the high risk households or drivers. In the banking industry, the residual market involves those households with few assets and fewer dollars of income. These markets need public protection. Even if competition exists, the members of the public may have neither the resources nor the ability to make competition work. More often, however, the markets are such that no sellers are engaged in active rivalry

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for the business of these households. Accordingly, the abuses which such power portends is controlled only by public regulation.

F. SUMMARY.

The objectives of public regulation of business incorporate both economic and non-economic factors. The oversight of prices and earnings is but one function of a regulatory agency. Ensuring the adequacy of service, controlling the presence and magnitude of external impacts, providing for procedural improvements, and protecting special customer classes all fall within the purview of state regulatory agencies as well.

Some, but not all, of the objectives of state regulation are "economic" in nature. Accordingly, some, but not all, of these objectives might be addressed (or even considered "relevant") by a competitive market. Even those objectives deemed "relevant," however, will not necessarily be achieved through the process of workable competition. Non-economic objectives not only <u>will</u> not be achieved, but <u>can</u> not be achieved through the operation of competition. In these instances, regulation is necessary, competition or not.

PART III: FACTORS WHICH INTERFERE.

If competition were sufficient to attain each of the goals of regulation, there would be no need for the public control of business. There are, however, innumerable reasons why competition not only <u>will</u> not, but <u>can</u> not substitute for regulation in the pursuit of these goals.

Monopoly control of an industry will create a need for public control of business. However, whether or not the interexchange telecommunications industry should be regulated does not depend exclusively on whether the industry is "workably competitive." An industry may be workably competitive but nevertheless still be necessarily subject to public control for the public good. The factors beyond monopoly which counsel for continued regulation notwithstanding the presence of competition include:

1.<u>NON-ECONOMIC VALUES</u>: Regulation is often designed to accomplish goals that are economically irrelevant. The pursuit of universal telephone service is one such example. Others might include the protection of particular customer classes; the provision of designated "fundamentally fair" procedures; and the allocation of total societal resources.[36] Whatever the extent of workable competition, a competitive system simply cannot account for these non-economic factors.

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[36] If one accepts, for example, that there is a limited supply of investment capital, society might wish some voice in deciding whether that capital is devoted to housing or to the technology needed to permit a called party to identify the number of a calling party before answering the phone.

2.**<u>ECONOMICALLY IRRELEVANT DECISIONS</u>:** Some decisions, though economic in nature, have no basis in economics for providing a rationale for decisionmaking. The allocation of common costs in a multi-product firm is an excellent example of such a situation. Because of the lack of any basis in economics for decisionmaking, the presence or absence of competition will not dictate the "best" or "most efficient" result. Accordingly, decisions are instead made based upon the social or political objectives of the decisionmaker. In such circumstances, government regulation stands as a surrogate for the public to ensure that the public interest will be protected and promoted.

3.**<u>MARKET FAILURES</u>:** Frequently, a market that otherwise fits a workably competitive model will suffer from market failures that prevent consumers from obtaining the benefits of that competition. Banking, insurance and telecommunications, for example, all suffer from information deficiencies that prevent consumers from attaining the goals sought from the operation of workable competition. Product differentiation, high consumer hurdle rates, interlocking corporate directorships and similar factors all also call for the imposition of public controls.

Moreover, some products and services, even though they have economic value, are needed by households that have insufficient funds to make the potential economically justified purchases. Housing, energy

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efficiency improvements and universal telephone service are examples of this type of market failure.

If market failures exist that prevent consumers from obtaining the benefits of workable competition, public control must step in with regulation to overcome or compensate for those failures.

4. **<u>ESSENTIAL NATURE OF SERVICES</u>:** The essential nature of some services, standing alone, is one factor that interferes with competition serving to protect consumers. When consumers perceive a service to be "essential,"[37] the demand for the service is more inelastic. Accordingly, price changes will result in little consumer reaction; no market discipline will occur. The fundamental premise of deregulation is that consumer reactions to price increases will serve to keep prices down. If a firm unreasonably raises its prices, in theory, consumers will simply move to a lesser cost firm. To the extent that consumer demand is price inelastic because of the necessity of the service, however, no such movement will occur.

5. **<u>INABILITY OF CONSUMERS TO PROTECT THEMSELVES</u>:** It matters not whether an industry's structure is conducive to competition if barriers exist to having consumers take advantage of that competitive market structure. The lack of information, the

[37] Frequently, the "necessity" is created through marketing.

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inability to obtain information, or the inability to assimilate information, is one way in which consumers are unable to protect themselves. Consider the impact of such an inability in the consumer credit area. Before federal Truth-in-Lending legislation, consumers were expected to comparison shop for interest rates on loans. However, borrowing $500 at 10 percent for two years can in fact be more expensive than borrowing $500 at 15 percent for two years, if the 10 percent is calculated by the add-on method and the 15 percent is calculated by the actuarial method. And the same loan at 20 percent calculated by the actuarial method is cheaper than if it were 10 percent discount. The inability to obtain, understand or assimilate information is a significant barrier to allowing consumers to protect themselves.

Lack of information, however, is not the sole barrier to self-protection in the marketplace. Market rationing, the lack of cash, and disparities in bargaining power, for example, all often lead to oppression. High prices in inner-city markets, oppressive "rent-to-own" terms, and high credit costs for loans from "finance companies" are examples of the results of such barriers.

6. COST: Economic theory assumes that transaction costs in obtaining and assimilating information in the competitive market is costless, that obtaining information happens instantaneously and effortlessly. Obviously, however, that is not the case. In many instances, even where information is available when sought, the cost of

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obtaining that information is considerable. For any given individual, therefore, the effort involved with seeking understandable and useable information is not justified by the benefits which that individual will obtain by having it. This result prevents information from being discovered, or developed, even if the cost of distributing the information beyond the original party is little or nothing.

7. **<u>PUBLIC vs. PRIVATE CONSIDERATIONS</u>:** Public and private agendas will not necessarily coincide even with the presence of a workably competitive environment. The goal of buyers in such a market is to maximize their own satisfaction; similarly, the goal of a firm is to maximize earnings. Societal goals will be coterminous with private goals only through sheer coincidence. Regulation provides a mechanism to reconcile societal political, economic and social objectives with the private economic objectives of a competitive industry.

FINDINGS

1.<u>ROLE OF COMPETITION</u>: The presence of absence of competition is not determinative of whether an industry should be regulated or unregulated. Some industries that are subject to workable competition are nevertheless subject to regulation by the state.

2.<u>BASIS FOR REGULATION</u>: Any one of a number of factors can justify the imposition of state economic regulation. These factors may be present in isolation or in tandem. If there is monopolistic or oligopolistic control of an industry, public regulation may be justified. If the industry is (or has been) supported by the grant of governmental powers or public perquisites, regulation may be in order. If an industry has the opportunity to impose significant public harm or oppression, regulation can be justified. Any one of these factors, when coupled with the provision of essential public services, is made more compelling.

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3. **OBJECTIVES OF REGULATION:** The pubic control of business has both economic and non-economic objectives. The control of prices and earnings is but one aspect of public regulation. Ensuring the adequacy of service, controlling the presence and magnitude of external impacts, providing for procedural improvements, protecting special customer classes, and providing consumer protections, all fall within the purview of state regulatory agencies.

4. **OBJECTIVES OF FIRMS IN A COMPETITIVE MARKET:** Some, but not all, of the objectives of regulation will be addressed (or even considered "relevant") by a competitive market. Even those objectives deemed "relevant," however, will not necessarily be achieved through the process of workable competition. Non-economic objectives not only will not be achieved, but cannot be achieved through the operation of competition.

5. **FACTORS THAT INTERFERE WITH ATTAINING REGULATORY OBJECTIVES:** A competitive market may not seek to effectuate certain regulatory objectives for any number of reasons. Market failures may prevent the operation of the market to pursue economic goals such as fair and non-discriminatory prices. Some goals involve factors that are external to the industry, with the costs not being paid, and the benefits not being realized, by investors but by society as a whole. Some goals are non-economic in nature. Some social goals may be in direct conflict with the narrower profit-seeking goals of the industry. In short, a private economic system cannot be expected to account for, let alone achieve, each of these objectives.

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RECOMMENDATIONS

In deciding whether to regulate or deregulate an industry such as the interexchange telecommunications market, the Florida legislature should consider more than claims that the competitive market will keep prices reasonable and the allocation of resources "efficient." The Florida legislature should undertake a two-step process of analysis in considering its decision on whether to regulate or deregulate:

First, the legislature should determine if workable competition exists. If workable competition does not exist in today's interexchange markets, the inquiry goes no further. Regulation is necessary.

Second, if competition does exist, it is necessary next to determine whether that competition is of the type and extent to displace social control through the process of government as a means of protecting the public's interest. The objectives of regulation must be considered, as well as those factors that interfere attaining those objectives.

In the event workable competition is found to exist, both steps of the analysis must be completed. Whether or not the interexchange telecommunications industry should be regulated does not depend on whether the industry is "workably competitive." An industry may be workably

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competitive but nevertheless still be necessarily subject to public control for the public good.

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