Research Report

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Principles For Texas Communications Law

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With A Forward By
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The Progress & Freedom Foundation is a market-oriented think tank that studies the digital revolution and its implications for public policy. Its mission is to educate policymakers, opinion leaders and the public about issues associated with technological change, based on a philosophy of limited government, free markets and civil liberties. PFF disseminates the results of its work through books, studies, seminars, conferences and electronic media of all forms. Established in 1993, it is a private, non-profit, non-partisan organization supported by tax-deductible donations from corporations, foundations and individuals.

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ABOUT THE TEXAS PUBLIC POLICY FOUNDATION

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The Foundation's mission is to improve Texas government by generating academically sound research and data on state issues, and by recommending the findings to opinion leaders, policymakers, the media and general public. The work of the Foundation is conducted by academics across Texas and the nation, and is funded by hundreds of individuals, foundations and corporations.

FORWARD

Any discussion of modern telecommunications policy finds its orbit around the 1996 Telecommunications Act. Ever since President Clinton signed it into law on February 8, 1996, titanic industry sectors have clashed. Promising new technologies have been invented and adopted. Fierce advertising battles have ensued. Fiercer still are the ongoing litigious lobbying efforts by all manner of firms engaged in the digital marketplace.

Amid all of the fury, rational discussions maintain their place at the table. This year promises to be a major year for telecommunications policy in Texas. But before we look ahead, first a few words by way of background.

In advance of the federal 1996 act, Texas had a head start on telecommunications reform by adopting major amendments to the Public Utility Regulatory Act (PURA) in 1995. Texas lawmakers anticipated the major elements of the federal act: interconnection, competitive local exchange (local calling) markets and universal service. In 1999, the legislature added price flexibility to the telecommunications tableau.

These principle issues remain with us today and are as thorny as ever. Policymakers must answer hard questions. Under what rules should telecommunications companies connect their networks? At what price should various services be offered to other firms or to consumers? How should Texas laws ensure that low-income consumers can afford telecommunications services?

The Progress & Freedom Foundation brought these questions to the fore in late 2003 with the following paper. Their research and analysis could not be more timely. Early this month a federal court in Washington D.C. vacated or remanded substantial portions of federal telecommunications regulation. A central question addressed by the court was about the role of state utility commissions in the transition to competition. Until the Federal Communications Commission adopts final rules that withstand judicial scrutiny, the role of state commissions in telecommunications policy remains a work in progress. As a result, thoughtful state statutes are more valuable now than ever.

Fortunately, the 79th Texas Legislature will review and reform PURA next year. As a matter of course, the laws administered by the Public Utility Commission are part of the discussion about PURA. To no surprise, the initial hearing of the year by the House Committee on Regulated Industries will address telecommunications law and the state of Texas' marketplace. At the Texas Public Policy Foundation, we are proud to bring market-oriented research to bear on such an important set of issues. The authors of this paper call for reasonable economic principles – like market contestability and property rights – to inform our statutes. We could not agree more.

Brooke Rollins, President
Texas Public Policy Foundation
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Introduction

Since passage of the Telecommunications Act of 1996 (Act), state communications law - and state utility regulation - have been subordinated to the implementation of federal law. State commissions have spent a great deal of time implementing the interconnection, unbundling and wholesale pricing mandates dictated by the Federal Communications Commission (FCC). While the federal Act has overshadowed state utility laws, the pervasive legacy of retail regulation under state law has affected tremendously the development of a competitive local communications marketplace.

State law is then crucial to the development of a competitive, consumer-beneficent communications marketplace. Yet, it has largely remained untouched since passage of the federal Act. In its aims, state law reflects the legacy purposes of regulation: to protect, and then control a franchised monopoly carrier through pervasive oversight of the rates, terms and service packages that are offered. While this legal legacy served its purpose, its remnants now often impede the current aim of communications law: to transition from a regulated monopoly to an open, competitive environment.

This paper examines the original regulatory premises embodied in state communications laws, and compares them to the current policy aspiration for a robust marketplace. From there, we identify what parts of the legacy regulatory mandate should remain - which might not frustrate the transition to competition - and what new principles might need to be introduced to promote consumer-welfare enhancing competition. We endeavor, then, to present the going-forward principles that should be embodied in state communications law.[1]

The Difficulty of Moving from Monopoly to Competition

Regulators do not have an easy task.[2] Experience with regulation suggests that regulatory decisions reflect three major considerations. The first involves the application of regulatory law and economics – i.e., the application of basic economic principles to legislative or judicial pronouncements in an attempt to maximize consumer welfare. The second is innovation – which Joseph Schumpeter has famously characterized as a “process of creative destruction” – and a factor that is applying with full force in the current telecommunications marketplace.[3] The third is public choice theory, broadly defined as the intersection of economics with political science.[4]

In devising principles for state communications law, each of these factors must be kept in mind. In the abstract, pure economic principles aimed at promoting consumer welfare and preserving economic dynamism is the ideal. A perfect regulator can cure the problems of an imperfect market. But regulators are not perfect and regulatory institutions face particular sets of incentives and pressures. In many cases, the prudent conclusion should be that an imperfect market is better than the imperfect regulator, who is often prone to long-lived and unanticipated errors.[5]

A glance at the history of state communications regulation counsels legislators to pay attention to the public choice hazards of regulation, above all else. In action, state regulators were unable to correct monopoly pricing,[6] and have often failed to promote consumer welfare, instead opting to favor given companies or constituencies.[7]

For instance, the non-cost-based and arbitrary suppression of rates in the local telephone market continues unabated, in large part, to this day. Acting in concert with archaic intrastate access charges and universal service subsidies, both local and long-distance carriers experience perverse market distortions, resulting in a social welfare loss. At the same time, asymmetrical regulation between different platforms such as wireline and wireless services creates arbitrage opportunities and further distorts the market. The residual impact on investment is eye-popping.[8] The decline in capital expenditures between 2001 and 2002 was $17.5 billion dollars for the Regional Bell Operating Companies, and competitors such as AT&T suffered a decline from $5.8 billion to $3.86 billion over the same time period.[9]

When new technologies arrive on the scene, such as Voice over Internet Protocol (VoIP), the regulatory response thus far has not been a forced reevaluation of existing rules, but has tended towards a reflexive query into "how do we regulate this thing?"[10] The "temptation of the kleptocrats," a phrase coined by noted-economist Alfred E. Kahn, describes the inclination of regulators to create "consumer benefits" through a welfare shift at the expense of shareholders and, ultimately, consumers.[11] This enticement has become a reality. Nevertheless, there is an opportunity to reorient state communications law toward a modest, cabined role that aids consumer welfare.

An Opportunity with Sunset

The Sunset Review process proceeding in Texas to determine the future authority of its Public Utility Commission (PUC) allows reconsideration of several fundamental questions, including: What should the Texas PUC look like? What should it (and should it not) do? What are the social costs of maintaining the current regulatory regime? And do these costs exceed the social benefits of the regulations?

Even if it has been well-intentioned, the onus of proving that true deregulation will succeed has thus far been placed on industry participants. It is no small feat to attempt to prove that a market that does not yet exist will operate in practice. Thus, a return to the lessons of regulatory law and economics, with proper regard for the pace of technological innovation, will assist in framing the proper solution.

The Texas PUC has recommended that a comprehensive approach be taken to telecommunications restructuring for the Sunset review in 2005.[12] This paper intends to serve as a starting point in tackling that challenge, and proceeds upon the following premises:

- To ensure a level playing field, deregulation means that the telecommunications sector should *ultimately* be subject to generally applicable laws. Drafted properly, generally applicable laws have two distinct advantages over heavy administrative oversight. First, they are less capricious and unpredictable. Second, they are less susceptible to industry capture.

- Unfettered agency discretion should be removed from the decisionmaking process. Delegating discretion to state commissions to regulate or deregulate under "the public interest"[13] or otherwise open-ended mandates speaks to the desirability of legislating rules over standards in competitive industries.[14]

With regard to the latter, Judge Easterbrook's observations about the impact of broad standards on judicial decisionmaking applies with equal force to the current regulatory environment in telecommunications:

> When everything is relevant, nothing is dispositive. Any one factor might or might not outweigh another, or all of the others, in the factfinder's contemplation. The formulation offers no help to businesses planning their conduct . . . The higher the stakes, the more firms are willing to spend on discovery and litigation.[15]

On the other hand, concrete, durable rules are more attractive because they allow for certainty – in short, "[s]trong presumptions would guide businesses in planning their affairs."[16]

Thus, after discussing the rationale for regulation in the abstract, this paper proposes a set of regulatory principles that would apply to the Texas PUC through new legislation. The principles are necessarily voluminous but can be summarized as follows:

- *The telecommunications market in Texas is increasingly contestable on a statewide basis, emerging-competitive in other areas and fully-competitive in given areas. As such, retail rate deregulation is mandatory, with the exception of a "safe harbor" basic service package.*

- *The end to distorted retail rates will allow for traditional cross-subsidy mechanisms, such as intrastate access, to be based upon cost.*

- *Rules that applied in the old, regulated monopoly environment, such as tariffing requirements or quality of service regulations, should be eliminated.*

- *State Universal Service Fund (USF) distributions and Provider of Last Resort (POLR) obligations should be targeted to high-cost areas through market-based mechanisms such as reverse auctions, whenever and wherever possible.*

- *Remaining regulations should be technologically neutral in order to create equal incentives for all market participants.*

One further point about methodology is warranted. The purpose of this paper is not to critique the federal regulatory regime, but assumes that it will continue to exist in its current form, more or less.[17]

Why Regulate?

As a general matter, the current administrative model has its foundation in two rationales. Both are crumbling. The first rationale is the traditional argument that certain telecommunications market segments – and, in particular, the local loop – are a natural monopoly. Without vigilant oversight, according to this line of reasoning, the monopolist could raise prices and sacrifice service quality to the detriment of consumers.

The natural monopoly rationale for regulation has been undermined by the passage of the Act and marketplace developments.[18] Nevertheless, natural monopoly regulatory mechanisms of the past continue to endure today. For instance, the historical under-pricing of the basic residential service – i.e., artificial, below-cost ceilings on the rates charged to consumers for local service – was intended as a check against monopoly abuse.[19] Basic local service rates in Texas have been capped for some incumbent local exchange carriers (ILECs) through legislation and regulation for the purpose of maintaining "affordable" basic phone service.[20] The Texas Public Utility Regulatory Act (PURA) does permit ILECs to "elect" into a deregulated rate structure and increased pricing flexibility, but that status is granted only in exchange for infrastructure investments such as digital switching, and rates for basic services are capped (with several possible exceptions) until September 2005.[21]

Pervasive tariff requirements are another example of superfluous regulation. In Texas, local exchange and interexchange companies are required to offer their services through tariff filings, and competitive carriers must list their rates in registration statements.[22] When "dominant" ILECs make promotional offerings of regulated services, those are subject to time limitations and filing requirements.[23] Transparency, once the purported benefit of tariff filings, now provides competitors with price signals, and opens the door to collusion, gaming and delay.[24] Tariffing can also deter carriers from moving to the market with new service offerings or promotions.

The "natural monopoly" basis for administrative oversight has evolved into a second rationale over time. As the dynamic "process of creative destruction" takes place, regulators are now focused on managing the transition from regulated monopoly to largely unregulated competition.[25] At the state level, there are practical reasons why this approach is increasingly unwarranted. For example, the growing delocalization of communication networks transcends state boundaries.[26] Control and intelligence in networks are becoming increasingly distributed and any attempt to regulate under traditional notions of state jurisdiction will create spillover costs for consumers in other states. This eventuality speaks to, as a general matter, regulatory senescence by the states.[27] This is not a novel concept in telecommunications, as the move towards competition has been a story of federal preemption.[28] Nor is it a historical accident that broad-based deregulation in the trucking and airline industries occurred at the federal level.

Regulating for Consumer Welfare

In the final analysis, states should not regulate for some lofty end-result such as "competition" or "regulation." Instead, they should regulate (or not regulate) with the sole aim of promoting consumer welfare. In economic terms, consumer welfare is enhanced when the sum of consumer surplus (the amount above a price paid that a consumer would be willing to spend) and producer surplus (the amount that firms receive for the service they sell above the amount it costs them to produce that service) are maximized. Regulation under this standard attempts to dictate to producers what they should produce, how they should produce it and at what prices they should charge.[29] Applied to communications services, this also means that consumers should pay for what they actually use.

The Texas PUC has recently proclaimed that the "regulatory oversight of rates, quality of service, and other customer protections are critical elements to sustain a competitive landscape."[30] However, with appropriate conditions in place, markets perform these functions better than regulators.[31] Furthermore, the regulatory temptation to use invasive regulation to try and foreordain an outcome, or favor one consumer class over another, is avoided by prudent retreat from the regulatory field. Put simply, a number of existing regulatory mechanisms are no longer necessary to promote consumer welfare.

This paper will now turn to the state of competition in Texas to illustrate that appropriate market conditions for further deregulation exist. It will then address those mechanisms that should be eliminated and which should remain in place under a new regulatory regime.

The Telecommunications Market in Texas Is Contestable

This summary includes public data provided by the Texas PUC and the FCC. In December 2002, competitive local exchange carriers (CLECs) were serving 12 percent of the customers in rural areas, 15 percent in suburban areas, and 20 percent in urban areas of Texas.[32] CLEC penetration in residential markets was only slightly below that in business markets, at 14 percent versus 17 percent. CLECs have penetrated the market in virtually all areas of the state.[33] Texas ILECs lost over one million total access lines between December 2000 and December 2002,[34] and CLEC market share continued to increase to 17 percent in December 2002.[35]

Beyond the traditional voice market, there were more than one million broadband subscribers in June 2002, and the broadband growth rate in Texas exceeds the national average.[36] In December 2002, Texas had the most high-speed service providers of any state in the nation.[37] Wireless subscribership in Texas doubled to over nine million customers between 1999 and 2001,[38] and there were nearly ten million subscribers by December 2002.[39] Cable operators such as Comcast and Grande have started to provide phone service in several Texas communities, and Vonage is offering broadband VoIP service in Austin.[40] A number of companies – including SBC, Sage Telecom, MCI, AT&T, Comcast, and Western Wireless – offer flat-rate and/or bundled service packages.[41]

This data helps to illustrate that the telecommunications market in Texas is fully competitive, or at least contestable, in many areas.[42] By way of background, contestability theory measures the ease in which carriers can enter or invade another competitor's market.[43] This includes the potential of entrants to serve as a check against incumbents in a market, even if the incumbent enjoys a high market share and exhibits efficiencies.[44] Contestability theory also measures the supply and demand elasticities of consumers and producers - i.e., the ability of consumers to switch service providers and the ability of those providers to serve the customers who switch - in order to determine whether a firm has "market power." The use of contestability theory is not just a rote exercise in economics. As Alfred Kahn notes, "[t]he deregulation of such industries as the airlines and trucking was rationalized, in very large measure, in terms of what was believed to be the high degree of contestability of their markets."[45]

For consumers, a contestable market means that the prices will gravitate towards a reasonable, competitive level. If a firm – say, for instance, a local wireline phone provider – attempts to raise its prices to supracompetitive levels, the customer may have one or more alternatives including wireless, cable telephony, or voice service through another provider.[46] In Texas, the presence of CLEC access lines, the availability of wireless alternatives, and/or the emergence of cable telephony and VoIP casts doubt upon the presumption of ILEC market power.[47]

As discussed below, this has important implications for the three "pillars" of telecommunications regulation. First, the continued regulation of retail rates is largely unnecessary. Second, as a result of rate deregulation, implicit support flows which traditionally subsidized retail rates through charges on long distance calls, known as intrastate or switched access, can be set on a glide path to cost. Third, intrastate access and retail rate reforms will have a foreseeable impact on the operation of the Texas USF.

Rate Deregulation

In regulatory and political circles, the retail rate structure is akin to that grating relative that comes to Thanksgiving dinner. You know they are in the room, but you try your hardest to ignore them. A widely known secret is: retail rates are not cost-based. It is a secret because the stated premise of regulation is cost-based rates. It is widely known because the disparities in retail rates are too great to ignore.

Maintaining artificially low retail rates for local phone service forces ILECs to price their basic service offering below cost in rural areas and above cost in urban or residential areas. Business rates are likewise inflated to subsidize residential service. Another portion of these losses are offset through intrastate (and interstate) access charges and universal service fund assessments placed on interexchange carriers, creating a disincentive to long-distance usage.[48] And as one additional element of the deal that is struck between regulators and ILECs, the prices on vertical services such as caller ID are allowed to be inflated well above cost. In Texas, pricing flexibility is most often utilized by ILECs to increase the rates on vertical services.[49] Between September 1999 and December 2002, for instance, SBC's price for caller ID name and number has risen 46 percent, to $9.50 per month.[50] Charges for directory assistance over the same time period have grown an astonishing 317 percent, to $1.25 for each use.[51]

The story does not end here. The regulatory inefficiencies spill over to the wholesale side of the market. In order to accelerate the growth of competition, regulators have drastically reduced the rates that CLECs must pay to lease portions of the ILEC network, exacerbating the vicious cycle of below-cost pricing. CLECs, moreover, have no obligation to serve all customers, and in a wholly rational attempt to maximize revenue, they must "cherry pick" the high-margin customers of the ILEC and avoid direct competition in the residential market. At the same time, the assault from cable telephony, wireless, and emerging services such as VoIP continues to intensify. Call it a race to the bottom.

Consumer welfare is not maximized under the current model. Without actual price points for different services, consumers are less inclined to use the services that they might value the most. With the industry floundering, less investment is going into the sector for new services or upgrades of existing service. It is not too cynical to submit that the *only* consumers who win under the current scheme live in rural areas, only want basic local service, have no desire for vertical services, and have no desire to use long-distance.

The regulator's (or legislator's, as the case may be) common aversion to rate deregulation is that retail rates will rise for most consumers – ignoring the possibility that prices for vertical services and long-distance will fall. It also ignores, at least for some consumers, the shift and preference towards bundled service offerings. Finally, the traditional rationale for the continuation of below-cost pricing of basic residential services is rendered meaningless as telephone penetration *is* universal, and demand for phone service can be insensitive to the rates that are charged.[52] In short, "it appears that the vast majority of customers would be able – and willing – to pay for cost-based telephone services."[53]

Data from Wyoming following the passage of the Wyoming Telecommunications Act of 1995, which mandated that rates be grounded on a cost-based formula, supports this proposition. Between 1995 and 2002, residential rates in Qwest's "base area" rose from $14.64 to $23.10.[54] Business rates over the same time period fell from $30.56 to the same rate, $23.10. Notably, telephone subscribership levels between 1997 (the first year following the Wyoming Act in which data was reported) and 2002 *increased* from 92.7 percent to 93.7 percent, a level slightly below the national average of 95.1 percent.[55] The Wyoming commission emphasized that the penetration data does not include customers that have substituted wireline service with wireless service, but implied that once that data is collected they expected an upward revision.[56]

The regulator's next "fear" is a subset of the first: low-income consumers or those in rural areas will no longer be able to afford phone service. Rate deregulation and access reform will eliminate a portion of the subsidies used by the Texas USF. However, there is less reason for concern because the maintenance of the Texas USF and the availability of a default basic service package will serve as a safety valve.

The Safe Harbor Exception

Concededly, political realities will likely dictate that notions of universal, affordable phone service should remain in Texas going-forward. Thus, a "second-best"[57] regulatory regime should include a "safe harbor" for basic telephone service at a tariffed, regulatorily-prescribed rate.[58] This rate should not be extended to consumers who purchase anything beyond basic local telephone service – the basic line charge and prices for those additional offerings would be fully deregulated and detariffed. This approach has been taken, for instance, by the Utah Public Service Commission in a recent decision regarding pricing flexibility for Qwest's business and residential service offerings.[59]

The basic service safe harbor should also be limited to a customer's primary line.[60] Anything beyond the primary line would essentially be a bundled service offering, and the competition for a "second line into the home" (from, for example, wireless carriers) cannot be seriously disputed. Finally, the PUC should be mandated to evaluate the basic service charge under the safe harbor exception on an bi-annual basis, with the burden on the commission to show that it is still necessary to retain the artificially low basic service rate to ensure service subscription levels.[61]

In the end, retail rate deregulation can facilitate further CLEC entry into residential areas and will result in dramatically lower long-distance charges, so long as access rates are adjusted accordingly. A concomitant reduction in access will eliminate the temptation to extend those obligations to other services, such as the Internet. Revenue growth for market participants raises the possibility of reversing the downward trend in capital expenditures, increasing the vitality of the sector and maintaining network quality. Lastly, retail rate deregulation is a real precondition to competition, which is what regulators should be in the business of pursuing.

Intrastate Access

Like other non-cost based leftovers from monopoly regulation, access charges must be addressed and "solved." New technologies like VoIP will ultimately undermine the viability of the access charge regime in any event, so the challenge should be faced foursquare.

Access charges are the fees paid by long-distance carriers (and ultimately their customers) to local carriers for the use of their network in terminating calls. In reality, however, these above-cost charges are used primarily to subsidize local carriers for universal service obligations and as an offset for regulated retail rates.[62] This helps to explain why VoIP – free from regulation and therefore access charge payments - is seen as more than a competitive "threat." Like the retail rate structure, then, the current access charge regime in most states is a survivor of an antiquated regulatory environment. With the divestiture of the Regional Bell Operating Companies from AT&T in 1984, access charges were conceived as a replacement for the preexisting revenue-sharing mechanisms of the monopoly entity.

It is generally accepted that access charges are set well above the cost of providing service.[63] In Texas, SBC's access charges were reduced between 1999 and 2000 from 12 ½ cents per minute to roughly six cents per minute, in part to reduce subsidies for the state USF.[64] This amount stands in stark contrast to the interstate access rate, which currently averages 1 cent per minute.[65] Although the FCC has prescribed a monthly Subscriber Line Charge on consumers, regardless of how much they use long distance service, the Texas PUC admitted that "in-state long-distance calls usually cost more than state-to-state long-distance calls."[66] Moreover, the PUC predicted that this cost disparity "will not likely diminish since interstate switched access charges continue to decline toward cost, while Texas intrastate access charges remain stagnant."[67]

In 2001, the Texas PUC submitted a comprehensive report on access charges to the legislature.[68] The commission found that the current structure could have several negative impacts on consumers – namely, on price and availability.[69] High access charges imposed by local carriers might deter long-distance companies from serving some areas or offering discount packages to consumers.[70] Moreover, the PUC noted that "disproportionately high switched access rates for small local telephone companies and cooperatives contribute to over-earnings of those companies."[71]

Access charge reform must occur in lockstep with rate deregulation. In Wyoming, for instance, intrastate access rates have been reduced on Qwest lines from 9.71 cents to 1.47 cents per minute, a downward adjustment of 85 percent.[72] Recently enacted legislation in Florida allows ILECs to raise residential rates after phased reductions in access charges.[73] In December, the Florida Public Service Commission will hold hearings on petitions filed by Bell South, Verizon and Sprint for local exchange increases of up to 60 percent to offset intrastate access charge reductions of up to 75 percent.[74]

When (not if) intrastate access charges go away, what will replace them, if anything? There are really very few options. Either the foregone access subsidy will be collected in retail rates charged to consumers, or through an expansion of the Universal Service Fund, which, in turn, means that it will be paid by consumers. The elimination of access simply changes who pays, not how much is paid.

Therefore, the decision becomes one of political prudence informed by efficiency. Ideally, for social welfare to be maximized, consumers should pay the cost for what they consume or cause. The optimal social welfare solution, then, is for the access subsidy to now be recovered through deregulated retail rates. The salutary effect of cost-based access is lower prices for intrastate long distance. Indeed, as consumer preferences in the wireless market demonstrate, access elimination may well be accompanied by the disappearance of long distance as a separate market altogether.

The political challenge then becomes how to shield those customers who do not use a lot of access from a welfare loss through a transition of the access subsidy into retail rates. The answer is to target these consumers with an interim subsidy through the universal service fund, but also to gradually wean them from the subsidy over a number of years.

Quality of Service Regulations

The recommended elimination of quality of service standards – rules pertaining to service outages or installation - may seem, at first blush, to be unthinkable. However, along with rate deregulation and access reform, quality of service deregulation must follow. Regulation is what creates the need for quality of service in the first instance, because a "firm forbidden to raise rates or ordered to reduce them may react by reducing the quality of its product or service."[75]

In Texas, PUC rules establish service objectives and performance benchmarks for dominant carriers, who must submit a "corrective action plan" if these standards are not met.[76] Quality of service complaints constituted just 4 percent of all calls received by the commission, far below the number of complaints regarding billing, slamming, or the state's no-call list.

Recently enacted Florida legislation is a better, but not optimal, approach. As an apparent tradeoff for access reform, the legislation allows for deregulation of quality of service standards when ILECs reduce access charges to "parity."[77] The regulations for ILECs will then mirror those that are applied to CLECs unless the commission "determines otherwise." Notably, the statute precludes increased service quality regulation of CLECs from those that were in place before January 1, 2003, but the Florida PSC reported that it *didn't have* service standards in place for CLECs at that time, explaining that it would eliminate unnecessary costs and because wholesale standards imposed on ILECs would flow through to CLEC service.[78]

Save for some underlying public safety standards - such as 9-1-1 service – in a competitive market service quality will gravitate to the level that reflects the aggregate preference of consumers for price and quality. Consumers who value high service quality will pay for it; consumers for whom price predominates will settle for lower quality offerings.[79]

Letting go of quality of service regulation will also encourage nascent technologies – like VoIP and who knows what – to enter the marketplace and seek a foothold. Right now, for instance, VoIP might fall short of state voice quality of service standards. But "pioneer" consumers might want VoIP, and there is no good reason to use regulation to keep it from them.

This leads to a final broad point about quality of service regulation. It can often be used to erect entry barriers and impede new, competitive entry by new services and technologies. Specifically, competitors can lobby to have equivalent (or even minimal) regulations placed on new or competing providers.

Thus, quality of service regulations are another relic of the old monopolized environment and have little place in a competitive, or even contestable, market. Notably, getting rid of quality of service does not mean that there will be no enforcement regime or, as discussed below, a role for the PUC to play; existing consumer fraud protection statutes, service quality standards for public safety networks, and wholesale performance measures between competitors[80] can coalesce as the optimal baseline model. Quality of service, then, can return to being just one of a number of factors in the contract between service providers and their customers.

What Functions Should the PUC Perform?

There are ultimately four rationales that justify regulation: 1) regulation of monopoly, 2) universal service; 3) public safety; and 4) consumer protection. Previous discussion in this paper has focused on the first, core rationale, which has dissipated to a transition role to a competitive marketplace. Nevertheless, the legacy rationale based on protecting and price regulating a monopoly should cease. This leaves universal service policy, public safety and consumer protections as plausible going-forward rationales for regulation. Each will be treated in turn.

The Texas Universal Service Fund

Universal service policy was conceived during the regulated monopoly era. Indeed, a reduction in access rates and a deregulation of retail rates will undoubtedly put pressure on the Texas USF, which is designed to enable all residents in the state to obtain basic telecommunications service. Currently, all telecommunications providers in the state, including wireless, contribute to the fund based on a uniform assessment. The revenue base for three programs in particular – the Texas High Cost Universal Service Plan, the Small and Rural ILEC Universal Service Plan, and Lifeline – would need to be reconsidered with deregulation.[81]

This is not to imply that the total distribution of the Texas USF – which amounted to $613 million in 2001 – should increase or even remain stagnant. Deregulation has the inevitable result of inducing transparency, and once the costs of the USF program are made explicit the public will “insist that its total amount be drastically compressed.”[82]

On the distribution side, USF subsidies should be primarily targeted to low-income consumers. Means-testing should be employed to pinpoint customers in rural areas that are truly in need. Efficiencies could also be enhanced through the use of a reverse auction model in the selection of a designated provider for a given area.

Reverse auctions, the business plan of Priceline.com being one example, are commonly used by government agencies to procure goods and services. One form of a reverse auction model for USF distributions would work like this, although a refined auction design proposal is beyond the scope of this paper. Competitors in a given area would seek to be designated as the universal service recipient by submitting bids that would include the distribution amount that would be necessary from the Texas USF. The lowest bid would win, but other competitors would be eligible for funds if they were also designated by the commission and they would only receive the same amount as the winning bid. In “thin” markets where there are only two competitors vying for designation, the possibility of collusion could be deterred through the establishment of a “reserve price” based upon a comparison of costs to similar areas and a lottery if there is a tie bid. In short, the most efficient firm wins, consumers may continue to choose between competing service providers, and the fund distribution is minimized.

A reverse auction model could also be used with regard to provider of last resort (POLR) obligations. ILECs are currently required to serve high-cost markets at non-compensatory rates. A competitive bidding process is precisely the mechanism that is mandated by the Texas code to be used to determine the POLR in Texas electricity markets.[83]

Public Safety

Obviously, the benefits to consumers of public safety systems such as 911 are immeasurable. Thus, the exception to minimum service quality standards is the continued oversight of public safety networks, and (when necessary) for homeland security. Issues relating to standards for new services such as VoIP should be driven by consumer expectations. However, these minimum standards should not be allowed to bootstrap full-blown quality of service and rate regulation under a public safety rationale. More than anything, consumers deserve to be informed of the public safety capabilities of a given platform. Thus, VoIP-based technologies, which may have limited or even no E-911 capability (particularly PS-ALI), should not be excluded from the Texas market by regulation. Rather, consumers should be able to choose the technology, carrier and communications platform of their choice, so long as they have knowledge of the carrier's public safety capabilities.

Consumer Protection

Eliminating quality of service does not mean that the PUC should not play a residual role in enforcement. Texas law requires the PUC to promulgate rules to establish consumer protection measures and deter fraudulent or anti-competitive conduct through its Customer Protection Division. As data in Texas illustrates, the three largest consumer complaints involve cramming (unauthorized charges on bills), slamming (unauthorized switching of service), billing matters and violations of the state's no-call list.[84] The role of the state commission in this context is best analogized to that of a "mini-Federal Trade Commission," the federal agency charged with policing consumer fraud. This role should remain. Indeed, policing consumer fraud could arguably become more robust if the Commission is freed from performing legacy duties that no longer serve a purpose.

Conclusion

The principles outlined herein rest on two basic foundations: first, competition in communications markets is real, if fitful; and, second, regulatory failure is more likely to occur than market failure. A regulatory code that was written to protect and regulate a monopoly is not suited to a competitive marketplace. Indeed, the breadth and legacy duties required by the current code will suppress competition and inhibit dynamism.

The pace of innovation will require a new regulatory regime that is technologically neutral and creates equal incentives for all players. In Texas, reaching this result will require the most dramatic alteration in the structure of its wireline rules. In the end, consumer welfare can only be enhanced when retail rates are allowed to gravitate towards their true price, with accompanying reductions in intrastate access (and long-distance), vertical service, and business rates.

The Texas PUC should, and will, have an important role to play in all of this. This role, however, should be more confined and nuanced. In the end, commission oversight for the sake of consumer protection, universal service, and public safety is needed to satisfy the social and political needs of a competitive marketplace.

ENDNOTES

[1] This paper is prologue to a more comprehensive Model State Communications Law that the Progress and Freedom Foundation will publish in the coming months.
[2] *See, e.g.,* Raymond L. Gifford & Kent Lassman, *How and Why We Regulate: Observations from the Skeptical Regulator,* The Progress & Freedom Foundation (Jul. 2003)(hereinafter "Gifford & Lassman"), available at *http://www.pff.org/irle/skepticalregulator/skepticalregulator1.0.pdf*:

> [Regulators] stand at the crossroads of public policy and private action in the marketplace. The work is arcane and riddled with impenetrable acronyms. Mainly, regulation demands predictive judgments made with too little information, on too short a time frame and, often, on questions that admit no clear answer.

[3] Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* at 81-86 (1942).
[4] Public choice theory regards regulation as another market in which parties compete for favor. In practice, this means examining the incentives for regulatory capture of the agency by regulated entities, and thus the use of regulation to erect anticompetitive entry barriers to manipulate the competitive process. Additionally, public choice examines the durability of regulatory errors because of reliance interests and other consumer-harming factors.
[5] See, *e.g.*, Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1, 24 (1984)("The entire corpus of antitrust doctrine is based on the belief that markets do better than judges or regulators in rewarding practices that create economic benefit and penalizing others. The common belief that if markets are imperfect then something else must be better is a logical fallacy.")
[6] *See* George J. Stigler & Claire Friedland, *What Can Regulators Regulate? The Case of Electricity,* J. L. & Econ. 5 (Oct. 1962).
[7] For a general discussion, see Charles F. Phillips, *The Regulation of Public Utilities* at 183-85, 867-73 (Public Utilities Reports 1993).
[8] We emphasize that the regulatory scheme is not the sole cause for a reduction in investment – the general downturn in the economy being another wholly valid explanation. However, the regulatorily-induced disincentives to invest are plain enough to conclude that the reduction in capital expenditures flow, in part, from current regulations. See, e.g., Lexecon Inc., *Report of Kenneth Arrow, Gary Becker, Dennis Carlton and Robert Solow on Behalf of Verizon* at 21 (Nov. 18, 2003)("[C]ross-subsidies in retail rates – combined with TELRIC-based prices for network elements – can attract inefficient entry. This could reduce ILECs' investments in maintaining and upgrading their networks and delay introduction of new technologies by both the ILECs and CLECs, thereby harming the economy.")
[9] The Hon. Fred Upton, Opening Statement, Hearing on Health of the Telecommunications Sector: A Perspective from Investment Analysts and Economists (Feb. 5, 2003), available at: *http://www.house.gov/upton/press-02-05-03.html*.
[10] *See, e.g.,* Mark Reilly, *Minnesota Leading Fight for Regulation of Internet Telephony*, The Minneapolis-St. Paul Business Journal (Sept. 8, 2003), available at: *http://twincities.bizjournals.com/twincities/stories/2003/09/08/story7.html*.
[11] Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation*, at 2 (MSU Public Utilities Papers 1998)(hereinafter "Kahn").
[12] Public Utility Commission of Texas, Report to the 78th Texas Legislature, *Scope of Competition in Telecommunications Markets of Texas*, at 120 (Jan. 2003)(hereinafter "Texas Competition Report").
[13] "What legislated standard, one must wonder, can possibly be too vague to survive judicial scrutiny, when we have repeatedly upheld, in various contexts, a 'public interest' standard?" Mistretta v. U.S., 488 U.S. 361, 416 (1989) (Scalia, J., dissenting).
[14] While "rules" and "standards" are often used interchangeably, in this context the primary distinction between rules and standards "is the extent to which efforts to give content to the law are undertaken before or after individuals act." Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L. J. 557, 560 (1992).
[15] Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1, 12 (1984).

[16] *Id.* at 14.
[17] An important threshold question for states to consider is the authorization of the state PUC to implement the federal Act. Since its passage in 1996, the lion's share of state commissions' time has been spent on implementing this *federal* law. Thus, state resources, presumably appropriated to accomplish *state* law ends, have been reallocated without state legislative consent to implementing a federal law. This may, indeed, be the right policy course for the state, but the state legislature should explicitly consent to the state commission doing what, in essence, is federal work.
[18] The efficacy of regulating the natural monopoly was, arguably, not even a clear-cut case. Three decades ago, Richard Posner argued that the effort to constrain a monopolist's pricing "is more likely to produce distortions than to bring about a reasonable simulcracum of competitive pricing and output. This is primarily because of information and incentive problems of regulators and because of efforts by the regulated firms to neutralize regulation or to bend it to their advantage." Richard A. Posner, *Natural Monopoly and Its Regulation* at 93 (Cato Institute reissue 1999)(hereinafter "Posner").
[19] Kahn at 130.
[20] Texas Competition Report at 115.
[21] Tex. Code Chapters 58 & 59; Texas PUC Substantive Rule § 26.224(c)(3).
[22] Tex. Code §§ 52.103 & 52.251. For companies electing into alternate regulation, PURA does allow for pricing flexibility on packaged offerings (including regulated services) and vertical services such as caller ID after ten days notice, but these may be subject to the same sort of competitive barriers as tariff requirements because notice must be given to "any person who holds a certificate of operating authority in the electing company's certificated area." Texas PUC Substantive Rule § 26.227(c).
[23] Texas PUC Substantive Rule § 26.210.
[24] *See, e.g.*, Kahn at 38.
[25] Gifford & Lassman at 2.
[26] *See* Douglas C. Sicker, *Delocalization in Telecommunications Networks*, The Progress & Freedom Foundation, Release 11.2 (Jan. 2004).
[27] *See* Michael S. Greve, *Subprime, but not Half-Bad: Mortgage Regulation as a Case Study in Preemption*, American Enterprise Institute at 3-4 (Sept.-Oct. 2003):

> [T]o the extent that economic transactions and their consequences are internal to each state, there is a powerful presumption against preemption . . . Conversely, when states regulate or otherwise interfere with interstate commerce, the presumption runs the other way – *for* federal preemption.

[28] For an overview, see Peter W. Huber, Michael K. Kellogg & John Thorne, *Federal Telecommunications Law* at 235-56 (2d Ed. 1999).
[29] For further discussion, see Raymond L. Gifford and Kent Lassman, *Consumer Welfare, Competition & Market Processes*. The Progress & Freedom Foundation (Oct. 2003), available at: *http://www.pff.org/irle/skepticalregulator/skepticalregulator1.3.pdf*.
[30] Texas Competition Report at xii.
[31] Gifford & Lassman at 3.
[32] Texas Competition Report, December 2002 Update, at Figure 12. 473 CLECs were certified to provide service, and 224 of them provided data to the Texas PUC. *Id.* at 10.
[33] Texas Competition Report at 24.
[34] Wireline Competition Bureau, *Local Phone Competition: Status as of December 31, 2002,* at Table 9 (Jun. 2003).
[35] *Id.* at Table 7.
[36] Texas Competition Report at 31-32.
[37] Wireline Competition Bureau, *High-Speed Services for Internet Access: Status as of December 31, 2002,* at Table 6 (Jun. 2003).
[38] *Id.* at 38.
[39] Wireline Competition Bureau, *Local Phone Competition: Status as of December 31, 2002,* at Table 13 (Jun. 2003).
[40] Press Release, *Vonage Digital Voice Launches Service in Austin, Texas* (Mar. 5, 2003).

[41] Richard O. Levine, Joseph S. Kraemer & Randolph J. May, *Trends in the Competitiveness of Telecommunications Markets: Implications for Local Services Deregulation* at 115, The Progress & Freedom Foundation (Dec. 2003).
[42] For an expanded discussion, including the application of contestability theory to Texas and four other states, see *id*.
[43] Kahn at 55. See also Richard A. Posner, *The Effects of Deregulation on Competition: The Experience of the United States*, Fordham Int'l L. J. (2000):

> Competition is not a matter of many sellers or low prices or frequent changes in prices or market shares. It is properly regarded as the state in which resources are deployed with maximum efficiency, and it is not so much the existence of actual rivalry, let alone any specific market structure or behavior, as the potential for rivalry, that assures competition.

[44] *See, e.g.*, Elizabeth E. Bailey & William J. Baumol, *Deregulation and the Theory of Contestable Markets*, 1 Yale J. on Reg. 111, 117-18 (1984).
[45] Kahn at 55.
[46] With regard to wireless substitution, the FCC's Triennial Review Order cited statistics that show that 3-5 percent of wireless subscribers have replaced their landline phone with a wireless phone. *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, at ¶ 445 (Aug. 21, 2003). The FCC, however, declined to recognize that wireless is a "suitable substitute" for wireline service. Further developments in the marketplace undermine this conclusion. Industry analysts have seen a surprisingly strong trend in wireless substitution this year, particularly among single households. Under one estimate, over eight million households utilize wireless phones only, with another 25 million households as candidates for substitution. Christine Nuzum, *Americans Cut Their Wires, Threatening Largest Telecoms*, The Wall Street Journal (Sept. 24, 2003). For the potential impact of local number portability on further wireless substitution, see Seth Schiesel, *The Bells Struggle to Survive a Changing Telephone Game*, The New York Times, at C1 (Nov. 24, 2003)(citing a recent Pew Internet and Life Project survey which estimated that 20 percent of all Americans have "seriously considered" dropping their landline service for wireless only.)
[47] Likewise, the presence of enormous economies of scale in services such as billing and advertising make it very costly and difficult for an incumbent provider to distinguish where, if anywhere, in a market it might have the power to raise prices supracompetively and where it cannot. Because of this, it may end up behaving competitively even where it has no direct head-to-head competition. In any event, if this is a concern, it can be obviated by simply forbidding undue price discrimination (something that may indicate pockets of market power being exploited). To make sure this non-discrimination requirement does not inhibit vigorous competition or prevent pricing differences where costs are different, it should be applicable only through a *post-hoc* complaint process, not used as the basis for an up-front prophylactic rule.
[48] Strangely, high access charges force high long distance rates, which may in turn discourage rural economic development because it increases the communications costs in rural areas for long distance users. A deregulated retail rate structure will reduce, if not eliminate altogether, the persistence of high in-state long distance rates. This should be a boon for rural Texas.
[49] Texas Competition Report at 55.
[50] *Id.* at Table 12.
[51] *Id.*
[52] *See, e.g.*, Robert Crandall & Leonard Waverman, *Who Pays for Universal Service? When Telephone Subsidies Become Transparent*, at 89-104 (Brookings 2000).
[53] Kenneth Gordon, *Reforming Universal Service One More Time* at 80, in *Communications Deregulation and FCC Reform* (Jeffrey A. Eisenach & Randolph J. May eds. 2001).
[54] Wyoming Public Service Commission, 2003 Annual Telecommunications Report, at 37 (Jan. 10, 2003)(hereinafter "Wyoming Competition Report").
[55] *Id.* at 56-57.
[56] *Id.* at 57.
[57] Another alternative would involve the use of statutorily prescribed, competitive triggers which, when met, would lead to price deregulation in a given service area. However, this approach is ill-advised due to high error

costs and the risk that interested parties will manipulate the triggers to their competitive advantage through the legislative process.

[58] By basic telephone service, we mean service available under the current federal definition for universal service, including voice grade access, and access to emergency, operator, and directory assistance services. See C.F.R. § 54.101(a). The definition of "basic local telecommunications service" under the Texas PUC's rules closely mirrors these requirements, but also allows the Commission to add any additional services after a hearing. Texas PUC Subst. Rule § 26.5.11. This authority should be circumscribed by statute.

[59] Utah Public Service Commission, *In the Matter of the Petition of Qwest Corporation for Pricing Flexibility for Residence Services in the Areas Served by 44 Central Offices*, Docket No. 03-049-49, Report and Order, at n. 1 (Oct. 31, 2003):

> For the purposes of this Order we define "basic residential service" to consist of a "1FR" account or a "1MR" account, or any other similar service that allows a customer to obtain a basic dial tone and industry standard connectivity with no added features. A customer who chooses to order other features or packages from Qwest is no longer considered a basic residential service customer.

Aside from this, the Utah decision is a good example of when deregulation is not deregulation. After finding that pricing flexibility should be afforded to Qwest in residential areas where Comcast offered a stand-alone, basic voice offering, the PSC proceeded to cap Qwest's basic residential offering at the going tariffed rate.

[60] *See, e.g.*, 4901: 1-6-01(A), Ohio Administrative Code (defining basic local exchange service as customer access to services "over the primary line serving the customer's premises").

[61] This review process, for instance, should allow for immediate deregulation of the basic service package where comparable alternatives are available to consumers in a defined service area, including (but not limited to) a stand-alone package provided by cable or a voice-based CLEC.

[62] Kahn at 104.

[63] *Id.*

[64] Texas Competition Report at 67.

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] Public Utility Commission of Texas, Report to the 77th Texas Legislature, *Intrastate Switched Access Charges* (Jan. 2001)(hereinafter "Texas Access Report").

[69] *Id.* at 18.

[70] *Id.* at 18-19. Kahn adds that long-distance carriers might be motivated to bypass the local network altogether by employing "access mechanisms that cost more than those of the LECs but less than their rates." Kahn at 105.

[71] Texas Access Report at 19.

[72] Wyoming Competition Report at 39.

[73] Fla. Stat. ch. 364.051(6) & (7) (2003).

[74] Communications Daily (Oct. 9, 2003).

[75] Posner at 56.

[76] Texas PUC Substantive Rule § 26.54.

[77] Fla. Stat. ch. 364.051(6).

[78] Florida Senate Staff Analysis and Economic Impact Statement, Bill CS/SB 654, at 12 (Apr. 8, 2003).

[79] The airline industry presents a reasonable analogy. Southwest Airlines and its fabulous success indicates the mass preference for low price and "no frills" airline service. By contrast, American Airlines serves a higher quality/higher price traveler preference with First and Business Class cabins.

[80] Though the Texas 271 Agreement (T2A) is set to expire early next year, SBC extended the terms of that agreement through October 2004, assuming a successor agreement (with attendant performance measures) is not approved before then.

[81] Notably, PURA contains a strong presumption against reductions in revenue through orders or rules of the Texas PUC or the FCC, mandating the Texas PUC to offset those reductions through new mechanisms. Tex. Code §§ 56.025(b) & (c).

[82] Kahn at 129.

[83] *See* Texas PUC Substantive Rule § 25.43.
[84] Texas Competition Report at Figure 32.

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