Competition Policy:
Regulating Dominant Carriers & Using Price Regulation to Foster Competition

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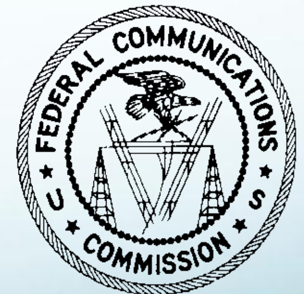

Note: The views expressed in this presentation are those of the author and may not necessarily represent the views of the Federal Communications Commission.

Overview

- U.S. dominant carrier regulation
- Overview of policy approaches to price regulation
- The FCC’s use of price caps
- The FCC’s use of a competitive test to deregulate prices

FCC Objectives

- Foster:
  - “Public interest”
  - “Consumer welfare”
  - “Economic efficiency”
- Prioritize what is good for service users, not what is good for service providers.
- Identify and prevent, or constrain the exercise of, harmful market power.

U.S. Dominant Carrier Regulation

Streamlining of regulation for AT&T Long Distance:

- 1989: Price cap regulation
- 1990-91: Competition in the *Interstate Interexchange Marketplace Proceeding* → FCC streamlined the regulation of certain AT&T long distance services subject to "substantial competition."
  - Pricing flexibility, subject to non-discrimination requirement.
  - Removal of competitive services from price cap regulation.
- 1995: AT&T Long Distance reclassified as non-dominant.

U.S. Dominant Carrier Regulation

Potential competitive concerns:

- Concerns that incumbent carriers with exclusionary market power may use that power to harm competition.
- Incumbent providers with exclusionary market power in one market that compete in another market may:
  - Engage in cost shifting (cross-subsidization) if rate regulation is based on costs.
  - Raise rivals costs by:
    - Denying access to essential facilities and services
    - Delaying the grant of access to facilities and services
    - Increasing the cost or degrading the quality of access

U.S. Dominant Carrier Regulation

Examples of competitive safeguards:

- Outright prohibition on providing a product or service (*AT&T Consent Decree*)
- Structural separation/separate subsidiary requirements
- Tariffing requirements
- Accounting separation (and possible special regulatory accounting rules for recording regulated costs and revenues)
- Rate regulation of wholesale service

U.S. Dominant Carrier Regulation

More examples of competitive safeguards:

- Access to essential infrastructure
  - Regulation of interconnection terms and conditions
  - Access to poles, ducts and conduits
  - Access to operation support systems
- Unbundling requirements (both services and facilities)
- Service quality reporting requirements, including performance metrics

U.S. Dominant Carrier Regulation

More examples of competitive safeguards:

- Resale requirements
- Network interface disclosure rules
- Requirements that subsidiary obtain its own financing without recourse to the parent owner

Plus: an enforcement process to address anticompetitive conduct.

U.S. Dominant Carrier Regulation

Ways to impose competitive safeguards:

- Imposed by the courts (examples: *AT&T Consent Decree*, modification of the final judgment)
- Mandated by statute → the 1996 Telecommunications Act
  - Imposed interconnection, unbundling, collocation and resale obligations on incumbent local exchange carriers
  - Required structural separation of BOC long distance services
- Imposed by Commission rule or order

Background: Rate of Return Regulation

- Congress has charged the FCC with ensuring rates, terms, and conditions for services are just and reasonable and not offered on an unreasonably discriminatory basis.
  - 1996 Act: Encourage deployment on a reasonable and timely basis.
- Through the end of 1990, interstate access charges were governed by "rate-of-return" regulation, under which incumbent local exchange carriers (LECs) calculated their access rates using projected costs and projected demand for access services.
- An incumbent LEC was limited to recovering its costs plus a prescribed return on investment. It also was potentially obligated to provide refunds if its interstate rate of return exceeded the authorized level.
  - However, a rate of return regulatory structure bases a firm's allowable rates directly on the firm's reported costs → led to criticism that it removed the incentive to reduce costs and improve productive efficiency.

Two Policy Approaches: Option 1

Create competitive environment to protect consumers.

- Break-up of the incumbent monopoly provider, or enable entry of new competitors.
- Considerable regulatory invention may be needed to ensure viable competition.
- However, there may be:
  - Practical barriers (legal or political).
  - Economic barriers (economies of scale or natural monopoly).

Two Policy Approaches: Option 2

Effectively regulate the incumbent monopoly to prevent harmful market activity.

- Such regulation can be technically difficult, costly, and prone to inadvertently creating adverse incentives.
- How are marginal costs to be estimated? How are fixed and common costs to be recouped?
- One appealing regulatory method: “incentive regulation,” or “price cap” regulation.

Price Cap Regulation

- Goal → prices change over time as they would in a competitive market.
  - Increases in input prices increase a firm's cost & output prices, and increases in productivity decrease a firm's costs and output prices.
- Under the FCC plan, services are placed in a basket.
- A revenue-weighted index of prices (*i.e.*, the actual price index, or API) for all of the services within a basket is calculated, and the API cannot exceed the price cap index (PCI) for that basket.
- Under price caps, carriers have significant incentive to increase their productivity, and thus decrease their costs, because doing so increases their earnings.

Price Cap Regulation
continued

- PCI adjusted annually by:
  - Prior year's rate of inflation
  - An "X-factor" (also known as productivity offset)
  - Exogenous cost changes (cost changes caused by regulatory, legislative or judicial action beyond the control of the carriers)
- The X-factor is the sum of two components:
  - Expected productivity growth rate for the regulated price cap ILEC industry
  - Expected difference between the rate of inflation for the entire economy and the rate of inflation of industry input prices
    - The X-factor for special access is not productivity based, but based on industry agreement.

Price Cap Regulation

continued

- Price cap basket is subdivided into different categories and subcategories. Price increases in the aggregate for services within each category and subcategory cannot exceed a certain percentage, generally 5% each year.
- Firms have no incentive to overcapitalize → under price caps, there is no rate base upon which a rate of return is to be earned.
- The incentive to cross-subsidize services is minimized because rates are not based on allocation of accounting costs (thus no incentive to shift such costs between services) and because similar services are placed in the same service categories or subcategories within a basket.
- Firms have flexibility to increase or decrease prices for different services and set prices to reflect different demand elasticities and production costs.
- Telecom markets are dynamic, so levels of regulated output prices and the X-factor used in the PCI are evaluated periodically.

Recent Developments in Price Regulations

April 2017 Business Data Services (BDS) Order:

- Move away from *ex ante* price regulation for local exchange providers.
- Applies to dedicated point-to-point data transmission at guaranteed speeds and service levels using high capacity connections.
  - These services had been given flexibility from price cap regulation and were in their own basket with separate X-factors.
  - Some incumbents had been granted forbearance from price cap regulation and from dominant carrier regulation.
- FCC found that nearby potential supplier generally tempers prices in the short term and results in reasonably competitive outcomes.
  - Competitors are generally aware of competitive facilities that can be expanded to reach additional customers at a reasonable cost should the incumbent's pricing exceed competitive levels.

BDS Order

- FCC found that price cap regulation is unnecessary for packet based service, TDM transport services, and higher bandwidth terminations (above DS3).
- *Ex ante* regulation will only apply to circuit based DS1 and DS3 channel terminations where a competitive presence is lacking.
  - Test adopted to determine whether competition exists:
    - If 50% of the locations with BDS demand in a county are within a half mile of a location served by a competitive provider or 75% of the census blocks in that county have a cable provider present, the county is deemed competitive and not subject to *ex ante* price cap regulation.
    - *Ex ante* price cap regulation is preserved in those areas where there is a substantial likelihood that competition will not ensure just and reasonable rates.
    - Sections 201, 202 and the 208 complaint process will be safeguards against incumbent's attempts to charge unjust or unreasonable rates for DS1 and DS3 services.

BDS Order

continued

- The X-factor for BDS services remaining under price cap regulation becomes productivity based.
- Selected X-factor (2%) reflects the FCC's best estimate of the productivity growth that incumbents will experience in the provision of these services relative to the productivity growth in the overall economy.
  - The X-factor was selected below the top of the zone of reasonableness, to recognize the diminishing share that the services, DS1 and DS3, will continue to have in the overall BDS market.
  - X-factor will allow incumbents to recover costs from customers using legacy technology, but does not incent customers to continue to rely on legacy technologies by keeping the prices artificially low.

BDS Order Benefits

- Removes unintended costs of regulation:
  - Regulation undermines entry, postponing gains from competition.
  - Inhibits competition and investment, which reduces end user benefits.
  - Regulation is risky in rapidly growing markets like BDS.
  - Difficulties in setting prices in a dynamic market.
- Encourages investment by incumbents.
- Competition is more likely to be effective in a dynamic, fast-growing market like BDS.
  - Entrants can court new customers or lure customers away from incumbents with new and innovative services.

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