Competition

Q. Would you now elaborate on the second problem you found with US West's plan–that the degree of pricing flexibility proposed is far too great?

A. Yes. The Company proposes that it be given total flexibility within a broadly defined range. For all services except residence Basic Exchange, the ceiling would be double the rate established in this proceeding and the floor would be TSLRIC [Teitzel Direct Testimony, p.18.] While the establishment of ceiling and floor prices is reminiscent of a price-cap approach to regulation, this proposal is not a normal price-cap system and it would provide far too much pricing flexibility.

Q. How does a normal price-cap system work?

A. A typical price-cap regulatory system has four basic characteristics: First, the regulator establishes an acceptable set of initial prices, which can be thought of as the starting point for the price cap system. Often, these are existing prices, established using traditional rate of return procedures, but some of the prices may have specifically been reduced during the process of establishing the price cap system. For example, in an effort to convince regulators to change to a price cap method of regulation, the carrier may voluntarily agree to reduce the initial rates below the level which would otherwise be charged.

Second, in a multiproduct industry, the regulator may not impose a strict limitation on the maximum price for each and every service. Rather, it may group related services and products into distinct categories, sometimes referred to as "baskets." An overall ceiling is established for the prices that can be charged in the aggregate for all of the services or service elements within each basket. This is typically accomplished by calculating a weighted average of the current or anticipated prices of the various items. The firm is typically allowed to change prices for the individual items (raising some and lowering others) as long as the aggregate index,

1 or weighted average of prices, does not exceed the aggregate price cap index established by
2 the regulator for that particular basket.
3 Third, the regulator may adjust the price cap over time by a predetermined adjustment
4 factor external to the firm. Ideally, the cap is tied to an index of industry-wide input prices and
5 industry-wide productivity. The idea is to have prices change over time in a manner that
6 simulates the pattern in competitive markets, where the market-clearing price level will reflect
7 the net effect of input cost inflation, which tends to push costs and prices upward, and
8 technological improvements and productivity increases within the industry, which tend to push
9 costs and prices downward.
10 Fourth, rather than deal with breakdowns in the price cap system on a purely ad hoc or
11 emergency basis, regulators typically provide for a periodic review of the system at set
12 intervals. At such times, the effects of the price cap formula are reviewed by the regulator and
13 the price cap changed or the system modified as needed. The review usually focuses upon the
14 profit conditions of the firm, much like a traditional rate case, although attention may focus on
15 the achieved return on equity, rather than on the return on rate base. In many instances the
16 review process includes a provision for revenue sharing (further reducing prices when profits
17 are high). Performance standards and quality may also be monitored.
18
19 **Q. What is the main goal of a price cap system as an alternative form of regulation?**
20 A. The main goal of a price cap formula is to eliminate, or at least weaken, the linkage between
21 cost and rates, without greatly deviating from the desirable results which would normally be
22 anticipated under traditional regulation or, for that matter, under effective competition (since
23 traditional regulation is designed to simulate the results of competition). Once the price cap is in
24 place, it is fixed for a specified period, usually a year. In turn, the firm is expected to produce
25 with the cost-minimizing input mix, invest in cost-effective innovation, and adjust optimally to
26 changes in input cost conditions. The reason for this behavior is rooted in economic incentive.

1 Since the firm is allowed to retain as profit (or, at least, a portion of the profit) any cost
2 reductions achieved relative to the price cap, it will choose (in theory) to produce efficiently.
3 With an appropriate price cap formula, prices are controlled by the price cap formula;
4 in turn, this reflects the normal variations in the prices of inputs used by the firm, offset by the
5 expected productivity improvements encompassed by the formula. This contrasts with
6 traditional regulation, where prices remain constant between rate cases, and are varied within
7 the context of a rate case based upon whatever changes have occurred in costs and
8 productivity since the prior proceeding.
9 With a price cap system, prices are regulated by focusing on the changes in the overall
10 level of costs that the firm faces (inflation of input costs), and subtracting the impact of
11 productivity or expected productivity growth as it impacts the industry generally. Although the
12 price cap should logically rise if the prices of a firm's inputs rise, the price cap is not linked
13 directly to changes in the specific cost of service of the firm in question. Thus,
14 Company-specific cost changes do not necessarily lead to price changes, and management is
15 not given mixed incentives.
16 Whenever management reduces costs, the benefits will immediately and directly flow to
17 stockholders (since revenues and the price cap remain unchanged). The same can be said
18 about traditional regulation between rate cases; however, when a rate case does occur,
19 incentives are diluted, because these cost savings will be redirected to the benefit of ratepayers.
20 Thus, one can argue that a price cap system provides stronger, more lasting incentives for
21 management to cut costs and increase efficiency, at least in comparison with a scenario in which
22 there are frequent rate cases, or the ever-present threat of a regulatory proceeding to roll back
23 rates due to excess profits.
24
25 **Q. Are the beginning rates important under a price cap plan?**

1 A. Yes. The initial starting point, the base price, must be the "correct price" for a price cap system
2 of regulation to yield optimal results. These rates are normally based on the same
3 cost-of-service and rate of return criteria used under traditional regulation. If the initial price cap
4 is set too high, the firm may generate monopoly profits, unrelated to the skills and performances
5 of its labor and management. If the price cap is set too low, the firm may incur losses or achieve
6 a return which is far below its cost of capital. In that case, it will turn to the regulator in order to
7 seek a higher price cap, abandonment of the price cap system, or other changes which will bail
8 it out of its difficulties. Most regulators adopting price cap plans have either started with the
9 firm's existing tariffs, or have required some downward reduction in those rates.

10 Under both effective competition and effective rate base regulation, profits will fluctuate
11 in a range around the cost of capital. When initiating a system of price cap regulation, however,
12 current profit levels are of special concern. If the firm is currently not earning its cost of capital,
13 capping prices at their existing level may deny the firm an opportunity to overcome the existing
14 deficiency, and thus hold profits below a normal level for many years into the future. The
15 converse is also true. If current rates are yielding a return that is significantly above the cost of
16 capital, by capping prices at the current level, excess profits may continue for many years into
17 the future. Under competitive conditions, these supra-normal returns would tend to disappear
18 over time, as competition intensifies and economic conditions return to normal. Under
19 traditional regulation, excess returns will indirectly be eliminated by the effects of input inflation if
20 a rate case is not held, or directly by regulators if a rate case is held. Accordingly, in adopting a
21 price-cap system, it is important to evaluate the current status of industry profits, and place
22 these into perspective with some reference to historic trends, or capital cost information.

23

24 **Q. Why doesn't US West's proposal qualify as a normal price-cap system?**

25 A. The Company's zone proposal contains none of the four key elements of a classic price-cap
26 plan. Rather, it is essentially deregulates pricing of US West's services within the designated

1 zones. In practical terms, prices would not actually be capped, but instead would be
2 determined by US West. If effective competition develops within the zone, prices may be
3 constrained by the market, and could potentially decline in response to competitive pressures.
4 For those services and market niches where effective competition is lacking, the Company
5 would be free to jack prices up to monopoly levels–whatever the market will bear. Rarely, if
6 ever, would the supposed ceiling price (double the current price) be a meaningful figure with
7 any impact on actual prices.
8 Why should the ceiling be twice the regulated rate? Why not set the ceiling equal to the
9 rates established in this proceeding? The Company contends that competitive pressures will
10 provide the market discipline that will prevent it from engaging in monopoly price gouging.
11 However, the Company's criteria do not require actual competition (much less effective
12 competition). The mere potential for competition is not enough to limit US West's prices to
13 reasonable levels.
14 The evidence suggests that economic, technical and psychological factors make it
15 difficult for new entrants to convince customers to change carriers. I don't believe it is plausible
16 to conclude that of the dozens or hundreds of announced competitors, none have chosen to do
17 much with the opportunities presented by the 1996 Federal Act. A much more plausible
18 explanation is that these firms are eager to take customers away from US West, but economic
19 and technical barriers to entry remain quite substantial, making it difficult for them to convert
20 customers.
21 The implied argument underlying US West's proposal is that it is so hamstrung by
22 regulation that it can't compete effectively unless it gets zone-specific pricing flexibility that is
23 essentially unlimited. There is no factual support for this line of reasoning. If new firms could
24 quickly and easily convince US West's customers to change carriers, and if US West were
25 truly a helpless giant that is precluded by regulation from defending itself, the market share data

1 would look much different than they do, more than four years after passage of the 1996 Federal
2 Act.
3