

**COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION**

**STAFF ANALYSIS OF
TELECOMMUNICATIONS BASIC SERVICES REGULATION
SENATE BILL NO. 383 HOUSE BILL NO. 938**

**PREPARED BY THE
DIVISION OF COMMUNICATIONS**

January 23, 2004

**STAFF ANALYSIS OF
TELECOMMUNICATIONS BASIC SERVICES REGULATION
SENATE BILL NO. 383 HOUSE BILL NO. 938**

EXECUTIVE SUMMARY

This legislation would create a new form of optional regulation for local telephone retail services and customers. Wholesale services, with some exceptions, would not be affected. It affords limited price regulation over the monthly rate for the basic dial tone line and usage. Essentially all other retail services offered by companies choosing this form of regulation would not be subject to SCC regulation. Certain requirements under current alternative regulation statutes would no longer apply, such as ensuring affordable basic local rates and quality local service, as well as certain competitive safeguards and whether such regulation is in the public interest. It would greatly reduce, or, in many cases, eliminate, Commission oversight of the telecommunications industry in Virginia, regardless of whether competitive alternatives exist. Rural Virginia, where limited or no competition is found, is particularly at risk.

Participating companies could:

- Increase rates for basic service by 10 percent per year;
- Increase rates for all other services without limitation;
- Discontinue services without SCC approval; and,
- Remain protected by its tariffs.

The Commission could not:

- Determine if basic rates are affordable and in the public interest;
- Promulgate and enforce retail service quality standards;
- Handle certain customer complaints; and
- Promote policies advancing fair competition.

Some may question the need for this legislation, contending that the issues and policy matters raised by it can be adequately addressed by the Commission under current statutes and commission rules.

Under current regulatory plans:

- Prices can change;
- Competition can be addressed and advanced;
- Rates can be balanced on a revenue neutral basis;
- Services have been, and can be, deregulated when competitive alternatives exist;
- Service quality can remain a priority without harming competition; and, most importantly,
- The essential interests of consumers and the industry can be equitably protected.

In short, effective competition is achievable under current law that also protects the public interest. Recent experience with Hurricane Isabel should serve as an important reminder that telephone service is as basic and vital to the health, safety, and economy of the Commonwealth as energy and water.

**STAFF ANALYSIS OF
TELECOMMUNICATIONS BASIC SERVICES REGULATION
SENATE BILL NO. 383 HOUSE BILL NO. 938**

PURPOSE

The following analysis was prepared by the State Corporation Commission Staff (“Staff”) to provide the Commission with the potential consequences of the telecommunications basic services regulation (“BSR”) legislation as introduced in the 2004 session of the Virginia General Assembly.

SUMMARY OF LEGISLATION

This legislation would create a new form of regulation for retail services and customers. Wholesale services, such as those provided to other local exchange companies, would largely be unaffected except in some cases (such as the price charged to competitors that resell telephone service). It is an optional form of regulation, and any Virginia-certificated local exchange company is eligible except small investor-owned companies subject to Chapter 16 (§56-231) of the Code of Virginia. (Telephone cooperatives already are essentially excluded from Commission jurisdiction pursuant to §56-502.)

With certain exceptions noted below, BSR essentially exempts participating companies from retail regulation by the State Corporation Commission (“SCC”). A company choosing this form of regulation, called an exempt telephone company (“exempt company”), would be required to offer basic telephone service (essentially the dial-tone line with unlimited usage) under tariff, and rates for such service would be allowed to increase by no more than 10 percent per year. After a transition period, such

prices would be the same throughout the company's local service territory. This would eliminate the rate group concept of pricing which ties rates to the number of customers in the local calling area.

Exempt companies would be required to offer under tariff a discounted service to qualifying low-income residential customers, and would be required to offer tariffed E911 network components at prices set by the company. All other retail services, including Extended Local Service, would be deregulated and could be offered without tariffs at rates set by the company. The SCC would retain authority to set rules governing network service quality standards limited to those necessary to maintain public health and safety; technical network and database standards of emergency 911 service; customer notice for tariffed rate changes and tariffed service withdrawals; disconnection of residential customers for nonpayment of local exchange service; and customer deposits.

The SCC would also retain authority to review tariff provisions not related to rates; discharge state commission responsibilities under the Federal Telecommunications Act of 1996; enforce the Underground Utility Damage Prevention Act; administer the Telecommunications Relay Service; assesses real and personal property of public service corporations; and collect the special revenue tax.

The SCC would no longer retain authority to set rules to govern retail customer service standards; approve affiliate transactions; and approve equity and debt financing. It would retain limited authority to handle customer complaints.

EFFECT OF BSR LEGISLATION

Basic Services

Under BSR, basic service is defined as one or more unbundled, single line, unlimited usage residential and business voice local exchange telephone services (essentially, what is commonly known as flat rate residence and business POTS, or plain old telephone service). The two components that would comprise Verizon Virginia's ("Verizon") basic services are highlighted on Attachment A. (The effect of BSR on other service offerings will be addressed later in this analysis.)

Although monthly rates for basic services must be filed under tariff (though not subject to SCC approval) and are limited to increases of no more than 10 percent per year, the potential effects of BSR (assuming that an exempt company would not be constrained by market considerations and would, of its own volition, raise rates to the maximum allowed under BSR) are illustrated in Attachment B for residential customers and Attachment C for business customers. While a 10 percent per year increase may seem nominal, the actual effect of BSR means that basic telephone rates could almost double over the next several years.

For example, in Verizon's Jonesville Exchange, as just one example of the several exchanges depicted in the attachments, the monthly rate for basic residential service could increase from the current \$10.89 per month to \$21.22 per month by 2010 -- an increase of 95 percent. The monthly rate for Jonesville's business customers could increase from \$34.71 to \$67.64 per month by 2010 -- again, an increase of 95 percent.

In its support for this legislation, Verizon apparently contends that it does not cover the cost of providing local exchange telephone service to many rural and residential customers. While the Staff recognizes that costs are most likely greater in rural areas,

this in itself does not automatically mean that urban customers subsidize rural customers or that businesses subsidize residential customers. Even if one entertains the subsidy line of reasoning, it is necessary to compare apples-to-apples in making an accurate assessment of whether rates cover costs.

Referring again to the Jonesville example, Verizon generally points only to the basic tariffed rate (i.e. \$10.89 per month) as the baseline for illustrating that a service does not cover its cost. Often omitted from the comparison are all of the other directly related revenues that residential customers must pay (i.e., the federal subscriber line charge of \$6.37 and the number portability charge of \$0.23 per month, both of which Verizon keeps). In addition, the majority of residential customers buy services (i.e. call waiting, caller ID, etc.) that provide additional revenue at very little incremental cost. In fact, a study referred to in a recent Verizon submission to the Commission (PUC-2003-00170) lists Verizon's region-wide, average residential revenue per line at \$38.59. If anything close to that holds true for rural Virginia, then telephone service there may well be profitable after all.

Despite allowing price increases under BSR, there appears to be no commensurate increases in services rendered. The local calling scope (the number of people one could call on a local basis) is not expanded, no features are added, there is no promise of improvements in the quality of service, nor are there any other recognizable benefits for consumers as a result of paying higher prices.

Further, if the legislation passes, a BSR participant could, at its discretion, raise the rates for Extended Local Service ("ELS"). ELS allows consumers (Va. Code §56-484.2.) to petition the SCC for expanded local calling into contiguous exchanges and has benefited numerous communities throughout the Commonwealth by eliminating long

distance rates in favor of slightly higher local “adders” rates. This ELS adder would not be considered part of the basic services under BSR and would, therefore, not be subject to any price cap.

Most importantly, the intended transition to a statewide, uniform rate may never occur. For example, if the highest basic rate in the state increases by the maximum 10 percent level and the lower rates also increase by the maximum 10 percent, as allowed under BSR, rates will never become equal.

BSR provides no price constraints for basic service non-recurring charges, such as installation fees. Typically, the rate for installing a residential line, using Verizon’s rates as an example, is \$38.50. With the implementation of BSR, an exempt telephone company may increase rates for connection and installation work, even for so-called basic services, without regard to the level of competition in any given market. Increases in non-recurring rates could, unlike today, be accomplished without Commission sanction and without the application of a public interest standard.

Non-Basic Services

The legislation would authorize the Commission to promulgate rules affecting the technical network and database standards of emergency 911 services provided to localities and require that those network components be offered under tariff. BSR would also allow the Commission to promulgate rules affecting 911 database providers over whom the Commission has no jurisdiction. While the rates for 911 services would be tariffed, there would be no regulatory constraints placed on price. Complaints from municipal 911 bureaus led the Staff to propose rules, currently under consideration by the Commission, that would establish enhanced 911 service quality standards and require that

rates be unbundled both to resolve existing disputes and to avoid future duplicate billing for the same services. BSR legislation would abolish any such price protection rules.

Common services for which there would be no requirement for pricing or tariff oversight include residential and business message, measured, and economy services. These are less expensive than basic services and are currently utilized by thousands of residential and business customers throughout the Commonwealth. BSR legislation would not prevent a participating telephone company from discontinuing these services altogether or from increasing the rates. (Verizon does not offer unlimited, flat rate local calling for business customers in Northern Virginia today. For strictly local exchange telephone service, business customers there may only subscribe to message or measured rate services.)

Another commonly used service at risk under BSR is local directory assistance. Today, consumers receive three free calls per month to account for telephone numbers that do not appear in the telephone directory. Under BSR, there would be no requirement to retain the three-call allowance, which is valued at \$0.87 per month. In addition, BSR legislation would allow a participating telephone company to increase the \$0.29 per-call rate to call directory assistance without Commission approval and without the application of a public interest standard. Verizon already charges \$1.25 per call for interstate directory assistance.

The list of services for which there could be no Commission oversight or the application of a public interest standard is quite extensive. It includes all services on Attachment A, other than the two highlighted. For example, the PBX connections that businesses throughout Virginia use as their basic local telephone service could be offered without tariff or price protection, as could Call waiting, Caller ID, and non-published

telephone numbers. According to a survey that was sponsored by the Staff and conducted by Virginia Commonwealth University's ("VCU") Center for Public Policy in 2002, two-thirds of Virginia's residential and almost half of small business customers subscribe to these services (see Attachments D and E).

Centrex exchange service, ISDN, and all data services, including common alarm circuits, are but a few of the many services that could be, for all intents and purposes, entirely deregulated under BSR. It also appears that an exempt company that provides public payphones, such as Verizon and Sprint who provide the majority of payphones in Virginia, would not be regulated pursuant to the Commission's rules governing payphones at 20 VAC 5-407-10 et seq., as are private payphone providers.

In short, other than the promise of continued discounted pricing for Virginia Universal Service Plan (low income) customers, there would no longer be an affordability or public interest requirement under BSR (Verizon had 7,615 low income customers as of July 1, 2003). Again, all of the rate implications noted above could be accomplished at the will of the BSR participant, without cost justification, or the opportunity for public input before the Commission.

Service Quality

BSR would allow the Commission to enforce only those network performance standards necessary to maintain the public health and safety. BSR would also allow the Commission to handle certain complaints; only to the extent, however, that the Commission retains authority, which BSR appears to severely limit.

It is not evident the degree to which the Commission could continue to assist consumers under BSR. For example, one local telephone company recently quoted a business customer almost \$189,000 to construct additional telephone facilities. After

receiving a complaint from the business owner, the Staff conducted an investigation, which resulted in the quote being reduced to \$95,000. In another investigation, the Staff found that one company over billed customers by approximately \$850,000 for services currently regulated, but which could be exempt from regulation under BSR. It took months for the provider to acknowledge its error and to provide the Staff with its plan for customer refunds. In both instances, the Staff used its current regulatory authority, which would, presumably, no longer exist under BSR.

Retail service quality standards would be eliminated under BSR. Telephone installation intervals, missed appointments, repeated trouble reports, noisy or static line conditions, transmission requirements, standards relating to a consumer's ability to access telephone company personnel, or any standard not considered to be a "public health and safety" standard, may be excluded from Commission jurisdiction.

In 2003, in recognition of the changing nature of the telecommunications industry, the Staff proposed a new set of retail performance standards to help reflect the emerging competitive landscape in Virginia. These service quality rules were proposed after an exhaustive nationwide benchmarking process, numerous consultations with the industry and consumer groups, and after considering the survey conducted by VCU's Center for Public Policy.

The purpose of the Staff's service quality research was to develop a set of standards that would balance the needs of today's industry with the needs of consumers. Without going into the specific merits of the proposed rules (since they are currently before the Commission in a formal rulemaking), the Staff's goal, as a matter of public interest policy, was to establish a floor below which service quality should not fall. Competitive distinctions from a service quality perspective would, therefore, be made

between the theoretical floor and ceiling. Accordingly, in the VCU survey, customers were asked at what level they would become *dissatisfied* with certain types and levels of service. From there, the Staff developed, with the cooperation of some in the industry, a set of standards that attempted to balance the needs of consumers and providers.

It is important to note here that local competition and deregulation has, thus far, not led to better service quality and lower prices for most customers, as predicted when competition was introduced. With regard to service, as illustrated in the charts labeled Attachment F, the total number of Commission complaints has increased significantly coincident with the deregulation/competitive era. Given the “public health and safety” standard for service quality as proposed under BSR, it is not evident, at least to the Staff, what practical role the Commission would retain in assisting Virginia’s consumers with telephone related complaints and service quality.

It has only been ten years since the Commission first deployed a formal set of telephone service quality standards. The existing rules were developed as a result of the increasingly poor performance of some companies as they cut costs while preparing for deregulation and competition. As some companies continue to cut costs even more dramatically now, as evidenced by recent force reductions of major telephone companies operating in Virginia, the need may even be greater today to set a floor below which service should not fall.

Competition

The VCU survey queried residential and small business customers about their knowledge of local telephone competition. Only 46 percent of residential customers said “yes” when asked if there were competitive local telephone service providers in their area. An additional 20 percent didn’t know (see Attachment G). More business

customers, though only 60 percent, answered “yes” to this question (see Attachment H). (Although comparisons have been made between telecommunications and other regulated industries, it is hard to imagine that consumers of insurance and banking products are as unaware of competitive alternatives as telephone consumers seem to be.)

Of course, even those consumers aware of competition are just now beginning to understand that, unlike other industries, local telephone service competitors rely largely on the incumbent’s network to provide service to their customers. This form of competition, which is by far the fastest growing and largest type of local telephone competition, is currently undergoing intense scrutiny at both the State and Federal levels. In fact, it is considered to be only a temporary fix to genuine facilities-based competition. Even in much of metropolitan Richmond, there are no facilities-independent competitive alternatives to Verizon’s wireline network of which the Staff is aware. In most cases in the existing competitive environment, if customers are dissatisfied with the service of their incumbent, they will find little relief for network related problems by changing providers.

In today’s environment, SCC rules cap the rates of competitive local telephone companies at the rates of incumbent providers (although waivers may be, and have been, requested and approved). Therefore, if an incumbent provider elects to participate in BSR, and chooses to eliminate its tariff and pricing structure for non-basic services, it may be difficult, if not conceptually impossible, for a non-participating competitive telephone company to ascertain the price it should not exceed.

Given that competitive providers have, for the most part, simply established prices just below those of the incumbent, it is possible that as an incumbent’s prices rise under BSR, so would the prices of its competitors. This is particularly true in the case of

resellers of local exchange service, whose prices are simply discounted at a fixed percentage below the rates of the incumbent.

Another potential consequence of BSR may actually be detrimental to both competitors and at least some consumers. For example, if an exempt company lowers its prices in competitive areas of the state, but, as allowed under BSR, raises prices in non-competitive areas, only the incumbent would seem to benefit economically (and, of course, the consumers for which the incumbent lowered prices). Further, if exempt companies have no obligation to file tariffs, then neither would competitors. Moreover, consumers would have difficulty in selecting providers if prices are unknown, difficult to determine, or subject to frequent change.

Current alternative regulation statutes require a finding that any such plan approved by the SCC does not unreasonably prejudice or disadvantage other providers of competitive services (Va. Code §56-235.5.B.(iii)). With the exception of localities certificated to provide local telephone service, and pricing for bundled services, no such safeguards are required under BSR.

Telephone service is complex. Even with the tools that already exist, shopping for and deciding upon a telephone service provider can be incredibly confusing. It will become more confusing as local competition becomes more prevalent, as happened with the long distance market. Worse, changing providers can be expensive and risky. The Staff can provide ample evidence of directory errors, telephone number migration problems, and out-of-service conditions that can arise when changing providers. For the thousands of business customers with intricate telecommunications products that take weeks to install and even longer to properly “break-in,” the notion of changing local telephone providers is one that cannot be taken lightly.

The VCU survey also sought to determine the public's view regarding the role of the SCC in today's telecommunications marketplace. Residential and business consumers, in some of the most adamant responses received on the survey, indicated that the Commission should protect Virginians from market abuses, help them understand their options, and should promote the development of a competitive market (see Attachment I for residential and Attachment J for business). It is difficult to ascertain how, under BSR, the Commission, or any other entity, could accomplish those goals.

Unquestionably, the telecommunications marketplace is changing. And, there is some anecdotal evidence of so-called intermodal forms of competition such as wireless and voice-over-internet-protocol ("VoIP"). Certainly, a small percentage of consumers are using wireless as a substitute for landline communications and a relative few are using more nascent technologies such as VoIP as an option. But, for the vast majority of consumers, and for the foreseeable future, wireline, or POTS, telephony will remain the foundation for fulfilling basic communications needs.

NEED FOR LEGISLATION

Rather than debate the merits of BSR, it may be more beneficial to establish the need for such legislation at the outset. The fundamental questions should be: (1) Has the telecom environment changed so drastically that a departure from a public interest standard is now warranted? (2) Does the legislation lead simply to higher prices and higher revenues for BSR participating companies? and, (3) If prices are to rise, should not there be some protection with regard to service quality or some other tangible public benefit?

Verizon Virginia (formerly Bell Atlantic), Verizon South (formerly GTE), and Sprint operate under alternative regulatory plans promulgated by the SCC in response to

legislation enacted in 1993 and amended in 1996, 2002 and 2003 (Va. Code §56-235.5). This legislation enabled the SCC to make permanent a variation of an experimental regulatory plan it initiated in 1989 to recognize the increasing competitive, technological and other changes being faced by the industry.

The Virginia Commission was one of the first in the nation to recognize that traditional, rate-base, rate-of-return regulation was not appropriate as the industry transitioned to a more competitive market. The current plans have been modified to reflect further changes in the industry, most recently for the Verizon companies in 2001 and the Sprint companies (formerly Centel and United) in 2000 and 2003.

Current statutes allow a company to opt into an alternative plan of regulation based on a Commission finding that four conditions are met. These are that the plan (1) protects the affordability of basic local service, (2) ensures the continuation of quality local service, (3) ensures customers or other competitive providers are not unfairly prejudiced or disadvantaged, and (4) is in the public interest. These four requirements are not found in Basic Services Regulation. Current alternative regulatory plans allow companies to declare services competitive where they can demonstrate the existence of competitive alternatives. In fact, legislation was recently passed to give the companies even more flexibility in this area.

Current alternative regulatory plans allow Verizon and Sprint to price services competitively on a case-by-case basis for specific customers when needed. Further, short of service quality difficulties, Verizon could raise any number of prices for services today. If it needs to raise prices in one area and lower prices in another, a company is free to make its claim before the Commission. Existing rules and statutes permit the Commission to allow such rate adjustments.

On the other hand, if any local telephone company under the Commission's jurisdiction seeks indiscriminate rate increases, attempts to discontinue services at will, or seeks to reduce the Commission's ability to intervene on behalf of consumers then, of course, the Commission would determine if such a change of policy is in the public interest. In fact, it was not that long ago that GTE (now Verizon South) proposed what it characterized as a revenue neutral plan to increase basic rates in the majority of its exchanges in its effort to prepare for competition. The result of that failed proposal was an unprecedented hue and cry from the public. Of the 23,985 letters and petition signatures received, 23,663 (or 99 percent) opposed the GTE rate plan.

Essentially everything allowed under this legislation can be done today, subject to public interest standards, under existing alternative regulation plans or statutes.

Accordingly, the need for this legislation is unclear.

CONCLUSION

Telephone rates statewide, particularly in rural areas and regardless of the level of competition, may increase dramatically and in perpetuity under BSR. This could be accomplished:

- Without Commission oversight;
- Without a demonstration of any concomitant benefit to consumers; and
- Without adding to the competitive landscape in Virginia.

Moreover, if the recent past is any indication of the future, one would reasonably anticipate service quality levels to fall, complaints to rise, and the Commission may have little or no authority over service quality or to handle and effectively resolve customer complaints.

Telecommunications is different from other industries. By its very nature, it is two-way. We have to speak to each other, no matter which provider we may have chosen. Therefore, the Staff believes that even if consumers make the worst possible choice among competitive service providers, service levels should be maintained at some minimal level to ensure we can still communicate at a price that is reasonably affordable.
