Memorandum

Date: January 21, 2003

To: Members of the Senate Technology and Energy Committee
Interested Parties

From: Patrick L. Anderson
Principal, Anderson Economic Group LLC

Re: Consumer impact of legislatively-set prices for local phone service as in 2003 SB 1

Introduction

The Michigan legislature is once again considering a bill that would legislatively fix prices for local phone service. SB 1 would reduce the price the largest telephone providers could charge for local phone service, by requiring them to obtain regulatory approval to charge a "common line" or "end-user common line" (EUCL) fee.

Similar efforts at legislatively-setting local phone rates were contained in the Michigan Telecommunications Act of 2000. Our analysis published in that year highlighted the likely unconstitutionality of such government price-fixing, as well as the ineffectiveness of such efforts in the past. These provisions were later enjoined by the US District Court, and the 6th Circuit Court of Appeals, due to their likely unconstitutionality.

The current senate bill would modify the MTA 2000 language, to avoid directly fixing prices and thereby violating the "due process" and "takings" clauses of the US Constitution. Instead, SB 1 would require the largest telephone providers to seek regulatory approval for rates that include a EUCL; it then directs the MPSC to consider "a reasonable rate of return" for the provider in approving rates.

We consider in this memorandum the following issues:

1. Is regulation based on "rate of return" (or "just and reasonable" prices)—or open competition—more likely to lead to lower prices for consumers?

2. Has price-fixing ever been successful in giving consumers better services at lower prices?

3. What would be the likely impact on consumers and competing telephone companies of a return to price-fixing via a "rate of return" regulatory regime?

I. Rate-of-Return versus Competitive Prices

Michigan, like other states, regulated its telecommunications markets until the early 1990's. Such regulation was based on the notion of phone companies as "natural monopolies," in which only one provider could afford to build the infrastructure needed to service large numbers of customers across a wide area. This notion began to crumble in the 1970's, when the federal government began forcing competition in certain sectors of the utility, airline, and other industries.[1] Later, the federal courts forced the break-up of the giant AT&T telephone system in 1984, which involved huge subsidies from one set of customers to others.[2]

However, in some industries, government-fixed prices continued to dominate the relationship between consumer and producer. Such price-fixing went under slightly different labels:

- Regulation of prices by guaranteeing a "rate of return" for investors;
- Regulation of prices by requiring them to be "just" or "reasonable," which in practice requires a "reasonable rate of return;"[3]
- Simple price freezes, which are often "temporary," and then are adjusted in a manner similar to "rate of return" regulation.[4]
- *De facto* confiscation, which in the United States has led to judicial intervention, as the US Constitution (in at least the 5th and 14th amendments) prohibits taking property with due process and proper compensation.[5]

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1. The federal PURPA statute of 1978 was a signal achievement of the Carter administration in this regard, as was the beginning of deregulation of the airline industry.
2. The landmark breakup of AT&T was presided over by Judge Harold Greene, who ordered in 1982 that AT&T divest itself of the regional Bell companies by January 1, 1984. The consent decree that settled the case was dissolved with the federal telecommunications act of 1996, although the general principal of the AT&T breakup was incorporated in the federal law.
   Greene fled from Nazi Germany early in his life, and his career before the AT&T case included assisting with the drafting of the Civil Rights Act of 1964 and the Voting Rights Act of 1965. See McClimans, Fred, "Remembering Judge Greene," *Network World Fusion*. Feb. 2000 and also see Tim Rice, "Judge Greene's Legacy," *The Industry Standard,* Feb. 2000.
3. The definition of "just" is often left to the regulator, who must grapple with the fact that unless producers earn a profit, they will stop producing. Because the Constitution requires that producers be allowed to earn a reasonable rate of return, "just" prices must allow "reasonable" returns.
4. In order for producers to stay in business, they must be allowed to earn a profit. Therefore, price freezes must allow for changes in prices. These change mechanisms are typically based on "rate of return" for the producer.
5. Indeed, the provisions of the MTA 2000 on which SB 1 is based were enjoined for these reasons. The Supreme Court over 100 years ago ruled that price controls that do not allow for investors to achieve a reasonable rate of return are deprivations of property without due process of law; *Chicago M & St. Railroad v Minnesota,* 134 US 418, 458 (1890); for an accessible narrative on regulations and the Constitution see Findlaw: US Constitution: 14th Amendment, at http://www.findlaw.com.

SB 1 is a classic example of “rate of return” legislation.

Regulated Rates versus Competitive Rates

The theoretical benefits of competition, versus government-fixed prices, were apparent to the great Scottish economist and moral philosopher, Adam Smith, at least as far back as the 1776 publication of *Wealth of Nations.* Smith noted that producers, competing to maximize their own profits, would produce the best products at the lowest prices.

In the 200 years since then, the benefits of competitive prices have been proven and re-proven. By the 1990’s, the benefits of competition to consumers, when compared to regulated prices and services, had become accepted across nearly the entire political spectrum. Michigan joined other states in de-regulating, in various forms, its telephone and utility industries. The federal telecommunications act of 1996 changed federal regulation from the regulatory model of the 1934 act to a competitive model, and allowed for full competition in long distance once local service became open to competition.[6]

Local Phone Service, Competition, and Rates in Michigan

We have previously published a number of analyses of Michigan’s telecommunications markets that are relevant to understanding SB 1, including:

- An extensive analysis of the effects of the 2000 Michigan Telecommunications Act, including an estimate of the impact on consumers in all four markets (local, local-toll, long distance, and broadband), in October 2000.
- An evaluation of competition in the Michigan’s Telcom market, in February 2002.
- A geographic analysis of broadband providers throughout the state, including maps showing service areas for DSL, ISDN, T1, and other broadband technologies, in December 2001.

Our analyses, which have been available on our web site since their release, have consistently shown that the local market has become increasingly competitive. In particular, competitors to Ameritech have succeeded in garnering a significant share of that market. Typically, the services sold to former SBC Ameritech customers are SBC Ameritech network services, re-sold by a CLEC at a lower price.[7] Such competition has resulted in lower prices for consumers, especially businesses that have purchased bundles of services from SBC Ameritech or from competing CLEC’s.[8] The advent of full competition—including the long distance market—will lead to significantly more

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6. On the 1996 federal act, see the discussion in Anderson, et. al, *Consumer Impact of MTA 2000,* page 14; in particular the references to “Local Telephone Service” in *Industry Studies, 2d ed.*
   Long distance competition involving former Bell operating companies is sometimes known as “271 entry” after section 271 of the act.
7. Under the competitive framework adopted in both the federal and state telecommunication acts, the former Bell operating companies must open their networks to allow competitors to access their switches, lines, and other elements. The satisfaction of these elements of the 14-point “271 checklist” was affirmed by the MPSC in their report to the FCC, in case no. U-12320, January 13, 2003.

opportunities to offer money-saving bundles of services to household and small business consumers.[9]

II. History of Government Price-Fixing

As of this millennium, we have 38 centuries of experience with government price-fixing.

Most economic historians place the first recorded attempt to set prices by government fiat to the Roman Emperor Diocletian in 284 A.D.[10] In modern times, governments ranging from the United States to the Soviet Union have attempted to fix prices.[11] "Rate-of-return" regulation is a form of price-fixing, in which the regulatory authority is charged with fixing a price that allows the provider to earn a certain profit on its investments, normally expressed as a "rate of return." Private investors are typically characterized as expecting to earn about 15%, on average, on their equity investments. The FCC previously set a rate-of-return guideline for about 1500 local providers at 11.25% (on both debt and equity).[12]

Example: A Stock Market "Rate of Return"

A "rate of return" regulation in the stock market would force companies to cover all their costs, and then pay their stockholders an annual dividend. Of course, there is no such regulation; and investors in private stock markets can, and recently often do, lose money.

What is "Rate of Return" Price fixing?

Regulated industries in the United States have a well-documented history under rate-of-return regulation.[13] The general effects of such regulation are quite predictable, and are instructive in anticipating the effects of SB 1:

i. The provider is often removed from the normal exigencies of competitive pressures.[14] Therefore, providers typically become less efficient under "rate of return" regulation, leading to higher prices over time.

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8. Competitive Local Exchange Carriers (or "CLEC's") are providers that compete with the "incumbent local exchange carriers" such as SBC and Verizon. CLEC's share of the local and local-toll markets has grown rapidly in Michigan.
   Note that CLEC's include both small companies, and large companies such as AT&T.
9. Our 2000 analysis of the MTA included projections of the consumer impact of delaying "271 entry" for SBC Ameritech; we estimated at the time that delaying full competition in long distance would cost Michigan consumers approximately $250 million in 2001, growing to over $750 million in 2002. See Patrick L. Anderson, et. al, "Changes in Rates and Fees by Segment" page 8, in *Michigan Telecommunications Act of 2000: Consumer Costs and Benefits,* (October 2000) available on www.andersoneconomicgroup.com.
   A similar analysis by the firm Telenomics put the cost penalty at a larger $1 billion per year. See Steven B. Pociask, et. al, "Executive Summary" page 3, in *Structure, Conduct and Performance of the Long-Distance Market and Consumer Benefits of Long-Distance Competition in Michigan,* (January 2001) also available on www.andersoneconomicgroup.com;
   See, e.g., "Let SBC Offer Long-Distance Calls", *The Detroit News,* January 17, 2003
10. See sources cited in Patrick L. Anderson, et. al, "Market Responses to Fixed Prices", in *Michigan Telecommunications Act of 2000: Consumer Costs and Benefits,* (October 2000) page 23; available on www.andersoneconomicgroup.com.

ii. The competitive market does not guarantee a profit. Indeed, at any time a good portion of private businesses are losing money. On the other hand, “rate of return” regulation guarantees a profit. Even if that profit is unduly low, it still covers all costs, and leaves additional revenue to be distributed to the owners of a firm. Thus, investors are somewhat insulated from business risk under “rate of return” regulation.

iii. Prices under “rate-of-return” regulation are typically higher, and innovation is slower.

iv. Providers, and their competitors, spend large amounts of resources attempting to influence regulatory authorities, rather than expending these resources on improving service to consumers.

v. Consumers, especially the large consumers, attempt to circumvent the effects of the regulation by making arrangements that go around the regulatory barriers, allowing them to purchase services at lower prices.

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11. US wage-and-price controls existed during WWII and were abandoned in peace time; President Nixon imposed wage and price controls in the 1970’s, which were again abandoned. While the US is generally regarded as the model capitalist economy, there are numerous sectors in which state, federal, or local governments impose some types of controls on prices or quantities. In many regulated industries in the US—such a civil aviation until President Carter deregulated it, and gasoline until it was deregulated by President Reagan, price controls have been systematically abandoned and replaced with market competition. However, some sectors of the economy, such as health care and public education, operate in a largely regulated environment.
    The Soviet Union, and other countries with “planned” economies, operated with pervasive price and quantity controls. Most such countries had islands of private markets, such as Hong Kong outside Communist China, and special “hard currency” shops in Moscow during the Soviet era. Almost all countries (with the notable exception of North Korea) have now abandoned the “planned economy” model.
12. See FCC report no. CC 98-33, October 1998.
13. For example, CATO economist Jeffrey Taylor summarizes several studies as follows: “There is little reason to believe that rate regulation acts to protect consumers.” He cites studies by George Stigler, Thomas Moore, and Walter Meade in the electric utility industry, each concluding that regulating electric utilities provided little or no net price reduction to consumers. See “Electric Utility Reform: Shock Therapy or Managed Competition,” *Regulation,* vol. 19 no. 3; available at: http://www.cato.org.
14. This often occurs in “natural monopoly” markets, or in those in which the government has established barriers to entry. At one time, local telephone service could be considered a natural monopoly, and there are barriers to entry. The US and Michigan statutes governing local telecommunication providers now require large local providers to open their networks. Prices for those resold “unbundled network elements” (UNE) are regulated.

III. Impact on Consumers of Price-fixing Local Phone Rates

We previously analyzed the similar MTA 2000 provisions.[15] In that analysis, we indicated that

- The MTA 2000 provisions were of doubtful constitutionality.[16]
- Had the law actually forced prices lower, the benefits to consumers would have been short-lived. In particular, we expected that local service costs over an extended period would be *higher* under a government price-fixing regime than under a competitive market.

The evidence of the past 2 1/2 years largely confirms our 2000 analysis:

- First, two different courts found that the MTA 2000 provisions fixing prices were likely to be found unconstitutional, and enjoined these provisions of the law.[17]
- Second, subsequent to the injunctions, the key price changes were the result of competitive market forces, including SBC Ameritech's decision to offer a number of lower-priced bundles of phone services, and its voluntary decision to lower local service charges by reducing its intrastate EUCL.

Likely Impact of SB 1

Given the experience in Michigan with the similar MTA 2000 provisions, the lengthy and well-documented history of regulatory price-fixing versus competitive markets, and the recent activity in prices and services for Michigan's telecommunications markets, we can summarize the probable impact of a SB-1-style return to regulatory price setting as follows:

1. Prices in the short-run (the next six months) would change very little. SB 1 allows some time for a rate case to be filed, and for the MPSC to review the case and make a decision. During this time, a competitive regime would allow prices to drop slightly. Slightly lower prices have occurred in the market since the MTA 2000 price-fixing provisions were enjoined by the Courts, and absent a change in the regulatory regime, those reductions would probably continue.[18]

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15. See Patrick L. Anderson, et. al, "Price Cuts, Price Increase, and Price Fixing" pages 49-50, in *Michigan Telecommunications Act of 2000: Consumer Costs and Benefits,* (October 2000) available on http://www.andersoneconomicgroup.com.
16. See Anderson et. al, "Constitutionality of Price and Service Controls" on page 50 and following; and "Responding to Government Price Fixing: GTE" on page 31; in *MTA 2000: Consumer Costs and Benefits.*
17. United States Court of Appeals for the Sixth Curcuit in *Michigan Bell Telephone Company v. John Engler,* 257 F.3d 587 (6th Cir. 2001); U.S. District Court for the Eastern District of Michigan, 2000, Nos. 00-73207; 00-73208;
  In late 2002, SBC and Ameritech entered into a settlement of this case, after the court heard arguments from Michigan's attorney general that the Governor and MPSC did not have authority to enter into an agreement that violated state statute. See http://pacer.ca6.uscourts.gov/cgi-bin/getopn.pl?OPINION=01a0219p.06.
18. Of course, SB 1 does not remove the largest providers from competitive pressures. Therefore, some price changes are likely to continue to occur as those providers attempt to maintain market share in the face of growing competition from CLEC's.

Therefore, in the short term, SB 1 would probably result in little or no rate reduction, while a competitive market would probably result in slightly lower rates.

2. Prices in the medium run (after a year) would likely be *higher* under a rate-of-return regime, for at least three reasons:

   i. Strong competition encourages providers to lower prices, even at the expense of current earnings. This is the situation today in the automobile industry, which is offering prices *lower* today than that of a few years ago.[19] It is likely that a "reasonable rate of return" for large providers would result in a higher price for these services than a competitive market.

   ii. "Rate of return" regulation encourages—if not requires—providers to allocate expenses across multiple service categories. Guaranteeing a "reasonable rate of return" in law means that 100% of these costs must be paid by consumers. Given such a regulatory regime, it is likely that large providers will spend more on resources directly allocable to local service.

   iii. "Rate of return" regulation eliminates competitive incentives for efficiency.

3. The MPSC's focus, which should be on ensuring consumer protection and a competitive market, would be diluted by a return to "rate-of-return" regulation. Instead of policing the anti-cramming, anti-slamming, and required market-opening provisions of the Michigan and US telecommunication statutes, MPSC resources would be devoted to determining what a "reasonable" rate of return is, what expenses should be allocated to local service, and other expensive and time-consuming activities.

For the reasons identified above, these effects would occur whether the bill was amended to re-characterize "reasonable rate of return" or "just and reasonable" or other similar phrase.

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19. General Motors reports that net sales prices on their vehicles have decreased for 8 consecutive quarters. See "GM slashes its way to $1.7B profit," *The Detroit News,* January 17, 2003.
    The US CPI also contains a quality-adjusted component for automobiles, which has dropped in recent years.

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