

1 SOUTHERN BELL TELEPHONE AND TELEGRAPH COMPANY
2 TESTIMONY OF PROFESSOR DAVID SAPPINGTON
3 BEFORE THE
4 FLORIDA PUBLIC SERVICE COMMISSION
5 DOCKET NO. 920260-TL
6 JULY 15, 1992
7
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9

ORIGINAL
FILE COPY

10 Q. WHAT IS YOUR NAME AND POSITION?
11

12 A. MY NAME IS DAVID SAPPINGTON. I AM THE LANZILLOTTI-
13 MCKETHAN EMINENT SCHOLAR IN THE DEPARTMENT OF
14 ECONOMICS AT THE UNIVERSITY OF FLORIDA.
15

16 Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL
17 BACKGROUND?
18

19 A. I RECEIVED MY BACHELOR'S DEGREE IN ECONOMICS FROM
20 HAVERFORD COLLEGE IN 1976. I OBTAINED MY MASTER'S
21 DEGREE IN ECONOMICS FROM PRINCETON UNIVERSITY IN
22 1978. I WAS AWARDED MY PHD IN ECONOMICS BY
23 PRINCETON UNIVERSITY IN 1980. THAT YEAR, I JOINED
24 THE FACULTY OF THE UNIVERSITY OF MICHIGAN AS AN
25 ASSISTANT PROFESSOR OF ECONOMICS. TWO YEARS LATER,

1 I MOVED TO THE UNIVERSITY OF PENNSYLVANIA IN THE
2 SAME CAPACITY. IN 1984, I JOINED THE MATHEMATICS
3 AND STATISTICS APPLIED RESEARCH GROUP AT BELL
4 COMMUNICATIONS RESEARCH (BELLCORE). WHILE AT
5 BELLCORE, I SERVED AS A VISITING PROFESSOR WITH
6 TITLE OF FULL PROFESSOR AT PRINCETON UNIVERSITY IN
7 1988. IN 1989, I WAS PROMOTED TO DISTRICT MANAGER
8 OF THE ECONOMICS RESEARCH GROUP AT BELLCORE. LATER
9 THAT YEAR, I JOINED THE FACULTY AT THE UNIVERSITY
10 OF FLORIDA AS THE MATHERLY PROFESSOR OF ECONOMICS.
11 IN 1991, I WAS AWARDED THE LANZILLOTTI-MCKETHAN
12 EMINENT SCHOLAR CHAIR. THROUGHOUT MY CAREER, MY
13 RESEARCH HAS FOCUSED ON THE DESIGN OF REGULATORY
14 POLICY, PARTICULARLY INCENTIVE REGULATION. I HAVE
15 PUBLISHED APPROXIMATELY FIFTY ARTICLES IN LEADING
16 ECONOMICS JOURNALS.

17

18 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

19

20 A. THE PURPOSE OF MY TESTIMONY IS TO EXPLAIN WHY
21 SOUTHERN BELL'S PRICE REGULATION PLAN IS A SOUND,
22 PROGRESSIVE REGULATORY PLAN THAT REPRESENTS A CLEAR
23 IMPROVEMENT OVER THE INCENTIVE PLAN UNDER WHICH THE
24 COMPANY CURRENTLY OPERATES.

25

1 Q. WHAT ARE THE MAIN IMPROVEMENTS OFFERED BY THE
2 PROPOSED PRICE REGULATION PLAN?

3

4 A. MY TESTIMONY WILL EXPLAIN THE KEY IMPROVEMENTS OF
5 THE PRICE REGULATION PLAN IN SOME DETAIL. VERY
6 BRIEFLY, THE GUARANTEED REDUCTIONS IN AVERAGE REAL
7 PRICES, THE INCREASED PRICING FLEXIBILITY, AND THE
8 PROPOSED CHANGE IN THE SHARING RATIO CONSTITUTE THE
9 MAIN IMPROVEMENTS OF THE PLAN. SOUTHERN BELL'S
10 CUSTOMERS WILL BENEFIT DIRECTLY FROM THE GUARANTEED
11 PRICE REDUCTIONS. THE INCREASED PRICING
12 FLEXIBILITY WILL ENABLE SOUTHERN BELL TO BETTER
13 RESPOND TO THE NEEDS OF ITS CUSTOMERS AND BETTER
14 MEET THE GROWING COMPETITIVE CHALLENGES IT FACES.
15 THE PROPOSED CHANGE IN THE SHARING RATIO WILL
16 PROVIDE ENHANCED INCENTIVES FOR SOUTHERN BELL TO
17 OPERATE EFFICIENTLY, WHICH IS BENEFICIAL FOR BOTH
18 THE COMPANY'S SHAREHOLDERS AND ITS CUSTOMERS.

19

20 Q. WHY IS IT IMPORTANT TO IMPLEMENT A SOUND,
21 PROGRESSIVE REGULATORY PLAN FOR THE
22 TELECOMMUNICATIONS INDUSTRY IN FLORIDA?

23

24 A. THE TELECOMMUNICATIONS SECTOR IN FLORIDA IS VITAL
25 TO THE STATE'S ECONOMIC SUCCESS AND WELL BEING.

1 BUSINESSSES OF ALL SORTS AND SIZES RELY ON
2 TELECOMMUNICATIONS SERVICES FOR THEIR EVERYDAY
3 OPERATIONS. NEEDLESS TO SAY, INDIVIDUALS ALSO RELY
4 ON THE TELECOMMUNICATIONS NETWORK FOR PROMPT,
5 RELIABLE SERVICE. VIRTUALLY EVERY CITIZEN IN THE
6 STATE IS AFFECTED, BOTH DIRECTLY AND INDIRECTLY, BY
7 THE PERFORMANCE OF THE TELECOMMUNICATIONS SECTOR.

8
9 THE IMPORTANCE OF THE TELECOMMUNICATIONS SECTOR
10 UNDERSCORES THE IMPORTANCE OF ITS PERFORMANCE. ITS
11 PERFORMANCE, IN TURN, IS HEAVILY INFLUENCED BY THE
12 REGULATORY MANDATES UNDER WHICH THE FIRMS IN THE
13 INDUSTRY OPERATE. THUS, THE NEED IS APPARENT FOR
14 REGULATORY PLANS THAT WILL ENSURE OUTSTANDING
15 PERFORMANCE BY THE FIRMS THAT OPERATE IN THE
16 TELECOMMUNICATIONS INDUSTRY.

17
18 Q. WHAT, IN YOUR VIEW, ARE THE DIFFICULTIES A
19 REGULATOR FACES IN DEVISING SUCH REGULATORY PLANS?

20
21 A. A REGULATOR'S JOB IS A DIFFICULT ONE BECAUSE THE
22 REGULATOR'S KNOWLEDGE OF THE REGULATED INDUSTRY IS
23 UNAVOIDABLY LIMITED. IF A REGULATOR HAD PERFECT
24 INFORMATION ABOUT EVERY ASPECT OF THE REGULATED
25 FIRM'S TECHNOLOGY, ABOUT EVERY DETAIL OF CONSUMERS'

1 PREFERENCES, AND ABOUT EVERY ACTION UNDERTAKEN BY
2 EMPLOYEES OF THE FIRM, THE REGULATOR'S JOB WOULD BE
3 RELATIVELY SIMPLE. THE REGULATOR WOULD ONLY HAVE
4 TO CALCULATE THE PRODUCT OFFERINGS THAT, NET OF
5 COST, PROVIDE THE GREATEST VALUE TO CONSUMERS. THE
6 REGULATOR COULD THEN DICTATE TO THE FIRM THE
7 PRECISE MANNER IN WHICH TO PRODUCE THE MANDATED SET
8 OF SERVICES AT MINIMUM COST, AND COMPENSATE THE
9 FIRM FOR ONLY THESE MINIMAL COSTS.

10

11 IN PRACTICE, OF COURSE, NO PERSON OR GROUP OF
12 PERSONS CAN BE SO OMNISCIENT. CONSEQUENTLY, A
13 REGULATOR MUST RELY IN PART ON THE EXPERTISE OF
14 OTHERS TO ACHIEVE SUCH DESIRABLE OUTCOMES AS
15 PRODUCTION OF THE BEST ARRAY OF PRODUCTS AT MINIMUM
16 COST. MANY INDIVIDUALS WITH CONSIDERABLE KNOWLEDGE
17 ABOUT THE REGULATED INDUSTRY ARE EMPLOYED BY THE
18 REGULATED FIRM. THE REGULATOR WOULD DO WELL TO
19 MOTIVATE THESE INDIVIDUALS TO EMPLOY THEIR
20 EXPERTISE IN THE SOCIAL INTEREST. APPROPRIATE
21 INCENTIVE REGULATION DOES JUST THAT. IT MOTIVATES
22 THE REGULATED FIRM TO FURTHER DEVELOP ITS EXPERTISE
23 AND TO USE ITS CREATIVE ENERGIES AND KNOWLEDGE TO
24 ENSURE GOOD PERFORMANCE IN THE INDUSTRY.

25

1 Q. WHAT DO YOU MEAN BY "GOOD PERFORMANCE"?

2

3 A. GOOD PERFORMANCE HAS A NUMBER OF DIMENSIONS. ONE
4 DIMENSION IS A RELIABLE SUPPLY OF THE PRODUCTS
5 DESIRED BY CONSUMERS AT REASONABLE PRICES. ANOTHER
6 IMPORTANT DIMENSION IS EFFICIENT OPERATION BY THE
7 PRODUCER, WHICH INCLUDES MINIMIZING CURRENT
8 PRODUCTION COSTS, AND CONSTANT STRIVING TO REDUCE
9 FUTURE OPERATING COSTS. GOOD PERFORMANCE ALSO
10 ENTAILS LIMITING THE EXPENSE AND BURDEN OF THE
11 REGULATORY PROCESS ITSELF.

12

13 Q. HOW HAS PAST REGULATORY POLICY ATTEMPTED TO ENSURE
14 GOOD PERFORMANCE IN THE TELECOMMUNICATIONS
15 INDUSTRY?

16

17 A. IN THE PAST, REGULATORS HAVE ATTEMPTED TO ENSURE AN
18 ADEQUATE SUPPLY OF REGULATED PRODUCTS AT REASONABLE
19 PRICES THROUGH VARIOUS FORMS OF COST-BASED
20 REGULATION. AS A ROUGH CARICATURE, COST-BASED
21 REGULATION CAN BE VIEWED AS A PROCESS IN WHICH THE
22 FIRM'S TOTAL COSTS ARE ESTIMATED, AND PRICES ARE
23 SET TO GENERATE REVENUES TO RECOVER THOSE COSTS,
24 WHICH INCLUDE A REASONABLE RETURN. THE RATIONALE
25 BEHIND COST-BASED REGULATION IS THAT PROVIDED

1 REVENUES RECOVER THESE COSTS, THE REGULATED FIRM
2 CAN PROMISE A RETURN TO INVESTORS THAT WILL ATTRACT
3 AN ADEQUATE SUPPLY OF CAPITAL FOR INVESTMENT, WHICH
4 IN TURN FACILITATES ADEQUATE SUPPLY OF THE FIRM'S
5 PRODUCTS.

6

7 Q. IS COST-BASED REGULATION THE MOST APPROPRIATE FORM
8 OF REGULATION?

9

10 A. I DO NOT BELIEVE IT IS, PARTICULARLY WHEN THE
11 REGULATED FIRM FACES COMPETITION IN THE
12 MARKETPLACE.

13

14 Q. WHAT ARE THE DRAWBACKS TO COST-BASED REGULATION?

15

16 A. ALTHOUGH COST-BASED REGULATION CAN FACILITATE
17 ADEQUATE PRODUCT SUPPLY, IT GENERALLY DOES NOT
18 PROVIDE THE IDEAL INCENTIVES FOR THE FIRM TO
19 OPERATE EFFICIENTLY. UNDER A PROCESS IN WHICH
20 ALLOWED REVENUES DECREASE AS COSTS DECLINE, THE
21 FIRM DOES NOT HAVE THE STRONGEST INCENTIVES TO KEEP
22 COSTS TO A MINIMUM. FURTHERMORE, IF THE FIRM'S
23 MAXIMUM RETURN IS CAPPED AT A RELATIVELY LOW LEVEL,
24 THE FIRM WILL HAVE LITTLE INCENTIVE TO DEVELOP NEW
25 AND BETTER PRODUCTS AND TECHNOLOGIES.

1
2 AN ADDITIONAL DRAWBACK TO COST-BASED REGULATION
3 ARISES WHEN COMPETITION IS PRESENT IN AN INDUSTRY.
4 COMPETITION, ITSELF, CAN MOTIVATE THE REGULATED
5 FIRM TO MINIMIZE PRODUCTION COSTS AND BE RESPONSIVE
6 TO CUSTOMER NEEDS. IF COMPLEX REGULATORY
7 PROCEDURES LIMIT THE ABILITY OF THE REGULATED FIRM
8 TO RESPOND TO COMPETITIVE PRESSURES, THE
9 OPPORTUNITY FOR COMPETITION TO DISCIPLINE THE
10 REGULATED FIRM MAY BE LARGELY FORFEITED.
11 FURTHERMORE, SINCE THE PROFIT MOTIVE IS WHAT SPURS
12 A FIRM TO BE RESPONSIVE TO CONSUMERS' NEEDS IN A
13 COMPETITIVE ENVIRONMENT, RESPONSIVENESS CANNOT BE
14 EXPECTED UNDER A COST-BASED REGIME IN WHICH ALLOWED
15 RETURNS TO THE FIRM ARE LARGELY INSENSITIVE TO ITS
16 EFFORTS AND PERFORMANCE.

17

18 Q. ARE THERE OTHER FORMS OF REGULATION THAT, IN YOUR
19 VIEW, ARE MORE APPROPRIATE, PARTICULARLY WHEN THE
20 REGULATED FIRM FACES COMPETITION IN THE
21 MARKETPLACE?

22

23 A. YES. A PLAN LIKE SOUTHERN BELL'S PRICE REGULATION
24 PLAN IS MORE APPROPRIATE. UNDER THE PRICE
25 REGULATION PLAN, SOUTHERN BELL'S PRICES ARE

1 GOVERNED LARGELY BY EXOGENOUS COST MEASURES AND
2 MARKET FORCES, RATHER THAN BY THE COMPANY'S OWN
3 EARNINGS AND COSTS. THE FOCUS OF THE PRICE
4 REGULATION PLAN IS ON PRICES RATHER THAN COSTS,
5 THEREBY LIMITING SOME OF THE MAIN DRAWBACKS TO
6 TRADITIONAL COST-BASED REGULATION THAT I'VE
7 MENTIONED.

8

9 Q. HOW ARE CUSTOMERS ASSURED OF REASONABLE PRICES
10 UNDER SOUTHERN BELL'S PRICE REGULATION PLAN?

11

12 A. UNDER ITS PRICE REGULATION PLAN, SOUTHERN BELL
13 GUARANTEES A REDUCTION IN REAL AVERAGE PRICES OF AT
14 LEAST 4.0% ANNUALLY, BARRING EXCEPTIONALLY LOW
15 EARNINGS OR ADVERSE CHANGES IN CERTAIN EXOGENOUS
16 FACTORS LIKE TAXES. THUS, SOUTHERN BELL PROMISES
17 IN ADVANCE TO PASS ALONG TO CUSTOMERS IN THE FORM
18 OF LOWER AVERAGE PRICES A 4.0% PRODUCTIVITY
19 DIVIDEND, WHETHER OR NOT THE COMPANY IS ACTUALLY
20 ABLE TO ACHIEVE AN INCREASE IN PRODUCTIVITY OF THIS
21 MAGNITUDE. THEREFORE, REASONABLE PRICE LEVELS ARE
22 ENSURED FOR SOUTHERN BELL'S CUSTOMERS BY SETTING A
23 REASONABLE PRODUCTIVITY TARGET FOR THE COMPANY IN
24 ADVANCE, RATHER THAN BY RESETTING PRICES AFTER THE
25 FACT TO OFFSET ANY PRODUCTIVITY GAINS ACTUALLY

1 ACHIEVED BY THE COMPANY. THIS PLAN PUTS STRONG
2 PRESSURE ON SOUTHERN BELL TO OPERATE MORE
3 EFFICIENTLY, KNOWING THAT IT MUST REDUCE REAL
4 PRICES ON AVERAGE EACH YEAR, EVEN IF ITS EARNINGS
5 ARE MODEST. FURTHERMORE, BECAUSE SOUTHERN BELL
6 MUST GUARANTEE THESE PRICE REDUCTIONS IN ADVANCE,
7 THE PRICE REGULATION PLAN IMPOSES ON THE COMPANY
8 RISK THAT IS NORMALLY BORNE BY CUSTOMERS UNDER
9 TRADITIONAL COST-BASED REGULATION.

10

11 Q. ARE THERE ANY PROVISIONS IN THE PRICE REGULATION
12 PLAN THAT ENABLE SOUTHERN BELL TO BETTER MANAGE
13 THIS INCREASED RISK?

14

15 A. YES. THE ADDITIONAL PRICING FLEXIBILITY THAT THE
16 COMPANY RECEIVES UNDER THE PLAN CAN BE USEFUL IN
17 THIS REGARD. SOUTHERN BELL'S ENHANCED ABILITY TO
18 ALTER TARIFFS IN RESPONSE TO CHANGING MARKET
19 CONDITIONS AND CUSTOMER PREFERENCES CAN HELP IT
20 MANAGE THE INCREASED RISK IT FACES UNDER THE PRICE
21 REGULATION PLAN.

22

23 Q. YOU HAVE MENTIONED THAT A REGULATORY PLAN SHOULD
24 LIMIT THE EXPENSE AND BURDEN OF THE REGULATORY
25 PROCESS. DOES THE PRICE REGULATION PLAN DO SO?

1
2 A. THE PRICE REGULATION PLAN REPRESENTS AN IMPROVEMENT
3 OVER THE CURRENT INCENTIVE REGULATION PLAN IN THIS
4 REGARD. UNDER THE PRICE REGULATION PLAN, THE PRICE
5 CHANGES THAT SOUTHERN BELL IS PERMITTED TO MAKE ARE
6 LARGELY PRESPECIFIED IN A COMPREHENSIBLE FORMULA.
7 FURTHERMORE, THIS FORMULA GENERALLY DOES NOT LINK
8 ALLOWED PRICES TO COST MEASURES THAT ARE DIFFICULT
9 TO CALCULATE. THEREFORE, THE REGULATORY PROCESS IS
10 STREAMLINED UNDER THE PRICE REGULATION PLAN, AND
11 LENGTHY REGULATORY HEARINGS ARE GENERALLY NOT
12 REQUIRED TO DETERMINE INDIVIDUAL TARIFFS.

13
14 A STREAMLINED REGULATORY PROCESS IS BENEFICIAL
15 QUITE GENERALLY, BUT IS PARTICULARLY BENEFICIAL
16 WHEN THE REGULATED FIRM FACES COMPETITION. TO
17 COMPETE EFFECTIVELY FOR CUSTOMERS, A REGULATED FIRM
18 MUST BE ABLE TO PROMISE NOT ONLY HIGH-QUALITY,
19 DEPENDABLE SERVICE, BUT TIMELY SERVICE ALSO. MANY
20 BUSINESS CUSTOMERS FACE STRONG COMPETITIVE PRESSURE
21 THEMSELVES, AND CAN'T AFFORD TO WAIT TO LEARN
22 WHETHER IMPORTANT TELECOMMUNICATIONS SERVICES CAN
23 BE PROVIDED AND ON WHAT TERMS. THE REGULATED FIRM
24 RISKS LOSING THESE CUSTOMERS IF REGULATORY DELAYS
25 ARE EXCESSIVE.

1
2 COMPETITORS ARE AFFORDED AN ADDITIONAL STRATEGIC
3 ADVANTAGE BY LENGTHY REGULATORY DELAYS. WHEN THE
4 REGULATED FIRM REQUESTS APPROVAL OF TARIFFS FOR
5 PARTICULAR SERVICES, IT SIGNALS IMPORTANT
6 INFORMATION TO COMPETITORS ABOUT ITS INTENDED
7 PRICING POLICIES AND SERVICE OFFERINGS. IF
8 REGULATORY APPROVAL OF TARIFFS IS NOT FORTHCOMING
9 IN A TIMELY FASHION, COMPETITORS MAY BE ABLE TO ACT
10 ON THE REVEALED INFORMATION, AND CAPTURE THE
11 REGULATED FIRM'S INTENDED CUSTOMERS BEFORE THE
12 REGULATED ENTERPRISE IS AUTHORIZED TO ACT.

13

14 Q. ARE THERE ANY OTHER ADVANTAGES OF THE PRICE
15 REGULATION PLAN RELATIVE TO THE INCENTIVE
16 REGULATION PLAN UNDER WHICH SOUTHERN BELL CURRENTLY
17 OPERATES?

18

19 A. YES, THERE ARE THREE ADDITIONAL ADVANTAGES. FIRST,
20 THE PRICE REGULATION PLAN ENHANCES SOUTHERN BELL'S
21 ABILITY TO MAINTAIN ITS COMMITMENT TO PROVIDE LOW-
22 PRICED BASIC TELEPHONE SERVICE THROUGHOUT FLORIDA.
23 SECOND, THE PRICE REGULATION PLAN ENABLES SOUTHERN
24 BELL TO BE MORE RESPONSIVE TO THE NEEDS AND DESIRES
25 OF ITS CUSTOMERS. THIRD, THE PLAN HELPS FOSTER A

1 MORE COMPETITIVE CORPORATE CULTURE WITHIN SOUTHERN
2 BELL.

3

4 Q. PLEASE EXPLAIN EACH OF THESE ADVANTAGES IN MORE
5 DETAIL.

6

7 A. AS MR. LOMBARDO'S TESTIMONY INDICATES, SOUTHERN
8 BELL HAS LOST CONSIDERABLE REVENUE TO COMPETITORS
9 IN RECENT YEARS. IF THE LOSS IN REVENUES TO
10 COMPETITORS IS NOT STEMMED OR REPLACED BY OTHER
11 REVENUES, SOUTHERN BELL'S ABILITY TO PROVIDE LOW-
12 PRICED BASIC TELEPHONE SERVICE THROUGHOUT FLORIDA
13 MAY BE JEOPARDIZED. THE PRICE REGULATION PLAN
14 ENHANCES SOUTHERN BELL'S ABILITY BOTH TO REDUCE
15 LOSSES IN REVENUE TO COMPETITORS AND TO REPLACE
16 FROM OTHER SOURCES SOME OF THE REVENUE THAT IS
17 ERODED BY COMPETITION. THE INCREASED PRICING
18 FLEXIBILITY UNDER THE PLAN WILL BETTER ENABLE
19 SOUTHERN BELL TO MEET COMPETITIVE CHALLENGES HEAD
20 ON. IT WILL ALSO IMPROVE THE COMPANY'S ABILITY TO
21 IMPLEMENT PRICES THAT MORE CLOSELY REFLECT THE
22 VALUE CUSTOMERS DERIVE FROM THE SERVICES THEY
23 PURCHASE.
24
25 WITH EXPANDED ABILITY AND INCREASED INCENTIVE TO

1 IMPLEMENT PRICES AND SERVICES THAT PROMISE MUTUAL
2 GAINS FOR SOUTHERN BELL AND ITS CUSTOMERS, THE
3 COMPANY IS NATURALLY MOTIVATED TO BE PARTICULARLY
4 RESPONSIVE TO THE NEEDS AND DESIRES OF ITS
5 CUSTOMERS, JUST AS IN A COMPETITIVE MARKETPLACE.
6 BY BETTER APPROXIMATING THE INCENTIVES IN A
7 COMPETITIVE ENVIRONMENT, THE PRICE REGULATION PLAN
8 WILL HELP FOSTER A MORE COMPETITIVE SPIRIT WITHIN
9 THE REGULATED FIRM. A COMPETITIVE CORPORATE
10 CULTURE IS IMPORTANT FOR THE LONG-RUN VIABILITY OF
11 A FIRM THAT IS CERTAIN TO BE FACING MORE INTENSE
12 COMPETITION IN THE COMING YEARS. THE PRESENCE OF A
13 STRONG, INNOVATIVE, COMPETITIVE TELECOMMUNICATIONS
14 PROVIDER IN FLORIDA WILL ATTRACT BUSINESS TO THE
15 STATE, WHICH IN TURN WILL PROVIDE MORE JOBS AND
16 SECURE OTHER BENEFITS FOR ALL FLORIDIANS.

17

18 Q. TO THIS POINT, YOU SEEM TO HAVE SPOKEN OF
19 UNRESTRICTED PRICING FLEXIBILITY FOR THE REGULATED
20 FIRM. YET SOUTHERN BELL'S PRICE REGULATION PLAN
21 EXPLICITLY LIMITS THE COMPANY'S FREEDOM TO RAISE
22 PRICES ON CERTAIN SERVICES. WHAT IS THE PURPOSE OF
23 THESE RESTRICTIONS?

24

25 A. THESE RESTRICTIONS SERVE AS ADDITIONAL GUARANTEES

1 TO CUSTOMERS THAT INCREASES IN THE PRICES THEY PAY
2 FOR CERTAIN SERVICES BE WITHIN SPECIFIED LIMITS
3 UNDER THE PRICE REGULATION PLAN. ALTHOUGH THE PLAN
4 REQUIRES REAL PRICES TO FALL BY 4.0% ANNUALLY ON
5 AVERAGE, IT IS CONCEIVABLE THAT PRICES FOR SOME
6 SERVICES COULD RISE IF PRICES ON OTHER SERVICES
7 FALL BY MORE THAN 4.0% IN REAL TERMS, OR IF THE
8 INFLATION RATE IS HIGH. THE PROPOSED PRICING
9 RESTRICTIONS LIMIT PRICE INCREASES ON THE
10 STIPULATED SERVICES, REGARDLESS OF HOW MUCH PRICES
11 ARE REDUCED ON OTHER SERVICES, AND REGARDLESS OF
12 HOW HIGH THE INFLATION RATE MIGHT BE.

13

14 Q. WHAT ARE THE MAIN RESTRICTIONS ON PRICING
15 FLEXIBILITY CONTAINED IN SOUTHERN BELL'S PRICE
16 REGULATION PLAN, AND ARE THESE RESTRICTIONS
17 APPROPRIATE?

18

19 A. THE KEY RESTRICTION IS THE LIMIT OF FIVE PERCENT ON
20 ANNUAL PRICE INCREASES FOR BASIC SERVICES SUCH AS
21 LOCAL EXCHANGE SERVICE. THIS RESTRICTION IS A
22 REASONABLE RESPONSE TO THIS COMMISSION'S SOCIAL
23 OBJECTIVE OF PROVIDING SUPPORT TO CONSUMERS OF
24 BASIC TELEPHONE SERVICES. FOR NON-BASIC SERVICES
25 THAT CURRENTLY HAVE BANDED RATES, THE EXISTING

1 MAXIMUM AND MINIMUM RATES IN THE BAND WILL BE
2 RETAINED AS PRICE CEILINGS AND FLOORS, THEREBY
3 PROVIDING AT LEAST THE PROTECTION THAT CUSTOMERS OF
4 THESE SERVICES CURRENTLY ENJOY. FOR NON-BASIC
5 SERVICES THAT DO NOT CURRENTLY HAVE BANDED RATES, A
6 TWENTY PERCENT LIMIT ON ANNUAL PRICE INCREASES IS
7 IMPOSED. THE LIMIT PROVIDES SOME ADDITIONAL
8 PROTECTION FOR CONSUMERS OF THESE SERVICES WITHOUT
9 UNDULY RESTRICTING SOUTHERN BELL'S FLEXIBILITY.

10

11 Q. ABSENT THESE RESTRICTIONS ON PRICING FLEXIBILITY,
12 ARE THERE ANY INCENTIVES FOR SOUTHERN BELL TO USE
13 APPROPRIATELY THE PRICING FLEXIBILITY IT IS
14 PROPOSING?

15

16 A. THE PRICING PREFERENCES OF THE REGULATED FIRM AND
17 SOCIETY ARE NOT NECESSARILY AT ODDS. FOR EXAMPLE,
18 SUPPOSE SOCIETY WOULD LIKE TO SET PRICES TO
19 GENERATE THE GREATEST DIFFERENCE BETWEEN THE VALUE
20 CONSUMERS DERIVE FROM REGULATED SERVICES AND THE
21 AMOUNT CONSUMERS PAY FOR THESE SERVICES, WHILE
22 ENSURING THE FIRM A FAIR RETURN ON ITS INVESTMENTS.
23 ALSO SUPPOSE CONSUMER DEMAND FOR EACH REGULATED
24 SERVICE DOES NOT DEPEND ON THE PRICES OF OTHER
25 REGULATED SERVICES. IN THIS CASE, IT TURNS OUT TO

1 BE BEST FOR SOCIETY TO RAISE PRICES FARTHEST ABOVE
2 COST ON THOSE SERVICES FOR WHICH CONSUMER DEMAND IS
3 NOT VERY SENSITIVE TO PRICE, AND TO KEEP PRICES
4 CLOSER TO COST ON THOSE SERVICES FOR WHICH CONSUMER
5 DEMAND IS MORE PRICE-SENSITIVE.

6
7 THE EXPLANATION FOR THIS CONCLUSION IS THE
8 FOLLOWING. WHEN CONSUMER DEMAND FOR A SERVICE IS
9 NOT VERY PRICE-SENSITIVE, AN INCREASE IN THE PRICE
10 OF THAT SERVICE WILL NOT CAUSE A SUBSTANTIAL
11 REDUCTION IN THE AMOUNT OF THE SERVICE THAT
12 CONSUMERS PURCHASE. THEREFORE, A PRICE INCREASE
13 WILL NOT RESULT IN A PRONOUNCED LOSS IN THE VALUE
14 CUSTOMERS DERIVE FROM CONSUMING THE SERVICE. IN
15 CONTRAST, WHEN CONSUMER DEMAND FOR A SERVICE IS
16 VERY PRICE-SENSITIVE, AN INCREASE IN THE PRICE OF
17 THAT SERVICE WILL CAUSE CUSTOMERS TO REDUCE THEIR
18 CONSUMPTION OF THE SERVICE BY A RELATIVELY LARGE
19 AMOUNT. THEREFORE, A SIGNIFICANT PORTION OF THE
20 VALUE CUSTOMERS MIGHT DERIVE FROM CONSUMING THE
21 SERVICE IS LOST WHEN THE PRICE OF THE SERVICE IS
22 RAISED. CONSEQUENTLY, IT IS BEST FROM SOCIETY'S
23 VIEWPOINT TO HOLD PRICES FOR SERVICES WITH PRICE-
24 SENSITIVE DEMAND CLOSE TO COST, AND RAISE PRICES
25 FARTHER ABOVE COST ON SERVICES FOR WHICH DEMAND IS

1 NOT VERY PRICE-SENSITIVE.
2
3 MOST IMPORTANTLY, A FIRM THAT FACES NO PRICING
4 RESTRICTIONS AND THAT CHOOSES PRICES TO MAXIMIZE
5 PROFITS WILL IMPLEMENT A SIMILAR PRICE STRUCTURE.
6 THE UNREGULATED MONOPOLIST WILL RAISE PRICES
7 FARTHEST ABOVE COST ON PRODUCTS FOR WHICH CONSUMER
8 DEMAND IS NOT PRICE-SENSITIVE, KNOWING THAT THE
9 HIGHER PRICES WILL GENERATE MORE REVENUE SINCE
10 CONSUMERS' PURCHASES WILL NOT BE REDUCED VERY MUCH.
11 THE FIRM WILL HOLD PRICES CLOSER TO COST ON
12 PRODUCTS FOR WHICH CONSUMER DEMAND IS PRICE-
13 SENSITIVE, SINCE LOW PRICES SPUR CONSIDERABLE
14 PURCHASES FOR THESE PRODUCTS AND GENERATE MORE
15 REVENUE. CONSEQUENTLY, EVEN WHEN ACTING ENTIRELY
16 IN ITS OWN SELF-INTEREST IN THIS SETTING, THE FIRM
17 WILL TEND TO MOVE PRICES IN THE DIRECTION THAT ALSO
18 SERVES THE BROADER SOCIAL INTEREST.
19
20 Q. ARE YOU SUGGESTING THAT THE FIRM WILL ALWAYS SET
21 PRICES IN THE SOCIAL INTEREST, EVEN IF THERE ARE NO
22 RESTRICTIONS ON ITS PRICING FLEXIBILITY.
23
24 A. THE PRICES THAT ARE BEST FROM SOCIETY'S VIEWPOINT
25 DEPEND ON SOCIETY'S GOALS AND OBJECTIVES. FOR

1 INSTANCE, SOCIETY MAY WISH TO FAVOR CONSUMERS OF
2 PRODUCTS FOR WHICH DEMAND IS NOT VERY PRICE-
3 SENSITIVE. IN THIS CASE, IT MAY BE BEST FROM
4 SOCIETY'S VIEWPOINT TO HOLD PRICES FOR THESE
5 SERVICES CLOSER TO THEIR COSTS OF PRODUCTION, AND
6 IMPLEMENT HIGHER PRICES ON CERTAIN SERVICES FOR
7 WHICH CONSUMER DEMAND IS MORE PRICE-SENSITIVE.
8 HERE, THE FIRM'S PRICING PREFERENCES AND THOSE OF
9 SOCIETY WILL NOT COINCIDE. IN CASES LIKE THESE,
10 WHERE THE SOCIAL OBJECTIVE IS EXPLICITLY TO FAVOR
11 SOME GROUPS OF CONSUMERS, ARGUMENTS CAN BE MADE FOR
12 ADDITIONAL SAFEGUARDS WHEN PRICING DECISIONS ARE
13 DELEGATED TO THE REGULATED FIRM. FOR EXAMPLE, THE
14 EXTENT TO WHICH THE FIRM IS PERMITTED TO RAISE
15 PRICES ON PARTICULAR SERVICES MAY BE LIMITED FOR
16 PUBLIC POLICY REASONS, AS UNDER SOUTHERN BELL'S
17 PRICE REGULATION PLAN.

18

19 Q. ARE THERE ANY DRAWBACKS TO THESE ADDITIONAL
20 RESTRICTIONS ON PRICING FLEXIBILITY?

21

22 A. THESE RESTRICTIONS ON PRICING FLEXIBILITY ARE NOT
23 COSTLESS. THE COSTS STEM FROM TWO SOURCES. FIRST,
24 LOWER PRICES IMPOSED ON SOME SERVICES WILL
25 GENERALLY RESULT IN HIGHER PRICES ON OTHER SERVICES

1 UNDER A PLAN THAT LIMITS THE AVERAGE LEVEL OF
2 PRICES. THIS MEANS THAT THE GAINS TO THE FAVORED
3 GROUP OF CUSTOMERS COME AT THE EXPENSE OF LOSSES TO
4 OTHER CUSTOMER GROUPS. SECOND, THE CEILING ON
5 PRICES COULD LIMIT THE REVENUE THAT THE FIRM CAN
6 GENERATE, LEADING TO A REDUCTION IN ITS POTENTIAL
7 EARNINGS. CONSEQUENTLY, THE LEVEL OF AVERAGE
8 PRICES THAT THE FIRM CAN REASONABLY ASK OF
9 CONSUMERS MAY NEED TO BE RAISED.

10

11 Q. MIGHT THE ADDITIONAL PRICING FLEXIBILITY THAT
12 SOUTHERN BELL RECEIVES UNDER ITS PRICE REGULATION
13 PLAN LEAD TO CROSS SUBSIDIES?

14

15 A. IT IS ENTIRELY POSSIBLE THAT LOCAL EXCHANGE SERVICE
16 WILL BE SUBSIDIZED UNDER THE PRICE REGULATION PLAN.
17 REVENUES FROM NON-BASIC SERVICES MAY BE EMPLOYED TO
18 SUPPORT A PRICE BELOW SOUTHERN BELL'S COST OF
19 PROVIDING LOCAL EXCHANGE SERVICE. HOWEVER, THERE
20 IS AN IMPORTANT SAFEGUARD BUILT INTO THE PRICE
21 REGULATION PLAN THAT WILL PREVENT SUBSIDIES TO
22 OTHER SERVICES. THE PRICE REGULATION PLAN
23 PROHIBITS PRICE REDUCTIONS FOR OTHER SERVICES BELOW
24 THE LONG RUN INCREMENTAL COST OF PRODUCING THESE
25 SERVICES. CONSEQUENTLY, THE PRICE OF EACH OF THESE

1 SERVICES WILL NOT FALL BELOW THE EXTRA COST THAT
2 SOUTHERN BELL INCURS BECAUSE OF ITS DECISION TO
3 SUPPLY THE SERVICE.

4

5 Q. WHAT IS THE ROLE OF EARNINGS SHARING IN THE PRICE
6 REGULATION PLAN?

7

8 A. EARNINGS SHARING SECURES FOR CUSTOMERS A PORTION OF
9 THE EARNINGS THAT SOUTHERN BELL MAY GENERATE UNDER
10 THE PRICE REGULATION PLAN. BECAUSE IT CAUSES THE
11 COMPANY'S RETURNS TO FALL SHORT OF ITS EARNINGS
12 OVER CERTAIN RANGES, EARNINGS SHARING SERVES TO
13 LIMIT INCENTIVES FOR EFFICIENT PERFORMANCE. THE
14 IDEAL INCENTIVES FOR COST MINIMIZATION ONLY ARISE
15 UNDER ANY REGULATORY PLAN IF THE REGULATED FIRM IS
16 PERMITTED TO RETAIN THE ENTIRE VALUE OF ANY COST
17 REDUCTIONS IT GENERATES. BY TAXING THE SUCCESS OF
18 THE REGULATED FIRM, THE FIRM'S INCENTIVES FOR
19 EFFICIENT PERFORMANCE ARE REDUCED.

20

21 DESPITE THIS DRAWBACK, THE EARNINGS SHARING
22 COMPONENT OF THE PRICE REGULATION PLAN REPRESENTS A
23 SENSIBLE COMPROMISE WITH POLITICAL REALITIES.
24 SHOULD SOUTHERN BELL GENERATE SIZEABLE EARNINGS
25 UNDER THE PRICE REGULATION PLAN BECAUSE OF DILIGENT

1 EFFORT, SOME WILL BE TEMPTED TO ATTRIBUTE THE
2 EARNINGS SUCCESS TO SHORTCOMINGS OF THE PLAN RATHER
3 THAN TO THE EFFORTS OF THE COMPANY. TO AVOID SUCH
4 CONTROVERSY, IT IS REASONABLE FOR SOUTHERN BELL TO
5 SHARE SOME EARNINGS DIRECTLY WITH CUSTOMERS, MUCH
6 AS IT DOES UNDER THE CURRENT INCENTIVE REGULATION
7 PLAN.

8

9 Q. ARE THERE ANY DIFFERENCES IN EARNINGS SHARING UNDER
10 THE PROPOSED PRICE REGULATION PLAN RELATIVE TO
11 SOUTHERN BELL'S CURRENT INCENTIVE REGULATION PLAN?

12

13 A. UNDER THE CURRENT INCENTIVE REGULATION PLAN, THE
14 FIRM RETAINS ONLY 40% OF ITS EARNINGS WHEN ITS
15 REALIZED RATE OF RETURN IS BETWEEN 14% AND 16%.
16 THE PROPOSED PRICE REGULATION PLAN INCREASES THE
17 FIRM'S SHARE OF EARNINGS IN THIS RANGE TO 50%.
18 THIS CHANGE PROVIDES ADDITIONAL INCENTIVES FOR THE
19 FIRM TO COMPETE AGGRESSIVELY IN THE MARKETPLACE AND
20 MINIMIZE PRODUCTION COSTS.

21

22 THREE POINTS SHOULD BE NOTED ABOUT THIS MODEST
23 INCREASE IN THE FRACTION OF EARNINGS THAT FLOW TO
24 SOUTHERN BELL. FIRST, THE INCREASE PROVIDES
25 BETTER, BUT STILL NOT IDEAL, INCENTIVES FOR THE

1 FIRM. THE IDEAL INCENTIVES FOR EFFICIENT
2 PERFORMANCE ARE ONLY PROVIDED IF THE FIRM RECEIVES
3 THE ENTIRE BENEFITS THAT RESULT FROM THE ACTIVITIES
4 IT UNDERTAKES TO IMPROVE PERFORMANCE. NOTICE THAT
5 THE PRICE-CAP PLANS UNDER WHICH AT&T AND BRITISH
6 TELECOM OPERATE DO NOT REQUIRE THE FIRM TO SHARE
7 ANY OF ITS EARNINGS WITH CUSTOMERS.
8
9 SECOND, CUSTOMERS WILL NOT NECESSARILY RECEIVE
10 FEWER DOLLARS WHEN THE FRACTION OF REALIZED
11 EARNINGS THEY ARE AWARDED DECLINES. THE INCREASED
12 INCENTIVES FOR EFFICIENT PERFORMANCE THAT ARISE AS
13 SOUTHERN BELL'S RETURNS MORE CLOSELY PARALLEL ITS
14 EARNINGS MAY RESULT IN GREATER EARNINGS.
15 CONCEIVABLY, EARNINGS MAY INCREASE SUFFICIENTLY TO
16 GENERATE GREATER NOMINAL RETURNS FOR CUSTOMERS.
17
18 THIRD, THE INCREASE IN THE FRACTION OF EARNINGS
19 THAT ACCRUE TO SOUTHERN BELL MUST BE VIEWED IN
20 RELATION TO THE COMPANY'S PROMISE TO REDUCE AVERAGE
21 REAL PRICES BY 4.0% ANNUALLY. SUBSTANTIAL BENEFITS
22 TO CUSTOMERS ARE BEING GUARANTEED IN RETURN FOR THE
23 OPPORTUNITY TO SHARE EARNINGS EQUALLY WITHIN THE
24 14% - 16% RANGE.
25

1 Q. IS SOUTHERN BELL'S PROPOSAL TO USE EXISTING RATES
2 FOR THE INITIAL PRICE REGULATION INDEX APPROPRIATE?

3

4 A. YES, IT IS. SOUTHERN BELL SHOULD BE REWARDED, NOT
5 PUNISHED, FOR ANY GAINS IT HAS ACHIEVED UNDER THE
6 CURRENT INCENTIVE REGULATION PLAN. IN PARTICULAR,
7 IF SOUTHERN BELL HAS MANAGED TO REDUCE OPERATING
8 COSTS IN RECENT YEARS, THESE REALIZED COST
9 REDUCTIONS SHOULD NOT BE USED TO JUSTIFY LOWER
10 FUTURE REVENUES FOR THE COMPANY. TO DO SO WOULD
11 CONSTITUTE A RETURN TO TRADITIONAL COST-BASED
12 REGULATION UNDER WHICH THE COMPANY'S INCENTIVE TO
13 OPERATE EFFICIENTLY IS REDUCED. BY INITIATING THE
14 PRICE REGULATION PLAN AT CURRENT PRICE LEVELS,
15 SOUTHERN BELL WILL BE SENT THE IMPORTANT MESSAGE
16 THAT IT WILL BE REWARDED FOR SUPERIOR PERFORMANCE,
17 AND HELD ACCOUNTABLE FOR SUBSTANDARD PERFORMANCE.
18 THIS IS PRECISELY THE MESSAGE THAT APPROPRIATE
19 INCENTIVE REGULATION SHOULD PROVIDE.

20

21 Q. PLEASE SUMMARIZE THE MAIN REASONS WHY SOUTHERN
22 BELL'S PRICE REGULATION PLAN IS A BETTER REGULATORY
23 PLAN THAN THE INCENTIVE REGULATION PLAN UNDER WHICH
24 THE COMPANY CURRENTLY OPERATES.

25

1 A. THERE ARE SIX MAIN REASONS WHY THE PRICE REGULATION
2 PLAN IS A BETTER PLAN. FIRST, EXPANDED PRICING
3 FLEXIBILITY UNDER THE PLAN BETTER EQUIPS SOUTHERN
4 BELL TO DEAL WITH THE EVER-INCREASING COMPETITIVE
5 CHALLENGES IT FACES. SECOND, THE PLAN PROVIDES
6 INCREASED ABILITY AND INCENTIVE FOR SOUTHERN BELL
7 TO IDENTIFY NEW REVENUE OPPORTUNITIES, THEREBY
8 ENABLING IT TO CONTINUE LOW-PRICED BASIC TELEPHONE
9 SERVICE THROUGHOUT FLORIDA WHILE SIMULTANEOUSLY
10 INCREASING THE COMPANY'S SENSITIVITY TO CUSTOMER
11 NEEDS AND DESIRES. THIRD, THE PRICE REGULATION
12 PLAN WILL ENHANCE SOUTHERN BELL'S ONGOING EFFORTS
13 TO FOSTER A MORE COMPETITIVE CORPORATE CULTURE
14 WITHIN THE COMPANY. THIS COMPETITIVE CULTURE IS
15 IMPORTANT FOR THE LONG-RUN VIABILITY OF THE FIRM.
16
17 FOURTH, THE PRICE REGULATION PLAN GUARANTEES
18 SIZEABLE REAL REDUCTIONS IN AVERAGE PRICE LEVELS
19 FOR CUSTOMERS. NOT ONLY ARE THE PRICE REDUCTIONS
20 VALUABLE FOR CUSTOMERS, BUT SO IS THE REDUCED RISK
21 THAT ACCOMPANIES THE UP-FRONT GUARANTEE OF PRICE
22 REDUCTIONS. FIFTH, THE INCREASED POTENTIAL FOR
23 EARNINGS SHARING UNDER THE PRICE REGULATION PLAN
24 PROVIDES ENHANCED INCENTIVES FOR EFFICIENT
25 PERFORMANCE. SIXTH, THE PRICE REGULATION PLAN HAS

1 THE POTENTIAL TO REDUCE THE COSTS AND BURDENS OF
2 THE REGULATORY PROCESS.

3

4 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

5

6 A. YES IT DOES.

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