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Legal Department

SIDNEY J. WHITE, JR.
General Attorney

Southern Bell Telephone
and Telegraph Company
Suite 400
150 South Monroe Street
Tallahassee, Florida 32301
(404) 529-5094

January 13, 1993

Mr. Steve C. Tribble
Director, Division of Records and Reporting
Florida Public Service Commission
101 East Gaines Street
Tallahassee, Florida 32301

RE: Docket No. 920260-TL

Dear Mr. Tribble:

Enclosed are an original and fifteen copies of Mr. A.M. Lombardo's corrected exhibit number AML-3, which was originally filed with his rebuttal testimony. Please replace the previous exhibit with the one enclosed herein.

A copy of this letter is enclosed. Please mark it to indicate that the original was filed and return the copy to me. Copies have been served on the parties shown on the attached Certificate of Service.

Sincerely,

Sidney J. White, Jr.

Enclosures

cc: All Parties of Record
A. M. Lombardo
H. R. Anthony
R. D. Lackey

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I HEREBY CERTIFY that a copy of the foregoing has been furnished by United States Mail this 13th day of January, 1993 to:

Robin Norton
Division of Communications
Florida Public Svc Commission
101 East Gaines Street
Tallahassee, FL 32399-0866

Michael J. Henry
MCI Telecommunications Corp.
MCI Center
Three Ravinia Drive
Atlanta, Georgia 30346-2102

Angela Green
Division of Legal Services
Florida Public Svc Commission
101 East Gaines Street
Tallahassee, FL 32399-0863

Richard D. Melson
Hopping Boyd Green & Sams
Post Office Box 6526
Tallahassee, Florida 32314
atty for MCI

Joseph A. McGlothlin
Vicki Gordon Kaufman
McWhirter, Grandoff & Reeves
716 - 315 S. Calhoun Street
Tallahassee, Florida 32301
atty for FIXCA

Rick Wright
Regulatory Analyst
Division of Audit and Finance
Florida Public Svc Commission
101 East Gaines Street
Tallahassee, FL 32399-0865

Patrick K. Wiggins
Wiggins & Villacorta, P.A.
Post Office Drawer 1657
Tallahassee, Florida 32302
atty for Intermedia

Peter M. Dunbar
Haben, Culpepper, Dunbar & French, P.A.
Post Office Box 10095
Tallahassee, FL 32301
atty for FCTA

Joseph Gillan
J. P. Gillan and Associates
Post Office Box 541038
Orlando, Florida 32854-1038

Chanthina R. Bryant
Sprint
3065 Cumberland Circle
Atlanta, GA 30339

Everett Boyd
Messer, Vickers, Caparello, Madsen, Lewis & Metz, PA
Post Office Box 1876
Tallahassee, FL 32302
atty for US Sprint

Michael W. Tye
AT&T Communications of the Southern States, Inc.
Suite 1410
106 East College Avenue
Tallahassee, Florida 32301

Charles J. Beck
Deputy Public Counsel
Office of the Public Counsel
Room 812, 111 W. Madison Street
Tallahassee, FL 32399-1400

Dan B. Hendrickson
Post Office Box 1201
Tallahassee, FL 32302
atty for FCAN

Benjamin H. Dickens, Jr.
Blooston, Mordkofsky, Jackson,
& Dickens
2120 L Street, N.W.
Washington, DC 20037

Monte Belote
Florida Consumer Action Network
4100 W. Kennedy Blvd. #128
Tampa, FL 33609

Mr. Cecil O. Simpson
General Attorney
Mr. Peter Q. Nyce, Jr.
General Attorney
Regulatory Law Office
Advocate General
Department of the Army
901 North Stuart Street
Arlington VA 22203-1837

Michael B. Twomey
Assistant Attorney General
Department of Legal Affairs
Room 1603, The Capitol
Tallahassee, FL 32399-1050

Florida Pay Telephone
Association, Inc.
c/o Mr. Lance C. Norris
President
202 - 8130 Baymeadows Cir. West
Jacksonville, FL 32256

Bill L. Bryant, Jr., Esq.
Foley & Lardner
Suite 450
215 South Monroe Street
Tallahassee, FL 32302-0508

Douglas S. Metcalf (Ad Hoc)
Communications Consultants, Inc.
P.O. Box 1148
Winter Park, FL 32790-1148

Thomas F. Woods, Esq.
Gatlin, Woods, Carlson, and
Cowdery
1709-D Mahan Drive
Tallahassee, FL 32308
atty for the Florida Hotel and
Motel Association

C. Everett Boyd, Jr.
Ervin, Varn, Jacobs, Odom &
Ervin
305 South Gadsen Street
Tallahassee, FL 32302

Laura L. Wilson, Esq.
Messer, Vickers, Caparello,
Madsen, Lewis & Metz, PA
Post Office Box 1876
Tallahassee, FL 32302
atty for FPTA

Nancy B. White

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PAGE 1 OF 3

The Challenge for Incentive Regulation

By Terrence L. Barnich

Incentive ratemaking must be viewed only as a transitional step along the road to open competition.

Symposiums, conferences, and seminars dedicated to discussing the application of incentive regulation to those sections of the energy and communications markets that still come within the jurisdiction of economic regulation are approaching ubiquity. The near unanimity of these conventions is that incentive regulation is, by far and away, a preferable regulatory regime to the traditional rate-of-return regulatory paradigm, due to the recognized distortions and inefficiencies caused by conventional, cost-plus regulation.

I approach the topic of incentive regulation with some sense of trepidation. Not because I don't "believe" in it, but rather because from what I can tell, too few of its acolytes advocate incentive regulation, properly understood. For me, as a regulator, incentive regulation should, for the most part, serve as a transitional step in a larger movement to a truly competitive model for each of its targeted regulated industries. Too often, incentive regulation is considered as an end in-and-of itself and the desired goal of promoting and developing effective competition is forgotten. Incentive regulation models should serve as the final regulatory alternative to ratebase/rate-of-return regulation only in those cases where free markets will likely fail. Surely major portions of currently regulated industries can be truly competitive if we, the regulators, would take steps to knock down the regulatory and legal impediments standing in the way of its emergence.

Conventional Aspects of Incentive Regulation

Utility regulators have conventionally applied incentiv regulation in order to repair the distortions arising out o the cost-plus nature of utility regulation. Traditionally, thes distortions have included such things as the Averch-John son (A-J) effect, in which utilities supposedly have th incentive to overbuild and "gold-plate." I say "suppos edly" simply because the A-J effect has not been quanti fied, and it has also become a less attractive theory in ligh of the recent history of such things as prudence and used and-useful disallowances in the electric industry. Nonethe less, I believe that it does exist, to one extent or anothe and it does play a role in the way utilities are managed an the way in which their managers look at their world.

Traditional incentive regulation plans have attempte to correct this type of distortion by attenuating or eve severing the tie between revenue requirement, ratebas and earnings. However, the real focus ends up "incentivizing aggregate shorter term cost reductions. While this is sound first step, and one that should not be discouraged, is only part of the picture.

Unfortunately our focus has not been on developir incentive mechanisms that promote investments in ne technologies, which in turn cut costs longer term. This is different question than that customarily raised with respect to the A-J phenomenon and one that needs addressing. With the introduction of new technologies, including reliance on software as opposed to hardware in telecommunications, many of the old economies of scale and scope analyses have been rendered obsolete.

Today, the main incentive mechanisms in use involve little more than a refinement of the effect of regulatory lag: allowing the utility the opportunity to retain only those savings achieved by cost cutting over some period of time between rate cases. As incorporated into incentive plans this provides only indirect and informal incentives, which certainly have only a short-term focus. In Illinois, for example, if the utility in question "over earns" due to this type of incentive, the commission has the obligation to call the company in and re-adjust its overall return accordingly. In the final analysis this is not a true incentive mechanism since most utilities will have only a relatively brief time period guaranteed to them that they can make any operating adjustment to enhance their earnings while keeping their prices constant.

There are those too, who cling to the maxim that regulated utilities already have the statutory obligation to operate in the most efficient, least-cost manner and coupled with the retention of "excess" earnings attributable to regulatory lag, there is duty and incentive enough for efficient operations without the need for new-fangled incentive plans. I would have thought that argument would have gone the way of the Berlin Wall, which was demolished by the power of the truth now assaulting traditional regulation: Regimes founded upon profit incentives induce people to act more efficiently (and thus more prosperously) than regimes propped up by the bludgeon of command and control regulation.

Incentive programs based upon earnings sharing represent a subset of commonly used incentive regulatory regimes, which look suspiciously like regulatory lag refinements. These systems, however, are designed from a perspective that is not necessarily predicated on a sound understanding of a company's economics. State utility commissions, as a general matter, really do not have in-depth understandings of the financial aspects of the businesses they regulate. In fact, today's political ethic holds that to have such knowledge is to somehow be prejudiced and therefore "anti-consumer." This means that such sharing mechanisms and their incentives may not work as hoped. Additionally, incentive programs based on sharing are sometimes designed such that the ranges of sharing are narrow or give the company no real retention once certain earnings levels are exceeded. The result is a dampening of the drive toward optimum efficiency.

We must bear in mind that the focus of any incentive mechanism should ultimately be set on the end-user. That is, the company should be given the incentive, through the opportunity to earn higher than "normal" returns, to provide state-of-the-art technologies and high quality service at stable or even declining prices to ratepayers. Neither of the examples above adequately achieve these objectives.

Regulatory Schemes: Price Caps

Conventional incentive regulation could be enhanced by moving to price cap type models. Often, price caps are lumped into incentive regulation and — for purposes here — they shall be considered to be a subset of incentive regulation models, since they are designed to achieve the goals identified. There are four primary ways price caps serve to enhance incentive regulatory models. First, price cap incentive regulation puts longer term investments in cost-cutting technologies on the same level as shorter term savings. Second, price caps will help make the incentive mechanism more closely resemble the dynamics of the competitive market. Third, a price cap model will give the regulated company selling a regulated service the freedom to meet the prices of competitors in the marketplace whose activities are not regulated. Finally, ratepayers will experience either stable or declining prices as new technologies are put into place.

Problems with Current Incentive Regulation

Traditional incentive regulation, including price caps, however, remains rooted in the notion that government regulators can successfully design a set of market-like forces that will elicit some of the behavior we value in competitive situations such as efficiency, cost-consciousness, and customer-centered thinking. I have my doubts. The problem here has two primary parts.

First, traditional incentive regulation designs often will *not* approximate competitive market forces. They focus primarily on the short-run and neglect the long-run, which firms operating in competitive environments cannot ignore if they are to survive for any extended period of time. In the regulated monopolistic setting, we allow (and indirectly encourage) firms to operate protected against competitive pressures of addressing the long term.

Second, there is a temptation to apply incentive regulation techniques to services that have actually become competitive, thus placing those services in the position of being offered under two different and quite possibly inconsistent sets of pressures (*i.e.*, incentives): (1) those designed by regulators, and (2) those developed in the free market. The continuation of the problem leads to several genuine problems that are just as bad as the distortions of cost-plus regulation that incentive regulation is intended to address.

First, to the extent that regulators continue to view the world through the regulated firms' lenses, they incorrectly perceive competitively available services as non-competitive; and thus the greater will be the tendency to fall into a protectionism trap, in which the utility is actually advantaged by various rules or even the channeling of cross-subsidies. This will tend to block out the new competitors and dampen the development of competition.

Second, the other side of the coin is that regulators — even if they act in a protectionist manner — may design the incentive in a way that is not conducive to the offering of the competitive service in a way attractive to customers or the utility. This inadvertently makes the utility uncompetitive.

Potential Solutions to the Shortcomings

Of course, there are ways of dealing with these problems. The key, as I see it, is for regulators to look at the world from the proper end of the telescope. This means that we must begin to understand that many of the services being offered by utilities are becoming competitively available and that competition is becoming increasingly prevalent across-the-board.

This being the case, and because things can change rapidly and without any action by regulators, utility regulators should take two steps. First, we must apply incentive regulation only to those services that retain some serious dimension of natural monopoly. To do otherwise only compounds the shortcomings presented by the old ratebase/rate-of-return regulatory model.

Second, for those services that are otherwise available or even may be incipiently available, there should be free entry and exit, and prices should be subject to market forces. The identification process should be easy for these services. We would rely primarily on declarations by the regulated utility or its competitive supplier that the service is available from more than one provider, and we would then put the onus on others to show that such is not the case. With respect to services to which incentive measures would be applied, there should be greater reliance on open-ended sharing of profits and/or leveraged pricing. These types of mechanisms would link the prices for the regulated services to those movements of prices in the comparable competitive services, thus assuring monopoly customers of the *benefits* of competition while providing the company with the incentive to operate efficiently.

Since I believe that incentive regulatory models must serve as transitional steps toward competitive models, a key step that regulators and utilities can take right now is to begin getting the prices "right" for services before competitors get too far ahead. The unbundling of services must also move ahead as much as possible. This will set the stage for competition to develop by providing the proverbial "level playing field." Local measured service and the deaveraging of prices in the local telephone exchange is a prime example of the direction that must be taken to prepare for the market and the incumbent for competition.

The Ultimate Incentive: Crafting an Effective Competitive Paradigm

A more effective role for all incentive regulatory models is to serve as transitional steps as we move toward effective competition in the regulated industries. Just as rate-of-return regulation is supposed to serve as a surrogate for competitive markets, we have touted incentive regulation as a better surrogate. This might well be the case, but I would quickly point out that incentive regulatory schemes are still just surrogates to competition and as Ray Charles sings about Diet Pepsi, "You've got the right one, baby, uh huh." Effective competition remains the best incentive model we have, and therefore we should always foster its development whenever possible. We need to begin reexamining the traditional bases of regulation — primarily the natural monopoly arguments — and see if technological developments have rendered these arguments irrelevant. Once that has been accomplished, we then need finally to demolish the Berlin Wall of regulation that remains in place.

Terrence L. Barnich is currently a commissioner on the Illinois Commerce Commission, and previously served as chair of that body. Prior to his appointment, he served as council to the governor and was also an associate attorney in the litigation department of Rudnick and Wolfe. Commissioner Barnich received his law degree from Fordham University and a bachelor's degree from Georgetown University.