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New approaches to regulation: The Vermont Telecommunications Agreement

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The dramatic changes in telecommunications in the past decade have caused many states to try new approaches to the regulation of local telephone companies. The "Vermont Telecommunications Agreement" was one of the earliest attempts at such innovative regulatory approaches. To learn more about that experience, the PURE '93 conference and MPR invited representatives with three different perspectives on the Vermont experience to share their observations.

The VTA Agreement: How has it done?

by Richard Sedano, Commissioner, Vermont Department of Public Service

Introduction

The State of Vermont has had a contract with New England Telephone (NET) since 1989. The contract covers most issues normally addressed by regulatory action and some that are not. This contract has been known as the "Vermont Telecommunications Agreement," and is sometimes called a "social contract" In essence, the first Vermont Telecommunications Agreement froze local rates for three years and guaranteed certain network investments by New England Telephone. In return, NET received greater flexibility in pricing of other services and in introduction of new services. NET and the state both entered the agreement believing that the company and ratepayers would fare better than under traditional regulation. I will examine in this paper the Vermont-NET contract from the state's perspective.

Background

In the mid-1980s, Vermont regulators, legislators, and telephone company officials recognized that the break up of AT&T signaled profound industry changes. In 1986, the legislature adopted provisions that authorized contract regulation to substitute for traditional methods of regulation. Contract regulation is an attempt to address the deficiencies of rate base/rate of return regulation in a market with multiple entrants and numerous consumer alternatives.

Why did Vermont do this? Many government officials were concerned that technical innovations would pass by Vermont. Vermont's population is low, and community densities are uniformly low. There was concern that Vermont would not be an attractive market for the sellers of advanced telecommunications services. If capital investment in telecommunications were made solely to meet growth and equipment retirement, Vermont would certainly be in a disadvantageous position to attract and to keep business and to provide services its citizens might want. This is especially true in rural Vermont, where business opportunities are often limited.

By law, the contract would be between the Vermont Department of Public Service and a local exchange carrier. The Department of Public Service (DPS) represents the public in telephone

contract negotiations. The DPS normally acts as the public advocate in regulatory matters, and is also the utility planning agency. The DPS is an executive agency that functions independently of the Vermont Public Service Board, which has regulatory authority. The DPS also fields consumer complaints about utility service. With these roles, the DPS was a good choice to represent the state. A contract is subject to approval by the Vermont Public Service Board. According to the law, the contract could be up to five years long and would specify: (1) basic rates; (2) a plant modernization schedule; (3) service quality; (4) information access for competitors; and (5) competitor access rates. Both sides may agree on other matters, and the local exchange carrier would be free of several traditional regulatory requirements. All documents produced in the negotiation would be catalogued and available to interested parties.

The legislature provided guidance to the contracting process and also directed the DPS to prepare a Ten-Year Telecommunications Plan, against which a contract could be evaluated. This ten-year plan would be revised every three years. (However, no plan was in place when the first contract was entered with NET).

To address concerns that the DPS role of public advocate might blur in the planning and contracting process, the legislature provided that a contracted public advocate would represent the interests of the public in the regulatory approval process. So the DPS becomes the advocate for the contract and a separate advocate appointed by the Attorney General and paid by the DPS assumes the broad view of the public interest before Vermont's Public Service Board.

The Public Service Board must complete its review within seven and one-half months. The contract parties have a brief opportunity to cure defects found by the Board, and the Board must complete its subsequent review within four months after the initial decision. Therefore, the approval process can take almost one year.

The Vermont Telecommunications Agreement

With this legislation and a recently resolved rate case in hand, the DPS and New England Telephone struck a deal on a social contract in 1988. Prior to the contract, local measured service was approved in 1986. No extended area service application has been approved since 1979, which was explicitly due to concern for the effect on basic rates. In that three-year contract, basic rates were frozen, NET made an investment commitment of \$284 million over the period 1987 through 1991, there was a set of service quality standards, and toll competitors were assured a margin of 33.3 percent over access rates. The Public Service Board approved the contract at the end of 1988 and also approved a one year extension in 1991. The extension allowed a \$5.5 million revenue increase through an increase of \$1.85 on basic service. NET was permitted to introduce new services and to change prices for all services not covered by the contract without regulatory approval.

Results of the VTA

The contract has had many effects in Vermont. Taken in isolation, the results are good. But the experience in proposing a successor agreement exposed several glaring problems in the initial

agreement and how it was managed. Several of the negative results could have been avoided had we been smarter, but some were unavoidable.

We correctly anticipated that competition driven by technological change did come and did challenge New England Telephone. The pricing and marketing flexibility were important to give choices to consumers.

Infrastructure modernization has been successful. Vermont has digital capability in all its central offices and has total inter-office fiber connectivity. For access lines, 92 percent use digital stored program control switches. The rest still use analog stored program control. Also, 88 percent of lines are equipped with Signaling System 7 capability. More importantly, Vermont can offer most telephone users all the telecommunication capability they need. Rural Vermont, particularly, received capability that would not otherwise have come for some years.

On the negative side

NET experienced low earnings during the period. While ratepayers are not directly hurt by this, I suspect a successor agreement would be easier to strike had company earnings been closer to expectations. Neither side was prepared with a successor agreement upon the 1991 expiration of the contract, so we agreed to an extension. As I will explain later, this was a mistake.

The extension increased the basic rate by \$1.85 for all subscribers, which raised the residential rate to \$12.75 and the business rate to between \$32 and \$38. Many viewed this as breaking faith with the initial agreement, which froze basic rates. The DPS did undertake an extensive review of NET costs in order to agree to the \$1.85 increase. That amount appeared to leave NET with roughly a \$5.5 million (3 percent) shortfall according to DPS calculations, assuming a 13 percent return on common equity.

The pressures on basic rates were not all under NET's control. The federal Universal Service Fund criteria placed large pressures on NET basic rates because the size of the company (more than 200,000 lines) caused it not to qualify for the rural formula which would have credited \$4.00 per NET customer. This made the NET basic rate seem high relative to other smaller, local companies. Some believe that NET basic rates would have declined under traditional regulations, but the effect of the USF formula coupled with other federal regulatory decisions on interstate plant factor allocations makes this unlikely.

NET demonstrated some lack of skill in marketing. This has improved markedly over time. Still, there is a lingering view that more revenue would have been available from new service offerings had NET been more aggressive with publicity and pricing.

NET had incentives to down-size its Vermont operation and did. It is impossible to say whether this would have happened without the contract, but the contract made this inevitable.

Services that relate to privacy receive the same passive review under VTA as other new services. If an investigation was warranted, as with Caller ID, the service went into the market while the Public Service Board simply heard evidence. This gap was filled by the legislature in 1991 when

it added a condition that privacy concerns need to be addressed explicitly in contracts. The successor contract would have allowed the DPS to stop the introduction of a service with privacy implications while a full review by the Public Service Board was pending.

Communications failure under VTA

Contract regulation was promoted as reducing the regulatory burden on the state. While it should reduce the formal proceedings, the level of staff oversight should not change. It is a false economy to count on anything more than less time in the hearing room. NET lost touch with its public. The public tired of image advertising and was uninformed about the wrenching industry changes that would cause great pressure on basic service rates. To be fair, the public seems to have a strong reservoir of suspicion reserved for this and other former Bell System units and it is not clear what management could do about that.

DPS also lost touch with NET as a regulated company, and with the direction of the telephone industry. DPS did not have to worry about telephone rate cases for years. The eight other local exchange companies did benefit from the universal service fund and were able to avoid significant regulatory entanglements during this period. The lack of pressure diverted staff attention to other utility sectors.

The DPS should have been doing more to monitor the agreement. One example is the quality of service standards. Over the course of the contract, and with dramatic improvements to network capabilities, the standards of 1987 became obsolete. Yet, they remain the standards. While contracts must protect both sides from harmful changes during their run, they should also have the capacity to recognize and to adapt to fundamental changes in the industry.

The public and the legislature lost touch with the meaning of the contract and with the emerging industry issues. Both developed an expectation that basic rates would always be frozen. During a period of great change in the telephone industry, the local press paid no attention. The legislature did not ask any questions. The contract parties needed to promote the agreement to these important constituencies to avoid misunderstandings later.

Other telecommunication service providers did not clearly communicate to the DPS their concerns with the contract and their vision for the future. I can only assume that they were too busy with their own markets and with regulatory work in other states to lobby their views in Vermont.

Since the contract was negotiated, the DPS commissioner changed three times and the governor has changed two times. This instability leads to uncertainty. A particularly awkward change occurred at the end of the Kunin administration. At this time in late 1990, NET and the state should have completed a successor agreement to be litigated in 1991 to become effective in 1992. Instead, there was little progress. The Snelling administration essentially began the process anew. This resulted in the disjointed use of an extension of the existing contract.

No serious discussions about a contract were held with any other local telephone carrier during the initial contract period. Vermont has nine local carriers. NET has 85 percent of Vermont's

access lines. NET is the dominant telephone company in Vermont and its tariffs have a ripple effect onto other carriers and other telecommunications providers. Some other local carriers appear willing to explore contracts, but they are reluctant to do so until NET'S future regulatory regime is clear. Some spreading of the contract approach to other carriers would have helped to cement its acceptance.

Contracts do not run on auto-pilot. They need to be managed. This statement appears obvious but was ignored by the Vermont parties. The evidence is the extraordinarily negative reaction to the successor agreement. We should have known better.

Lessons from VTA

A key concern among many VTA observers is whether to break the link between cost of service and contract regulation. To this point, Vermont has been unwilling to enter a contract without a shadow cost of service analysis that demonstrates the fairness of the contract to ratepayers. Some have gone so far as to suggest that there needs to be a rate case now and then to assure a thorough review of utility operation. Ratepayers are comforted by the scrutiny of a company's costs in the context of a rate case. This comfort is not matched when the state negotiates a contract with a company. Paradoxically, from the DPS perspective, we have greater access and time to review company documents in the context of a contract than in a rate case. Others, however, have less access and time.

A long contract (more than three years) troubles some advocates. The industry changes so quickly in unexpected ways that it is right to ask if a long agreement can keep pace. Others are concerned with a sustained period of inattention to the company's costs. Short contracts may also be easier to reach because the parties can find easier agreement on shorter term forecasts.

If the local carrier can articulate its objectives and the two parties can find common ground, a contract is extraordinarily powerful, since all sides are improving their situation - the network will more efficiently meet the public's needs. Contract regulation is good when the state can clearly identify a set of objectives on behalf of consumers. The focus from the general public appears to be on the basic rate and the amount of investment (beyond normal replacement and growth). Also important is the treatment of competitors.

Both sides must manage the contract, look for new opportunities within the bounds of the contract and build good faith for the next contract. The contract parties must stay in touch with their constituencies, including business, low-income, elders, other consumers and competitors.

A state should probably consider alternatives between traditional and contract regulation (like forms of incentive regulation). This allows some flexibility which benefits consumers when a contract is unreachable.

Should other states consider contract regulation?

Other states should consider contract regulation if decision-makers can see the possibility of promoting competition through mutually beneficial agreements. After all, isn't win-win better?

But let me also suggest several important questions for these states:

- Does the state have a clear set of policies or goals for telecommunication development?
- Does the state have the staff to support this activity, which is quite different from the rate case approach?
- Does the executive branch wish to be identified as the contract partner with the telephone company?
- Does the local carrier's rate structure help or hurt efficient use of the telecommunication network?
- If the rate structure needs fixing, can the burden of rate redistribution be endured by all, especially low use residential customers?
- Does the state find the benefits of modernization to be limited to only some areas, and, if so, does the state want modernization of telecommunications service available to everyone?

Conclusion

The Vermont Telecommunications Agreement has been an important factor in Vermont as we confront the tough issues in today's telecommunications industry. It has raised people's awareness that the state has some ability to influence the direction of network modernization and rate redesign. It also exposed many flaws in how Vermont sets and implements telecommunications policy. For this reason, too, the VTA deserves credit

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