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The mission of the Center for Governmental Studies includes education of the public on important public policy issues. This article is one in a series of policy briefs designed to provide an objective view of an issue.

Issue: *Why Rewrite Illinois' Telecommunications Law?*

The Illinois law under which telephone companies are regulated, commonly called the Telecommunications Act, is scheduled to expire on July 1, 2001. This means that the Illinois General Assembly must either pass a new telecommunications act or extend the existing Act during its current session. If it fails to do so, the Illinois telecommunications industry will no longer be regulated by the state and Illinois telecommunications users, including all telephone users, will lose the protection of state regulation.

Why is the Telecommunications Act expiring in July?

In recent years, the Illinois legislature has written expiration dates, called "sunset" provisions, in its regulatory laws. This is done to force periodic reviews of the state's regulatory policies. In rapidly changing fields such as telecommunications, regular reviews help assure that state regulations continue to be effective when applied to recent developments and emerging industry practices.

The present Telecommunications Act, technically known as Article XIII of The Public Utility Act of Illinois, was comprehensively rewritten in 1985 to deal with major developments in telecommunications:

- The break-up of AT&T.
- Increasing competition in telecommunications.
- Rapid technological change.
- The need for more flexible and, in some cases, less regulation of parts of the telecommunications industry.

Since that time, various sunset provisions were applied to the Telecommunication Act. The most recent major revision was in 1997.

What does the current Act provide?

The current Telecommunications Act establishes goals, one of which seeks to insure "that the economic benefits of competition in all telecommunications service markets are realized as effectively as possible" [Section 13-102 (e)]. To this end, the Telecommunications Act also states that "the competitive offering of all telecommunications services will increase innovation and efficiency in the provision of telecommunications services and may lead to reduced prices for consumers, increased investment in communications infrastructure, the creation of new jobs, and the attraction of new businesses to Illinois" [Section 13-102 (f)]. The Telecommunications Act goes on to state that the "protection of the public

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interest requires changes in the regulation of telecommunications carriers and services to ensure, to the maximum feasible extent, the reasonable and timely development of effective competition in all telecommunications service markets” [Section 13-102 (g)].

To achieve these goals, the Telecommunications Act states that “competition in all telecommunications service markets should be pursued as a substitute for regulation in determining the variety, quality and price of telecommunications services and...the economic burdens of regulation should be reduced to the extent possible consistent with the furtherance of market competition and protection of the public interest” [Section 13-103 (b)].

What does the Illinois Commerce Commission do?

The Illinois Commerce Commission (ICC) is the state agency that regulates Illinois utilities. The Illinois General Assembly has charged the ICC with regulating telecommunications consistent with The Public Utilities Act of Illinois. This can include the extent and type of regulation, the degree of competition, and deregulation. *A good telecommunications act sets goals and broad policy outlines and leaves the day-to-day regulation of telecommunications to the ICC.*

Why is the ICC needed?

Telecommunications changes too quickly and requires too much specialized knowledge to be well suited to legislative regulation. Utility regulations specified in statutory law have two problems. First, they soon become outdated as the industry changes. Second, laws specifying regulations are also very hard to change and thus become inflexible when the need for adjustment arises. A regulatory agency, such as the ICC, can respond much more quickly and with much more expertise to changing industry conditions.

The Illinois General Assembly, through legislation, should establish regulatory objectives (such as promoting competition whenever possible) and should give the necessary tools to the ICC to achieve the legislature’s stated objectives (in this case, to permit competition and to deregulate segments of the industry when sufficient competition is possible).

Statutory law should not be used to determine what is competitive, what is not, or how to deregulate. Legislators should rely on the expertise of the ICC to carry out their legislative objectives and policies. They should avoid following the example of too many other states, such as California, which have attempted to regulate by statute and, in the end, have harmed customers by preventing necessary regulatory reaction to changing market conditions.

What happened in California?

The current problems in the California electricity market are at least partly a result of the California legislature attempting to regulate the industry by legislation, setting up various procedures and making rules that, in fact, accomplished the opposite of what the legislators intended. This happened because, as is to be expected, most legislators are not sufficiently familiar with the technical details of the way energy markets work. Further, the inflexibility of regulation by legislation prevented California from making, in a timely fashion, necessary regulatory adjustments when changes occurred in the nation’s utility markets.

Unfortunately, the California legislators appear not to have learned their lesson; they are attempting to fix their electricity problems with still more legislation that may well result in yet additional problems, including ever-higher costs for California electricity customers.

What has been Illinois’ recent experience with telecommunications regulation?

The current Telecommunications Act contains goals and policies that have served the people of Illinois well. Competition and deregulation in Illinois began aggressively in the 1980’s, ahead of much of the rest of the country. The hoped-for benefits of regulation have materialized, and the people and businesses of Illinois have benefitted from the pro-competition policy currently articulated in the Telecommunications Act. As a result,

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Illinois has excellent telecommunications services with low prices and high quality, the present short-run problems of Ameritech notwithstanding.

Long distance competition is well established in Illinois and has been for a number of years. Customers have a choice among a number of carriers for calls made both within Illinois and to locations outside of Illinois anywhere in the world.

What makes this competition work is the existence of competing physical networks for long distance service. If all of the service providers were simply reselling the service offered by Ameritech for in-state service and AT&T for out-of-state service, there really wouldn't be much competition. The underlying network would be the same, and competition would be limited to sales and marketing. Furthermore, since the network would be the same for every service provider, the service would be pretty much the same for everyone.

Fortunately, long distance competition is not limited to one underlying long distance network. Several competing service providers have their own facilities, and even though other service providers may resell service, there is still plenty of underlying competition for customers to be assured of receiving all of the benefits of competitive long distance service.

What, if anything, in the current Telecommunications Act needs to be revised?

Because long distance competition is so well established in Illinois, the regulatory focus of any legislative revision should really be on competition for local phone service, including the provision of high-speed Internet access or broadband.

Certainly, any consideration of a revision of the Telecommunications Act will center on the speed at which competition for local telephone service is developing. Many have been quick to declare federal telecommunications policy and the federal Telecommunications Act of 1996 a failure, or at least a disappointment, because of the slow pace at which local competition has developed. This criticism, though, deserves a closer examination before attempting to fix the perceived problem with a revision of Illinois' Telecommunications Act.

Long distance competition began in urban areas where there are high concentrations of heavy users of long distance service. These were mostly business customers. Of course, given a little time, long distance competition spread virtually everywhere for every customer.

It is not surprising, though, that competition began with the most lucrative customers and then spread throughout the rest of the market. It is also not surprising that local telecommunication competition and the

provision of broadband service is beginning in the same manner. Once again, given a little time, local competition and the provision of high-speed Internet access will become available to most customers, including residential customers.

The risk is not that competition will not spread nearly everywhere, but the risk is that legislation or regulation, through mis-guided attempts to over-rule the workings of the market, will delay or prevent competition from reaching all customers.

How can regulation make competition more difficult to achieve?

One important example of regulation making new problems for competition occurs when well-intended but misguided regulations only create the illusion of competition. For instance, policies can be put in place that encourage the existing phone company to offer large discounts for telephone wholesale services sold to another phone company which will then resell phone service to customers at the retail level. Superficially, this will result in more phone companies competing to sell retail phone services, but, realistically, there will still be only one underlying telephone service network. Because all phone companies are using the same network, very little true competition results.

The same is true when a new retail service provider uses some parts of the traditional provider's network to provide its services. For example, the new

provider may want to use the incumbent's local loop — the figurative “last mile” — and related services (unbundled network elements, or UNEs in the language of telecommunications) in combination with some of the new provider's own services or equipment, such as a switch, to provide local service or high-speed Internet access service.

While there are somewhat more competing facilities in this case, much of the service still depends on the underlying monopoly facilities of the incumbent. True competition will result only when there are competing networks for local service, or what is called facilities-based competition.

Are there other variations on this example?

Yes. When the regulators, or the legislators, set prices for wholesale phone services that are lower than actual cost, problems result. Prices are typically set lower than cost by regulators in order to give more of a profit margin to new service providers who do not have their own networks. Since this gives new providers a better chance to offer service profitably, it increases the number of competing phone companies and thus gives the appearance of more competition.

Such regulation of wholesale prices, however, makes it more difficult for another new company — one that wants to build its own facilities and offer real competition — to compete with the companies that pay a below-cost price for the use of the original phone company's facilities or services.

As a result, because competing networks are excluded from the market, the monopoly network of the original phone company is protected. The effects of such regulatory policies are actually anti-competitive. As is happening in California, higher prices for the consumer are the likely consequence.

The development of facilities-based local service and broadband Internet access service takes patience, but policies that promote the development of competing networks are the best way to encourage true competition — the only kind of competition that will deliver maximum long-term benefits to consumers. Quick regulatory fixes aren't that, and they will harm consumers in the longer term through higher prices and poorer service.

What complaints about the present telecommunications system are Illinois' legislators likely to hear?

There are frequent complaints about the slow pace at which local telephone competition and broadband Internet competition is developing. This is happening for two reasons. First, artificially low wholesale prices are discouraging new service providers who want to develop their own networks. When competitors can buy access to pieces of the present provider's service or network components at artificially low wholesale prices, there is neither incentive nor potential profit to be gained from new investments in communications facilities. The reseller's retail price can be lower than

the present network owner's own retail price, simply reflecting the wholesale bargain and nothing more.

Who pays for this? It is the customers of the traditional supplier who find their prices higher than they otherwise would be. How is a new facilities-based competitor to match the prices charged by these other providers renting facilities at artificially lowered prices? The competitor cannot, except in unusual cases where the facilities-based competitor's costs to serve certain customers are unusually low. If there is any facilities-based competition in this situation, it is likely to be restricted to business customers in high-density, low-cost urban centers.

Second, there is not as much resale competition, or competition using parts of the traditional supplier's network, as might have been expected. This is because the new service providers are finding it technologically difficult to provide service on a resold basis or by combining part of the traditional provider's network with some of their own facilities.

How should Illinois legislators respond to these competition problems?

These problems with resale competition result when legislators or regulators decide in advance how a market should work and what type of competition there should be. *True competition only emerges in response to market forces, not to artificial regulatory manipulations of the market.*

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Legislators and regulators should also understand that not every business plan put forward by every entrant should be successful. Some business plans just aren't sound or don't work out as anticipated. Some entrants deserve to fail, and they should not be bailed out by still lower wholesale prices or other forms of subsidy. Attempting to override the realities of the marketplace can provide disincentives for investment by service providers who cannot compete when some market participants have artificial advantages. This will deter investment in telecommunication infrastructure in Illinois and will prevent Illinois businesses and residential customers from securing the benefits of new technologies and more telecommunications networks.

What the state can do to improve the regulatory climate in Illinois is somewhat restricted by the requirements of the federal Telecommunications Act of 1996. For example, at the moment telephone companies with their own equipment — and this means the customers of existing telephone companies through higher prices — are forced to pay billions of dollars so that retail customers can have the choice of buying essentially the same underlying service provided by the traditional telephone supplier from a choice of telephone retailers. It is not clear where the customer benefit is in this; it certainly does not describe competition. Illinois legislators will want to be careful not to make this situation even worse for Illinois consumers.

So does the current Act need to be changed and, if so, what should be in a revised Act?

When considering a revision of Illinois' present Telecommunications Act, members of the Illinois General Assembly will feel political pressure to respond to short run concerns, such as the decline in Ameritech Illinois' quality of service. While tempting, legislators should resist such pressures. Legislation is a poor way to solve short-run problems. The General Assembly must make certain that the regulator — the Illinois Commerce Commission — has the tools to address such short-run problems. Writing too many rules and remedies into legislation will both insure that the legislation is soon out of date and result in unintended consequences, usually harmful for customers, as the industry evolves.

What does Illinois need from a Telecommunications Act rewrite?

Perhaps nothing. The legislators will need to determine if the objectives expressed in the Act are still the ones that they desire for the future. Certainly, the competition objectives are still the right ones. Second, the legislators will need to determine if the ICC has the tools necessary to work towards the Act's objectives.

But care should be taken not to micro-manage the industry and not to regulate by legislation. If, for example, facilities-based competition will take some time to become established, the legislation should see that any legal barriers are removed for competitors and that the

ICC has the power to allow competitors into the market. Given this, though, there is little that legislators can do to speed up the competitive process, even if they believe it is too slow. Indeed, as has been seen at the federal level, legislative steps to speed up the competitive process have, in fact, probably slowed it down by erecting barriers for facilities-based entrants.

The legislators may decide that the Act does not need any revision at this time. In that case, they can simply extend the sunset date for a few more years. Alternatively, they may decide that the objectives of telecommunications regulation in Illinois should be revised or that the regulatory powers given to the ICC need revision. In either of these cases, modifications to the current Act will be required.

The legislators will have a tough job, however, if they are to resist the entreaties of competitors and entrants alike to include legislative "gifts" for any group in the Act's revision. The legislators will want to remember that both incumbents and entrants have certain interests of their own, and these are not necessarily the same as the public interest. There are many examples of revised legislation being worse legislation, so a clear understanding of the issues at hand and some caution will serve the legislators well as they tackle the Telecommunications Act in Illinois.

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