

A PERSPECTIVE ON SOCIAL CONTRACT  
AND TELECOMMUNICATIONS REGULATION

Douglas N. Jones  
Director

THE NATIONAL REGULATORY RESEARCH INSTITUTE  
1080 Carmack Road  
Columbus, Ohio 43210

June 1987

This report was prepared by The National Regulatory Research Institute (NRRI) with funding provided by participating member commissions of the National Association of Regulatory Utility Commissioners (NARUC). The views and opinions of the author do not necessarily state or reflect the views, opinions, or policies of the NRRI, the NARUC, or NARUC member commissions.

TABLE OF CONTENTS

	Page
FOREWORD . . . . .	.iii
ACKNOWLEDGEMENTS . . . . .	iv
Part I. INTRODUCTION . . . . .	1
II. ORIGINS AND MODERN USAGE . . . . .	1
A. Origins . . . . .	2
B. Modern Usage. . . . .	9
III. SOCIAL CONTRACT AS PARTIAL DEREGULATION. . . . .	12
A. Focus and Forums. . . . .	12
B. Some Questions and Worries. . . . .	17
1. Structural Design. . . . .	18
2. Presumptions . . . . .	20
3. Changed Relationships. . . . .	20
IV. POSTSCRIPT . . . . .	21

## FOREWORD

The idea of social contract regulation as an alternative to traditional regulation in the telecommunications sector is being discussed in a number of states and a variety of forums. The idea itself is somewhat elusive, but it is clearly in the category of deregulation proposals now so current. The Board of Directors of NRRI asked for a short report to be done as a timely contribution to the ongoing debate. This paper is an attempt at bringing perspective to the issue and takes a somewhat cautionary stance as to the hurried adoption of a social contract approach. It is intended to help fill in the answer to the question, What should public policy require of the social contract idea, as advanced, if it is to replace the anchors of rate base regulation?

DNJ  
May 22, 1987

## ACKNOWLEDGEMENTS

The library research efforts of Mr. Paul L. Ford, Graduate Administrative Assistant at NRRI, are acknowledged in helpfully retrieving the basic works on classical political philosophy. Mrs. Wendy Windle's (repeated) typing of the small manuscript and patient treatment of its changes are appreciated.

## I. INTRODUCTION

The limited object of this report is to add to clarity of thought on the part of regulators about the social contract concept. It is not to say "who's right" in the debate surrounding its current invocation in some legislatures, at some regulatory commissions, at some federal agencies, and in the trade and journalistic press as an alternative to traditional utility regulation. What is attempted is to describe "how we got here from there" in our use of the term social contract, what has been implied by it over time, and how appropriate the terminology is to public policy discussion of state regulation of the telecommunications industry. Also attempted is some delineation of what should be required of the concept if it is to truly compete with the current apparatus of regulation.

The report is organized around three themes. The first is the historical appearance and reappearance of Social Contract Theory in western philosophy, classical political thought, and economics. The second is why it matters to know and recall the origins and periodic usage of the social contract when facing its most recent invocation in telecommunications. The third considers what can be fairly said about reliance on a social contract approach as currently being proposed. And, lest any reader not know, the instant occasion is the labeling of the deregulation of all but basic local exchange services in exchange for the freezing (or capped rise) of rates for the latter services as a Social Contract Approach intended to replace conventional rate base, rate of return, cost-of-service regulation in this part of the telecommunications industry.

## II. ORIGINS AND MODERN USAGE

Imprecision in meaning is a greater problem now in popular usage of the term Social Contract (or Social Compact) than it ever was during its long and varied history in philosophy and political theory. Setting aside, for the moment, its applications in the public utility field which is our ultimate focus, the idea of social contract as an implied restraint in the way we behave with each other is all around us, sometimes embraced in law and sometimes implicitly in interpersonal behavior. One can say, for example (or could until a decade or so ago), that there is a "social

compact" assumed to be operating among ourselves that allows each of us to board an airplane with a couple hundred other people we do not know and be reasonably assured that none is suicidal or homicidal - at least for the duration of the flight.

It is claimed that there is a "social compact" that says that income paid by the citizenry into the Social Security Fund can be counted on as being there and with similar purchasing power years later when one needs it. During the period of compulsory military service there existed a "social compact" that in exchange for "giving up" several years of one's life to soldiering at nominal pay, there would be forthcoming various compensating financial entitlements (e.g., schooling, medical care, lower cost mortgages) in addition to the satisfaction of having helped provide for the common defense. There is a widely held "social contract" that involves the involuntary payment of taxes on the presumption that the society's tax system is fairly intended and uniformly applied. There may be a "social compact" to be cited that involves the collective looking after of the accuracy of scientific and financial information and the non-toxic preparation of drugs and foodstuffs for consumers unable to do so on their own. Society best negotiates a roadway intersection on the basis of a "social compact" by which each of us agrees implicitly to take turns proceeding through it in accordance with signs or signals (or sometimes with neither). Even some sports depend upon a "social compact" between opposing players for the contest to work at all, as when golfers in a foursome keep their own scores and tennis players are counted on to correctly call shots "faults." Needless to say, the popularization of social contract theory by the great political philosophers of the Renaissance Period never contemplated its usage in any of these ways - and surely not its invocation by state legislators and others in the regulation of telephone companies.

#### A. Origins

What, then, were the roots of social contract theory and its historical evolution? What did it mean and how was it used? A good start is with the Encyclopedia Britannica where the term appears directly. The opening paragraph reads,

Social Contract, in political philosophy, idea of a compact between the ruled and their rulers. In primeval times, according to the theory, the individual was born into an anarchic state of nature, which was happy or unhappy according to the particular version. He then, by exercising natural reason, formed a society (and a government) by means of a contract with other individuals.<sup>1</sup>

Three source books of particular relevance to the task at hand are J.W. Gough's The Social Contract: A Critical Study of Its Development, first published in 1936; Ian R. MacNeil's The New Social Contract: An Inquiry into Modern Contractual Relations, published in 1980; and Patrick Riley's Will and Political Legitimacy: A Critical Exposition of Social Contract Theory in Hobbes, Locke, Rousseau, Kant, and Hegel, published in 1941 and again in 1982.<sup>2</sup> The historical tracing that follows draws mainly from these sources.

First as to the alternate phrasings, "social contract" and "social compact." Both were commonly employed. Hobbes (for example) uses "contract" while Locke used "compact," and Rousseau uses both. The explanation apparently is that many of the writers using the term social contract were neither jurists nor law professors but rather men of letters who probably did not use the word in any strict sense.<sup>3</sup> Also the word "compact" gave more of a collective connotation to the concept which may better fit uses such as the Pilgrim Fathers made of it in 1620 in resolving to "...solemnly and mutually, in the presence of God and of one another,

---

<sup>1</sup> Encyclopedia Britannica, 15th ed., s.v. "Social Contract."

<sup>2</sup> J. W. Gough, The Social Contract: A Critical Study of Its Development, 2nd ed. (London: Oxford University Press, 1957); Ian R. MacNeil, The New Social Contract: An Inquiry into Modern Contractual Relations (New Haven: Yale University Press, 1980); Patrick Riley, Will and Political Legitimacy: A Critical Exposition of Social Contract Theory in Hobbes, Locke, Rousseau, Kant, and Hegel (Cambridge: Harvard University Press, 1982). Also helpful as a source book on more modern philosophical applications is John Rawls' Theory of Social Justice: An Introduction (Athens: Ohio University Press, 1980), H.G. Blocker and E. H. Smith, editors.

<sup>3</sup> Gough, op.cit., p. 6. One finds in Rousseau's writing even within the same paragraph, "The clauses of this contract are determined . . . and if the compact is violated . . ." (emphasis supplied).

covenant and combine ourselves in a civil body politic."<sup>4</sup> Among scholars, the main argument against using the word contract seemingly is that it can contribute to confusion because legal systems as we know them were not really in existence at the time of the forming of societies and the creation of states, and thus "unhistorical associations" are avoided.<sup>5</sup> In any event "compact" is the political counterpart to the law's "contract," and writers conclude that, "Whether we call it compact or contract makes no real difference to the theory behind the phrase or to its implications."<sup>6</sup> We will, therefore, use them interchangeably here.

In point of fact political philosophers wrote of two major types of social contract. One was focused on how individual persons living isolated lives arranged themselves into a society with certain agreed upon obligations to each other, and the second was focused on how a state was brought into existence with emphasis on relations between the rulers and the ruled.

The heyday of the social contract was clearly the 17th and 18th centuries, but it had some discernable beginnings in Roman Law, the Stoic philosophers, and ancient Greece. St. Augustine has been regarded as the main source of the idea of contractual government throughout the Middle Ages. His view of pactum societatis as holding a state together may be conjectured to be an antecedent to subsequent contract theory.<sup>7</sup> The political principle expressed was that a ruler was owed allegiance by his subjects dependent upon his recognizing their rights, an idea that was formalized in 633 A.D.<sup>8</sup> In 856 A.D. Frankish Kings described this reciprocity of rights and obligations as constituting a contract.<sup>9</sup> Still, writers on the subject conclude that any idea of contract was not common from the 7th to the 11th Century, was theological and not positivistic when it was found, and surely was not yet developed as social contract theory.<sup>10</sup>

---

<sup>4</sup> Ibid., p. 2 along with similar expressions in the constitutions of the states of Massachusetts, Rhode Island, and Connecticut in a lecture by John Quincy Adams, November 25, 1842 in Providence entitled "The Social Compact Exemplified in the Constitution of the Commonwealth of Massachusetts."

<sup>5</sup> Ibid., p. 4.

<sup>6</sup> Ibid., p. 5.

<sup>7</sup> Ibid., pp. 23-24.

<sup>8</sup> Ibid., p. 25.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid., pp. 25-32.

Expressions of a theory of deliberate popular consent as the proper origin of governing authority began to appear in the 14th and 15th centuries. Marius Salamonijs writing in 1544 is credited with major early contributions to social contract theory in highlighting individualism and voluntarism.<sup>11</sup> Richard Hooker, writing in 1594, and from whom John Locke drew inspiration, saw a sociable life as a natural inclination and the formation of the state as requiring "a deliberate act of union by individuals, and an agreement on the terms of their union, which amounts in principle to a social contract . . ."<sup>12</sup> Some scholars attribute the first real theory of social contract to Johannes Althusius, a law professor writing in 1603, for his idea that contracts were the basis of all associations, that the contracting parties were not individuals but associations themselves; that each is formed by the contractual union of smaller ones, e.g., the family, the local communities, the provinces, the state; and that only a necessary part of their full rights is surrendered to the higher association.<sup>13</sup>

Hobbes in 1651 and Spinoza in 1670 wrote of a social contract based on fear and enforced by the power to command obedience.<sup>14</sup> To Hobbes, man was not "naturally sociable" but quarrelsome and competitive. His social contract was one where individuals surrendered their personal liberty to a common sovereign who was the recipient of power thus conferred but not a party to any contract.<sup>15</sup>

A major antagonist to this point of view was Locke (1690) who believed in popular rights and limited monarchy (the argument of the day was typically about the succession of kings). Locke agreed that the foundation of society was a social contract having mostly to do with agreed upon cooperation among society's members. A compact could be made to create a "civil government," but the resulting relationship was not one of a contract with a ruler, rather more one of having established a trusteeship on

---

<sup>11</sup> Ibid., p. 47.

<sup>12</sup> Ibid., pp. 71-72.

<sup>13</sup> Ibid., p. 75.

<sup>14</sup> Ibid., p. 108 and p. 115.

<sup>15</sup> Ibid., p. 108.

society's behalf.<sup>16</sup> And, as attorneys are given to saying, a trust is not a contract. Popular in England and North America, Locke has always been viewed as one of the principal exponents of social contract theory. But it is with Rousseau that the social contract is most closely associated above all other writers.<sup>17</sup>

For Rousseau the emphasis was on the superiority of social life over the original "state of nature," a state which is brought to an end by a social contract.<sup>18</sup> The "cost" is the surrender and alienation of certain rights, while the individual, operating under the "general will," receives equal or greater benefits in return for a "nobler preferable life."<sup>19</sup> Thus by a fundamental compact the parties bind themselves with the people having "concentrated all their wills in one "and the ruler acts" in conformity with the intention of his constituents, to maintain them all in the peaceable possession of what belongs to them, and to prefer on every occasion the public interest to his own."<sup>20</sup> Here, then, may be found the ideas of property rights and the public interest emerging in social contract theory.

In the last half of the 18th Century social contract theory came under particular attack from Kant, Hegel, Hume, and Jeremy Bentham. Kant saw the social contract as superfluous since political obligations followed directly from moral obligations which already were universally binding.<sup>21</sup> Hegel denied the premises of social contract, and Hume found the theory illogical and not empirically supportable.<sup>22</sup> Bentham in 1776 and subsequent followers of utilitarianism argued that the principle of utility was a better explanation of political duties and behavior, apart from any contract.<sup>23</sup>

So by the 19th Century the social contract idea was clearly on the wane, except for some rehabilitation of it in England with Samuel Coleridge (1839) and for its relative vitality in America. Coleridge's modification

---

<sup>16</sup> Ibid., p. 135. In point of fact the trusteeship idea may be the most appropriate analogy for application of the social contract in which new relationships would be formed, as discussed in section III., infra.

<sup>17</sup> Ibid., p. 164. Indeed Rousseau's "Contract Social" is often described as providing the literary inspiration to the French Revolution.

<sup>18</sup> Ibid., pp. 171-172.

<sup>19</sup> Ibid., p. 167.

<sup>20</sup> Ibid., p. 165.

<sup>21</sup> Ibid., p. 183.

<sup>22</sup> Ibid., pp. 184-185 and pp. 186-188.

<sup>23</sup> Ibid., pp. 190-191.

involved the notion of a dynamic "ever-originating social contract" in the course of the workings of society and requiring a continuing consent based on a sense of duty.<sup>24</sup> For its part America employed various elements of the social compact in the Declaration of Independence, the U.S. Constitution, and (as mentioned) in several state constitutions, e.g., Massachusetts in 1780 and Kentucky in 1792. Not surprisingly, American revolutionaries preoccupied with establishing legitimacy to their new governments focused importantly on compacts which in Madison's and Jefferson's words involved only limited submission to central government and only for special purposes.<sup>25</sup> As Riley has summarized it, to them the legitimacy of government did not depend on divine right, natural superiority of an elite, habit, convenience, compulsion, patriarchy, or the naturalness of a political life, but rather on the consent of those establishing a government or a society.<sup>26</sup> And, of course, the Civil War was in a real sense fought over an important element of social compact--the question of secession and federalism.

Detractors reduced the social contract to little more than an imaginary hypothesis, not historically founded, and at best only a kind of logical postulate, a supposition, really a fiction. A fairer appraisal perhaps is Gough's at the conclusion of his book (from which we have here drawn). He says that "The rights and duties of the state and its citizens are reciprocal and the recognition of this reciprocity constitutes a relationship which by analogy can be called a social contract. ...If the phrase...is to be retained, therefore, it had probably best be interpreted as an abbreviation for the idea... This...is the maximum that can be conceded to the contract theory."<sup>27</sup> Finally, in what may be prophetic of the current usage of the term, Gough wrote (in his 1956 edition),

...the contract theory did not develop entirely by the force of its own inner logic. It was evoked at different times and in different places by historical circumstances, usually as a means of attacking some existing regime, and then men went to books to find and

<sup>24</sup> Ibid., pp. 208-211.

<sup>25</sup> Ibid., p. 235.

<sup>26</sup> Patrick, op.cit., p. 1.

<sup>27</sup> Gough, op.cit., p. 248.

adapt and refurbish the arguments that suited them.<sup>28</sup>

Turning to a book of lectures for more recent treatment of social contract theory, Ian R. MacNeil in The New Social Contract adds several points of relevance to our tracing of the term to current usage. The author sees the social contract as a basic socioeconomic tool in the West having the attributes of reciprocal exchange (and hence a transaction) and of projecting into the future, "a promise."<sup>29</sup> He finds five elements of promise in the exchange oriented aspects of social contract.<sup>30</sup> These are:

- (1) the will of the promisor
- (2) the will of the promisee
- (3) present action to limit future choice
- (4) communication between the separate wills
- (5) measured reciprocity

Each of these elements could be seen to have application to the social contract idea in telecommunications.

Further he says that typically there is both tacit and overt recognition that a promise made is not always the one received and that these differences are natural, expected, and that a good deal of promise breaking is tolerated and sometimes desired.<sup>31</sup> MacNeil believes that while command and hierarchy are enforcing elements in the beginning of contractual relations, the dynamics of bilateral relationships create internal habits, customs, and social norms that over time are more complex and powerful than externally imposed norms.<sup>32</sup> In arguing that social contract remains a current force he cites the Conservative Party victory in 1979 elections in England as a case in point.<sup>33</sup> The Labor government of Prime Minister Callaghan had described its deal with British labor unions respecting productivity rises and wage restraint as a "social contract." He concludes that the election of Mrs. Thatcher resulted partly from the public's perception that the unions had breached that "social contract" and that this was a real life analogue to Rousseau's concept.

---

<sup>28</sup> Ibid., p. vi.

<sup>29</sup> MacNeil, op.cit., p. 1-6.

<sup>30</sup> Ibid., p. 7.

<sup>31</sup> Ibid., p. 9.

<sup>32</sup> Ibid., pp. 34-35.

<sup>33</sup> Ibid., p. xii.

## B. Modern Usage

To this point the historical development of social contract theory has been identified and sketched as a philosophical and political concept of interest mainly to scholars and theorists. Here we turn to its application in economics and the industrial organization literature and, most particularly, in the public utility field.

Despite the eminent status of the term historically in philosophy and its now frequent usage in both the electric and telephone sectors, its appearance in the older public utility literature was uncommon and certainly not comparable in meaning. A scanning of eight of the leading textbooks on public utility economics published in the last forty years indicates only one that actually contains the term "social contract," and even there the wording had become simply "contract" by the 1985 edition of the book. Wilcox and Shepherd wrote in their 1975 version,

To understand regulation, you must see it as part of a Basic Social Contract: a monopoly is officially granted, in exchange for a degree of public control. This basis largely predetermines the outcome, as the industry and its regulation evolve.<sup>34</sup>

Writing further as to the "usual result" of this arrangement the authors state, "Regulators operate within the Contract ...They cannot really change it... The Contract excludes seller competition from the service area in exchange for a review process. ...The contract is formally with the utility owners, ...But its key effects are on managers."<sup>35</sup> They see a downside bias that "The regulatory contract lacks mechanisms for enforcing any possible standards... (it) breeds mutual vested interests against change... This Contract...tend(s) to induce inefficiencies of several sorts."<sup>36</sup> Other authors used similar and even synonymous terms to describe the idea of the social contract in the public utility field, including (Bernstein's) "working agreement," (Wilson's) "regulatory charter," and perhaps most common, "the regulatory bargain."

---

<sup>34</sup> William C. Shepherd and Clair Wilcox, Public Policies Toward Business, Fifth Edition (Homewood: Richard D. Irwin, Inc., 1979), p. 348.

<sup>35</sup> Ibid., p. 350.

<sup>36</sup> Ibid., p. 351.

Lineage of this application of the social contract concept to the original is very unclear. Recall that in the field of philosophy the contract was primarily between the governed and the governors, ruled and rulers, while in the public utility field it was between the private enterprise and the public authorities. There was no private business dimension to it in the classical political theorists' use of the term. Only if one reasons by analogy that, as Justice Brandeis said in Southwestern Bell, "the company is the substitute for the State in the performance of the public service"<sup>37</sup> and, as Justice Harlan said about a railroad in the Smyth case, "It performs a function of the State"<sup>38</sup> can one attempt to bridge this difference of application.

The generalized and original "social contract" of public utility regulation--private capital with public oversight as to its employment, pricing, and profitability--involves a number of "subcompacts," as claimed by various participants. Thus, calling for more congenial depreciation policies, "The regulatory compact requires that the present value of expected future earnings (discounted according to the cost of capital) allowed by the regulator equal the initial cost of the investment. . .The regulatory compact will be breached much more quickly if capital recovery is inadequate."<sup>39</sup> A "White Paper" recently prepared for the United States Telephone Association decrying the new federal tax law reads, "A regulated firm must be assured of recovering its prudently invested capital. . .in the end telephone companies must be made whole. This, is in effect, a compact with regulators."<sup>40</sup>

Prudence investigations also call forth citations of the regulatory compact. A breach thereof may be claimed by utilities if power plants are excluded from their rate base only on a failure to meet the "used and useful" test but without a finding of imprudence. Inside F.E.R.C. reports

---

<sup>37</sup> Missouri ex rel. Southwestern Bell Telegraph Co. v. Missouri Public Service Commission, 262 U.S. 276, 291 (1923).

<sup>38</sup> Smyth v. Ames, 169 U.S. 466, 544 (1898).

<sup>39</sup> "Primer on Capital Recovery, Regulatory Treatment of Taxes and Cash Flow Financial Analysis," prepared for the United States Telephone Association by Shooshan & Jackson, Inc. (Washington, D.C.: January 30, 1987), p. 57.

<sup>40</sup> "The Negative Effects of Tax Reform on the Telephone Industry," prepared for the United States Telephone Association by Shooshan & Jackson, Inc. (Washington, D.C.: January 30, 1987), p. 29.

this action in, for example, Massachusetts, Kansas, and Pennsylvania as having "dismantled the 'regulatory bargain'" there.<sup>41</sup> Treating the same subject a Harvard University research policy group, hired by a local electric utility, recently published a report with the revealing title, "Re-Establishing the Regulatory Bargain in the Electric Utility Industry."<sup>42</sup>

Another "clause" in the regulatory contract that is increasingly being asserted has to do with the idea of a utility having an exclusive service territory in exchange for the obligation to serve. In an editorial entitled "The Social Compact and the Sharing of Risk" the Public Utilities Fortnightly in 1986 described the quid pro quo this way:

It is generally agreed that public utilities, ...have struck a bargain with the rest of society - also called a social compact - whereby the owners assume a responsibility to serve all members of the public whenever and to whatever extent desired - which means maintaining a capacity to serve through investment in reliable and adequate facilities. In exchange for this commitment, most members of the public give up the right to "shop around" for cheaper or otherwise more attractive service from another supplier. A franchise on the part of the utility, conferring an exclusive right to serve, free of competition from purveyors of the same genre of service, is recognized.<sup>43</sup>

What gives rise to this line of argument, of course, is the loosening of entry barriers and the phenomenon of various forms of system bypass by major customers in all sectors of the fixed utilities - electric, gas, telecommunications, and water. Some observers argue that the old "obligation to serve" maxim is dead with the allowance of incursions into traditionally exclusive service areas by cogenerators (electrics) or outright competitors (telecommunications) or by alternate institutional arrangements for the provision of supplies (natural gas) - all with a view of the established "monopoly carrier" as a welcome provider of last resort.

Finally, there is another aspect of the arrangement that is asserted to be a part of the social contract. That is, that the public has guaranteed

---

<sup>41</sup> Reported in Inside F.E.R.C., March 23, 1987, p. 7.

<sup>42</sup> Reported in Electric Utility Week, March 30, 1987, p. 6.

<sup>43</sup> Public Utilities Fortnightly Vol. 118, No. 1, editorial, July 10, 1986, p. 4.

to a utility's owners a reasonable opportunity of earning a fair return on their investment in exchange for accepting a ceiling on the earnings which the utility is allowed to realize - presumably something lower than would otherwise be the case. Pressures for the "breaching" of this bargain on the upside can come from various proposals for "incentive returns" to the utility for superior performance of one kind or another, e.g., an increase in plant availability.

The above examples are illustrative of what could be called the conventional use of the social contract idea in the public utility field of, say, the past three decades. Its new and perhaps unconventional usage in the current telecommunications deregulation environment is the focus of the next section.

### III. SOCIAL CONTRACT AS PARTIAL DEREGULATION

#### A. Focus and Forums

The foregoing sections on the classical origins and evolving usage of the term "social contract" might be claimed to be the setting up of straw men with regard to its current application in telephone regulation, i.e., the deregulation of all but local exchange service in exchange for a ceiling on local rates. One could argue that the current usage never was intended to draw from traditional meanings of the social contract concept, and therefore references to the earlier idea are unnecessary or unfair. Such criticism is not fully persuasive.

Employing the term at all clothes the idea with a certain populist and progressive connotation it may not deserve. If the social contract label is to be used, its historical and diverse interpretations need at least to be acknowledged and perhaps remembered. While proponents and opponents of any idea, of course, can choose their terms of characterization, clarity of thought about the matter is generally aided if those terms carry with them neither a halo nor excess baggage. It could be asserted, for example, that any chance for objective discussion about the desirability of income maintenance schemes for the continued provision of utility services to the poor probably was lost the moment that proponents selected the word "lifeline" to describe their plan. The terms "soft paths" and "renewables"

may play similarly subtle roles in debates on alternatives to central power station generation; "stranded plant" may do the same in considering system bypass. "Regulatory reform" became equated with deregulation (though of course it need not), and "streamlining regulation" in the context of the Bell Operating Companies' and their Regional Holding Companies' current initiatives is seen by some as really meaning achieving the least amount of regulatory oversight that can be gotten away with. In any event, words matter, and public policymaking is best done with as neutral a description of an issue as possible.

While there are a number of variations to it, for our purposes the description of social contract by FCC authors in the August 1986 Federal Communications Law Journal provides a workable definition. They write,

Under "social contract" proposals, deregulation would take place through an agreement between state authorities and individual telephone companies. The companies would be required to limit local rate increases according to some external index, such as the Consumer Price Index, and to make specified capital investments during the contract period to maintain and upgrade their networks. In return, the companies would be freed from the burdens of rate-of-return regulation for all services and would be subject to minimal regulation, at most, of particular services.<sup>44</sup>

In any application of the social contract it would seem important to have clearly in mind just who the "contracting" parties are. At least four possibilities come to mind as primary candidates and three more as secondary ones. Figure 1 groups and displays the several parties with the public ones to the left and the private ones to the right. The solid line portrays direct "contract" relationships and the dotted lines ancillary ones.

The bargain struck could be said to be between the dominant telephone company and the legislature. Some evidence for this view is the lobbying activity of the Bell operating companies and their parent holding companies in legislatures around the country. The count is still small, but at this writing stands at perhaps six states where this approach to partial

---

<sup>44</sup> Mark S. Fowler, Albert Halprin, and James D. Schlichting, "'Back to the Future:' A Model for Telecommunications," Federal Communications Law Journal 38 (August 1986), p. 196, footnote 156. Various permutations of this general quid pro quo would, of course, be possible, and indeed several have been proposed.

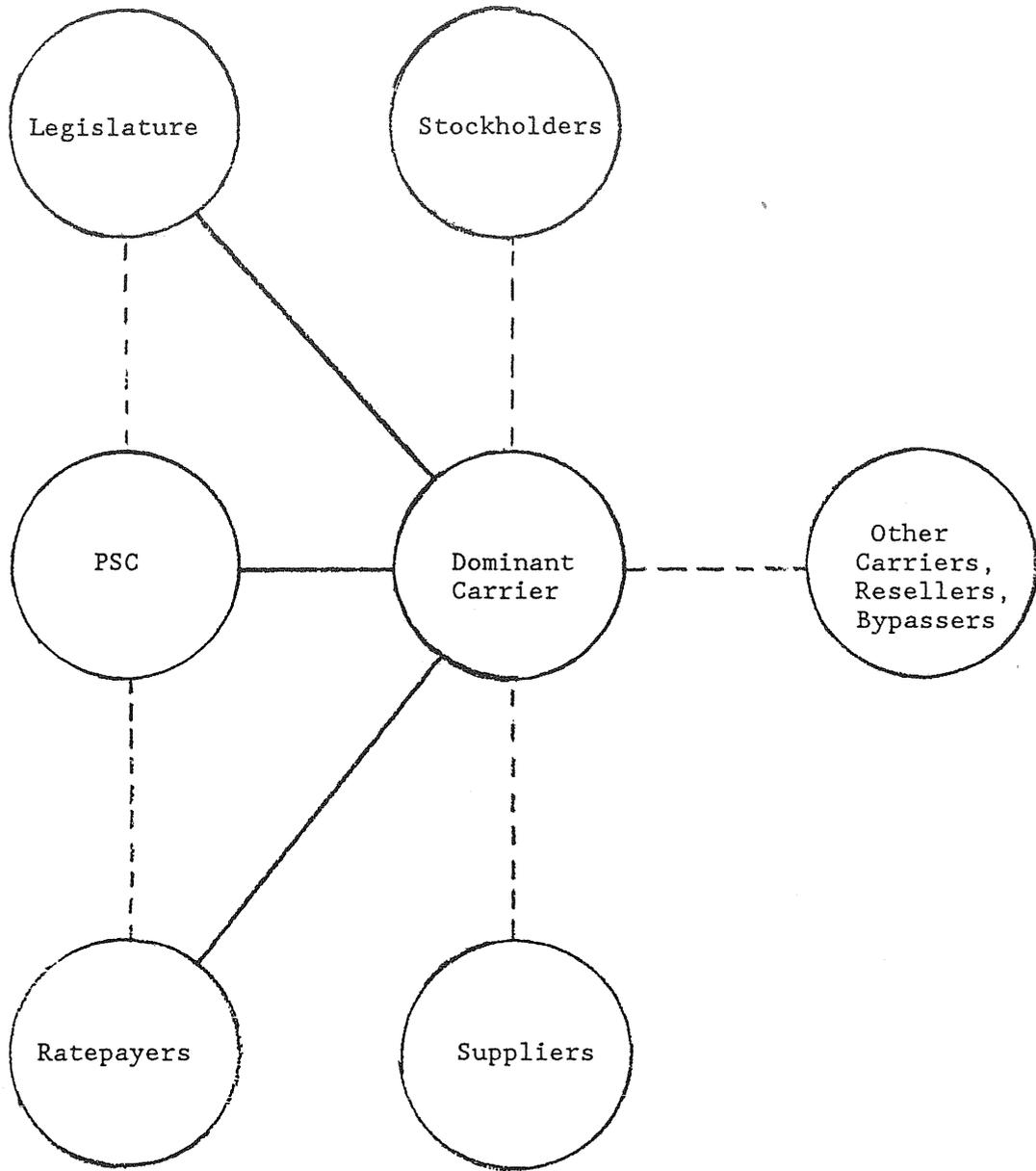


Fig.1 Schematic of contracting parties to social contract.

deregulation of telcos has been used, with the debate explicitly couched in social contract terms. Interestingly, however, the phrase "social contract" has not actually appeared in any piece of deregulation legislation that one can find.

The agreement could be said to be between the dominant telephone company and the state public utility commission. This might be the case in states where PSCs already have the statutory authority to enter the social contract arrangement or do not need prodding by the legislature. A variation of this could be agreement between the company and the state's "Department of Public Service" (instead of the state's PSC), where states have such a division of regulatory responsibility.<sup>45</sup>

Or, it could be viewed that the contract is really between the dominant telephone company and the ratepayers or the public at large. This would follow from viewing the PSC and the legislature as merely agents for the subscribers and the citizenry, respectively.

Finally, if not direct parties to the contract, at least three other groups (as depicted in Figure 1) have indirect interests involved -- suppliers of various inputs to the company (including labor), stockholders, and other telecommunications carriers, resellers, bypassers, and even non-carrier competitors. So a clear understanding of just who the main and supporting parties of interest are in the social contract approach, the political legitimacy of the agreement, and the nature of the agent and bargainer roles involved is fundamental. In this connection it would seem, for example, the social contract model would most congenially be applied where the utility is a cooperative or a municipality rather than being investor-owned. Here the connection would more closely be between "social" parties, i.e., subscriber owners in one case and taxpayer owners in the other. This has not, however, been the arena of the social contract initiative.

In addition to discussion of social contracts for telecommunications by a few PSCs and a few more legislatures, by some of the BOCs and RHCs, and by the trade press, two federal entities provided recent important forums for featuring the approach. The National Telecommunication and Information

---

<sup>45</sup> This was the intent in at least one state where "social contract legislation" was drafted, though not as yet passed.

Administration in October 1986 announced a "Comprehensive Review of Rate of Return Regulation of the U.S. Telecommunications Industry" and requested comments from interested parties.<sup>46</sup> In its Notice in the Federal Register the NTIA describes its study objective as including determining "whether there are preferred alternative regulatory mechanisms."<sup>47</sup> The agency introduces its write up on seeking commentary on "Alternatives to Rate of Return Regulation" with the following statement.

Given the costs and inefficiencies attributable to rate of return regulation, it may be appropriate to replace rate of regulation with another mechanism that provides comparable protection against excessive rates with lesser social and economic costs. (emphasis supplied)<sup>48</sup>

This stated presumption of costliness and inefficiency attending traditional regulation is of special note in that other portions of the NTIA's Notice indicate the purpose of the inquiry included importantly what the "cost imposed" and "any inefficiencies" were.

The first of "several alternatives" mentioned was "Social Contract and Related Schemes." As part of its response to the inquiry, the National Association of Regulatory Utility Commissioners reported on the results of polling its membership regarding this particular subject by saying, "Only a handful of States responding to the NARUC's survey indicated that the 'social contract' approach to telecommunications regulation has been addressed in some form in their jurisdiction."<sup>49</sup>

The most recent forum is the Federal Communication Commission's 1987 docket on "Decreased Regulation of Certain Basic Telecommunications Services." In the "Comments of the Ameritech Operating Companies," for example, one finds reference to the social contract as the end state of apparent equilibrium as the "Deregulatory Plan Model" moves

<sup>46</sup> Federal Register, Vol. 51, No. 200, October 16, 1986, 36837-41.

<sup>47</sup> Ibid., 36837.

<sup>48</sup> Ibid., 36839.

<sup>49</sup> Comments of the National Association of Regulatory Utility Commissioners, In the Matter of Comprehensive Review of Rate of Return Regulation in the U.S. Telecommunications Industry, Docket No. 61091-6191, before the National Telecommunications and Information Administration, Washington, D.C., December 15, 1986, pp. 4-5.

from full to streamlined regulation and, eventually, to an unregulated category [for competitive services] as quickly as circumstances warrant. The transition ...should proceed apace until only core services remain fully regulated. Then, under a 'social contract' regulatory approach, the rates for core services would be capped to reduce the level of remaining regulation."<sup>50</sup>

Social contract schemes are given some prominence in a third forum, the Huber Report done for the Antitrust Division of the U.S. Department of Justice. It contains a section entitled "Detariffing and Social-Contract Pricing Initiatives in US West Region."<sup>51</sup> The author comments favorably on the ability of social contract pricing to curb incentives for cross-subsidization but adds that it "will not, on the other hand, eliminate the incentive to monopolize adjacent markets through the discriminatory provision of network access."<sup>52</sup>

#### B. Some Questions and Worries

What, then, should public policy require of the current social contract idea for telecommunications if the proposal is to replace the apparatus and anchors of rate base and rate of return regulation? It is fair to cast the question (and this final section) in this way because generally the burden should be on any new scheme to demonstrate the logic of its superiority over the old. There are worries, and for purposes of exposition they are here grouped into three categories. These are worries about the structural design of the social contract; worries about its presumptions; and worries about the changed relationships it implies for the parties.

---

<sup>50</sup> Comments of the Ameritech Operating Companies, In the Matter of Decreased Regulation of Certain Basic Telecommunications Services, cc Docket No. 86-421, before the Federal Communications Commission, Washington, D.C., March 6, 1987, p. 8.

<sup>51</sup> Peter W. Huber, The Geodesic Network, a Report on Competition in the Telephone Industry, for the Antitrust Division, U.S. Department of Justice, Washington, D.C., January 1987.

<sup>52</sup> Ibid., p. 2.24 and footnote 77.

## 1. Structural Design

A number of selections must be made in structuring the basic features of the social contract, and just what selections are made very much influences the outcome. One is the index by which local telephone rates (if not frozen) are allowed to rise. The Consumer Price Index, sometimes mentioned, may not be best for this purpose. It is especially sensitive currently to cost components having little to do with telephone services - namely, housing costs, mortgage interest, and medical costs. There are price series within the CPI that track both local and toll telephone services, but of course some circularity would be involved in employing them in this fashion.<sup>53</sup> Moreover, the Producer Price Index or the GNP Implicit Price Deflator may be better overall indexes to use and would tend to result in slower price rises for local telephone service. Still better, a special index of the cost of providing telephone service (not the tariff cost of acquiring service) might be constructed similar to the Handy-Whitman Index of telephone company costs.

Another selection is the choice of the base rates under the social contract upon which any indexing would operate. There is a premium on the base rates being "correct" in the first place, as any initial distortion is subsequently magnified by application of the index. It may be, for example, that with favorable capital markets, tax reductions, near zero inflation, and perhaps even some productivity and efficiency gains that rates are currently too high, and to freeze them at this level or build upon them is to do injustice to any faint cost-of-service perspective.<sup>54</sup> If the cap selected were unduly high, it would encourage a prompt run up in pricing, and result in excess earnings for the services. Also, the structure of the base rates should be compared to that of telephone costs. For example,

---

<sup>53</sup> For a recent and comprehensive report on telephone price indexes and their behavior see James L. Lande and Peyton L. Wynn, Primer and Sourcebook on Telephone Price Indexes and Rate Levels, a study prepared at the Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, Washington, D.C., April 1987.

<sup>54</sup> Consumers' counsels (among others) make many of these arguments in opposing social contract schemes. See, for example, comments of the Director of Consumer Intervention for the New York Protection Board as reported in State Telephone Regulation Report, Vol. 5, No. 3, February 12, 1987, pp. 9-10; and testimony of the Ohio Office of the Consumers' Counsel before NTIA in Docket No. 61091-6191, dated December 29, 1986.

certain usage sensitive rates may be recovering costs which are not in fact usage sensitive. In this case, if usage increases, the companies will over-recover costs, even though rates are capped. Further, the timing of implementation is significant with respect to the cost components, i.e., whether in stable equilibrium or experiencing volatile price changes. One would also want to review the experience with indexing in other areas before applying it to telephone service. In particular, cost of living allowances which link wage increases to a price index have had mixed results in the U.S. and abroad. Closer to the public utility field, the "New Mexico Cost-of-Service Index" experiment of the late 1970's might be instructive as well.

Still another selection to be made is defining just which telephone services fall under the monopoly service category and which ones are set free of regulation. How the services get separated in the first place and how changes over time are accommodated are of obvious importance. Today's local service may appear primitive by tomorrow's standards, and pressure might build for the telephone company tariffs to be permitted to exceed the cap to take into account the improved basic service. Moreover, as technology evolves, state regulatory commissions may encounter the same difficulty that the FCC had in Computer Inquiries I-III in distinguishing between regulated and unregulated, basic and enhanced services.

Duration of the social contract is also important. Horizons of five to twenty years have been mentioned, which could be seen as suggesting great uncertainty as to the vigor and pace of the growth of competition in local service markets. Finally, provision would seem to be necessary for cases where the hoped-for workability of a social contract did not in fact eventuate.<sup>55</sup> A reregulation feature would be a prudent element in any social contract, for it is not likely that any party that was unduly profiting from the arrangement would gracefully yield back its "gains" to the legislative or administrative process.<sup>56</sup>

---

<sup>55</sup> This was reportedly one reason that the Governor of Idaho vetoed HB-149, a social contract type deregulation bill initiated by US West. (See State Telephone Regulation Report, Vol. 5, No. 6, March 26, 1987, p. 1.)

<sup>56</sup> A hundred years of public utility regulation do not support the idea that statutes, legislative authorities, and court cases extending regulation are easy to come by--even in the face of real need.

## 2. Presumptions

Several presumptions underlie the social contract approach which need at least identification in any discussion of the subject. One is that utility behavior during the "experimental" phase of the contract is an accurate indicator of its longer term conduct. Like couples dating, it might be supposed that they would be "on their best behavior" in the early period. Another is that the dominant carrier will not perpetrate abuses against other carriers in the competitive portion of its business. Reliance on federal and state antitrust laws to look after the free play of competition in the wake of the social contract is a major presumption. Antitrust actions are historically ill suited for prompt and effective regulatory intervention, and state antitrust laws are notoriously weak in content and enforcement.

There is also a small presumption about the "shrinking nickel candy bar" phenomenon. That is that the local exchange carriers will not extract increased returns from the monopoly portion of their activity by keeping prices flat but degrading service quality.

Lastly, while not singular to the social contract approach, the scheme does have a strong presumption that technology can be counted on for continued development and rapid adoption and that this can be equated nearly one-to-one with increases in the competitive nature of telecommunications markets. This belief is rather different from the view that consumers and not technology are the central force in markets.

## 3. Changed Relationships

The social contract, as proposed, is designed to markedly change certain relationships. Some of these changed relationships involve the carrier and the public service commission while others involve the ratepayer and the commission. In the first instance the PSC abandons cost-of-service, rate-of-return, and rate base regulation with respect to the carrier. Universal service and stability in local exchange rates are promised in the social contract and not (as before) shaped and actively monitored in a participatory way by PSCs. Cross subsidization opportunities are thought to be minimal, and constant surveillance of this matter is not foreseen. In some arrangements there may be an elective aspect as to utility company participation in the social contract, in which case companies would likely

seek to be "in" or "out" depending on their perception of the benefits to them.

From the vantage point of the consuming public there may be greater difficulty in mounting challenges to the rate changes by the carrier. The burden of proof would no longer seem to be on the utility to demonstrate that rate changes were "fair and reasonable." Lawfulness of a rate is thus presumed, and judgement making is replaced by formula regulation. Further, some accountability may be lost over control of the process where legislatures and antitrust departments become the real points of recourse and remedy, and PSCs lose authority and perhaps interest.

#### IV. POSTSCRIPT

Stripped of the favorable (or unfavorable) connotations of the label, social contract proposals in telecommunications are merely part of the array of initiatives for partial deregulation in the move to dismantle government oversight of economic processes. It is a rather extreme one when it is viewed as a "way station" to full deregulation of local telephone service.<sup>57</sup>

The social contract approach might be placed on the spectrum of public control as depicted in figure 2. This schematic is intended to show a gradation of social control of utilities with the highest degree of intervention on the left and the lowest on the right. This typology, moving from full public ownership to full deregulation, provides one context in which to view social contract regulation. It is here placed on the deregulatory side of two companion proposals that are receiving some attention in telecommunications discussions, "market basket regulation" and "banded pricing."<sup>58</sup> The former involves monitoring the overall performance of a telephone company's stock against a portfolio of comparably risky stocks and annually adjusting earnings as necessary. The latter is the relatively common concept of allowing telecommunications firms the discretion to raise or lower prices within a prescribed range without seeking regulatory approval. If the above graphic is an accurate

---

<sup>57</sup> Such a view is expressed, for example, in Ameritech's "Comments before the FCC," op.cit., pp. 8-9.

<sup>58</sup> Federal Register, NTIA, op.cit., p. 36840.

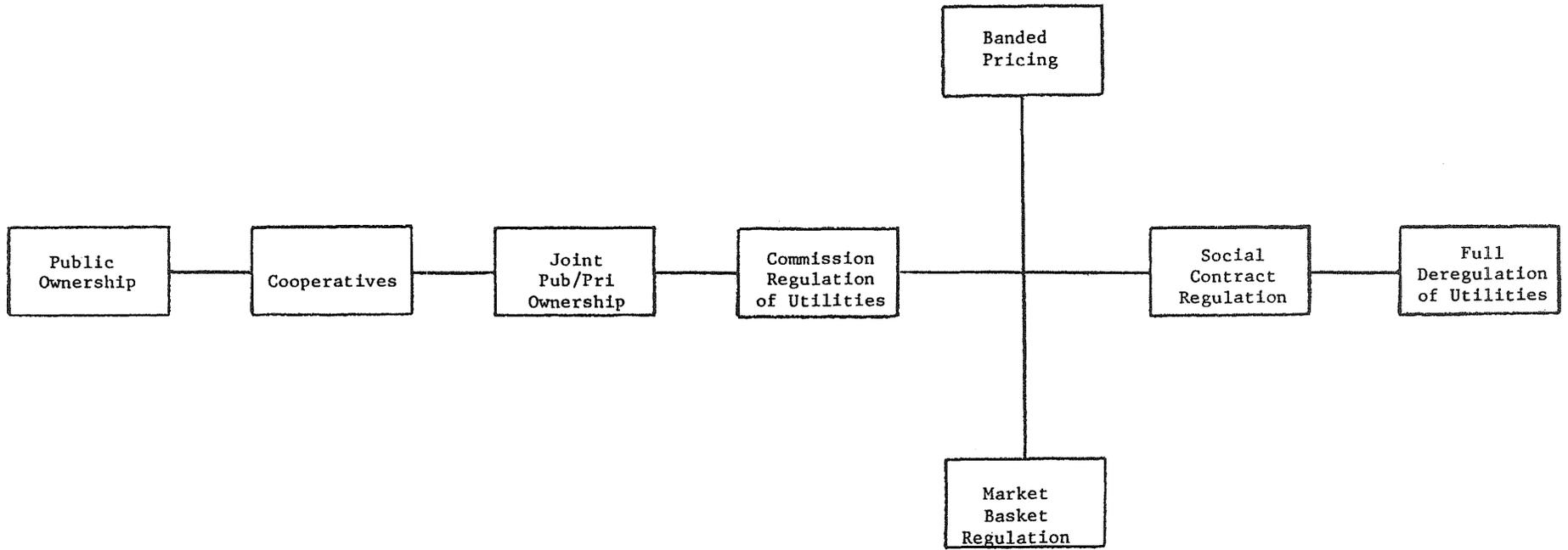


Fig. 2 Schematic of social control of utilities

portrayal, then it can be seen that the social contract approach brings the public interest very close to being dependent upon fully workable competitive markets or, failing that, a combination of vigorous antitrust enforcement and a faith in what is variously called "the corporate soul" and "the social responsibility of business" as restraining forces in industry conduct.

However this may be, the surfacing of the social contract approach, along with other modifications and refinements to traditional public utility regulation, confirms the oft-cited theme that state PSCs can be the laboratories in which are tried "novel social and economic experiments without risk to the rest of the country."<sup>59</sup> As summed recently by one state regulator,

If competition does not in fact pervade the telecommunications marketplace as fully as many have expected, those states that have deregulated telecommunications service will discover that they had made a mistake . . . In contrast, those states that have maintained a handle on LEC cost allocation and pricing decisions will be in a better position to protect their citizens from the abuses of a monopolistic or oligopolistic marketplace.

Conversely, if the marketplace becomes truly competitive, those states that have deregulated telecommunications services are likely to benefit from such competition more than those states that have maintained controls on LEC's costing and pricing.<sup>60</sup>

This is the familiar uncertainty of public policy in matters economic. What is involved would be a trading of present known rights for a new and different and less certain future configuration of entitlements. Renegotiation of the traditional regulatory bargain in the fashion contemplated would go a long way toward applying what amounts to a "sunset provision" to state regulation of telecommunications. In the public policy debate on the issue it would seem fair to say that whatever the ultimate benefits to the several parties to the proposed social contract approach

---

<sup>59</sup> Justice Brandeis dissenting opinion in New State Ice Co. v. Liebman, 285 U.S., 311 (1932).

<sup>60</sup> Honorable Paul F. Levy, Chairman, Department of Public Utilities, Commonwealth of Massachusetts, "The Swing of the Pendulum," IEEE Communications Magazine, Vol. 25, no. 1, p. 24.

might be, the advantages to the carriers are in somewhat clearer focus at this point than those to the ratepaying public.