STATE OF ILLINOIS
Illinois Commerce Commission
OFFICE OF GENERAL COUNSEL
180 N. LaSalle Street, Suite 810
Chicago, Illinois 60601

(312) 793-2877
(FAX) 793-1556

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VIA FEDERAL EXPRESS

Ms. Donna R. Searcy
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation
FCC CC Docket No. 92-135

Dear Ms. Searcy:

Enclosed please find the Reply Comments of the Illinois Commerce Commission in the above-captioned docket. I have included an original plus five copies of the comments to fulfill the filing requirement in this docket.

I would appreciate your acknowledging receipt of this filing by returning a duplicate time-stamped copy of this letter in the enclosed self-addressed stamped envelope.

Thank you for your attention to this matter.

Very truly yours,

Darrell S. Townsley

Darrell S. Townsley
Special Assistant Attorney General

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Enclosures

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Regulatory Reform for	)	CC Docket No. 92-135
Local Exchange Carriers	)	
Subject to Rate of Return	)	
Regulation	)	

TO: THE COMMISSION

REPLY COMMENTS OF THE ILLINOIS COMMERCE COMMISSION

Darrell S. Townsley
Special Assistant Attorney General
Illinois Commerce Commission
180 North LaSalle Street
Suite 810
Chicago, Illinois 60601
(312) 793-2877

September 25, 1992

Reply Comments of the
Illinois Commerce Commission
CC Docket No. 92-135

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Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation	)	CC Docket No. 92-135

Reply Comments of the
Illinois Commerce Commission

I. Introduction

The Illinois Commerce Commission ("ICC") hereby respectfully submits its Reply Comments to the Federal Communications Commission ("Commission" or "FCC") in the above-captioned docket.[1] The ICC supports the FCC offering greater opportunities for small and mid-size local exchange carriers ("LECs") to participate in a form of incentive regulation. In comments submitted in CC Docket No. 87-313[2] (the price caps proceedings for AT&T and the LECs), the ICC supported price caps as superior to rate-of-return regulation to achieve a number of economic efficiency goals and social objectives in the interstate jurisdiction.[3] The ICC agrees with the FCC's tentative conclusion that the preferred approach for regulatory reform is a continuum of increasingly incentive-based approaches that permit companies to choose a plan that best fits their circumstances. NPRM at ¶ 3. The ICC supports the FCC's proposal to adopt an optional incentive plan for rate of return carriers that is designed as an intermediate step toward price caps.

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[1] Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135, Notice of Proposed Rulemaking, 7 FCC Rcd 5023 (1992) ("NPRM").

[2] See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 87-313, Notice, 2 FCC Rcd 5208 (1987); Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 87-313, Further Notice, 3 FCC Rcd 3195 (1988); and Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 87-313, Report and Order and Second Further Notice, 4 FCC Rcd 2873 (1989); Erratum, 4 FCC Rcd 3379 (1989).

[3] See Comments of the Illinois Commerce Commission, Policies and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, filed Oct. 15, 1987 ("ICC Initial 87-313 Comments").

II. The ICC has supported the FCC's moves to increase regulatory flexibility for telecommunications carriers

The ICC filed comments in the price caps proceeding on three occasions. In its Initial 87-313 Comments, the ICC found rate of return regulation to be lacking in its ability to meet four regulatory objectives: (1) reasonable rates, (2) pricing efficiency, (3) innovation and modernization, and (4) minimization of regulatory costs. The ICC stated that "under rate of return regulation, even rates not subject to intentional cross-subsidization,[4] contain inherent inefficiencies . . . [since] rate of return regulation requires the allocation of joint and common costs."[5] The ICC noted that, under rate of return, the firm had "strong incentives for the continual expansion of capital stock," and that "management is not compelled to execute cost-cutting measures and improve the efficiency of the firm's operations."[6] Under price regulation, on the other hand, the ICC observed that "control of the level of profits recovered by the firm, or costs incurred by the firm, is not the focal point for regulators" and that "each gain in efficiency rewards the price-regulated firm with increased profits."[7] The ICC also provided a specific proposal for price cap regulation of AT&T's interstate rates which was consistent with the four criteria enumerated by the ICC in its Initial 87-313 Comments.[8]

In Further Comments submitted in Docket 87-313, the ICC restated its assessment of rate of return regulation and of price cap regulation, in general. The ICC also offered a critique of the FCC's proposals for price cap

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[4] That is, rates other than those to achieve objectives such as universal service.

[5] ICC Initial 87-313 Comments at p. 7.

[6] Id. at p. 8.

[7] Id. at p. 11.

[8] Id. at pp. 21-27.

regulation of AT&T and the LECs.[9] For example, in response to concerns for the quality of service under price caps, the ICC recommended "that the FCC adjust its minimum standards to reflect actual levels of quality prior to implementing price cap regulation."[10] The ICC was also concerned that "the use of a single productivity factor for all carriers may not adequately account for carrier and market differences."[11] Subsequent to the issuance of the FCC's Report and Order and Second Further Notice in Docket 87-313,[12] the ICC filed comments that provided further review of the details of the price caps plan for LECs, concluding that "upon refinement, the price cap plan for LECs will represent a step forward in the regulation of LEC interstate services."[13]

Thus, the Illinois Commerce Commission has supported finding alternatives to traditional rate of return regulation and improving the regulatory incentives to operate efficiently. The proposal by the FCC contained in this NPRM offers an additional option for smaller LECs to seek greater flexibility and achieve greater efficiencies than possible under traditional rate of return regulation. The ICC supports this proposal and comments as follows.

III. The optional incentive plan proposed by the FCC provides desired increased flexibility for smaller local exchange carriers

A. Increasing regulatory lag by one year provides additional incentives for innovation and efficiency

The FCC tentatively concluded that biennial filing will substantially reduce regulatory burdens, while permitting scrutiny of rates to fulfill

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[9] Further Comments of the Illinois Commerce Commission, CC Docket No. 87-313, filed July 26, 1988 ("ICC Further Comments").

[10] Id. at pp. 12-13.

[11] Id. at p. 20.

[12] See note 2, supra.

[13] Reply Comments of the Illinois Commerce Commission, CC Docket No. 87-313, filed July 18, 1989, at p. 19.

statutory requirements and that revisions should be limited. NPRM at ¶ 10. The effect of the FCC's proposal is simply to increase the regulatory lag by one year. With a greater regulatory lag, the firm has the incentive to decrease production costs through technological innovation because it can enjoy greater profits for a longer period.[14]

Since the regulatory lag is increased by one year under this proposal, it is appropriate to impose a greater standard on midterm changes. The efficiency gains are maximized when prices are held constant. The FCC has proposed that LECs seeking midterm tariff revisions should bear a heavy burden of proof that cost changes render current rates unreasonable. NPRM at ¶ 10. The ICC agrees with this proposal.

B. An earnings band is a step in the right direction

The ICC agrees with the FCC's tentative conclusion that it is appropriate to apply an approach similar to the price cap earnings band where, if a company achieves lower costs by increasing its efficiency, its earnings increase. NPRM at ¶ 11. The increased flexibility the FCC is offering to smaller LECs' earnings is a step in the right direction. A band of allowable earnings is preferable to a single-point rate of return because an earnings band creates incentives for the LEC to be more efficient and innovative in order to achieve greater earnings than could be achieved under a single-point rate of return regulation.

An opportunity for LECs to achieve greater rewards is a reasonable approach. Sharing mechanisms for earnings above some range may be appropriate. For example, a competitor and large customer of LECs' access services, MCI, has proposed in a number of jurisdictions what it calls a

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[14] Sweeney, *Adoption of Cost-Saving Innovations by a Regulated Firm*, American Economic Review, June 1981, Volume 3, pp. 437-447; See Bailey, *Innovation and Regulation*, Journal of Public Economics, August 1974, Volume 3, pp. 285-295.

"reverse taper" where, as earnings increase, the LEC is able to retain a greater portion of the earnings.[15]

C. Because mid-term corrections are proposed to be allowed, "known and measurable" future costs should not be included in biennial filings

The FCC proposes that LECs that participate in this plan would base the first tariff filing on a cost of service study for the most recent 12 month period with related demand data for that same period. Subsequent filings would be based on similar cost and demand data for all elements for the period since the LEC's last filing. NPRM at ¶ 13. The FCC also proposes that LECs may argue for the inclusion of additional costs that are "known and measurable" if such costs would otherwise cause the carrier to fall short of earnings. NPRM ¶ 14. The ICC agrees with AT&T's assessment that the inclusion of "known and measurable" costs in biennial filings "guarantees LECs an up front reimbursement of costs that may not materialize."[16] As AT&T further points out, this provision does not provide incentives for LECs to reduce costs and appears unnecessary, since the FCC is proposing that midterm corrections be permitted. The midterm revision is the appropriate forum in which the LEC should argue for recovery of such costs. Furthermore, if filings are to be biennial, the LEC is not likely to incur such a degree of harm in that time to warrant frequent midterm revisions.

The ICC agrees with the FCC's tentative conclusion that exogenous cost changes, as defined in price caps as a change in cost beyond the control of the LEC, be incorporated in this incentive plan as in price caps. NPRM at ¶ 14. In its comments, NECA added that long term support obligations to NECA by

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[15] Testimony of Dr. Nina Cornell of Behalf of MCI Telecommunications Corporation before the Public Utilities Commission, State of Colorado, Application of Mountain States and Telegraph Company d/b/a US West Communications, Inc., for Approval of a Five Year Plan for Rate and Service Regulation and for a Shared Earnings Program, Docket No. 90A-665T, filed Sept. 11, 1991, pp. 23-25.

[16] Comments of American Telephone and Telegraph, CC Docket No. 92-135, at pp. 5-6 ("AT&T Comments").

LECs that depool to elect the plan should be treated as exogenous as is done for price cap LECs.[17] The ICC agrees that similar treatment of long term support obligations should be accorded to incentive plan LECs as to price cap LECs.

D. Regulation of new service prices should be streamlined

The ICC agrees with the FCC's proposal that new service rates be introduced with a presumption of lawfulness if anticipated revenues[18] are no more than 2 percent of total operating revenue and do not exceed the rate charged by the geographically closest price cap LEC offering the same or similar service. NPRM at ¶ 16. The ICC believes that it would be unduly burdensome to require that rates be calculated based on historical costs of the service after its first 12 months. The ICC submits that an approach similar to that utilized in Illinois would be more reasonable. In Illinois, a small LEC, defined as a LEC with 25,000 or fewer access lines, is not required to file traditional cost justification with a noncompetitive service tariff filing. In fact, the ICC must institute an investigation of a non-competitive small LEC tariff rate only upon a complaint by a telecommunications carrier that is a customer of the LEC or when complaints are filed by the lesser of 5% or 75 potentially affected access line subscribers. In this case the ICC has "the power and duty to establish the rates, charges, classifications [of services] it finds to be just and reasonable."[19] Regulatory burdens for small LEC competitive offerings are even less onerous, although the ICC may require small carriers to furnish whatever information the ICC "deems necessary for a determination that rates and charges . . . are just and

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[17] Comments of the National Exchange Carrier Association, Inc. ("NECA"), CC Docket No. 92-135, filed Aug. 28, 1992, at pp. 14-15 ("NECA Comments").

[18] Though the FCC uses the term "earnings," the ICC will assume that the term "revenues" was intended.

[19] Ill. Rev. Stat. 1991, Ch. 111 2/3, par. 13-504(a), as amended by Public Act 87-856.

reasonable."[20] If a biennial filing schedule is to be implemented for the FCC's incentive plan, the information required to determine whether rates are just and reasonable need only be included in the filing initiating a service.

E. Average schedule carriers that pool should not be eligible

The ICC agrees with the FCC's tentative conclusion that this option should not be available to companies that collectively offer a single interstate tariff with pooled rates or earnings. NPRM at ¶ 22. This is consistent with the ICC's position in price caps election where the ICC agreed that "it may be difficult to construct a workable price cap arrangement which could govern pooling arrangements without endangering policies and programs such as the High Cost Fund and Lifeline."[21]

F. Carriers that elect to participate in the optional incentive plan should commit to participate for longer than two years

The FCC proposes that for this incentive plan only a two-year commitment is necessary and that participation be optional. If a carrier subsequently elects not to participate, then it must file rates on a company-specific basis. A company opting out will not be eligible to participate again in the incentive plan until the fourth year following the cessation of its previous participation. NPRM at ¶ 26. While the ICC agrees that this plan should be optional for non-price cap LECs, the ICC notes that it is unlikely that much will be learned about whether a LEC choosing this plan has increased efficiencies or made other gains in service quality and its abilities to respond to pending competition in just two years.

IV. The NECA and OPASTCO proposals appear to encourage additional pooling, which is inappropriate

NECA has proposed that rate of return LECs must be able to adjust rates by 5% up or down during tariff period to maintain access rate relationships

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[20] Ill. Rev. Stat. 1991, Ch. 111 2/3, par. 13-504(b), as amended by Public Act 87-856.

[21] ICC Further Comments at p. 17.

similar to those of larger LECs. A showing of revenue neutrality would be required.[22] NECA appears to seek the maintenance and expansion of current pooling participation. While the ICC supports permitting greater pricing flexibility, the ICC's preference is not to encourage greater participation in the pools. LECs that wish greater flexibility in pricing must be willing to bear some risk. Bearing greater risk includes the possibility of exiting the NECA pools.

Both OPASTCO[23] and NECA[24] recommend that small LECs be permitted to elect average schedule status which is currently limited to those on average schedule as of December 1, 1981. NECA has submitted a specific proposal for LECs to elect average schedule status. The ICC opposes these suggestions, as movement away from the pooling process is the more appropriate form of regulation. A step in the right direction is to permit LECs to set rates based on their own costs, then offer an incentive for LECs to decrease those costs, as the FCC has done here and in the price caps proceedings. The options offered in this NPRM are more effective at furthering the goals enumerated by the FCC rather than increasing the scope of average schedule status.

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[22] NECA Comments at pp. 13-14.

[23] Comments of the Organization for the Protection and Advancement of Small Telephone Companies ("OPASTCO"), CC Docket No. 92-135, at p. 9.

[24] NECA Comments at p. 16-17.

WHEREFORE, the Illinois Commerce Commission respectfully requests that the FCC adopt rules in this proceeding consistent with the foregoing comments.

Respectfully submitted,

Illinois Commerce Commission

By: Darrell S. Townsley

Darrell S. Townsley
Special Assistant Attorney General
Illinois Commerce Commission
180 North LaSalle Street
Suite 810
Chicago, Illinois 60601
(312) 793-2877

September 25, 1992

CERTIFICATION OF SERVICE

I hereby certify that a copy of the foregoing Reply Comments of the Illinois Commerce Commission in CC Docket No. 92-135 has been served this 25th day of September, 1992, upon all known parties of record in this proceeding by first-class mail, postage prepaid.

Dated at Chicago, Illinois this 25th day of September, 1992.

Darrell S. Townsley

Darrell S. Townsley
Special Assistant Attorney General
Illinois Commerce Commission
180 North LaSalle Street
Suite 810
Chicago, Illinois 60601
(312) 793-2877