MCI Telecommunications Corporation
1801 Pennsylvania Avenue, NW
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FEDERAL COMMUNICATIONS COMMISSION
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August 2, 1993

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, NW
Washington, D.C. 20554

Re: In the Matter of Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179

Dear Mr. Caton,

Enclosed herewith for filing are the original and nine (9) copies of MCI Telecommunications Corporation's Comments in the above captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI pleading furnished for such purpose and remit same to bearer.

Sincerely,

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

In the Matter of:	)	
	)	
Price Cap Regulation of Local Exchange carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing and Lower Formula Adjustment	)	

COMMENTS

MCI Telecommunications Corporation, Inc.
1133 19th Street N.W.,
Washington, DC 20036

August 2, 1993

SUMMARY

MCI Telecommunications Corporation respectfully submits its Comments on the Commission's NPRM involving sharing and lower formula adjustments. MCI's comments demonstrate that the Commission's proposal to add-back amounts for both sharing and lower formula adjustments, and thereby exclude such amounts from the calculation of LEC rates of return (earnings), is inappropriate, and inconsistent with both rate of return and price cap regulation and the calculation of earnings in general.

MCI agrees with the Commission's proposal to add-back sharing amounts. Sharing amounts, like refunds under rate of return regulation, must be excluded from base-period financial results in order to properly calculate rates of return for regulatory purposes. However, MCI vehemently disagrees with

In its Comments, MCI demonstrates that the proposed add-back for LFAs (also referred to as low end adjustments) in LEC rate of return calculations is inappropriate for the following reasons:

1) The LFA add-back unequivocally and permanently excludes revenues derived from LFA rate increases from ever being included in the calculation of base period earnings;

2) LFA add-backs are inconsistent with earnings monitoring under rate of return regulation;

3) LFA add-backs are inconsistent with the objectives of price cap regulation because they significantly diminish incentives for LECs to improve their performance; and

4) LFA add-backs effectively insulate price cap LECs from earning below a 10.25 percent rate of return under price cap regulation--a guarantee which is tantamount to retroactive ratemaking and not provided for under rate of return regulation. the proposed LFA

For these reasons, MCI requests the Commission to disallow LFA add-backs when computing LEC rate of returns.

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COMMENTS

MCI Telecommunications Corporation ("MCI") hereby respectfully submits its Comments on the Commission's Notice of Proposed Rulemaking ("NPRM") in the above-captioned matter. In its NPRM, the Commission proposes to exclude amounts associated with sharing and the lower formula adjustment from the calculation of local exchange carrier rates of return.[1] MCI's comments demonstrate that the Commission's proposal to add-back both sharing and lower formula adjustment amounts, and thereby exclude such amounts from the calculation of local exchange carrier rates of return (earnings), is inappropriate, and inconsistent with both rate of return and price cap regulation and the calculation of earnings in general.

I. Introduction

MCI agrees with the Commission's proposal to add-back sharing amounts. Sharing amounts, like refunds under rate of

[1] See, In the Matter of Price Cap Regulation of Local Exchange Carriers, Rate of return Sharing and Lower Formula Adjustment, ("NPRM"), para 4 and Appendix B.

return regulation, must be excluded from base-period financial results in order to properly calculate rates of return for regulatory purposes.

However, MCI vehemently disagrees with the Commission's proposal to add-back amounts associated with lower formula adjustment ("LFA") amounts. LFA amounts, just like the revenues from any rate increase under rate of return regulation, must be included in base-period financial results in order to properly calculate rates of return for regulatory purposes.

Under price cap regulation, the backstop adjustments serve two entirely different purposes even though both adjustments are based upon the "same" rate of return calculations. On the one hand, if local exchange carrier ("LEC") earnings exceed a certain level, the sharing backstop kicks in and LECs are required to lower rates in a future base period.[2] The sharing backstop allows LEC customers to share in historical productivity gains made by LECs. Conversely, if LEC earnings fall below a certain level, LECs are entitled to a prospective automatic upward adjustment to their caps and rates.[3] Even though both backstop adjustments are based upon the same rate of return calculations, each adjustment serves

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[2] See, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, ("Report and Order"), Adopted September 19, 1990, Released October 4, 1990, para 3.

a different purpose and therefore must be treated differently when calculating rates of return.

On the surface it may appear for the sake of symmetry that sharing amounts associated with prior base periods, and prospective LFA-related rate increases which are implemented in future base periods should be added-back when calculating rates of return. However, nothing could be farther from the truth.

The proposed add-back for LFAs (also referred to as low end adjustments) in LEC rate of return calculations is inappropriate for the following reasons:

1) The LFA add-back unequivocally and permanently excludes revenues derived from LFA rate increases from ever being included in the calculation of base period earnings;

2) LFA add-backs are inconsistent with earnings

have happened had certain events not occurred. The Commission must not confuse what has happened with the actions it intends to take with regard to the future when calculating LEC rates of return.

Moreover, there are two fundamental questions the

service incurred during the base period that such LFA rate increases were actually billed to customers, the Commission has no choice but to disallow LFA add-backs when calculating LEC rates of return.

For these reasons, MCI requests the Commission to disallow LFA add-backs when computing rates of return.

II. The Commission's Proposal

In its NPRM, the Commission questioned how amounts related to sharing and LFAs (collectively referred to as backstop adjustments by the Commission) should be treated for the purpose of calculating rates of return. Based upon its review and analysis, the Commission proposed that all backstop adjustments should be excluded (i.e., added back) when performing rate of return calculations.

The Commission tentatively concluded that it was appropriate to add-back amounts for both sharing and LFAs for the following reasons:

1) Without the add-back, the relationship between rate of return and productivity growth for the current base period will be hidden;[4]

2) Without the add-back, artificial swings in earnings occur;[5] and

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[4] NPRM, para 11.

[5] Id., para 12.

3) The add-back appears necessary in order to determine the price caps LECs' sharing obligations and rights for LFAs.[6]

The best way to illustrate that LFA add-backs permanently exclude the additional revenues associated with LFAs from ever being included in rate-of-return calculations is to make a comparison of such calculations with and without the LFA add-back.

The revenue, expense and rate base amounts used in MCI's illustration, which is denoted as "Table 1," are the same as that used in the Commission's analysis in Appendix A. The only change that has been made is to present the LFA add-back right below the amount of revenues actually billed to customers instead of presenting such amount further down in the earnings calculation. The LFA add-back was presented in this manner to highlight how the LFA add-back permanently excludes the additional revenues associated with LFA-related rate increases from ever being included in rate of return calculations. This is accomplished, in part, by totalling the various amounts in the earnings calculations for Years 1 and 2 in column 3 of each set of calculations. Bear in mind that the complete cycle associated with both sharing and LFAs occurs over two base periods. In the case of earnings below 10.25 percent the two periods are; the base period in which earnings actually fall below 10.25 percent, and the following base period in which rates are increased by way of the LFA.[7]

Note that in the following illustration that the billed

[7] The revenues that give rise to sharing in Year 1 of the two-year cycle are included in the earnings calculations in Year 1.

revenue amounts (i.e., the amount of money actually billed to and ultimately paid by customers) is the same for each year and in toto under both the with and without LFA add-back earnings calculations. And especially note that in the without LFA add-back calculations that the billed revenue amounts are the same as the net revenue amounts (i.e., the revenue amounts actually used to calculate earnings). Whereas, billed and net revenues amounts are different with respect to the with LFA add-back calculations.

In the without LFA add-back calculations the actual amounts billed to customers in each year and in toto through the cycle are equal to the net revenue amounts used in the earnings calculations. In this earnings calculation the LEC actually bills customers a total of $3,950 for services rendered over the two year cycle and a total $3,950 in net revenues is included in the earnings calculations.

On the other hand, in the with LFA add-back calculations the actual amounts billed to customers in Year 2 and in toto do not equal the net revenue amounts used in the earnings calculations. In this calculation the LEC actually bills customers $3,950 for services rendered over the two year cycle (which is the same amount of revenues billed and used in the earnings calculations in the without LFA add-back calculations), but only $3,850 in net revenues is included in the earnings calculations--a difference of $100.

TABLE 1

	WITHOUT LFA Add-back			WITH LFA Add-back		
	Year 1	Year 2	Total	Year 1	Year 2	Total
Billed Revenue	1,925	2,025	3,950	1,925	2,025	3,950
LFA Add-back	0	0	0	0	(100)	(100)
Net Revenue	1,925	2,025	3,950	1,925	1,925	3,850
Expenses	1,000	1,000	2,000	1,000	1,000	2,000
Rate Base	10,000	10,000	10,000	10,000	10,000	10,000
ROR W/ Add-back	9.25%	10.25%	9.75%	9.25%	9.25%	9.25%

In this example, the $100 difference in net revenues represents the LFA rate increase which went into effect in Year 2. And as shown above, the revenues associated with the $100 LFA are excluded in Year 2 (the year in which the LFA revenue increase was actually billed to customers) and in the "Total" column under the with LFA add-backs earnings calculation. Put another way, the revenues associated with LFAs are never included in the earnings calculations in any base period even though the $100 represents cash actually paid by customers when LFA add-backs are allowed in earnings calculations.

IV. Under Rate of Return Regulation, the Add-back Only Applied to Refunds--Never to Rate Increases

In its NPRM, the Commission stated that it anticipated the backstop to operate in much the same way as rate of return enforcement does for LECs subject to rate of return regulation.[8] The Commission also stated that rates of return would continue to be calculated and reported in essentially the same manner.[9] Be that as it may, the Commission's proposal to allow add-backs for LFAs when computing rates of return under price caps fails to operate or calculate rates of return in the same manner as under rate of return regulation.

Under rate of return regulation, refunds made during a current enforcement period were and continue to be excluded from the computation of current period earnings by way of the add-back. The add-back for refunds associated with overearnings in a prior period allows the Commission to

or applied to rate increases. If LEC rates were increased in either annual access filings or mid-year correction filings (both of which retargeted rates to earn the authorized rate of return) the additional revenues derived from such rate increases were always included in the base period that such rates were billed to customers when computing earnings. If current period earnings exceeded the allowed rate of return, LECs were required to make appropriate refunds. On the other hand, if LECs earned less than the allowed rate of return, no future action was taken with respect to such earnings; LECs were not allowed to recoup costs or earnings below their allowed rate of return in a subsequent base period. Thus

only sharing amounts but not LFAs when computing rates of return.

V. The LFA Was Intended to Save LECs From Low Earnings Over a Prolonged Period of Time, Not Effectively Guarantee LECs a Minimum Rate of Return

The LFA was never intended to effectively ensure that LECs earn a minimum rate of return of 10.25 percent under price caps. Instead, the LFA was intended to ensure that the newly adopted price cap regime did not cause LECs to realize especially low earnings over a prolonged period of time. The Commission decided that such a mechanism was necessary to ensure that price caps did not jeopardize the LECs ability to attract capital and provide service, yet maintain the incentives for LECs to improve their performance. In its LEC price cap order, the Commission stated:

> We are also adopting a modified version of our proposed lower stabilizer or low end adjustment mechanism in order to ensure that the application of the price cap plan does not subject an individual LEC to such low earnings over a prolonged period that its opportunity to attract capital and ability to provide service are seriously impaired.[10] (Emphasis added)

The Commission also stated that:

> If the earnings of a LEC whose rates are below the PCI fall below the lower adjustment mark in a base year period, it is entitled to adjust its rates upward to target earnings to an amount not to exceed the lower mark, using the prior period as the base line. This limited upward adjustment should ensure that the LEC will remain healthy and able to provide needed services, while retaining substantial incentives to take the action

[10] Report and Order, para 127.

> necessary to improve performance and thereby raise its earnings above this minimal level.[11] (Emphasis added)

The Commission went on to state that:

> And, because the lower end adjustment adjusts the PCI only enough to allow the LEC to earn at the lower end adjustment mark, using the prior period as the baseline, it continues to require that LECs gain in efficiency and productivity if they are to achieve even the average return allowed to them under rate of return regulation.[12] (Emphasis added)

The Commission's Order clearly shows that the LFA was not intended to guarantee price cap LECs a 10.25 percent rate of return under price cap regulation. The purpose of the LFA was simply to ensure that price caps (specifically the price index and the productivity factor offset) did not subject individual LECs to too low earnings over a prolonged period of time.[13] The LFA allows LECs an out to thereby raise rates and have the opportunity to earn at the lower end adjustment mark. The purpose of the LFA was to allow LECs to raise their rates prospectively so that they would not continue to realize such low earnings in the future so as to impair their ability to raise capital and provide service. This procedure undoubtedly requires LECs to become more efficient and productive if they are to achieve even the average return allowed to them under rate of return regulation.

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[11] Id.

[12] Id., para 147.

[13] Id., para 10.

If LFAs are added back, the LFA-related rate increase will not only ensure that LECs will not realize low earnings in the future, it will also have the unintended effect of guaranteeing LECs a minimum rate of return of 10.25 percent. Such a guarantee does not exist under rate of return regulation and is nothing short of retroactive ratemaking.

VI. Appendix A of the NPRM Illustrates the Problem With the LFA Add-back

The Commission's LFA analysis in Appendix A aptly illustrates the problem with the Commission's proposed LFA add-back. Moreover, the Commission's analysis also shows that the LFA add-back permanently excludes revenues derived from LFA rate increases from ever being included in the calculation of base period earnings.

The portion of Appendix A which deals with the LFA add-back contains three scenarios. The first scenario illustrates the financial effects when a LEC receives LFA amounts via checks (direct payments) during the base period in which the company would have otherwise earned below 10.25 percent. This scenario will be hereafter referred to as Scenario 1. The second scenario (which will be referred to as Scenario 2) illustrates the financial effects when a LEC calculates its earnings without the LFA add-back. The third scenario (Scenario 3) illustrates the financial effects on a LEC that receives LFA rate increases and calculates its earnings with the LFA add-back.

The Commission's analysis shows that the LFA add-back permanently excludes revenues derived from LFA rate increases from ever being included in the calculation of base period earnings. This occurs because the additional revenues brought about by the LFA are excluded (i.e., removed) via the LFA add-back when calculating the earnings of the base period in which the LFA-related rate increases were actually billed to customers.

According to the Commission's analysis, Scenarios 1 and 3 demonstrate that a LEC which <u>includes</u> the LFA add-back in its rate of return computation earns the same rate of return and receives the same amount of money as the LEC who receives its low-end adjustment by way of a check in the base period in which it would have otherwise earned below 10.25 percent.[14] Scenario 1 of the Commission's analysis shows that LECs will indeed earn 10.25 percent in each and every year when they receive LFA-related checks by December 31 of each year.[15]

However, contrast this with the rate of return calculations in Scenario 3 which <u>include</u> the proposed LFA add-backs. In Scenario 3, the calculated rates of return <u>after</u> the LFA add-back are only 9.25 percent, <u>not 10.25 percent</u>, in each and every year that the LFA-related revenues are excluded from the earnings calculation.[16] The 9.25 percent rate of

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[14] NPRM, Appendix A, pg 2.

[15] <u>Id</u>.

[16] <u>Id</u>.

return only appears in Scenario 3 because the additional revenues from the LFA rate increases are excluded from the earnings calculation.

Interestingly enough, the real rate of return in Scenario 3 is reflected on the line before the LFA add-back.[17] That line shows that the LEC earned 9.25 percent in year one when it became eligible for the LFA, and 10.25 percent in each subsequent year in which it received additional revenues via the LFA rate increase. The 9.25 percent return that results from the rate of return calculation after the LFA add-back does not reflect the LEC's earnings for any base period because it pretends that customers were not charged higher rates which in turn translated into higher revenues for the LEC.

In addition, the Commission's analysis assumes that the low-end adjustment was intended to ensure that LECs are entitled to a minimum rate of return of 10.25 percent. In fact, the analysis (Scenario 1) shows that LECs will earn a 10.25 percent rate of return in each and every year. This is retroactive ratemaking.

On the other hand, if the LFA was only intended to ensure that low LEC earnings under price caps were not perpetuated into the future, then the LFA add-back should not be allowed. Scenario 2 aptly illustrates the financial effect in this regard.

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[17] Id.

LFA: to maintain the LECs' ability to attract capital and provide service yet maintain the necessary incentives for LECs to improve their performance. LECs were not allowed to recoup earnings below their allowed rate of return under rate of return regulation, and such an outcome should not be permitted under price cap regulation.

VII. The Reasons Given by the Commission for the LFA Add-back do Not Add Up

It is quite clear under both rate of return and price cap regulation that refunds/sharing amounts related to prior periods must be removed from current base-period financial results in order to ascertain what the LECs current base-period earnings are; i.e., what the current base-period earnings would have been had no prior-period refund/sharing obligations existed. In order to understand why it is not appropriate to also add-back LFA amounts when calculating base-period earnings, the Commission must keep in mind that regardless of whether rate of return or price cap regulation is employed the ratemaking process is by its very nature a "current and forward" looking proposition, whereas the calculation of rates of return is not.

Regardless of the type of regulation used to set rates, rates to be charged prospectively are set with certain earnings objectives or parameters in mind. Under rate of return regulation, prospective rates are targeted to earn a

specific rate of return. Under price cap regulation earnings fluctuate within a prescribed range, and prospective rates may be re-targeted, via the LFA, to earn at the lower end of a specified rate-of-return range. Prospective rates under both forms of regulation may be set lower than they would otherwise be in order to refund prior-period overearnings/sharing amounts. Prospective rates are not, however, set above what they would otherwise have been in order to recoup prior-period under-earnings. The import of the prospective nature of the rate setting process is that LECs are not guaranteed to earn their allowed rate of return or earn some minimum rate of return in any base period.

To summarize, the only role that earnings monitoring plays in the rate setting process is to ascertain whether or not LECs exceeded the level of earnings to which they are legally entitled. In addition, under price cap regulation earnings monitoring is used to calculate the amount of a prospective rate increase (LFA) for the subsequent base period. In the event that LEC earnings exceed the allowed level, prospective rates are reduced with regard to such over-earnings/sharing amounts. On the other hand, prospective rates are never increased with regard to any amount of under-earnings in a prior base period.

A. The Purpose of Calculating Rates of Return is to Identify Sharing Amounts and LFA Situations for Prospective Rate Setting Purposes, Not to Measure Productivity Growth Relative to the Price Cap Target

The purpose of calculating earnings under both rate of return and price cap regulation is simply to ascertain if LEC earnings have exceeded some prescribed level. Under price caps, the calculation of earnings is also used to determine whether or not prospective rate increases are in order because of low prior-period earnings. Earnings calculations are not expressly and primarily used to evaluate productivity growth.

The Commission's reasoning in providing the LFA add-backs is misplaced. The question with regard to the propriety of the LFA add-back is whether the additional revenues associated with LFA rate increases should be accounted for (included) in the base period in which such increased rates were actually billed to customers, or in a prior base period. To be sure, the additional revenues associated with LFA rate increases must be included in some base period. Given the prospective nature of the rate setting process and the fact that LEC rates of return are not guaranteed, it is clear to MCI that the additional revenues derived from LFA rate increases must be included in the base period in which such increased rates were actually billed to customers. It is not rational to include revenues billed in a particular base period in the earnings calculations of another (<u>prior</u>) base period.