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FEDERAL COMMUNICATIONS COMMISSION
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of

Price Cap Regulation
Local Exchange Carriers

Rate of Return Sharing
And Lower Formula Adjustment

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CC Docket No. 93-179

GTE's REPLY COMMENTS

GTE Service Corporation and
its affiliated domestic
telephone operating companies

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September 1, 1993

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SUMMARY

The add-back proposal of the *Notice* is alien to the price caps plan adopted by the Commission. It proceeds on the false premise that the sharing backstop is supposed to operate in much the same way as rate of return enforcement. The Commission's rules and orders provide no support for this interpretation, which conflicts with the very nature of the FCC's price caps plan. As clearly stated in the Commission's own language, the sharing backstop results in a one-time adjustment to the Price Cap Index ("PCI"). Turning that mechanism into a refund is in direct conflict with what the Commission decided.

This would be an alteration in the carefully balanced price caps plan that would be tantamount to reinstatement of rate of return regulation. If the proposal of the *Notice* merits further consideration, it should be taken up as part of the scheduled four-year review.

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GTE Service Corporation and its affiliated domestic telephone operating companies ("GTE") submit the following reply comments in reference to the Notice of Proposed Rulemaking (the "*NPRM*" or "*Notice*"), FCC 89-91 (released July 6, 1993) and the related comments of various parties.¹

BACKGROUND

The Commission's price cap plan² became applicable to Tier 1 Local Exchange Carriers ("LECs" or "exchange carriers"), including GTE, for the 1991 calendar year. The *Notice* (at paragraph 15) proposes to revise the exchange carrier price cap rules to

¹ American Telephone and Telegraph Company (AT&T), Ameritech, Bell Atlantic, BellSouth Telecommunications, Inc. ("BellSouth"), MCI Telecommunications Corporation ("MCI"), NYNEX Telephone Companies ("NYNEX"), Pacific Bell and Nevada Bell ("Pacific Companies"), Rochester Telephone Corporation ("Rochester"), Southwestern Bell Telephone Companies ("SWBT"), and U S West Communications, Inc. ("US West").

² Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313 ("D.87-313"), Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989), and Erratum, 4 FCC Rcd 3379 (1989), ("*D.87-313 Report & Order*"), Second Report and Order, 5 FCC Rcd 6786 (1990), and Erratum, 5 FCC Rcd 7664 (1990), ("*LEC Price Cap Order*"), modified on recon., 6 FCC Rcd 2637 (1991) ("*LEC Price Cap Reconsideration Order*"), *aff'd. sub nom.* National Rural Telecom Association, 988 F.2d 174 (D.C. Cir. 1993).

specifically require sharing and the Lower Formula Adjustment ("LFAM") to be computed employing the "add-back" methodology used to compute refunds under rate of return regulation.

DISCUSSION

1. The proposal of the *Notice* is in direct conflict with the price caps plan.

The price caps plan as adopted by the FCC entailed a set of risks taken by each side. While an exchange carrier subject to price caps did not forego its constitutional protection against confiscation³, under price caps the carrier took the risk that in a twelve-month period its rates might fall below the compensatory level.

Similarly, while the agency continued to fulfill its role of protecting the public against unreasonable rates, the risk was taken knowingly that for a particular twelve-month period the carrier's return might exceed the compensatory level.

Indeed, the plan was consciously designed to escape from the rigidities of rate of return regulation. Under rate of return, since the entire focus of the system is assuring that a carrier's return does not exceed the compensatory range, "overearnings" is a significant phrase referring to carrier earnings above the compensatory level that are subject to (under certain circumstances) a refund requirement.

As the Commission stressed in adopting price caps, this single-minded focus of rate of return regulation sacrifices in many ways efficiency and logic and the public

³ "As we have indicated elsewhere, LECs also retain the opportunity to demonstrate on a case-by-case basis that an adjustment in their allowed rate levels will be necessary to prevent a confiscatory outcome." *Id.* at 6807.

interest.⁴ The price caps system replaces the single-minded concentration on preventing "overearnings" during a particular period of time – characteristic of rate of return regulation – with a system designed to offer to carriers a more balanced and rational set of incentives. If, responding to these more balanced and rational incentives, the carrier improves efficiency to an even greater extent than contemplated by the price caps formula, this does not indicate "overearnings"; it is a sign not of failure but rather that the system is working as intended.

Given the greater risk the carrier faces under price caps that its realized return during a particular twelve-month period may fall below the compensatory level, the fact that the carrier's return during a twelve-month period exceeds the compensatory level does not raise questions of "overearnings." Indeed, this phrase has no proper application under the price caps plan. As pointed out by US West (at 4): "Under price cap regulation, there is no such thing as 'overearnings.'"

Because of the uncertainties of price caps as a pioneering initiative, the Commission decided to add to the basic price caps plan a back-stop mechanism. This backstop was designed to provide protection in both directions: (1) to protect the ratepayer from an extreme form of rates in excess of the compensatory level; and (2) to protect the carrier from an extreme form of non-compensatory rates. This backstop mechanism was never intended to negate the whole purpose of the price caps plan, to return the regulatory system to rate of return regulation. Thus, this backstop

⁴ Measuring alternative regulatory methods against the rate of return system, the Commission identified five flaws in rate of return regulation: (1) it provides incentives for carriers to be inefficient; (2) it provides carriers with insufficient incentives to encourage innovation; (3) it tends to foster cross-subsidization and inability to move toward an optimally efficient set of prices; (4) its administrative costs are high; and (5) consumers are better off under incentive regulation than under rate of return regulation. *D.87-313 Report & Order*, 4 FCC Rcd at 2922.

mechanism operates in a forward-looking way only, and only through a one-time adjustment to the Price Cap Index ("PCI").⁵

The price caps plan provides for a review of its results after four years. This review is scheduled for 1994. In the course of this review, the totality of the system can be considered and its results evaluated. Then the carefully balanced price caps plan may be revised.

The *Notice* is not part of the four year review. Ostensibly in the name of clarification, it proposes to make a major change in the price caps plan, a change that is at odds with the whole nature of price caps. As stressed by GTE's Comments (at 2-8), the proposal of the *Notice* is grounded in the mistaken premise set out in paragraph 8 of the *Notice*:

We anticipated that the [sharing] backstop would operate in much the same way as rate of return enforcement for LECs still subject to rate of return regulation.⁶

Thus, the *Notice* would turn the sharing mechanism from one concerned with one-time changes in next year's PCI⁷ into a refund provision – one of those alternatives the

⁵ If a carrier can meet its formidable productivity commitment, and then above and beyond that produce savings that can be shared with ratepayers, it is a sign that the system is working. Those savings are factored into the PCI for the following year – one year only. *LEC Price Cap Order*, 5 FCC Rcd at 6803.

⁶ To similar effect, Appendix A to the Notice says: "Thus [under the proposals of the Notice] the company which includes the add-back in its rate of return computation has the same rate of return and returns the same amount of money to ratepayers as the company which makes its refund by a check."

⁷ "[T]he sharing mechanism operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings...." *LEC Price Cap Order*, 5 FCC Rcd at 6803. "[W]e conclude that sharing should be implemented by adjustments to the next year's PCI." *Id.*, 5 FCC Rcd at 6805.

Commission chose not to adopt.⁸ Moreover, it would reintroduce that element of the also-rejected automatic stabilizer in that the add-back proposal of the *Notice* would not be one-time but would necessarily have an impact on the calculations for subsequent years.

Further, this change would be made without an overview of the total results. This necessarily means the change represented by the *Notice* would be effected without the ability to implement appropriate changes – if justified – that retain or improve the careful balancing of the price caps plan.⁹ In effect, the *Notice* proposes an abrupt shift in one aspect of price caps during the course of its operation. The *Notice* would have this change in the essential nature of price caps effected without exploring what the total implications of this change would be, what other changes would be appropriate under the circumstances, and so forth.

The change in the plan proposed by the *Notice* would be a major step backwards to rate of return regulation. This is indicated by those exchange carriers opposing the plan – including GTE, Ameritech¹⁰, US West, and the Pacific Companies.

As pointed out by US West (at 2): "[I]n proposing to 'add back' sharing and low-end adjustment amounts, the Commission is abandoning the price cap concept of one-time adjustments and proposing that hypothetical rates of return be calculated to determine price caps adjustments for future years." US West (*id.*) finds "particularly troubling" the proposal of the *Notice* "in that it equates 'sharing' under price cap

⁸ The Commission considered proposals for including a refund feature in its plan and for including an annual adjustment known as an automatic stabilizer. *D.87-313 Report & Order*, 4 FCC Rcd at 3215-17. The Commission consciously put aside these proposals, deciding that the sharing mechanism would duly protect the public interest. *LEC Price Cap Order*, 5 FCC Rcd at 6803.

⁹ In explaining how it had "fashion[ed] the backstop plan for LEC price caps," the Commission stressed the importance of "balanc[ing] competing goals." *LEC Price Cap Order*, 5 FCC Rcd at 6801.

¹⁰ Ameritech at 1-3 stresses the distinction between sharing and refunds.

regulation with 'refunds' under rate of return regulation and all but ignores the fact that the Commission found traditional rate of return regulation distorted carrier incentives."¹¹

Indeed, US West says (*id.*):

By itself, the **NPRM** gives the impression that rate of return regulation is the rule of the day rather than price cap regulation.

GTE submits that US West is quite correct in pointing out the distinct origins and differing nature of the two forms of regulation:

Sharing and refunds are the products of totally different regulatory regimes. Price cap regulation is incentive-based regulation which limits price changes and rewards LECs for productivity improvements. Rate of return regulation, on the other hand, is basically 'cost-plus' regulation where LEC rates are established based on costs including a prescribed rate of return.

As observed by US West (at 4), under rate of return regulation a refund "is the product of 'overearnings' and is based on a finding that rates are unlawfully high." On the other hand (*id.*),

Under price cap regulation, there is no such thing as 'overearnings.' The sharing and low-end adjustment mechanisms were adopted due to variations in LEC productivity, not to limit LEC earnings.¹²

That the change in the plan proposed by the *Notice* would be a reversion to rate of return regulation is implicit even in the pleadings of those that support the proposal such as NYNEX.¹³

The implication of NYNEX's arguments is that a carrier must never, never be required to operate at less than a compensatory level even for a twelve-month period.

¹¹ Footnote omitted.

¹² Footnotes omitted. See *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2676 and *LEC Price Cap Order*, 5 FCC Rcd at 6801.

¹³ Discussed further *infra* is MCI, which takes a position of complete opportunism. Add-back is good when it reduces MCI's rates, bad when it would increase MCI's rates. The Commission will not – and would not be permitted to by the courts – stand on its head its carefully developed price cap policy to suit MCI – a company that opposed price caps from the outset.

This argument is in conflict with the nature of price caps, which requires subject carriers to take increased risks in exchange for an improved opportunity, and requires regulation to permit increased returns in exchange for the constant downward pressure on rates by virtue of the PCI.

The NYNEX pleading indicates the quandary in which the Commission would be placed if it adopted the proposal of the *Notice*. In effect, the FCC would then be hybridizing price caps by turning a back-up mechanism designed to operate only prospectively through the PCI into a refund plan – even though in adopting its back-up mechanism the Commission explicitly rejected refunds. This hybridized system would recreate the very incentives the price cap plan was designed to escape. While it might produce rate reductions in some cases, in others an honest application of the logic of the *Notice* might produce rate increases.

This would mean the four-year period designed to provide experience on how well price caps works will be essentially truncated, and the Commission will have taken the first major step to defeating its own plan. The FCC's forward-looking price caps initiative was generally well received by the financial community. Commission action dramatically revising the plan – and without considering overall impact as part of the four-year review – would raise questions before the financial community about whether the FCC has the determination to carry through on its carefully developed plan to replace the illogicalities and inefficiencies of rate of return with incentive regulation.

In summary: The proposal of the *Notice* is directly at odds with the price caps plan.

2. The Commission rejected a refund provision as part of price caps; the claim that sharing is tantamount to a refund provision is not supported by Commission language or by the nature of the price caps plan.

The arguments presented by AT&T and MCI amount to converting sharing into something indistinguishable from refunds under rate of return regulation. Thus, in agreeing with the proposal of the *Notice*, AT&T (at 1) baldly insists the proposal of the

Notice should be adopted to "assure that the LECs' earnings computations are consistent with the methodology under rate of return regulation, on which the Commission's sharing and [LFAM] procedures are based." MCI, always an opponent of price caps, argues for the effective reinstatement of rate of return regulation.¹⁴ Thus, AT&T and MCI would have the FCC effectively reverse its decision to apply price caps to exchange carriers; and on a smaller scale would have the Commission – which rejected a refund provision¹⁵ – now turn sharing into a refund provision.

Neither of these parties recognize the inherent difference between refund and sharing. This difference relates to the nature of price caps as opposed to rate of return regulation. Price caps was designed to encourage efficiencies that will produce benefits for both the carrier and the ratepayer. If the LEC can attain a productivity level in excess of its selected productivity target (3.3 percent or 4.3 percent) it is permitted to retain a certain portion of the resultant savings and to share the other portion with consumers. When this occurs, it demonstrates that price caps is producing the intended benefits to both parties.

In adopting price caps, the Commission did not speak of the LEC "overearning" and "refunding" the overearnings to the ratepayers. Neither AT&T nor MCI nor NYNEX cites any language used by the Commission – until the issuance of the *Notice* – to suggest sharing was intended to be tantamount to a cash refund.

In summary: There is no support for the notion that sharing is tantamount to a refund provision.

¹⁴ "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." MCI at 1-2.

¹⁵ *LEC Price Cap Order*, 5 FCC Rcd at 6803.

3. Add-back is not contained in, or implied by, the current Commission rules.

AT&T (at 4) concedes that "this issue [add-back] was not addressed specifically in the LEC price cap plan,...." Similarly, the Pacific Companies (at 3) observe, "Add-back is not a requirement of the price cap rules as they now stand". NYNEX (at 8) argues that, since the Commission is "clarifying" its rules, this does not imply that "normalization [add-back] is not required in the current rules..." but rather that add-back is implied in the earnings limitations rules.

In GTE's view, NYNEX simply misunderstands the character of price caps regulation. NYNEX says (at 11):

Sharing is like a credit or refund, because it is a reduction in revenues to return to ratepayers a portion of revenues that were overearned in the prior period. Those sharing revenues must be added back to the revenues in the reporting period to reflect revenues that would have been received in the reporting period absent the exogenous adjustment for sharing.

Taken together with NYNEX's insistence on "normalization," this language seems to imply the reinstatement of "cost-plus" regulation so that the carrier can never suffer a fall below the confiscatory level. In GTE's view, this is most emphatically not the price caps system adopted by the FCC. The FCC's price cap system leaves the exchange carrier at risk in a particular twelve month period if it is not able to meet its productivity formula commitment. By the same token, the exchange carrier that is able to meet that commitment and also bring its return up to the sharing level is entitled to "keep" the return in accordance with the sharing formula even though it might work out to exceed the traditionally-calculated confiscatory level.

As mentioned *supra*, price caps increases the real risk of the exchange carrier — and to balance this improves its opportunity. That's the nature of price caps. NYNEX's notion of normalization seems to amount to nothing but a more complicated approach to rate of return regulation. This is not the forward-looking and pioneering plan the FCC adopted.

The price caps plan makes provision for a situation where a carrier is falling below the confiscatory level. The carrier may file a traditional rate case.¹⁶ Thus, if after-arising circumstances or the miscalculation of carrier management left a carrier at a confiscatory rate level, the plan does not strip the carrier of its constitutional and statutory right to be secure from confiscatory government action. Thus, the carrier may step outside of price caps, and make the necessary showings under rate of return regulation to justify rate adjustments. In this way, the carrier would be able to find a remedy – to the extent that higher rates would be a remedy. But this is a far cry from the NYNEX concept which assumes some process of "normalization" never provided for in any Commission order.

GTE has acted in accordance with its understanding of the price caps plan. GTE is unique among exchange carriers in that it has twenty-six interstate tariff entities. As such, it must look at each entity separately to determine if that entity is required to share or is in need of a LFAM. In 1991, GTE had nine entities which were in a sharing mode and seven which were below the low end of 10.25%. When GTE filed its 1993 tariff filing, it did not add-back for either the nine sharing entities or the seven LFAM entities because sharing and LFAM are one-time PCI adjustments. GTE then made no effort to reinterpret the Commission's rules to meet a near-term earnings objective. GTE acts as it speaks, in accordance with the price caps plan in fact adopted by the Commission.

In summary: The current Commission rules do not provide for add-back, expressly or implicitly.

4. Whether it is a matter of sharing or LFAM, there is no justification for add-back.

MCI takes an opportunist approach, arguing that add-back is required when it will produce lower rates for MCI, not when it would produce higher rates for MCI. Thus,

¹⁶ See n.3 *supra*.

it insists sharing should produce cash refunds under price caps; but when it comes to LFAM, MCI (at 11) pronounces that LECs are not allowed to "recoup costs or earnings below their allowed rate of return in a subsequent base period ... Thus refunds and rate increases were not treated similarly when calculating rates of return under rate of return regulation." Specifically, MCI (at 11-12) says the Commission must add-back only sharing amounts but not LFAM when computing rates of return.

MCI's version of price caps is very strange indeed. It just happens to coincide precisely with MCI's financial interests. It would turn price cap regulation back into rate of return regulation by turning sharing into a refund provision and the LFAM into a proposed price increase as in the case of a traditional rate of return showing; but with an asymmetric aspect similar to what was found unlawful in *AT&T v. FCC*, 836 F.2d 1386 (D.C. Cir. 1988), *conditional application for review en banc denied*, No. 85-1778, Slip Op. (November 2, 1988).

This bears no resemblance to the Commission's balanced plan. LFAM was established to assure that a LEC is not subjected to "low earnings of a prolonged period [so] that its opportunity to attract capital and ability to provide service are seriously impaired."¹⁷ This was balanced by the risk taken by the LEC when it began operating under price caps since it is not allowed to set rates up to the prescribed rate of return of 11.25 percent but only up to the floor of 10.25 percent.

What this means is: in order to receive flexibility above 11.25 percent, the carrier had to take on the risk of 10.25 percent. Since LFAM is merely a one-time PCI adjustment for temporary low earnings, and not a full blown cost-of-service showing, it should be treated in the same way as sharing; neither one should be added-back.

NYNEX (at 6) argues that LFAM must receive add-back treatment to "normalize" the earnings over time; otherwise, it will "tend to drive the LEC's earnings below the

¹⁷ *Id.*, 5 FCC Rcd at 6802.

level that the Commission has defined as confiscatory." But this assertion relates to NYNEX's peculiar view of price caps, and the LFAM in particular, as a reversion to a more-or-less guaranteed minimum rate of return. The LFAM is a one-time temporary adjustment designed to correct for limited earnings problems of an exchange carrier – a temporary slump, for example. If a LEC is in serious earnings difficulties, as mentioned *supra*, the Commission made provision for submission of a full blown rate case.¹⁸

In summary: There is no justification for add-back whether it is a matter of sharing – which favors the ratepayer – or the LFAM – which favors the carrier.

5. Uniform application of rules will be attained when all LECs exclude add-back treatment of sharing and LFAM.

Reaching to find support for add-back, AT&T (at 5) asserts finds that Commission adoption of add-back will produce "crucially important uniformity in the manner in which the LECs' current earnings are computed for purposes of enforcing their sharing and [LFAM] obligations."

Uniformity would be attained equally if all exchange carriers exclude add-back from the sharing and LFAM obligations – which is what the Commission intended from the outset.

In summary: GTE urges the FCC to require uniform treatment of sharing and LFAM by excluding add-back.

6. If the Commission continues its investigation on add-back, it should defer the investigation to the LEC Price Cap four-year comprehensive review.

A number of parties¹⁹ make the sensible suggestion that the Commission should defer resolution of the add-back question raised by the *Notice* until the four-year performance review set to commence in the Fall of 1993. If any further consideration of

¹⁸ *LEC Price Cap Order*, 5 FCC Rcd at 6807.

¹⁹ GTE at 14, Bell Atlantic at 4, BellSouth at 2, Pacific Companies at 3, Southwestern Bell at 2.

the add-back question is required, it should be in the context of a complete review of performance. This is particularly important in view of the Commission's heavy emphasis on the careful balance reflected in the price caps plan.²⁰

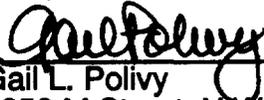
Ad hoc decisions changing elements of the plan should not be made without a close and careful examination of how it would affect the balance of all the elements. Moreover, given the experience now available under price caps, it might be the sharing-LFAM provision should be eliminated altogether when the Commission finally decides the next step in price caps. In such a case, premature action would be confusing for the capital markets and unfortunate in its consequences for the stability of the Commission's plan.

In summary: If further consideration of add-back is justified, it should be part of the four-year review.

Respectfully submitted,

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²⁰ *LEC Price Cap Order*, 5 FCC Rcd at 6801.

Certificate of Service

I, Ann D. Berkowitz, hereby certify that copies of the foregoing "GTE's Reply Comments" have been mailed by first class United States mail, postage prepaid, on the 1st day of September, 1993 to all parties on the attached list.

A handwritten signature in black ink, appearing to read "Ann D. Berkowitz", is written over a horizontal line.

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