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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

December 16, 1993

RM-8389

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

Re: In the Matter of Proposed Revision of Part 69 of the Commission's Rules to Allow for Incentive Settlement Options for NECA Pool Companies, RM Docket No. 8389

Dear Mr. Caton:

Enclosed herewith for filing are the original and eleven (11) 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,

Randy R. Klaus (HFA)

Randy R. Klaus, CPA
Senior Staff Member
MCI Telecommunications Corp.

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

In the Matter of:)
)
Proposed Revision of)
Part 69 of the) RM 8389
Commission's Rules to)
Allow for Incentive)
Settlement Options for)
NECA Pool Companies)

COMMENTS

MCI Telecommunications Corporation (MCI) hereby respectfully submits its Comments on NECA's Petition for Rulemaking in the above-captioned matter.

In its petition, the National Exchange Carrier Association (NECA) proposes to amend Part 69 of the Commission's rules thereby allowing incentive settlement options for NECA member companies.[1/] According to NECA, the

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1/ See NECA Petition for Rulemaking, In the Matter of Proposed Revision of Part 69 of the Commission's Rules to Allow for Incentive Settlement Options for NECA Pool Companies, RM Docket No. 8389, dated November 5, 1993.

The first option, known as the "Pool Profit Sharing Incentive Option," provides for the development of settlement rates between NECA member companies and the NECA pools based upon historical, company-specific cost. Such settlement rates may be adjusted for exogenous cost changes and the LEC is allowed to earn up to 150 basis points above the authorized rate of return. Earnings in excess of the upper earnings threshold are shared with customers and certain other LECs.

The second option is referred to as the "Pool Small Company Incentive Option" and it is designed for companies which serve 50,000 or fewer access lines. Its settlement rates are also based upon historical, company-specific costs. However there are no provisions for profit sharing, earnings limitations or adjustments for exogenous cost changes. Both options require the settlement rates to be reset to the authorized rate of return after a certain period of time.

two settlement options for pool participants are designed to provide incentives similar to those adopted by the Commission for non-NECA member companies.[2] NECA argues the public interest is served by such options through increased efficiency, i.e., lower rates in the future, and/or profit sharing.[3]

In the comments that follow, MCI will briefly address some of the concerns its has with NECA's proposal. MCI's concerns center around commitment periods, profit sharing, identification and allocation of exogenous cost changes, and the measurement of earnings.

With regard to commitment periods under the Pool Small Company Incentive Option, NECA's proposal calls for historically-based settlement formulas which are to be reset to the authorized rate of return at the end of each two-year period.[4] LEC earnings are unrestricted during this two-year period. Furthermore, the option allows LECs to withdraw from this option after only one two-year period.[5] As a result, customers would be denied the benefits associated with efficiency gains, i.e., lower future rates, if LECs are allowed to withdraw from this option before rates are reset to the authorized rate of return. Even though NECA states that

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2/ Id., p 1.

3/ Id., pp 5-6.

4/ Id., p 11.

5/ Id.

rates would be reset to the authorized rate of return at the end of each two-year period,[6] it is unclear how this would occur if the LEC commits to only one two-year period.

Since there is no profit sharing under this option, the only potential customer benefit occurs in a subsequent two-year period after rates have been reset to the authorized rate of return. However, once a LEC withdraws from the option, its rates would be set according to prospective costs and demand. Since earnings are unlimited under this option, MCI believes that the LECs should be required to commit to "two" two-year periods, instead of just one, so that customers will have an opportunity to receive some benefit from the option. If LECs are allowed to elect out of the option after only one two-year period, they could game the system by cutting costs and earning higher profits during the initial two-year period, and then electing out of the option. In this scenario, lower rates never become effective, and customers are denied the benefit of such lower rates altogether.

If two two-year periods is considered to be too long, MCI suggests, as an alternative, that the historically-based settlement formulas could be reset annually with a minimum commitment period of two years.

Even with an overall commitment period which provides for the opportunity for customers to receive the benefit of LEC efficiencies in a subsequent period, as discussed above,

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[6] Id.

neither the Pool Small Company or Pool Profit Sharing Incentive Options provides a means for customers to receive any benefit associated with LEC efficiencies which occur during the final period of such incentive options, e.g., the two-year period before a LEC withdraws from the option. MCI believes that both options must come full circle in terms of passing along benefits to customers.

For example, LECs should not be allowed to retain any excess earnings which arise during the final two-year period under the Pool Profit Sharing Incentive Option just because the LEC withdraws from such option. If the proposals are to fully benefit customers, the incentive options must make customers "whole" with respect to the final rate period. LECs should not be allowed to reap the financial benefits of higher earnings under the incentive options, and then not have to return excess earnings earned during the final rate period.

With regard to exogenous cost changes, it is clear that NECA proposes to adjust historically-based settlement rates for cost changes (including excess earnings) under the Pool Profit Sharing Incentive Option.[7/] However, its proposed rule simply references exogenous cost changes applicable to companies filing under Section 61.50 of the Commission Rules for the proposition of such cost changes,[8/] instead of more directly referencing that portion of the Commission Rules

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[7/] Id., p 8.

[8/] Id., Appendix A, p A-2.

which generally describe the type and nature of exogenous cost changes under price caps. MCI believes that NECA's proposed rule, at Section 69.607(c), should reference Section 61.45(d) for purposes of both identifying and apportioning exogenous cost changes (on a cost-causative basis) amongst its various service categories.

MCI also does not believe it is reasonable or appropriate for LECs electing the Pool Profit Sharing Incentive Option to share earnings with LECs who happen to earn below the lower earnings threshold (i.e., 75 basis points below the authorized rate of return). All earnings which exceed the upper threshold of 150 basis points above the authorized rate of return should be returned to customers, not other LECs. LECs who opt for such incentive regulation should bear the entire risk of under-earning, as well as the reward of over-earning, and should not be sheltered by the unilateral actions of other LECs.

Sharing excess earnings with other LECs, essentially guarantees LECs a minimum rate of return of 75 basis points below the authorized rate of return. This is inconsistent with the Commission's LEC price cap decision as regards to earnings which fall below the lower threshold.

The lower formula adjustment (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.[9/] (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 necessary to improve performance and thereby raise its earnings above this minimal level.[10/] (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.[11/] (Emphasis added)

[9/] See In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Released October 4, 1990, Second Report and Order, para 127.

[10/] Id.

[11/] Id., para 147.

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 low earnings over a prolonged period of time.[12/]

The LFA allows LECs earning below the threshold to raise rates and, thus, have the opportunity to earn at or above 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 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.

Under the rules proposed by NECA, customers are denied all or portion of the sharing they would otherwise be entitled to receive, since earnings would first be directed to other carriers. Customers, not other LECs, should share in the benefits associated with LEC efficiencies. There is no rational basis for taking excess earnings from one LEC and sharing it, in part or in whole, with LECs who fail to become more efficient. Each LEC should stand on its own. To do otherwise simply perpetuates the existing pooling process.

[12/] Id., para 10.

Instead of LECs sharing excess earnings with one another, the settlement formulas of LECs who under-earn should be increased in order to allow the them the opportunity to earn, on a prospective basis, a rate of return of 75 percent below the authorized rate of return. This approach is consistent with price caps and the long standing view, which has been upheld by the courts, that regulated carriers are not guaranteed a profit, or a minimum rate of return.[13]

Another area of concern to MCI is the calculation of LEC earnings. MCI is concerned that current-period earnings will not be correctly, or accurately, calculated for periods in which excess earnings from prior periods are actually returned to customers. MCI believes that excess earnings, like sharing amounts under price caps, must be added back when calculating the earnings for periods in which such amounts are actually returned to customers.

In CC Docket 93-179, MCI demonstrated that the add-back for sharing was necessary and appropriate, but that the add-back for the lower formula adjustment amounts was not.[14] MCI's comments showed that sharing amounts must be excluded from the computation of current-period earnings by way of the sharing add-back in order to ascertain whether or not any new

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13/ See American Tel. and Tel Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988).

14/ See MCI Comments and Reply Comments, In the Matter of Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179.

sharing obligations exist with regard to the current period. In other words, what would current-period earnings have been had no sharing occurred? MCI herein incorporates its arguments regarding the add-back by reference in order to remind the Commission of the importance of including this issue in any Notice of Proposed Rulemaking that may be released in response to NECA's petition.

MCI therefore respectfully requests the Commission to amend the proposed rule as noted above and require LECs to include the sharing add-back when calculating earnings under the proposed Pool Profit Sharing Incentive Option.

Respectfully Submitted,

MCI TELECOMMUNICATIONS CORPORATION

Randy R. Klaus (MFA)

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Dated: December 16, 1993

STATEMENT OF VERIFICATION

I have read the foregoing, and to the best of my knowledge, information, and belief there is good ground to support it, and that it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on December 16, 1993.

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CERTIFICATE OF SERVICE

I, Susan Travis, do hereby certify that copies of the foregoing MCI'S Comments were sent via first class mail, postage paid, to the following on this 16th day of December, 1993:

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