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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of)
)
Price Cap Performance Review)
for Local Exchange Carriers)

CC Docket No. 94-1 ✓

NOTICE OF PROPOSED RULEMAKING

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Comment Date: April 18, 1994
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By the Commission: Commissioner Barrett issuing a separate statement.

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I. EXECUTIVE SUMMARY

1. The price cap plan for local exchange carriers (LECs) that took effect three years ago, on January 1, 1991, represented an important regulatory reform effort. Price caps sought to require even monopoly carriers to reduce their rates, while creating positive incentives for greater efficiency and innovation. This in turn was expected to produce lower rates and improved services benefitting customers as well as society and the many businesses that use telecommunications to produce goods and services. The price cap plan also reaffirmed the Commission's commitment to the various programs that promote affordable telephone service throughout the United States.

2. Within the last few years, however, we have witnessed dramatic changes in telecommunications technology and markets, especially changes leading to lower prices and greater usage of telecommunications as networks are interconnected and opened to competition. The Open Network Architecture tariffs, expanded interconnection, 800 data base technology, video dialtone, and the allocation of spectrum for wireless Personal Communications Services are all examples of the increasing capability of the telephone network, and all contribute to making that network open to market forces.

3. Yet these changes, important as they are, are only the prelude. The potential contribution of telecommunications to our society and economy has never been greater. New technologies hold the promise of a national telecommunications infrastructure capable of providing rapid distribution of the information and entertainment consumers will need. Effective competition in telecommunications investment, facilities, and services has the potential to help meet those needs in the most efficient and least costly manner possible, while stimulating domestic economic growth and international competitiveness. This economic growth should, in turn, increase jobs for Americans.

4. As a forum for considering further regulatory reform, the scheduled fourth year review of the LEC price cap plan could not be more timely. The basic purpose of this review will be to consider whether the plan should be revised to better serve the goals of the Communications Act and the public interest in the years ahead. Specifically, we seek data, analysis, and comment on three sets of issues.

5. First, we request comment on whether the goals of price caps should be refined to assure that regulation facilitates the deployment of the facilities and services consumers and businesses will need in the years ahead. We ask for example, how the current price cap plan or possible revisions facilitate economic growth and the creation of jobs for Americans. We also seek comment on how the price cap plan might further the goal of deploying the national information infrastructure, including facilities needed to provide educational, health, and emergency services. We also will consider whether we need to revise the plan to better meet the goal of providing universal service to all geographic areas and of comparable type and quality for all Americans at affordable prices.

6. Second, we identify a set of baseline issues raising questions of whether to revise the current plan to improve its performance or to adjust the plan in response to

changes in technology, regulation, and the market in the near term. Any such revisions and adjustments would be targeted to take effect on January 1, 1995. These baseline issues include implementation of infrastructure development goals, possible changes in the composition of price cap baskets and bands, appropriate changes in the productivity factor or rate levels, the revision or elimination of the sharing and low-end adjustment mechanisms, and possible revisions to the rules governing new services.

7. Third, we request comments on a set of transition issues, issues related to adjustments needed to prepare the baseline plan for anticipated changes in market structure, technology, and regulation within the next few years. This inquiry focuses on transitional steps toward reduced or streamlined regulation of LEC services as competition grows. We ask comment on the current state of competition and the criteria by which competition should be measured, appropriate transition stages, and possible revisions to the price cap baskets as competition develops. Also, we request comment on the effect price cap LEC entry into related industries (e.g., cable TV) and BOC entry into inter-LATA marketplaces should have on the LEC price cap plan.

8. The regulatory policies we apply to the price cap LECs, which provide local telephone facilities essential to the current national network, should help prepare for the network that is now emerging, the information superhighway of the future. We expect that the record developed in this proceeding will guide us in shaping the LEC price cap plan to play its part in setting regulatory policies to assure that the bright potential offered us by modern telecommunications becomes a reality.

II. INTRODUCTION

9. With this Notice, we begin the fourth year review of the performance of local exchange carriers (LECs) under price cap regulation. As the Commission stated when it adopted price caps for LECs in 1990, this review will be a comprehensive examination of the effects of price cap regulation using all available data and information. To begin this proceeding, we summarize information collected by the Commission in monitoring the course of LEC performance since price cap tariffs took effect on January 1, 1991, including data on rates, earnings, and service quality. From the information we have now, it appears that access rates have declined, service quality remains the same as before price caps, and earnings have been higher than under rate of return regulation. Based on our experience with the plan, we discuss several ways in which the plan may be improved, as well as related aspects of the AT&T price cap plan. In addition, we examine changes in the local access marketplace that may increase competition for LEC services and that might warrant a transition from price caps to more flexible streamlined regulation. Finally, we request data, analysis, and comments regarding both revisions to the current baseline plan and transitional mechanisms that could adapt the plan to certain or likely marketplace changes over the next several years.

III. BACKGROUND

10. The Commission adopted price cap regulation as part of a fundamental reappraisal of telecommunications rate regulation in the wake of the changes that had swept over telecommunications in the last few decades, but especially since the Bell System divestiture in 1984. Technological advances in computers, fiber optics, and microelectronics transformed the capabilities of "plain old telephone service" while expanding the range and quality of new services, and creating new opportunities for improved efficiency. In place of the monolithic Bell System, customers may now select telecommunications equipment and services from hundreds of suppliers offering an ever-expanding menu of choices.¹

11. Moving from traditional rate of return regulation to price cap regulation was a significant improvement and response to these dramatic changes. Traditional rate of return regulation provided few incentives for telephone companies to respond to these changes and opportunities by becoming more innovative and efficient. Under rate of return regulation, rates are set to recover the carrier's costs plus a reasonable rate of return on invested capital. Such "cost-plus" regulation potentially discourages efficient investment, and encourages cost-shifting when the carrier also participates in more competitive markets.² Further, carriers achieving the prescribed rate of return have little profit incentive to introduce new and innovative services. In addition, rate of return regulation requires elaborate regulatory oversight of all the carrier's costs.

12. In contrast to rate of return regulation, a regulatory system that caps prices creates profit incentives similar to those in fully competitive markets and generates positive motivations for reasonable rates, innovation, productivity growth, and accurate cost allocation, while reducing regulatory burdens. The plan's method is to control prices directly, rather than indirectly by examining costs and profits. The price cap limits are set by the Commission to assure that rates are reasonable and lower than under rate of return regulation.³ The effect of capping prices rather than profits is to replicate the marketplace forces of competition. Prices are held to a maximum level by the cap, much as they are by the rivalry among companies in competitive markets. The carrier gains the opportunity to earn higher profits, but may do so only by operating more efficiently or by developing new services customers want, not by raising overall prices. This opportunity to increase its profits in turn encourages the carrier to apply its resources in the most efficient manner possible, providing more and better service at lower cost. In this way, the carrier can increase its productivity, and thus its profitability. At the same time, customers directly benefit from lower prices and new services that better meet their

¹ See J.R. Haring and E.R. Kwerel, OPP Working Paper No. 22, "Competition Policy in the Post-Equal Access Market," (Feb. 1977) and K.B. Levitz, OPP Working Paper No. 23, "Loosening the Ties That Bind: Regulating the Interstate Telecommunications Market for the 1990s," (Feb. 1987).

² See, e.g., H. Averch and L. Johnson, "Behavior of the Firm Under Regulatory Constraint," 52 Amer. Econ. Rev. 1052 (1962); 2 A.E. Kahn, *The Economics of Regulation*, ch. 2 (1971); and K.E. Train, *Optimal Regulation*, ch. 1 (1991).

³ See *infra* para. 17.

needs, and indirectly from the lower costs of non-telecommunications goods and services provided by firms that use telecommunications in their businesses. Also, consumers are protected from cross-subsidization by the grouping of similar services in price cap baskets, which prevents a carrier from raising rates in one basket and lowering them in another to the detriment of customers taking service in the first basket, and from rapid rate changes by annual rate band limits. The 0.5 percent annual Consumer Productivity Dividend (CPD) under price caps approximates this two percent rate reduction, during the initial implementation period, before the performance review.⁴ In addition, all Americans benefit from the economic growth that should be generated by price caps incentives, particularly because telecommunications is a significant and growing portion of the economy generally. One econometric forecasting organization estimated that if price caps reduced rates by 2 percent, the effect on the economy after 5 years would be a \$5.0 billion annual increase in the Gross National Product, a gain of 22,000 jobs, and a \$1.1 billion reduction in the federal debt.⁵

13. The Commission initially considered adopting a single price cap plan for AT&T and the largest local exchange carriers, but decided to apply price caps first to AT&T.⁶ This plan took effect on July 1, 1989. After further study and comments, the Commission adopted the LEC price cap plan in 1990; the initial LEC price cap rates took effect on January 1, 1991.⁷ In adopting both plans, the Commission recognized the need to monitor the carriers' performance to assure that the plans worked as intended. We scheduled a comprehensive review of each plan in its fourth year of operation. The fourth year performance review for AT&T was completed in the summer of 1993. In that proceeding, the Commission concluded that price caps had worked well, producing for AT&T the lower rates, improved efficiency, and innovation the Commission had sought to achieve.⁸

⁴ The CPD assigns the first price cap productivity gains to customers in the form of lower rates.

⁵ "The Impact on the U.S. Economy of Regulatory Changes in the Interstate Long Distance Telecommunications Market," Wharton Econometric Forecasting Associates, submitted as Appendix E, Comments of AT&T, CC Docket No. 87-313, submitted Oct. 19, 1987.

⁶ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987) (Notice); Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 (1988) (Further Notice); Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989) (AT&T Price Cap Order); modified on recon., 6 FCC Rcd 665 (1990) (AT&T Price Cap Reconsideration Order).

⁷ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) (LEC Price Cap Order), Erratum, 5 FCC Rcd 7664 (Com.Car.Bur. 1990), modified on recon., 6 FCC Rcd 2637 (1991) (LEC Reconsideration Order), aff'd, National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

⁸ Price Cap Performance Review for AT&T, CC Docket No. 92-134, 8 FCC Rcd 6968 (1993). The Commission has proposed relatively minor adjustments to the AT&T price cap plan, including moving some interexchange services that may be effectively competitive out of price caps and into more streamlined regulation. Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, 8 FCC Rcd 5205 (1993).

IV. THE LEC PRICE CAP PLAN

14. The price cap plan adopted for the LECs is similar to the AT&T plan and shares many of its rules. The carrier's interstate services are grouped within baskets. Rates within each basket are capped based on a formula that limits the maximum percentage by which rate changes can occur in the aggregate to inflation (measured by the Gross National Product Price Index or GNP-PI) minus a productivity factor. The resulting figure is also adjusted for a limited set of exogenous cost changes, generally those caused by changes in administrative, legislative, or judicial action beyond the carrier's control and not otherwise reflected in price cap calculations. This formula produces the Price Cap Index (PCI) for the basket. Within each basket, rate changes in any one year are also limited by rate bands. The appropriate rate band for each designated service category is computed around the Service Band Index (SBI).

15. Rate changes that conform to the limits set by a LEC's PCIs and SBIs are presumed lawful and permitted to take effect under streamlined review, on 14 days' notice. Should a LEC decide to file rates outside the PCI or SBI limits, the price cap rules call for more rigorous scrutiny. More extensive documentation must be filed, the presumption of lawfulness disappears, and longer notice periods apply. Above-cap and above-band filings carry a heavy burden of justification and a strong likelihood of suspension. For new services that will be subject to price caps, the carrier must submit a study of projected costs or net revenue effects.

16. The LEC plan does, however, differ from the AT&T plan in substantial ways. The interstate services the LECs offer are primarily access services used by long distance carriers, and the LEC service baskets thus differ from the AT&T baskets of services offered primarily to end users. In the LEC Price Cap Order, the Commission adopted four baskets (Common Line, Traffic Sensitive Switched, Special Access, and Interexchange) which corresponded to the access rate categories established by Part 69 of the Commission's Rules. The productivity factor, reflecting historical telephone industry productivity growth, and a Consumer Productivity Dividend of 0.5 percent annually, was set at a minimum of 3.3 percent for the three access service baskets. For the Interexchange basket, the productivity factor was set at 3.0 percent, matching the factor established for AT&T's interexchange services.

17. The LEC price cap plan also includes sharing and low-end adjustment mechanisms that an individual LEC's rate of return performance can trigger. The sharing and low-end adjustments mechanisms were intended to compensate for the possibility of an error in the choice of the productivity factor and variations among the different LECs. Under the sharing mechanism, if a LEC elects the minimum 3.3 percent productivity factor, thus reducing its rates by 3.3 percent annually after adjustment for inflation and exogenous cost changes, it is allowed to retain all earnings up to 12.25 percent, and half of all higher earnings up to 16.25 percent. Above 16.25 percent, all earnings return to ratepayers through adjustments to the PCI in the following year. Alternatively, LECs may elect a more challenging 4.3 percent productivity factor, and earn the right to retain all earnings up to 13.25 percent and half of all higher earnings up to 17.25 percent. All earnings over 17.25 percent return to ratepayers. Conversely, under the low-end adjustment mechanism, if a LEC's earnings fall below 10.25 percent in any base year,

the LEC is granted an automatic one year upward adjustment in its PCI in the next year, sufficient to bring its earnings back up to 10.25 percent. The rate of return thresholds in the sharing and low-end adjustment mechanisms were adopted in conjunction with the Commission's prescription of 11.25 percent as a reasonable target for rate of return carriers beginning in 1990.

18. The LEC price cap plan is mandatory for the largest LECs, the seven Regional Bell Operating Companies (RBOCs) and GTE. It is optional for other LECs. Companies and their affiliates were required to enter price caps on an "all or nothing" basis, with the exception of any average schedule affiliates. Those LECs electing price caps include United Telephone, Rochester Telephone, The Lincoln Telephone and Telegraph Company, and Southern New England Telephone.

V. REGULATORY CHANGES DURING THE INITIAL LEC PRICE CAP PERIOD

19. The LEC price cap plan was intended to remain relatively stable during its first four years, but in fact numerous regulatory changes have been made since the plan was adopted, some of which have required revisions in the price cap rules. In other cases, changes occurred when the Commission has been faced with resolving issues of price cap implementation.

20. Among the most significant regulatory changes occurring within the last three years, or that are scheduled to occur within the near future, are those reflecting the Commission's continuing efforts to lower prices and stimulate demand by expanding customer choice and opening communications marketplaces to competition. These efforts have facilitated the development of competition both in local exchange markets that LECs have traditionally dominated and in markets from which LECs have been excluded. For example, the Open Network Architecture tariffs took effect, offering unbundled services designed for enhanced service providers (ESPs).⁹ Commission decisions requiring expanded interconnection of special access and switched transport¹⁰ and revising the rate structure of local transport should increase local competition.¹¹ Implementation of 800 data base technology permits improved services and increased competition in the 800 service market. The allocation of spectrum and establishment of market structure rules for

⁹ See Section 69.118 of the Commission's Rules, 47 C.F.R. Section 69.118.

¹⁰ Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369 (1992) (Expanded Interconnection Order), modified on recon., 8 FCC Rcd 127 (1992), modified on second recon., 8 FCC Rcd 7341 (1993), petitions for recon. pending, appeal pending sub nom. Bell Atlantic Corp. v. FCC, No. 92-1619 (D.C. Cir., filed Nov. 25, 1992); see also id. CC Docket No. 91-141, Second Report and Order, 8 FCC Rcd 7374 (1993).

¹¹ Transport Rate Structure and Pricing, CC Docket No. 91-213, 7 FCC Rcd 7006 (1992), petition for recon. pending, modified on recon., 8 FCC Rcd 5370 (1993), modified on second recon., 8 FCC Rcd 6233 (1993), petitions for recon. pending, appeal dismissed sub nom. New England Tel. and Tel. Co. v. FCC, No. 93-1494 (D.C. Cir. Sept. 7, 1993), appeal pending sub nom. Full Service Computing Corp. v. FCC, No. 93-1670 (D.C. Cir., filed Oct. 1993).

wireless Personal Communications Services (PCS) has the potential to generate a range of new services that could compete with existing landline and wireless local exchange services.

21. Meanwhile, the LECs have gained the opportunity to enter additional markets. The MFJ's prohibition on BOC provision of information services was removed in 1991. LECs may now provide "video dial tone" services.¹² Several legislative initiatives are underway in Congress that would reduce or eliminate regulatory barriers to the convergence of voice, data, and video services through a variety of networks within a framework of open competition. The implications of these changes in the services LECs provide, often using the same facilities employed for interstate access, indicate the need to reevaluate aspects of price cap regulation. We expect this review to be broad enough to evaluate the effect of this convergence of services on price cap regulation of LEC access services.

VI. INDUSTRY AND MARKETPLACE CHANGES

22. Changes in the industry and marketplace have been at least as rapid. Within the last several years, we have witnessed incipient competition within the local exchange. As fiber optic technology reduced the costs of transmission, a growing number of competitive access providers (CAPs) deployed fiber networks to compete for the traffic of high-volume business customers in large cities. In 1990, the CAPs deployed 55,000 fiber miles. As of the end of 1992, this figure had increased to approximately 131,000 fiber miles.¹³ By way of comparison, the large price cap LECs deployed 3,121,062 fiber miles in 1990, and approximately 5,504,370 fiber miles in 1992.¹⁴ While the investment and revenues of the CAPs are still a small fraction of the LECs,¹⁵ the CAPs do provide alternative services in many cities; their ability to compete with the LECs should be enhanced by implementation of Commission decisions mandating special access and switched transport interconnection.

23. Since the beginning of price cap regulation, price cap LECs have made approximately 200 new service filings. New technologies such as Common Channel

¹² Telephone Company - Cable Television Cross-Ownership Rules, Sections 63-54-63.58, Second Report and Order, Recommendation to Congress, and Second Further Notice Of Proposed Rulemaking, 7 FCC Rcd 5781, 5783 (1992), petition for recon. pending.

¹³ Fiber Deployment Update, End of Year 1992, Industry and Analysis Division, Common Carrier Bureau, Federal Communications Commission (released Apr. 30, 1993). These numbers reflect both a growing number of CAPs deploying fiber miles, as well as an increase in the number of fiber miles deployed by each CAP. Id.

¹⁴ Id. These numbers reflect fiber miles deployed by the BOCs, GTE/Contel, and United Telephone. Id. Fiber mileage data was not collected from the other price cap LECs.

¹⁵ Based on information contained on the 1993 Form 431 Telecommunications Relay Service Fund worksheets, it appears that the three largest CAPs had less than \$500 million of alternate access service revenues in 1992.

Signalling (CCS) have been deployed, leading to the development of the Line Information Data Base (LIDB) and 800 data base, which permits 800 number portability. New services and standards such as video dialtone, frame relay, Switched Multimegabit Data Service (SMDS), Asynchronous Transfer Modes (ATMs), and Synchronous Optical Networks (Sonet) have expanded the capabilities of the telephone network. Also, the percentage of lines with access to new technologies such as Signalling System 7 (SS7) have grown from 17 percent of total price cap lines in 1989, to 65 percent of total price cap lines in 1992.

24. Recent industry events suggest that in place of the traditionally separate markets and networks for local and long distance telephone service and for broadcast and cable TV, telecommunications appears to be evolving toward the transfer of all forms of information over interconnected digital networks. The Clinton Administration has initiated efforts to link these networks through development of the National Information Infrastructure (NII), the information equivalent of America's superhighways.¹⁶ "Infotainment" has been coined to describe the merger of information and entertainment envisioned in services such as movies on demand and interactive video. Major alliances and mergers across traditional market boundaries have already occurred or have been proposed for example among price cap telephone companies and cable TV companies. All of these developments should be considered in determining what changes need to be made to price cap regulation.

VII. LEC PERFORMANCE UNDER PRICE CAPS

25. During the first three years of LEC price caps, all of the LECs have kept their rates at or below the applicable PCIs; none has requested above-cap rates. Overall, LEC interstate access rates are currently \$1.5 billion lower than at the start of price caps, despite overall inflation in the economy of 11.6 percent.¹⁷ Of this total, \$373 million is the result of LEC pricing below the cap.¹⁸ For example, for 1993, Ameritech priced services within its interexchange basket, special access basket, and traffic sensitive basket 14.3, 5.3, and 1.5 percent, respectively, below the relevant price cap indexes. In comparison, for 1993, NYNEX priced services within its traffic sensitive and special access baskets at the relevant price cap indexes, and priced services within the interexchange basket .05 percent below the applicable price cap index. The LECs generally reduced DS1 and DS3 prices faster than other services.

¹⁶ See Speech by Vice President Gore (Gore) at the University of California at Los Angeles, Jan. 11, 1994 (Speech by Gore at UCLA) (Gore announced the Administration's plans to introduce a bill that "[1] will contain provisions designed to ensure that each telephone carrier's networks will be readily accessible to other users . . . and [2] will create an affirmative obligation to interconnect and to afford nondiscriminatory access to network facilities, services, functions and information.").

¹⁷ This figure represents the increase in GNP-PI from the fourth quarter of 1989, through the fourth quarter of 1992, as reflected in LEC price cap indices.

¹⁸ See Price Cap LEC Annual Access Tariff Filings.

26. LEC profits also increased under price cap regulation. The initial price cap rates in January, 1991 were targeted at an 11.25 percent rate of return. In 1992, the most recent year for which complete data are available, the overall interstate rate of return for price cap LECs had risen to 12.25 percent, and all price cap LECs earned above 11.25 percent. For the RBOCs, earnings ranged from a low of 11.41 percent for Bell Atlantic to a high of 13.32 percent for NYNEX. GTE earned 11.26 percent, Rochester 12.00 percent, and United 12.81 percent.

27. Service quality monitoring data indicate that service quality under price caps has been similar to levels under rate of return regulation. Performance standards such as trunk blockage, installation and repair intervals, and dial tone response times have been met successfully over 95 percent of the time. The price cap LEC average unscheduled downtime per loop remains less than 4 minutes per year. However, other measures, notably residential service quality complaints, show the possibility of some problem; the number of service quality complaints per million residential customers rose in 1991, and remained high through the first quarter of 1993.¹⁹

28. Through the Section 63.100 service outage reports required of all carriers, the Commission continues to monitor LEC network reliability.²⁰ The major service outages on the LECs' networks (i.e., the outages caused by (1) Hurricane Andrew in Florida in 1992, (2) the riots in Los Angeles in May of 1992, and (3) the flooding in the Mid-West in July and August of 1993) were fully investigated by the Commission and did not appear to be directly traceable to price cap regulation or to any strategy to maximize short-term profits. The majority of the service outages reported by carriers under Section 63.100 appear to have been the result of fiber cuts caused by construction activity. The Commission currently is studying the specific reasons behind these construction-related fiber cuts.

29. The Commission has also monitored LEC infrastructure development under price caps, including deployment of technologically superior hardware and software. For example, under rate of return regulation, the price cap LECs were replacing electromechanical switches with more advanced digital switches at the rate of about 5 percent of total lines per year (1 percent of total lines were connected to digital switches in 1980, 40 percent had been converted by 1989). The conversion rate under price caps has been about 12 percent per year; by 1992, 75 percent of LEC price cap carriers' lines were connected to digital switches. The deployment of ISDN (from 6 percent of total price cap lines in 1989, to 26 percent in 1992), and SS7 (from 17 percent of total price cap lines in 1989, to 65 percent in 1992) are similar measures of deployment of new

¹⁹ Specifically, the average number of residential customer service quality complaints per million price cap access lines rose from 31 in the first quarter of 1991, to 43 in the fourth quarter of 1991. Further, from the first quarter of 1992, through the first quarter of 1993, the average number of such complaints ranged from a low of 39, to a high of 45. The average number of such complaints fell to 24 in the second quarter of 1993.

²⁰ We note, however, that the Section 63.100 service outage reporting requirements were adopted, in part, because in the summer of 1991, Pacific Telesis and Bell Atlantic experienced a number of incidents associated with newly installed software that resulted in more than 30 million blocked call attempts. See Service Outage Order, CC Docket No. 91-273, 8 FCC Rcd 8517 at para. 12 n.15 (1993).

technologies under price caps. Further, mandatory price cap LECs have extended their service in non-urban areas from 11.5 million lines to 17.4 million lines under price cap regulation, and therefore, from 10 percent of total lines to 15 percent. Fiber optic transmission facilities have grown from less than 4.5 million equipped channels in 1989 to over 10.4 million in 1992. Further, the percentage of households subscribing to telephone service rose from an annual average of 93.3 percent in 1990, to 94.2 percent in July of 1993.²¹ The percentage of households subscribing to telephone service, however, varies, inter alia, by state, the householder's race, and family income.²² For example, the percentage of households subscribing to telephone service ranges from lows of 86.2 and 86.7 in Alaska and Arkansas, respectively, to highs of 97.0 and 97.2 in Delaware and Pennsylvania, respectively.²³ Also, the percentage of households subscribing to telephone service where the householder is white, black, or Hispanic is 95.5, 85.0, and 87.4, respectively.²⁴ Further, the percentage of households subscribing to telephone service with an income below \$5,000 is 73.2, with an income between \$10,000 and \$12,499 is 91.5, with an income between \$20,000 and \$24,999 is 96.5, and with an income at or above \$40,000 exceeds 99.²⁵ There is also some evidence that telephone penetration rates are substantially lower in certain insular areas, such as Indian reservations.²⁶ These figures raise the issue of whether all Americans have an equal opportunity to use telephone service at affordable rates.

30. In addition to services ordered by the Commission such as Open Network Architecture services and 800 Database, the LECs have initiated a range of new services under price cap regulation. These include electronic directory assistance (e.g., Ameritech Directory Search, Bell Atlantic Electrical Request),²⁷ access to the Common Channel Signalling system (e.g., NYNEX Common Channel Signalling Access/SS7 and SNET

²¹ Telephone Subscribership in the United States, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, (rel. Dec. 29, 1993); see also id. at 2 ("The number and percentage of households that have telephone service represent the most basic measures of the extent of universal service.").

²² Id.

²³ Id.

²⁴ Id.

²⁵ Id.

²⁶ See, e.g., Speech by Congressman Richardson at the National Telecommunications and Infrastructure Administration Field Hearing in Albuquerque, New Mexico, Dec. 16, 1993 ("[A]mong the Native American reservations and pueblos of New Mexico, over 60 percent of households have no telephone.").

²⁷ Ameritech Directory Search and Bell Atlantic Electrical Request allow customers to electronically gather data from the directory assistance listings without the assistance of an operator or reference to printed white pages.

SS7),²⁸ improved video transmission (Pacific Bell Digital Video, SW Bell Business Video),²⁹ frame relay (e.g., US West Frame Relay),³⁰ and upgraded fiber optic services (e.g., GTE Fiberconnect).³¹

VIII. DISCUSSION

A. Policy Goals and Directions for Regulation of LECs

31. The goals of price cap regulation, as we said when we adopted LEC price caps in October, 1990, include ensuring that LEC rates are just, reasonable, and nondiscriminatory, and promoting a communications system that offers innovative, high quality services. It was hoped that price caps, by replicating many of the effects of competition, would encourage price cap LECs to make economic decisions such as they would make in a fully competitive market. In particular, the Commission hoped that price caps would encourage the LECs to modernize their networks, deploy new technologies, and offer new services. To achieve these goals, LEC price cap regulation harnesses the profit incentive to reward companies that become more productive and efficient, while ensuring that productivity and efficiency gains are shared with ratepayers.³² Consumers would benefit from the lower rates resulting from the capping of prices and the increasing productivity and lowering costs of the LECs. The national economy would benefit because the lower telecommunications prices would help lower the prices of the many goods and services using telecommunications in their businesses, and from increased jobs and domestic economic growth generated from increased sales in international and domestic markets. The LECs, in turn, would benefit from the heightened demand for services resulting from the lower rate levels under price cap regulation. Accordingly, the Commission believed that price cap regulation would promote economic growth and stimulate "an even healthier, more vital sector of the U.S. economy[.]"³³

²⁸ NYNEX Common Channel Signalling Access/SS7 provides customers with access to a digital data network that interfaces with the telephone company voice/data network for services using American National Standard Institute (ANSI) Common Channel Signalling Protocol. Common Channel Signalling Protocol is an out-of-band signalling network that uses the ANSI code. SNET SS7 is a non-chargeable rate option available when a customer orders switched access Feature Group D (i.e., equal access) service.

²⁹ Pacific Bell Digital Video is a digital video service which has better picture and audio quality and shorter provisioning intervals than current analog video service. SW Bell Business Video provides for two-way compressed video/audio service on a two-point basis. It is also suitable for teleconferencing, which connects two groups at different locations.

³⁰ US West Frame Relay is a fast packet switched service.

³¹ GTE Fiberconnect provides the customer with fiber optic facilities capable of transmitting isochronous serial data at a rate of 6.312 Mbps.

³² Second Report and Order, 5 FCC Rcd at 6787.

³³ LEC Price Cap Order, 5 FCC Rcd at 6790-91.

32. The Commission also reaffirmed its commitment to the range of programs that promote affordable telephone service throughout the United States. The Commission adjusted the LEC price cap plan to ensure that these programs continued intact³⁴ and pledged to initiate a further proceeding to deal specifically with regulatory issues of concern to small and mid-size LECs.³⁵ We concluded this proceeding in 1993, adopting optional incentive regulation plans tailored for small and mid-size LECs.³⁶ In addition, the Commission recently adopted interim rules to moderate the growth of the Universal Service Fund (USF) during the pendency of the Commission's broader USF rulemaking.³⁷

33. We believe that the basic goals of price caps remain valid. The lower prices and improved services generated by price caps should continue to benefit consumers, in much the same manner as the competitive markets price caps seeks to replicate. However, as we discussed earlier in this Notice, the last few years have seen important changes in telecommunications technology and markets. Markets and services are converging as telecommunications technology improves and enlarges the capabilities of the telecommunications networks. In the years to come, there is every reason to believe that telecommunications will increase in importance to society and the domestic economy, provided that regulation facilitates the deployment of the facilities and services consumers and businesses will need. For these reasons, we believe that a refinement of our goals in this proceeding is warranted. In this proceeding, we expect to consider whether the current LEC price cap plan facilitates economic growth and the creation of jobs for American workers. One of the goals of price cap regulation is to reward carriers for becoming more productive and efficient. Cost-reducing technological and organizational innovations may result in reduced carrier workforces, at least initially. However, the expansion of the telecommunications sector should create more jobs as lower prices attract new customers and induce existing customers to make greater use of telecommunications services. Moreover, lower telecommunications prices and innovative services should help create new jobs in the many businesses that increasingly rely upon telecommunications in the production of goods and services. We request comment on the extent to which price cap regulation has succeeded in improving consumer welfare, benefitting the economy, and creating net economic gains and jobs, and on the potential future effects of the current plan or possible revisions. Also, we solicit comment on whether the economic and job growth predicted in the Wharton Report occurred and whether such growth can be expected to continue in the future.³⁸

³⁴ LEC Price Cap Order, 5 FCC Rcd at 6826.

³⁵ Id. at 6827.

³⁶ Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, 8 FCC Rcd 4545 (1993).

³⁷ Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 80-286, FCC 93-549, X FCC Rcd XXX (adopted Dec. 22, 1993, released Dec. 23, 1993). Under these rules, which will remain in effect for a two-year period beginning on January 1, 1994, the total USF would be subject to an indexed cap to moderate growth in the fund.

³⁸ See supra para. 12.

34. We also expect to determine whether the price cap plan furthers the development of the telecommunications infrastructure and services that will be needed in the years ahead. For instance, we will consider whether price cap regulation encourages the development of the national information infrastructure or needed telecommunications services for education, health care and emergency services. In addition, we will consider whether price cap regulation is consistent with the goal of promoting universal service to all geographic areas and of comparable type and quality for all Americans at affordable prices.³⁹ We will also consider whether revisions to the plan are required to better meet those needs, for example, by promoting competition, open access to the network, and wide availability of the services the infrastructure of the future can provide. We request comment on whether and how the goals of the LEC price cap plan should be revised to better serve the purposes of the Communications Act and the public interest in the years ahead.

General Issue 1: Should the Commission revise the goals of the LEC price cap plan so that the plan may better achieve the purposes of the Communications Act and the public interest, and if so what should be the revised goals?

General Issue 2: What has been the effect of the price cap plan on consumer welfare, the economy, and the creation of jobs both in telecommunications and in other sectors of the economy. Quantify the effects of the price cap plan or of possible revisions on consumer welfare, the economy, and the creation of jobs in the future; *e.g.*, quantify the extent to which productivity is increased, the extent to which this increased productivity leads to domestic job growth, the extent to which profit margins improve because of the lower cost of telecommunications, and the ways in which the conduct of business has changed as a result of increasing reliance on telecommunications. We ask commenters to provide data and analysis on how the current price cap plan or a revised plan would affect growth in telecommunications markets, revenues, profits by LECs and CAPs, competition in local exchange and access services, competition in interexchange services, and levels of demand for telecommunications services.

B. Changes to the Baseline LEC Price Cap Plan and Future Transitional Changes

35. Conceptually, it appears useful to divide the issues in this review into two groups. The first set are what might be called baseline issues, questions of whether to revise the current plan to improve its performance or to adjust the plan to changes in circumstances. These changes would be targeted to take effect at the end of the fourth year, effective January 1, 1995, or soon thereafter. This set includes issues of whether to revise the current productivity factor or maximum rate level and the rate of return thresholds in the sharing and low-end adjustment mechanisms. The second set of issues relates to adjustments needed to prepare the baseline plan for anticipated changes in the market, technology, and regulation within the next few years. These issues include developing criteria for moving to reduced or streamlined regulation of LEC services as competition grows. These two sets of issues no doubt overlap. Nevertheless, we believe

³⁹ See generally Speech by Gore at UCLA (Gore announced the Administration's intent to support a bill that will "guarantee[] access to essential services[.]").

that a more useful record will be developed if the analysis and comments focus separately on the question of which changes if any should occur in 1995 (i.e., changes to the baseline plan) and which should be implemented later (i.e., transitional changes).

C. Baseline Issues for Comment

Baseline Issue 1: Infrastructure Development

36. The goal of deploying an advanced telecommunications infrastructure available to all Americans may justify steps to guide LEC investment and other decisions. The national information infrastructure that is now being designed and deployed has great potential to stimulate economic growth and job creation, while providing needed telecommunications services for education, health care, and emergency services. Many of the local links in this infrastructure will be provided by the price cap LECs. Revisions to the LEC price cap plan may help this infrastructure achieve its full potential. For example, we solicit comments on how the facilities of the network can be made available to all users, including suppliers of other telecommunications services and to other businesses that can improve their productivity by greater use of this infrastructure. Most important, we request comments on meeting the universal service goal of providing services of comparable type and quality to all Americans at affordable prices. We request comment on whether and how the LEC price cap plan should be revised to help development of a ubiquitous, national information infrastructure. With this in mind, we request comment on the following issues:

Baseline Issue 1a: Whether, and if so how, the Commission should revise the LEC price cap plan to support the development of a ubiquitous national information infrastructure.

Baseline Issue 1b: Whether the goal of providing universal service to all geographic areas and of equal type and quality for all Americans at affordable prices is being met, or whether we should revise the LEC price cap plan to ensure the provision of universal service.

Baseline Issue 1c: We request that interested parties submit data and analysis regarding the rate at which price-cap LECs are replacing copper wire with fiber optic cable and increasing the bandwidth capacity of copper wires with signal compression techniques and other technologies.

Baseline Issue 2: Composition of Baskets and Bands

i. Background and Current Provisions

37. In view of developing competition in the local exchange services market, one of our major areas of concern will clearly be whether the LEC plan should be revised to permit more streamlined and flexible regulation of LEC services when market changes justify such revisions. One model for this approach is the path the Commission has already followed in the case of AT&T. AT&T's services were assigned to baskets largely

on the basis of the perceived level of competition for the services.⁴⁰ Services in two of the baskets initially placed under price caps were later moved almost entirely from price caps and into streamlined regulation, as the services were found to be effectively competitive.⁴¹ The Commission is currently considering moving additional services out of the remaining AT&T price cap basket.

38. The Commission's LEC price cap plan divides services among four service baskets, each subject to its own price cap.⁴² The four service baskets are common line, traffic sensitive, trunking, and interexchange services.⁴³ Within these baskets, services are grouped into separate service categories, each of which has its own pricing constraints, designed to limit the LECs' ability to offset increases in the prices of certain services within a basket by reducing the prices of other services in the basket.⁴⁴ There are four service categories within the traffic sensitive basket,⁴⁵ and six service categories

⁴⁰ AT&T Price Cap Order, 4 FCC Rcd at 3052.

⁴¹ Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, 6 FCC Rcd 5880 (1991) (IXC Rulemaking), modified on recon., 7 FCC Rcd 2677 (1992).

⁴² See LEC Price Cap Order, 5 FCC Rcd at 6811; see also id. ("Subdividing LEC services into baskets substantially curbs a carrier's pricing flexibility, as well as its ability to engage in unlawful cost shifting between the broad groups of services."); see also Transport Rate Structure and Pricing, CC Docket No. 91-213, FCC 94-9, X FCC Rcd XXX, para. 12 (adopted Jan. 19, 1994, released Jan. 31, 1994) (Second Transport Order).

⁴³ Second Transport Order, X FCC Rcd XXX at para. 10. In the LEC Price Cap Order, the Commission divided services among baskets according to the then-existing interstate access structure set forth in Part 69 of the Rules. LEC Price Cap Order, 5 FCC Rcd at 6788; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2679. In the Second Transport Order, the Commission realigned the division of services among baskets by combining transport and special access services into the newly-created trunking basket. The Commission decided to "mov[e] transport services out of the traffic sensitive basket and into a basket with special access services . . . [to] prevent the LECs from offsetting rate reductions for transport services subject to competition with rate increases for switching and other traffic sensitive services, which are subject to much less competition at this time." Second Transport Order, X FCC Rcd at para. 12.

⁴⁴ Second Transport Order, X FCC Rcd at para. 1; see also LEC Price Cap Order, 5 FCC Rcd at 6788, 6811; see also id. at 6811 ("By grouping similar services together [into the same service category, the LEC price cap plan] . . . acts as a substantial bar on a LEC's ability to engage in anticompetitive practices.").

Streamlined tariff procedures apply to LEC rate changes that are below the price cap index (PCI) levels for the basket and within the service category bands. By contrast, LECs must file cost support to justify rate changes that fall outside the constraints applicable to baskets or service categories. Second Transport Order, X FCC Rcd at para. 3 n.3.

⁴⁵ The service categories within the traffic sensitive basket are (1) local switching, (2) information, (3) data base access, and (4) billing name and address. Second Transport Order, X FCC Rcd at para. 12. See also Treatment of Operator Services Under Price Cap Regulation, CC Docket No. 93-124, Notice of Proposed Rulemaking, 8 FCC Rcd 3655 (1993) (the Commission proposes to establish a new category in the basket for traffic sensitive switched interstate access elements to include the rates set by local exchange carriers for operator services).

and two subcategories within the trunking basket.⁴⁶ The assignment of services to price cap baskets and bands is intended to replicate the effect of competition. Services with common characteristics, for example similar levels of competition, are grouped within a basket, for which price cap indexes are computed. The carrier has little incentive to shift costs between baskets, because changes in prices within one basket do not affect prices in the others. Within the basket, however, the carrier has the incentive to change prices, in order to increase efficiency and maximize its profits. In the LEC Price Cap Order, the Commission stated that its goal in employing a system of baskets and bands is to permit incremental changes in prices that will reward LECs that become more productive and efficient, without subjecting ratepayers to precipitous changes in the prices for LEC services and without enabling LECs to disadvantage one class of ratepayers to the benefit of another class.⁴⁷ Separating services subject to differing levels of competition into separate baskets and service categories hinders the LECs' ability to increase prices of less competitive services so that the LECs can decrease prices of more competitive services without a concomitant revenue loss. LECs are permitted modest pricing flexibility to adjust prices in response to their business needs and the needs of their customers.

ii. Discussion

39. Several proposals have been put forward to modify the composition of the LEC baskets. United States Telephone Association (USTA) avers that our current price cap basket design must be restructured to allow the LECs to meet customer requirements. USTA suggests that the Commission create transport, switching, and public policy baskets, as well as a basket designated as "other" to include interexchange services and rate elements that do not fit in the other three baskets.⁴⁸ Ameritech has requested that the Commission grant waivers of the price cap rules permitting it to consolidate access services into two categories, one for competitive services and one for non-competitive services.⁴⁹

⁴⁶ The six service categories within the trunking basket are (1) voice grade flat-rated transport, voice grade special access, WATS, metallic, and telegraph, (2) audio, and video, (3) high capacity and Digital Data Service (DDS) (4) wideband data and wideband analog, (5) tandem-switched transport, and (6) the interconnection charge. Within the high capacity-DDS service category are the two subcategories for (1) DS1 special access and DS1 flat-rated transport and (2) DS3 special access and DS3 flat-rated transport. Second Transport Order, X FCC Rcd at paras. 12, 21; see also id. at paras. 21-23 (the Commission incorporated the flat-rated transport offerings at the voice grade, DS1, and DS3 levels into the corresponding voice grade, DS1, and DS3 service categories and subcategories for special access after determining that flat-rated transport and special access are similar services provided over similar facilities and will be subject to similar competitive pressures).

⁴⁷ LEC Price Cap Order, 5 FCC Rcd at 6810-11.

⁴⁸ United States Telephone Association Interstate Access Reform Proposal, at 15-17 (dated Jan. 12, 1993); id. at 16 (USTA's Public Policy basket would include, for example, Lifeline Assistance, Universal Service Fund, carrier common line, long term support, and any other elements established for public policy purposes).

⁴⁹ Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, Appendix at A-11 (filed Mar. 1, 1993) (Ameritech Petition). Also, Ameritech has requested waivers to allow it to remove competitive services from LEC price cap regulation

40. Since the initiation of price cap regulation, the Commission has adopted other policies and rules that we expect will increase competition to the LEC services that currently are subject to price cap regulation. For example, in the Special Access Expanded Interconnection Order, CC Docket No. 91-141,⁵⁰ the Commission required Tier 1 LECs, excluding NECA pool members, to file tariffs offering expanded interconnection for special access services to all interested parties. Specifically, the order required these LECs to permit competitors and users to terminate their own special access transmission facilities at LEC central offices and to interconnect with LEC special access services.

41. At least three types of issues are presented by proposals to revise or restructure the LEC baskets. The first set encompass whether the revisions will carry out the goals of price caps, including increased efficiency, reasonable nondiscriminatory rates, and the minimal regulation necessary to achieve those goals. Second, we need to identify and understand the implications of the revisions for other aspects of the price cap plan. For example, changes in the composition of the baskets (e.g., movement of services from one basket to another or movement of a service entirely out of price caps) might warrant adjustments to other features of the plan, such as the sharing mechanisms and the formula used within the common line basket. Third, if the Commission adopts a mechanism to permit adjusting the price cap plan in response to changes in local exchange access competition, the baseline basket structure that will serve as the starting point for that transition becomes very important. This structure might include grouping services subject to similar competitive pressures in the same baskets. Commenters who propose revisions to the LEC baskets and bands should address these issues and explain how the changes they seek would improve the price cap plan in these issue areas.

42. With these considerations in mind, we request comment on the following issue:

Baseline Issue 2: Whether the rules relating to the LEC price cap baskets and bands should be revised. Specifically, commenters should address whether current or revised price cap baskets and bands would reflect expected levels of competition for LEC interstate services, or other relevant common characteristics. For example, we request information and comment on whether differences in pricing behavior within and among baskets evidences different levels of competition.

Baseline Issue 3: Changes in Productivity Factors or Rate Levels

(including rules relating to pricing bands and floors) and "to cap rates for services in the competitive class for three years, at an inflationary measure (GNPPI)[.]" *Id.* In addition, Ameritech has requested waivers to allow it to "apply the current price cap formula to non-competitive services, and permanently incorporate any sharing at the 1993/94 level through a one-time rate reduction in that amount . . . and to forego any individual rate increases for the first three years of the plan for [non-competitive services.]" *Id.*

⁵⁰ Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369 (1992) (Expanded Interconnection Order), modified on recon., 8 FCC Rcd 127 (1992), petitions for recon. pending, appeal pending sub nom. Bell Atlantic Corp. FCC, No. 92-1619 (D.C. Cir., filed Nov. 25, 1992).

i. Background and Current Provisions

43. The price cap decisions replaced rate of return regulation with an incentive-based system of regulation that rewards carriers whose performance exceeds a benchmark measure of efficiency improvements, and penalizes those who fall short. The benchmark, known as the price cap index or PCI, is adjusted each year based on a measure of inflation that embodies economy-wide productivity gains and price changes (the Gross National Product Price Index (GNP-PI)), minus a productivity factor (reflecting the amount by which LEC productivity historically exceeded that of the economy as a whole, plus a consumer productivity dividend of 0.5 percent).⁵¹ The PCI may be further adjusted for exogenous cost changes. In the LEC Price Cap Order, we mandated a price cap index that includes at least a 3.3 percent productivity offset⁵² each year. Alternatively, price cap LECs may elect a 4.3 percent productivity offset.⁵³

ii. Discussion

44. All the price cap LECs have experienced higher earnings on average under price caps than in earlier periods. Their rate of return has increased from 11.25 percent at the start of price caps,⁵⁴ to an average of 12.25 percent in 1992.⁵⁵ Not only have the LECs achieved relatively higher earnings under price caps, but they also have enjoyed sharply declining interest rates, which have fallen to their lowest levels in many years.

⁵¹ In the LEC Price Cap Order, we determined that the GNP-PI does not fully reflect that the LECs' higher than average growth in productivity had resulted in lower than average telephone prices, relative to inflation. We therefore concluded that a productivity factor offset must be included in the price cap formula to ensure that rates continued to decline in relation to the GNP-PI. LEC Price Cap Order, 5 FCC Rcd at 6796.

⁵² LEC Price Cap Order, 5 FCC Rcd at 6796. The 3.3 percent productivity factor was based largely upon two Commission staff studies investigating the extent to which LECs had historically outperformed the economy as a whole in obtaining improved productivity. Id. A short term study examined productivity trends in interstate access from 1984 through 1990; a long term study covered interstate charges generally for the years 1930 through 1989. The 0.5 percent Consumer Productivity Dividend was then added, assigning the first price cap productivity gains to customers in the form of lower rates.

⁵³ LEC Price Cap Order, 5 FCC Rcd at 6799. By selecting the more challenging 4.3 percent productivity offset, the LEC lowers its rates an additional 1 percent, but may retain a greater portion of its profits if it can increase its productivity. Id. at 6796; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2641-42. Because interexchange services are capped based on the productivity offset we adopted to cap AT&T services (*i.e.*, 3 percent), a LEC selecting the higher productivity factor must use a 4 percent productivity factor for its interexchange basket. LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2642.

⁵⁴ The price cap indexes were initiated at a rate of return of 11.25 percent. See LEC Price Cap Order, 5 FCC Rcd at 6814; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2643.

⁵⁵ For the BOCs, 1992 rates of return ranged from a low of 11.41 percent for Bell Atlantic to a high of 13.32 percent for NYNEX, while GTE earned 11.26 percent, Rochester 12 percent, and United 12.81 percent.

Moreover, because these earnings gains and cost decreases occurred while the national economy was relatively weak, the LECs' productivity and profitability are likely to improve even more as the economy recovers and they experience greater demand per line for calling and thus greater apparent utilization of their networks. On the other hand, interest rates may also rise as the economy improves.

45. Based on these developments and considerations, we believe that there may be a good case for revising the 3.3 percent and 4.3 percent productivity factors, requiring a one-time reduction in rates, or both. Alternatively, it may be appropriate to adopt a permanent mechanism for adjusting the plan to reflect changes in interest rates. For example, this might permit either an automatic review or an automatic adjustment to the plan if interest rates rise substantially in the future. In making any such changes, however, it is crucial to avoid modifications that might undercut the incentives price caps seeks to create. Under price caps, this incentive is profitability. The LECs are rewarded with higher profits if they achieve productivity growth above the target, and are penalized with lower profits if they fall short. For this incentive to work properly, the productivity factor should not be changed either to recapture all profits or to compensate LECs for relatively low efficiency performances in the past. At the same time, the productivity factor should be set at a level ensuring fair and reasonable rates for the LECs' customers.

46. In light of the above discussion, we seek comment on the following issues:

Baseline Issue 3a: Whether the productivity factor used to compute the LEC price cap indices should be changed; in addition, or in the alternative, whether a one-time change in the LEC's price cap index should be required. If a rate reduction were required, commenters should discuss how such a reduction should be distributed among price cap baskets and service categories. As a further alternative, whether the Commission should adopt a mechanism which would adjust the plan to reflect changes in interest rates. Commenters should discuss how such a mechanism would operate, including, for example, what deviations in interest rates would trigger the adjustment mechanism. Commenters should address how the option they advocate would preserve or improve price cap incentives and assure just and reasonable rates.

Baseline Issue 3b: Are the price cap LECs profits levels reasonable under the current LEC price cap plan in light of the price cap goal that higher profits are intended to be the reward for attaining increased efficiencies?

Baseline Issue 3c: If the productivity factor should be changed, what method should the Commission use to determine a revised and reasonable productivity factor?

Baseline Issue 4: Sharing and Low-end Adjustment Mechanisms

i. Background

47. In adopting the sharing and low-end adjustment mechanisms, we sought to balance competing goals.⁵⁶ In recognition of possible errors in the productivity factor and

⁵⁶ LEC Price Cap Order, 5 FCC Rcd at 6801.

variations in the productivity of the LECs, the Commission adopted the sharing and low-end adjustment mechanisms to ensure that LECs and their customers share fairly the risks and rewards of future productivity gains, and to prevent any price cap LEC from experiencing such low earnings over an extended period of time that its ability to provide quality service and attract capital would be seriously impaired.⁵⁷ On the other hand, we knew that sharing and low-end adjustment mechanisms might dampen the LECs' risks and rewards, and thus reduce the incentives offered by a "pure" price cap plan. We did not adopt sharing and low-end adjustment mechanisms for AT&T because competition similarly limits AT&T's earnings.⁵⁸

ii. Current provisions

48. Under the sharing mechanism, a LEC that selects and outperforms the 3.3 percent productivity offset is entitled to retain all of its earnings up to 1 percent above the initial 11.25 percent rate of return⁵⁹ (i.e., 12.25 percent).⁶⁰ A LEC using the 3.3 percent productivity offset must share 50 percent of its earnings between 12.25 percent and 16.25 percent, and 100 percent of its earnings in excess of 16.25 percent.⁶¹ The sharing mechanism effectively allows a LEC selecting a 3.3 percent productivity offset to reach a maximum 14.25 percent rate of return.⁶²

49. A LEC selecting the higher 4.3 percent productivity offset may retain all of its earnings up to 13.25 percent. The LEC, however, must share with its customers 50 percent of its earnings between 13.25 percent and 17.25 percent, and 100 percent of its earnings in excess of 17.25 percent. In electing a productivity offset of 4.3 percent, a LEC is effectively able to reach a 15.25 percent rate of return.⁶³

50. The shared amounts are calculated on the basis of total interstate earnings and not on a basket-by-basket basis.⁶⁴ The customer's share plus interest is returned

⁵⁷ LEC Price Cap Order, 5 FCC Rcd at 6787, 6801, 6802; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2677.

⁵⁸ AT&T Price Cap Order, 4 FCC Rcd at 3144.

⁵⁹ The initial 11.25 percent level corresponded to the rate of return established for rate of return carriers in Represcribing the Authorized Rate of Return for Interstate Service of Local Exchange Carriers, 5 FCC Rcd 7507 (1990) (Represcription Order).

⁶⁰ LEC Price Cap Order, 5 FCC Rcd at 6788.

⁶¹ LEC Price Cap Order, 5 FCC Rcd at 6801.

⁶² LEC Price Cap Order, 5 FCC Rcd at 6801.

⁶³ LEC Price Cap Order, 5 FCC Rcd at 6788, 6801-02; see also Price Cap Reconsideration Order, 6 FCC Rcd at 2652.

⁶⁴ LEC Price Cap Order, 5 FCC Rcd at 6805; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2680; see also id. at 2679 (The Commission affirms that sharing based on total interstate earnings, rather than on per-basket earnings is appropriate because "[t]he sharing mechanism . . . is

though a one-time reduction in the PCI for the next rate period, calculated in the same manner as other exogenous changes in the formula.⁶⁵

51. Under the low end adjustment mechanism, if the earnings of a LEC fall below 10.25 percent in a base year, the LEC may adjust its rates upward to target earnings to 10.25 percent, using the prior period as the baseline.⁶⁶ We set the lower adjustment mark at a level which is symmetrical with the 12.25 percent top of the no sharing zone.⁶⁷

iii. Discussion

52. Several LECs have suggested that rate of return prescription and sharing mechanism are inappropriate under price caps where the emphasis is on placing constraints on price, rather than on earnings.⁶⁸ They therefore recommend that the sharing mechanism be eliminated from price caps to provide LECs with a greater incentive to invest in the infrastructure because they will have "an opportunity to maximize the return on shareholder equity over the long run."⁶⁹ Also, during informal discussions with Commission staff, MCI maintained that the sharing mechanism does not always operate as it was intended because the LECs can manipulate reported earnings. MCI therefore suggested that the sharing mechanism be eliminated in favor of an increase in the productivity factor to at least 5 percent for all LECs. Alternatively, MCI suggested that the 100 percent sharing mechanism be eliminated for LECs electing a 5.3 percent productivity factor. Further, AT&T suggested during informal discussions with Commission staff that the Commission prohibit the LECs from using the lower adjustment formula if the low earnings are the result of a one-time charge against earnings.

53. The Commission recognized that the sharing and low-end adjustment mechanisms might reduce efficiency incentives and would certainly increase the complexity of the plan. Our concern was that if the productivity factor was an erroneous measure of productivity for an individual price cap LEC, the productivity factor might produce unintended and undesirable results for that LEC or its customers. Thus, an initial question for review is whether this concern remains valid, or whether the sharing and low-end adjustment mechanisms can be replaced by adjustments to the productivity factor or other aspects of the plan.

created as a backstop to the plan as a whole [and t]he plan stresses LEC overall productivity[.]").

⁶⁵ LEC Price Cap Order, 5 FCC Rcd at 6801; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2686.

⁶⁶ LEC Price Cap Order, 5 FCC Rcd at 6788.

⁶⁷ LEC Price Cap Order, 5 FCC Rcd at 6802.

⁶⁸ See, e.g., United States Telephone Association Interstate Access Reform Proposal at iii (USTA January Proposal) (dated Jan. 12, 1993); see also id. at 27.

⁶⁹ USTA January Proposal at iii; see also id. at 27.

54. If the sharing and low-end adjustment mechanisms are retained, we also must consider whether to revise the rate of return thresholds triggering their application. The current sharing and low-end adjustment mechanisms are centered around 11.25 percent, the LECs' cost of capital in 1988. Because interest rates are now much lower, the 11.25 percent rate of return may be higher than warranted under existing economic conditions. This may be cause to adjust the sharing and low-end adjustment mechanisms.

55. We therefore request comment on the following issues:

Baseline Issue 4a: Whether the sharing and low-end adjustment mechanisms should be realigned with capital costs, and if so, how this should be done.

Baseline Issue 4b: Whether the sharing and low-end adjustment mechanisms should be revised or eliminated.

Baseline Issue 5: Common Line Formula

i. Background and Current Provisions

56. In the LEC Price Cap Order, we adopted a formula to cap non-traffic sensitive access rates (i.e., common line charges) different from the basic price cap mechanism.⁷⁰ This difference stems from the unique characteristics of the carrier common line charge, which recovers a portion of non-traffic sensitive costs through a traffic sensitive, per minute charge. We designed the common line cap formula based on the view that interexchange carriers as well as the LECs can influence interstate usage of local common lines. To ensure that both the LECs and the interexchange carriers have incentives to exploit opportunities for increased productivity associated with greater per line usage of common line, the mechanism we adopted for common line services (the "Balanced 50/50 formula") contains an adjustment that splits the benefits from growth (as well as the risks of a decline) in minutes per line for common line service between the LECs and the interexchange carriers.⁷¹

57. Some commenters in the initial LEC Price Cap rulemaking asserted that the LECs have little ability to stimulate increased interstate long-distance calling and, therefore, there is no rational basis for awarding half the benefits in demand growth to the LECs under the Balanced 50/50 formula.⁷² Accordingly, they suggested that because common line costs do not vary with usage, a more rational approach to capping the common line basket would be to impose a cap on the price of each common line (or "subscriber line").⁷³ They argued that because common line revenues are collected both

⁷⁰ LEC Price Cap Order, 5 FCC Rcd at 6787.

⁷¹ LEC Price Cap Order, 5 FCC Rcd at 6794.

⁷² See, e.g., LEC Price Cap Order, 5 FCC Rcd at 6860-61 (Commissioner Ervin S. Duggan, dissenting).

⁷³ See, e.g., id.

through flat charges (the subscriber line charges) and through usage-based charges (the carrier common line charge), the effect of a per-line price cap approach would be to drive the per-minute charge down as usage increases. As costs per minute fall, rates per minute would fall proportionally. They therefore contended that a per line approach would give LECs the incentive to reduce their costs for providing subscriber lines, while giving their customers a price incentive to increase usage.⁷⁴

ii. Discussion

58. In the LEC Price Cap Order, we acknowledged the uncertainty of identifying the current sources of carrier common line demand growth, and predicting future sources and their magnitude.⁷⁵ We also stated that the 50/50 division strikes the best balance in splitting incentives for this particular form of productivity growth, at least in the initial four-year period of price cap regulation.⁷⁶ Further, we stated that as we gained experience with the price cap plan, we might develop sufficient evidence to calculate a different split.⁷⁷ Given that we now have actual experience in the formula's operation, we therefore will use this proceeding to reexamine our selection of the Balanced 50/50 formula for capping the common line basket. We may, for example, consider the use of a per line formula to cap common line charges. This may warrant adjustments to other parts of the plan, e.g., the overall productivity factor.⁷⁸

59. Accordingly, we request comment on the following issues:

Baseline Issue 5a: Whether the Commission should reconsider its use of the Balanced 50/50 formula to cap common line charges.

Baseline Issue 5b: If so, what method should the Commission use to cap common line charges?

Baseline Issue 5c: If the Commission were to adopt a per-line charge, how should this affect possible changes in the productivity factor or the composition of baskets, e.g., changes such as the inclusion of common line rates in a public policy basket?

Baseline Issue 5d: What incentives are generated by the current Balanced 50/50 formula, the per line formula, or other possible formulas? What incentives should the formula seek to generate?

⁷⁴ See, e.g., id.

⁷⁵ LEC Price Cap Order, 5 FCC Rcd at 6795 n.83

⁷⁶ LEC Price Cap Order, 5 FCC Rcd at 6795.

⁷⁷ LEC Price Cap Order, 5 FCC Rcd at 6795 n.83.

⁷⁸ See also LEC Price Cap Order, 5 FCC Rcd at 6798 (the Commission stated that because the Balanced 50/50 formula gives part of the benefit of demand growth to LECs, while the per line formula does not, it requires a productivity offset that is about 0.51 percent higher than per line).

Baseline Issue 6: Exogenous Cost Changes

i. Background and current provisions

60. In the LEC Price Cap Order, the Commission determined that certain costs incurred by LECs caused by administrative, legislative or judicial requirements beyond the control of the carriers should result in an adjustment to the PCI to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates.⁷⁹ The Commission found that a decision not to recognize these costs in the PCI would either unjustly punish or reward the carrier by treating them as changes in the carrier's level of efficiency.⁸⁰ The Commission called these costs "exogenous" or "Z factor" costs. Examples of cost changes that we consider to be exogenous include: (1) completing the amortization of depreciation reserve deficiencies; (2) amendments to the Uniform System of Accounts; (3) changes in the Separations Manual; (4) reallocation of regulated investment to nonregulated activities; and (5) changes in transitional and long term support.⁸¹ Exogenous treatment was not permitted for other categories including depreciation rate changes and equal access costs.⁸²

61. In practice, the LECs have requested exogenous cost increases for several events not listed in the existing rules, including changes in federal regulations affecting the disposal of telephone poles⁸³ and implementation of a state telephone facilities improvement plan.⁸⁴ The most significant request for higher exogenous costs concerned a change in GAAP accounting for employee post retirement liabilities, such as medical benefits.⁸⁵ In that case, the LECs relied largely upon an elaborate economic model which they claimed demonstrated that the impact of the change would be disproportionate for the price cap LECs, although the change applied to all companies and affected only the way costs are reported.

62. The Commission has also determined that not all changes beyond the carrier's control are to be given exogenous treatment. For example, the Commission held that although tax law changes are outside the carrier's control, general tax law changes are reflected in the GNP-PI component of the price cap formula and, therefore, exogenous treatment of such changes would unfairly "double count" their impact. Accordingly, the Commission decided that only those tax changes that "uniquely or disproportionately"

⁷⁹ LEC Price Cap Order, 5 FCC Rcd at 6807.

⁸⁰ LEC Price Cap Order, 5 FCC Rcd at 6807.

⁸¹ See Section 61.49(d) of the Commission's Rules, 47 C.F.R. Section 61.49(d).

⁸² LEC Price Cap Order, 5 FCC Rcd at 6806-09.

⁸³ NYNEX Request for Waiver of the Commission's Rules.

⁸⁴ Petition for Waiver of the Commission's Rules to Recover Network Depreciation Costs, FCC 93-522, X FCC Rcd XXX (adopted Nov. 29, 1993, released Dec. 8, 1993).

⁸⁵ OPEBs Order, 8 FCC Rcd 1024.