Baseline Issue 3c:

If the productivity factor should be changed, what method should the Commission use to determine a revised and reasonable productivity factor?

Finally, the Commission has requested comment on the method it should use to determine a revised and reasonable productivity factor. In this regard, BellSouth recommends that any revised productivity factor should at a minimum possess or retain the following characteristics:

(1) **Industry-wide Measure** --

The LEC productivity target should not be affected by the short-term performance of a particular firm. Instead the productivity offset should be based on a LEC productivity index that reflects the long-term productivity growth potential of the industry as a whole. By ensuring that the level of the productivity offset is unaffected by a firm's actual performance, carriers will be provided with incentives to become more productive than the industry norm.[79]

(2) **Long-Term Productivity Results** --

Similarly, the productivity offset should distinguish long term industry productivity growth from temporal short-term fluctuations in productivity. The use of long term productivity results appropriately reflects those elements that lead to sustained effects of productivity growth, but weeds out fluctuations that merely affect the achieved level of

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[79] An industry-wide productivity measure is consistent with the workings of a competitive market, in which the price of a good "is not determined by the productivity of any one firm, but rather by the productivity of all firms in the sector." Thomas C. Spavins (Assistant Bureau Chief for Economics, Common Carrier Bureau), An Introduction to the Economics of Price Cap Regulation, Paper (Jan. 31, 1990), at 14. Thus, the productivity factor "reflects the difference between industry productivity and the productivity of the economy as a whole, which is reflected in the price adjustment. Just as in the competitive sector if the firm can exceed the productivity of its benchmark the price capped firm can also increase in profitability." Id.

productivity at a given point in time.[80] This allows the average price of the firm to move with the long term productivity potential, contributing to the long term stability of the price cap plan.[81]

(3) **Avoid Attempts to "Recapture" Past Productivity Gains** --

Any adjustments to the productivity offset based upon short term productivity gains are not appropriate, and run directly counter to the objectives of price regulation. The attempt to "recapture" past productivity gains by revising the productivity offset effectively penalizes the carrier for achieving the very efficiencies that price caps are intended to promote. For example, one way that the productivity offset can be tied inappropriately to past performance is if there is the prospect of frequent re-negotiation of the price cap plan. Productivity incentives will vary inversely with the frequency of review of the productivity offset -- the more the plan is renegotiated, the less efficiency can be expected.[82] Similarly, under the earnings sharing mechanism adopted by the Commission, prices are adjusted downward on the basis of a LEC's earnings in the previous year so that the LEC is able to

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80/ Thus, for example, although a one-time cost reduction achieved through downsizing may cause a productivity gain in a particular period, the productivity offset should not be revised because the incremental gain in productivity achieved as an immediate result of the force reduction does not produce additional or incremental gain in subsequent years.

81/ See Spavins, supra note 79 at 16.

82/ As Strategic Policy Research explains:

> The deployment of new technology and the pace of innovation are key sources of efficiency gains that are substantially retarded when the firm cannot expect the benefits to be sustained. If the regulated carrier is to be encouraged to make profound, systemic changes, then efficiency incentives must be sustained over a period of time long enough to be reflected in capital deployment decisions and fundamental marketing decisions that give rise to efficiencies.

SPR Vision Paper at 19. Building on the analysis of Richard Schmalensee at MIT, SPR recommends that regulators not adjust their pricing formulas until 8-10 years in the future. See Id. at 20; Richard Schmalensee, Good Regulatory Regimes, RAND Journal of Economics 20 (Autumn 1989).

realize only a fraction of any efficiency gains. This mechanism thus severely dilutes efficiency incentives and reduces efficiency gains.[83]

(4) **Total Factor Productivity (TFP)** --

The best method of measuring productivity is to employ a Total Factor Productivity approach using direct, observable measures of inputs and output. TFP is the ratio of total output to an aggregation of all relevant factor inputs, measured in real terms.[84] Because the productivity offset conceptually reflects the ability of the LECs to exceed the productivity of the U.S. economy as a whole, it must reflect all sources of unit production cost reductions. Thus, the use of TFP is appropriate because it incorporates the effects on overall productivity of all productive inputs.

In a recent study commissioned by the USTA, Laurits Christensen, Philip Schoech and Mark Meitzen performed a TFP study of price cap LECs covering the period from 1984 to 1992. The TFP study defines as the ratio of total output to total input, where total output includes all LEC services and total input includes the capital, labor, and materials used to provide those services. The study concludes that over the 1984-92 period, total output for the price cap LECs grew at a 3.5% average annual rate and that total input grew at a 0.9% average annual rate, yielding TFP growth of 2.6%.[85]

The productivity offset is related to the differential in productivity growth between the LECs and the U.S. economy. Taking as a given that economy-wide TFP

83/ See SPR Vision Paper at 22 ("The higher the sharing percentages, the less are the efficiency incentives and the less are the efficiency gains. Sharing is inherently counter productive when the price cap plan is too short, and incentives are diluted to start with -- as is the case with all existing price cap plans.").

84/ Christensen Productivity Study at i.

85/ Id. at 10.

growth has averaged 0.9% annually since 1984, the Christensen study concludes that the TFP growth differential between the LECs and the overall economy is 1.7%.[86] BellSouth 66 recommends that the Commission adopt this calculation in revising the current LEC productivity offset.

Baseline Issue 4: Sharing and Low-End Adjustment Mechanisms

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.

As BellSouth discusses below in response to Baseline Issue 4b, the Commission should eliminate the sharing and low end adjustment mechanisms altogether. In the unfortunate event that the Commission chooses to retain the sharing and low-end adjustment mechanisms, it should in no event undertake to realign them with capital costs.[87] The Commission's raising of this issue stems from a concern that interest rates have fallen in the years since the 11.25% LEC cost of capital was determined in 1988.[88] However, the Commission has not undertaken to re-prescribe the rate of return for non-price cap carriers, nor has the Commission adjusted the AT&T price cap plan to reflect changes in capital costs. Here, there is similarly no justification for singling out price cap LECs for a cost adjustment, particularly when the Commission very recently decided to preserve 11.25% as the cost of capital component in its regulation of cable television providers.[89] More

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86/ Id. at ii, 12. The economy-wide TFP figure is based on the U.S. Bureau of Labor Statistics' (BLS) measure of "multifactor" productivity for the private business sector of the U.S. economy. BLS multifactor productivity measures are reported in a BLS publication, Monthly Labor Review. Id. at 11 n.2.

87/ See Notice at 23, ¶ 55 (Baseline Issue 4a).

88/ See id. at 23, ¶ 54.

89/ See In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision

important, determining a new cost of capital will require a new Part 65 represcription proceeding. The Commission has in that context rejected the notion of re-determining the cost of capital based simply on changes in interest rates.[90] In any event, changes in interest rates are already reflected in the GNP-PI component of the price cap adjustment formula. Changes in interest rates reflect changes in investor expectations concerning inflation. To adjust the sharing thresholds to reflect changes in interest rates would double count those expectations.

If the Commission decides to retain a sharing mechanism with an optional upper mechanism, such as the present 4.3% option, then the Commission should correct an anomaly in the current rules that discourages carriers from electing the higher offset.[91] Under the present rules, if a carrier elects the higher 4.3% productivity offset, it is allowed to earn an additional 100 basis points before sharing starts and at the upper sharing threshold. The anomaly occurs because the additional earnings potential exists only for the year in which the higher productivity offset is elected, while the downward adjustment to the PCI is permanent. The Commission should correct this anomaly by making both the higher productivity offset and the downward PCI adjustment one-year events. This would provide carriers with a straightforward economic decision each year and would encourage more carriers to elect the higher productivity offset, thereby providing customers with an additional, up-front price reduction.

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of Regulated Cable Service, Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 93-215, CS Docket No. 94-28 (released Mar. 30, 1994), at 109, ¶ 207.

90/ See Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, 6 FCC Rcd 7193, 7201 (1991).

91/ Once again, BellSouth strongly urges that the sharing mechanism be eliminated altogether. The Commission will not need to address the anomaly described here if it does so.

Baseline Issue 4b:

Whether the sharing and low-end adjustment mechanisms should be revised or eliminated.

Because it lacked experience in calculating and applying the LEC productivity offset, the Commission decided that in its initial stage of implementation of LEC price caps, it would take a "cautious and careful" approach.[92] The Commission superimposed earnings sharing and low end adjustment mechanisms onto the LEC price cap plan that were intended to provide a "backstop" measure of protection against excessively high or low LEC earnings.[93] The Commission did so acknowledging that these mechanisms "might dampen the LECs' risks and rewards, and thus reduce the incentives offered by a 'pure' price cap plan."[94] The Commission also acknowledged that the sharing and low-end adjustment mechanisms "certainly increas[es]" the administrative and bureaucratic complexity of the plan.[95]

92/ LEC Price Cap Order, 5 FCC Rcd 6787, ¶ 4.

93/ See id. at 6801, ¶ 120 (stating that "possible sources of errors in the productivity offset support the adoption of a backstop program (at least until we acquire additional experience with LEC price caps), to adjust the rates in the event that such unanticipated errors in the price cap formula occur").

94/ Notice at 21, ¶ 47. 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% rate of return. 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. The sharing mechanism thus effectively allows LECs selecting a 3.3 percent productivity offset to reach a maximum 14.25 percent rate of return. LECs electing to take a 4.3 percent productivity offset may retain all earnings up to 13.25 percent; must share 50 percent between 13.25 and 17.25 percent; and must share 100 percent of earnings that exceed 17.25 percent. Thus, LECs electing a 4.3 percent productivity offset are effectively permitted a 15.25 percent rate of return. The shared amounts are calculated on the basis of total interstate earnings and not on a basket-by-basket basis. Id. at 21, ¶¶ 48-50 (citations omitted).

95/ Id. at 22, ¶ 53. For example, sharing requires the Commission to preserve the entire overlay of rate-of-return regulation in order to "backstop" its price cap plan, which in turn perpetuates the need for complicated cost allocation procedures. This is an unnecessary drain on both carrier and Commission resources. See Barrett, Beyond Price Caps at 7 ("[A]s long as we impose an overall rate of return ceiling, we must either regulate the prices of all services, even if it's only incidentally through the imposition of a cap, or we must engage in some sort of cost allocation scheme between those services we regulate and those we don't.").

The time has now come for the Commission to eliminate the sharing and low-end adjustment mechanisms. These devices are interim safeguards that were never intended to be long-term features of the LEC price cap plan and they are no longer warranted. The Commission now has had significant experience with price cap regulation of both the LECs and AT&T, and the empirical data gathered over the first four years of price cap regulation contain no extraordinary or unexpected scenarios that justify continued administrative and regulatory impediments to the functioning of a pure price cap system.[96] Given the explosive competitive development of the telecommunications sector even since the inception of price caps, the Commission now should align its LEC price cap regime fully with the basic objectives of incentive regulation.

Conceptually, the sharing mechanism ties prices to costs by retaining the central concept of rate of return regulation, i.e., by looking to overall earnings on a rate base to measure LEC productivity and performance.[97] As the Commission itself recognizes, this approach is fundamentally at odds with the theory of price caps. Price regulation seeks to stimulate carriers to reap profits by becoming more internally and operationally efficient, and by developing new services and technologies in the hopes of maximizing returns to shareholder equity over time. However, if a carrier must share half or all of its significant productivity gains, it will have far less incentive either to undertake significant (and

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96/ Empirically, LEC earnings have risen under price caps, which is consistent with the realization of increased efficiencies expected under such a regime. The Commission initially targeted price cap rates for LECs at 11.25%. The price caps LECs earned 11.77% as a group in 1991, 12.35% in 1992, and 12.93% in 1993, thus averaging approximately 12.35% over the 1991-93 three-year period. BellSouth individually had a 12.62% rate of return in 1991, a 12.8% rate of return in 1992, and a 13.72% rate of return in 1993, yielding a three-year average of approximately 13%. In 1992, the single-year earnings among price cap LEC study areas ranged from approximately 8% to 17.8% with lower and higher study areas offsetting each other within a number of LECs. By way of comparison, the average firm in the Standard & Poors 400 firms earned 17.77% during the four-year period from 1989-1992. During this same period, the middle quartiles of these nonregulated firms earned in a range from 12 percent to 21.9%. Thus LEC earnings during the price cap years have not significantly exceeded the norm of other major U.S. corporations in a manner that justifies special regulatory attention.

97/ See LEC Price Cap Order, 5 FCC Rcd at 6801, ¶ 121.

potentially risky or disruptive) cost reductions. For the same reason, the carrier will also have far less incentive to innovate or plow back its limited pool of investment funds into infrastructure investment in a heavily regulated area (where its investment return is severely restricted) vis-a-vis other more favorable opportunities in nonregulated areas. Thus, because firms are only permitted to keep a fraction of their efficiency gains, many of the efficiency incentive benefits of a price cap regime are dramatically diluted if a sharing mechanism is retained.[98]

While it does not pose the same direct hindrance to efficiency and productivity incentives, the low-end adjustment mechanism is also an inappropriate rate of return construct that has no place in a price cap regime. Although LECs must retain the ability to file tariff revisions as required by economic circumstances, there is no reason for LECs to be afforded an upward adjustment for "underearnings" because this concept should henceforth have no meaning under price caps. For price caps to truly function as they are intended, the Commission must sever **all** conceptual links between prices and earnings.[99]

The Commission's imposition of sharing and low-end adjustment mechanisms in the LEC Price cap plan has required the inefficient maintenance and application of two separate and fundamentally different regulatory structures in an effort to "backstop" the initial implementation of price caps. These mechanisms are no longer necessary. If left in place, they will severely dilute the profit incentives that constitute the "engine" of price caps. Given the priorities of the NII initiative and the productivity benefits that have been validated

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98/ An analysis by Strategic Policy Research shows that a 4-year hybrid price regulation plan with 50/50 sharing, i.e., a plan similar to the current LEC plan, has only approximately 18 percent of the efficiency incentives provided in unregulated competitive markets. SPR Vision Paper at 22. Indeed, such incentives "only slightly exceed" those under a system of 1-year rate-of-return regulation. Id.

99/ In the unlikely event that the price cap formula drove a carrier's earnings to confiscatory levels, the present plan makes provision for filing above-cap rates. See LEC Price Cap Order, 5 FCC Rcd at 6823, ¶ 303. This provision should be retained.

to flow from purer forms of incentive regulation,[100] the Commission should modify its LEC price cap plan to eliminate these complex and inefficient vestiges of the rate of return system.

Baseline Issue 5: Common Line Formula

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?

In the LEC Price Cap Order, the Commission adopted a formula to cap common line charges that is different from the price cap mechanism, based on the view that interexchange carriers as well as LECs can influence interstate usage of local common lines. In order to ensure that both LECs and IXCs share the increased productivity, incentives and benefits associated with greater usage of the common line, the Commission adopted the "Balanced 50/50 formula," which contains an adjustment that was intended to split benefits

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100/ In completing its review of the AT&T price cap plan, which is much purer than the LEC plan and contains no rate-of-return holdover mechanisms, the Commission found that the plan was achieving its goals of encouraging AT&T to provide services more efficiently, "thus generating benefits to the carrier, its customers, and society that might otherwise be lost under rate of return regulation." AT&T Price Cap Performance Review, 8 FCC Rcd at 6968.

of growth in minutes of use per line.[101] The Commission now asks whether the Commission should reconsider its use of the Balanced 50/50 formula to cap common line charges, and raises the possibility of moving to some other method such as a per-line formula.

The Commission has recognized that there is a direct relationship between the productivity offset and the common line formula.[102] In response to Baseline Issue 3, BellSouth has recommended that the Commission amend the current price cap plan and adopt a new productivity offset of 1.7 based on a recent Christensen study of total factor productivity. Because TFP already incorporates the effects on overall productivity of all productive inputs, any common line formula which includes an adjustment for demand growth (such as the Balanced 50/50 formula) effectively double counts the productivity gains reflected in the measure of TFP. Accordingly, the current common line formula should be modified to remove the demand growth adjustment.

If, however, the Commission were either to retain the Balanced 50/50 formula or to attempt to move to a per line formula, then the productivity offset would have to be adjusted downward. Both the balanced formula and a per line formula result in a substantially higher effective productivity hurdle than would be appropriate based on the TFP study. Indeed, recognizing this effect, the Commission adjusted the long term productivity offset when it adopted the initial price cap plan.[103]

Specifically, the Commission found that the long term productivity offset would have to be reduced by .67 under a per line common line formula. Under the Balanced

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101/ See Notice at 23, ¶ 56; LEC Price Cap Order, 5 FCC Rcd at 6794.

102/ LEC Price Cap Order, 5 FCC Rcd at 6795-798 (1990).

103/ See id. at n.106.

50/50 formula, the Commission found that the productivity offset would be .51 higher than the productivity offset associated with the per line formula because the balanced formula gives part of the benefit of demand growth to the LEC.[104] BellSouth believes similar adjustments would be necessary to the revised total factor productivity offset under a per line or balanced common line formula.[105]

Baseline Issue 6: Exogenous Cost Changes

Baseline Issue 6a:

Whether the number of cost changes currently eligible for exogenous treatment under price caps should be reduced.

Baseline Issue 6b:

If so, which cost changes should be eligible for exogenous treatment under price caps?

Baseline Issue 6c:

Whether we should adopt an administrative process to allow access customers or other groups to request cost changes eligible for exogenous treatment and, if so, what should be the procedures in such an administrative process?

Under the current LEC price cap formula, certain costs incurred by carriers that are caused by administrative, legislative or judicial requirements beyond the carrier's control merit an adjustment to the PCI to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates.[106] Recognizing such costs in the PCI would

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104/ Id. at 6798, ¶ 95.

105/ The adjusted productivity offset would be 1.03 under a per line formula, and would be 1.54 under the balanced formula.

106/ See Notice at 25, ¶ 60; LEC Price Cap Order, 5 FCC Rcd at 6806-09.

either unjustly punish or reward the carrier by treating them as changes in the carrier's level of efficiency.[107]

The Commission suggests that the category of "exogenous cost" changes under the price cap formula should be tightened to include only "economic cost" changes, i.e., those that "might be expected to affect prices in competitive marketplaces." This is contrasted in the Notice by way of example to GAAP changes implemented in the USOA, which the Commission reasons "may represent only a change in how books are kept and costs are recorded."[108]

BellSouth disagrees with the Commission's attempt to draw a distinction between "accounting" cost changes and "economic" cost changes for purposes of exogenous cost treatment. Price cap LECs are regulated based on accounting costs, and more important, the rates of price cap LECs were initiated based on the accounting costs recognized by the Commission at that time. Subsequent corrections to accounting costs therefore must be reflected in the PCI. Otherwise LECs will not be afforded the opportunity to recover true economic costs.

Section 61.45 of the Commission's rules lists certain categories of costs which the Commission determined at the start of price cap regulation would qualify for exogenous treatment. That list is now somewhat obsolete and in need of revision. Section 61.45(d)(1)(viii), for example, references "Inside wire amortizations" which are now completed. This section thus can be eliminated.

107/ This category of cost changes thus operates as an exception to the general requirement that cost changes do not alter the PCI and its attendant incentives. Notice at 26, ¶ 63. Examples of such "exogenous" or "Z factor" costs currently include completion of the amortization of depreciation reserve deficiencies; amendments to the Uniform System of Accounts ("USOA"); changes in the Separations Manual; reallocation of regulated investment to nonregulated activities; changes in transitional and long term support. See 47 C.F.R. § 61.45(d).

108/ Notice at 26, ¶ 64.

Section 61.45(d)(1)(i) references "The completion of the amortization of depreciation reserve deficiencies." The amortization of the depreciation reserve deficiencies approved by the Commission at the time price caps were initiated have now been completed. However, the Commission has continued to prescribe depreciation rates for the price cap LECs that BellSouth believes are inadequate, thereby resulting in a recurrence of depreciation reserve deficiencies. BellSouth estimates that it has a current depreciation reserve deficiency of over $3 billion, and that amount can be expected to grow under the Commission's current method of regulating LEC depreciation rates. If the Commission recognizes such depreciation reserve deficiencies in the future and permits their amortization, such amounts should qualify for automatic exogenous treatment under Section 61.45(d)(1)(i). Therefore, BellSouth proposes that the wording of this section should be changed to read: "Amortization of depreciation reserve deficiencies approved by the Commission."

As noted in BellSouth's response to Baseline Issue 4b, BellSouth recommends that the Commission eliminate the sharing and lower formula adjustment mechanisms, thereby moving the LECs to a "pure" price regulation plan. If the Commission does so, then Section 61.45(d)(1)(vii) (which requires exogenous cost treatment for the sharing and lower formula adjustment mechanisms) would be rendered obsolete, and should be removed.

In the LEC Price Cap Order, the Commission clearly stated its intent to treat changes in GAAP as exogenous once the Commission found the changes to be consistent with its regulatory accounting requirements. Accordingly, to eliminate any doubt as to that intent, the Commission should modify Section 61.45(d)(1)(ii) to read "Such changes in the Uniform Systems of Accounts and in Generally Accepted Accounting Principles as the Commission shall permit or require."

With respect to the Commission's possible adoption of an administrative process to allow access customers or other groups to request cost changes eligible for

exogenous treatment, BellSouth believes that customers should generally be bound by the same exogenous cost categories as carriers. To the extent that such customers wish to bring other cost categories to the Commission's attention, they are free to petition the Commission and do so. Carriers now self-identify exogenous changes in their tariff filings. Customers similarly could use either the tariff review process or formal complaint procedures if they believe that a particular carrier has not identified required exogenous cost changes. BellSouth does not believe that any new administrative procedures are required.

Baseline Issue 7: Service Quality, Infrastructure Monitoring, and Network Reliability

> ***Baseline Issue 7a:***
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> *Whether the Commission should increase or revise the monitoring of the LECs' network reliability, service quality, and infrastructure development. Commenters are requested to submit data, information, and proposals in this inquiry that in their view will contribute to assuring state-of-the art reliability, service quality, and infrastructure development for the LECs. Commenters also are requested to submit data identifying the administrative and business costs associated with their proposals.*
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> ***Baseline Issue 7b:***
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> *Whether and if so how the Commission should expand its service quality monitoring to include price cap LEC facilities and services that may be interconnected with the local exchange network or used to provide similar capabilities, including wireless services and coaxial cable. Commenters are requested to submit specific data on the administrative and business costs associated with their recommendations on the reporting requirements.*

In the LEC Price Cap Order, the Commission considered and rejected the suggestion that implementation of price cap regulation would lead to downgraded service and diminished investment in network modernization. The Commission reaffirmed its belief that by creating appropriate investment incentives, price cap regulation would encourage the LECs to promote cost savings and efficiencies; innovate and modernize their networks;

invest in new technology; develop advanced applications; and introduce new services.[109] The Commission also rejected the argument that price caps would lead the LECs to jeopardize their own infrastructure by shifting investments to more lucrative enterprises [110] Nevertheless, in order to ensure high-quality service to ratepayers and to better predict carrier behavior under the price cap structure, the Commission expanded its monitoring of network reliability, service quality and infrastructure development. The Commission seeks comment on whether it should increase or revise these monitoring requirements.

The data cited in the Notice confirm the Commission's prediction in the LEC Price Cap Order that LECs would not cannibalize their network infrastructure in the search of short-term profits.[111] To the contrary, a significant amount of infrastructure, new technology and new service development have been achieved under the Commission's price cap plan (although BellSouth believes that much more innovation can and will occur if the Commission improves the plan in the ways that BellSouth suggests). Thus, the Commission should continue to reject this argument as a rationale either for retaining existing service quality reporting requirements or for imposing new ones on LECs.

To the extent that the Commission determines that the public interest requires it to continue to monitor network service quality, BellSouth urges the Commission to require the same reports from **all** service providers who use the network. In light of the expanding interconnection opportunities for other service providers and the buildout of a telecommunications infrastructure that will truly be a "network of networks," the Commission must consider the service quality offered by all service providers located on the network. Correspondingly, no one group of service providers can or should be held solely

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109/ See LEC Price Cap Order at 6827, ¶ 335.

110/ Id.

111/ See Notice at 10-11, ¶ 29.

responsible for network reliability in such an expansive, multi-network telecommunications environment.[112]

BellSouth believes that the market will ultimately be far more effective than the Commission in policing network reliability and service quality. As competition grows, high service quality will become a competitive necessity and the market will penalize or eliminate altogether those providers who do not meet customer quality expectations. Therefore, BellSouth urges the Commission to reduce existing reporting requirements once it determines that competition has developed in a particular access market.

Baseline Issue 8: Rates and Regulations for New Services

As the Commission observed in the Notice, one of its primary objectives in adopting LEC price cap regulation was to provide "carriers with incentives to become more innovative in the development and introduction of new, high quality services."[113] Realization of such an objective is essential to achieving the many public interest benefits associated with incentive regulation. Because of the important role that new service introduction must play in overall performance of any incentive regulation plan, the Commission correctly recognizes that the current rules regarding new service introduction by price cap LECs must be reevaluated.[114]

112/ BellSouth has provided a detailed assessment, in response to Transition Issue 1a below, of the emerging competition in all areas of BellSouth's business, including the expanding base of competitors gaining access to BellSouth facilities.

113/ Notice at 31, ¶ 73.

114/ As Chairman Hundt recently reiterated to Congress, the movement of various telecommunications markets toward a more competitive environment demands that the Commission fashion policies that will encourage this development, including policies which "promote the deployment of new technologies and services." Statement of Reed E. Hundt, Chairman, Federal Communications Commission, before the Subcommittee on Commerce, Justice, State and Judiciary Committee on Appropriations, United States Senate (April 28, 1994). Revising the price cap rules governing the introduction of new services is consonant with this goal.

Baseline Issue 8a:

Whether the LEC price cap new service requirements impose unnecessary regulatory impediments to the development and introduction of new services, with specific identification of what those impediments are and an assessment of their magnitude.

BellSouth believes that the Commission's present new service requirements have indeed functioned as an impediment to the development and introduction of new services. They reflect a series of modifications that are a substantial departure from the approach first adopted by the Commission in the LEC Price Cap Order, and that have had negative repercussions on the introduction of new services by the LECs.

In the LEC Price Cap Order, the primary constraint placed upon the price of new services offered by LECs paralleled the new service rules for AT&T, i.e., LECs had to satisfy a "net revenue" test that was designed to establish a lower bound on new service prices as a safeguard against predatory pricing.[115] This test requires a service to be priced at a level that covers its direct costs plus any net losses it creates for a carrier by attracting customers away from the carrier's other services. In the LEC Price Cap Reconsideration Order, an upper bound was added to the LEC new services test in response to a petition for reconsideration filed by MCI. This interim rule limited LECs to prices justified by the pre-price cap cost support rules -- a fully distributed cost showing.[116] In the Part 69 ONA Order[117] the Commission retained the upper bound on the prices of new LEC services, but stated that LECs could load overhead on new services in a non-uniform manner, provided

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115/ See LEC Price Cap Order, 5 FCC Rcd at 6825, ¶¶ 319-321.

116/ See LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2693-2695.

117/ See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6824, and Erratum, 5 FCC Rcd 7664 (1990) (LEC Price Cap Order), modified on recon., 6 FCC Rcd 2637 (1991) ("Part 69 ONA Order"), further modified, 6 FCC Rcd 4524 (1991), clarified and modified on second further recon., 7 FCC Rcd 5235 (1992) ("Second Further Reconsideration"), further recon. pending.

that they could justify such loadings.[118] The order also offered LECs the opportunity to recover an additional "risk premium" to reflect any unusual riskiness in the development of new services.[119]

BellSouth believes that the Commission's continuous regulatory activism with respect to the new services portion of the LEC price cap plan has considerably dulled LEC incentives to aggressively develop and initiate new services. In the LEC Price Cap Order, the Commission acknowledged the importance of having a long initial period in which to have the opportunity to fairly evaluate the operation of the plan before the instigation of periodic review and major adjustments, reasoning that the "[f]ailure to provide a reasonable period of acclimation could result in regulatory ambiguity, and resulting uncertainty, that would effectively stifle the intended incentives."[120] With respect to the new service rules, however, the Commission's admonition turned out to be a premonition. Only a year into the new price cap regime, the Commission revised -- and in BellSouth's view, worsened considerably -- the new service rules.[121]

The onerous cost support, notice and tariff requirements grafted onto the price cap framework by the Commission in the period following the LEC Price Cap Order are

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118/ Part 69 ONA Order, 6 FCC Rcd at 4531; see Second Further Reconsideration, 7 FCC Rcd at 5236-37.

119/ If a particular new service is unusually risky, the Commission has recognized that a LEC might need to earn a risk premium on its investment in order to justify undertaking the service's implementation. The risk premium can be reflected in the LEC's price provided that the LEC provides "evidence of comparably risky undertakings by firms in relevant industries, together with the cost of capital associated with the undertakings." Part 69 0NA Order, 6 FCC Rcd at 4531, ¶ 43. LECs attempting to make such a demonstration must make a record showing of: "(1) research and development expense and investment for the new venture; (2) marketing expense; (3) the type and functions of any new technologies employed; (4) an explanation of the method by which projected demand has been derived; and (5) any special elements of risk." Id.

120/ LEC Price Cap Order, 5 FCC Rcd at 6834, ¶ 386.

121/ Thus, the Commission's approach to new services has created a dual restraint on the incentives for LECs to innovate. It has produced a climate where there is significant regulatory risk associated with offering a new service but little upside potential. LECs' cost/benefit analysis for new services has been skewed to the negative not only by the price cap rules but by the Commission's overall implementation approach.

summarized in paragraphs 75 and 76 of the Notice. They substantially increase the filing burdens on LECs seeking to introduce new services. Despite an initial recognition that traditional tariff regulation did not create an environment that encouraged new service introduction,[122] the Commission anomalously retreated to a pre-price cap regulatory approach when it changed the LEC new services rules.[123] Although the Commission hoped that its decision to adopt "a flexible cost-based upper bound" would encourage LECs to develop improved versions of existing services and risky new innovative ones,[124] these rule changes have undeniably detracted from LEC incentives to innovate under price caps by imposing regulatory burdens that exceed traditional, pre-price cap tariff regulation.

Baseline Issue 8b:

Whether, and how, we should modify the LEC price cap new service procedures and cost support rules to ensure that these rules advance our goals of encouraging innovation and setting reasonable rates.

The cost support requirements associated with new services must be reformed to encourage innovation and to reinforce price cap goals by providing better incentives to price cap LECs. In this regard, a particularly relevant consideration is that core access services are already in place. It is therefore most likely that new service development will surround new technology applications and approaches focused upon meeting customer demand. BellSouth predicts that the vast majority of new service development will thus fall into a category of discretionary services.

122/ While far from perfect, the net revenue test at least provided some relief from the onus of the detailed cost and demand support that had become the norm for tariff filings under Section 61.38 of the Commission's rules. Indeed, in adopting the net revenue test the Commission rejected requests from various parties that new services be subject to traditional tariff review standards, including cost support and quarterly reporting of all costs, revenues, and expenses. LEC Price Cap Order, 5 FCC Rcd at ¶ 317.

123/ Moreover, the risk premium and overhead loading rules are additional regulatory requirements that pertain only to price cap LECs.

124/ See Notice at 32 n.119; Second Further Reconsideration, 7 FCC Rcd at 5235.

As a first step to modifying its new service rules, the Commission must better align the requirements governing new services with economic principles in a manner that seeks to emulate the competitive marketplace. At most, the focus of the new services requirement should be to establish the appropriate price floor for a new service, consonant with the original plan set forth in the LEC Price Cap Order. In this regard, BellSouth believes that a long-run incremental cost standard would most parallel the basis upon which business decisions are made and would afford sufficient protection against anticompetitive pricing.[125]

With respect to cost support requirements, BellSouth urges the Commission to make reduced support requirements the rule rather than the exception for new services. For those services for which the Commission believes that more stringent review requirements or scrutiny should be imposed,[126] the Commission can create a special, pre-determined and narrowly-tailored class of new services that are exceptions to the general rule. Exceptions should only be created for services in which the Commission, pursuant to rulemaking, has mandated that the particular service should be provided.[127] The rulemaking would afford all parties an opportunity to comment upon whether the Commission's objectives and the public interest would be served by requiring additional justification (beyond the price cap

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125/ The concerns that the Commission has expressed in imposing an upper bound on new service prices do not account for the fact that there truly is a marketplace limitation on a LEC's pricing discretion that is not dependent solely on competition (although the emergence of competition certainly functions as a further pricing constraint). Customers themselves restrain LEC pricing. By definition, new services create new options. No existing service is removed or altered by the new service filing. If the new service is priced improperly, customers simply will not subscribe. It is thus contrary to the LECs self-interest to price the service inappropriately.

126/ The Commission has expressed some reservation about relaxing support requirements for services that present substantial issues of potential anticompetitive effects. For example, the Commission states that it "would not expect to reduce initial support requirements for new services implementing Commission-mandated rule changes such as expanded interconnection." Notice at 34, ¶ 83.

127/ BellSouth does not believe that the exception should be based on the degree of competition a service is perceived to face. As mentioned, the absence of a competitive alternative does not translate into unfettered pricing discretion for the LEC. If a service is not priced consistent with customer demand, no market for the service will develop.

new service requirements) when the new service rates are filed. In addition, the rulemaking would serve as a constraint to assure that the "heightened-scrutiny" exception does not swallow the rule.[128]

Where a service falls within the exception category, then, in addition to the cost floor showing, the price for the new (exception) service must be justified by the filing LEC as being just and reasonable. Because the just and reasonable standard encompasses a range of prices, the Commission should not mandate a single type of showing that must accompany the filing. To do so would unnecessarily limit the range of permissible rates. In the first instance, the filing LEC should have the opportunity to provide the materials that it believes justifies the filed rate. Through the tariff review process, the Commission will have ample opportunity to solicit and obtain any additional information that it believes to be pertinent.

By creating a mechanism to deal with specifically identified exception services, the Commission can allow the new service rules to be flexible enough to encourage not only the filing of new services but also to establish an environment in which such services become effective with a minimum of disruption. Accordingly, the new service rules should be modified not only with respect to the support requirements (e.g. a price floor test) but also should be designed to facilitate new services taking effect.

To that end, several features should be incorporated into the new service rules. The notice interval for new services should be shortened to 30 days.[129] In addition, new

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128/ Absent such a constraint, any tariff filing could be declared to be exempted from the new service rule, which would undercut completely the rationale for reducing cost support requirements and once again stifle new service development and introduction.

129/ The current 45-day notice period builds into the process considerable opportunity to delay the implementation of a new service. The notice period itself is long, particularly if the LEC is attempting to respond to customer demand, and is often extended. Moreover, a petition to suspend or reject a new service filing is a regulatory weapon often used by LEC competitors to delay the effectiveness of the new service.

service filings that satisfy the price floor test should be presumed valid. A presumption of validity would mean that the tariff would take effect at the end of the notice period without suspension except that the Commission could suspend the filing for one day for the purpose of imposing an accounting order. A presumption of validity still reserves to the Commission its principal tariff review tools of investigation and prescription, but recognizes that considerable public interest benefits can accrue if new services can be implemented more quickly than is the current practice.

Adopting a more relaxed regulatory approach to new services in the manner suggested should be a vital part of the Commission's effort to reinvent government and stimulate LEC contributions to the NII. The Commission has the opportunity to revitalize LEC interest in new service development, and should create an environment whereby risk is rewarded and experimentation is encouraged. Indeed, this is the very environment that the Commission envisioned when it adopted the LEC Price Cap Order but has not yet achieved. The Commission should seize the opportunity to recapture the additional benefits that can be obtained by constructing an approach to new services that is complementary to incentive regulation.

Baseline Issue 8c:

Whether new services are available on an equal basis to all LEC customers. Whether we should revise the LEC price cap plan to ensure the universal availability of new services. How widely available have LECs made new services to their customers?

None of BellSouth's new interstate services have been restricted with respect to their availability to all BellSouth customers. The Commission's inquiry, however, implies that all new services must be affirmatively provided to all customers.

The Commission seems to confuse one of its long term policy objectives, infrastructure development, with a far narrower issue of new service deployment. They are

not the same. It would be irrational to mandate or expect that every new service be made available to every customer. Not every customer has the same telecommunications requirements. Even customers with similar telecommunications needs do not necessarily want those needs satisfied in the same manner.

The Commission must be careful not to usurp the role of the marketplace in defining the services that customers need and want. The Commission will simply chill innovation and experimentation if it creates regulations which impose obligations on LECs to make new services "universally" available without regard to the market.

It has been a long standing approach of the Commission to substitute market forces for detailed regulation and that approach should be followed here. Any problems that are present in the LEC price cap plan with regard to new services have largely been a consequence of over-regulation. The Commission here should strive to correct these problems and not exacerbate them.

Baseline Issue 9: Equalization of Rates for LECs and CAPs

Baseline Issue 9a:

Whether our current rules for computing AT&T's exogenous costs should be revised to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous access costs.

Under the current price cap rules applicable to AT&T, LEC access charge reductions are treated as "exogenous" cost changes that must be flowed through to AT&T's customers. Access cost reductions realized by AT&T through the substitution of CAP facilities or through self provisioning, on the other hand, are treated simply as cost reductions that can be retained by AT&T. This disparate treatment creates an uneconomic incentive for AT&T to bypass the LECs in securing access.

BellSouth views the present rules as seriously flawed, and recommends that the Commission require the same treatment by AT&T of access charge reductions, regardless of

the source. The Commission would appear to have two alternatives: 1) require AT&T to treat all reductions in access costs as "exogenous," regardless of the source of the reductions; or 2) eliminate the requirement that AT&T treat LEC access cost adjustments as exogenous. The first alternative would ensure that ratepayers receive the benefit of all access cost reductions realized by AT&T. However, this alternative would be administratively burdensome and would undermine the incentive of AT&T to seek reductions in its access costs. The second is more consistent with pure price regulation, but relies solely on competitive market forces to secure the benefit of access cost reductions to end users. The ability of market forces alone to drive down end user prices charged by AT&T and the other IXCs is certainly questionable, in light of the lock-step price increases recently implemented by AT&T and the other large IXCs in the face of falling LEC access charges.

Baseline Issue 9b:

Whether any other rules or policies that relate to LEC price cap regulation should be revised to equalize our treatment of LECs and CAPS, and if so, what the revised rules and policies should be.

While the primary emphasis of this proceeding should be and is to modify the price cap rules to improve the LEC incentive framework, the Commission properly recognizes that the telecommunications market is rapidly changing, with competition for access services increasing apace but with increasingly disparate regulations governing LECs and their competitors.

To stand on equal footing with their competitors, LECs must be free to offer services in the same way that their competitors do. Changing the new service rules would be a significant step towards equalizing treatment of LECs and CAPs. Yet, there are other rules, specifically the Part 69 access charge rules, which continue to place LECs at a serious disadvantage vis-a-vis competitors. These rules still impose rate structure limitations on common line and switching services. Unless a LEC first obtains a waiver from the

Commission, it is precluded from restructuring its rates or developing new service applications which have rate elements not specified in the Commission's rules.

In its access charge Petition for Rulemaking, USTA discussed the delay that has been incurred in obtaining waivers.[130] In addition, USTA identified numerous technology changes and new service developments on the horizon that are incompatible with a rigid Part 69 access structure.[131]

If the Part 69 rules cannot accommodate the introduction of new services, many of the positive steps the Commission can and should take here to improve the performance of price caps will be undercut. The Part 69 rules also affect dramatically the incentives for LECs to innovate, and the failure of these rules to promote new service development could actively retard infrastructure deployment. Currently, the Part 69 rate structure rules hinder LECs who seek to develop new, advanced capabilities.

The rate structure limitations of the Part 69 rules result in an enclosed system for access. New technologies challenge the static nature of the access rules. Such technologies may afford a new means of providing an existing service or form the basis of new capabilities, neither of which are contemplated or easily accommodated in the enclosed system of access charges. For example, common channel signalling not only provided a new means of transmitting signalling information (i.e., call setup) for switched access but also enabled the development of new database services. None of these capabilities could be tariffed as separate service elements without first going through protracted regulatory proceedings simply because the Part 69 rules did not define elements for these services.

130/ See, e.g., USTA, Petition For Rulemaking, Attachment 1, "Reform of the Interstate Access Charge Rules" (September 17, 1993).

131/ Id. at Attachment 2.