A. The nature and extent of any barriers to market entry and exit

The barriers that currently prevent market entry are delineated in response to Transition Issue No. 2a, infra. The removal of these barriers is a primary prerequisite to permitting reduced or streamlined regulation for LECs. For instance, further unbundling of the network, e.g., loops and switches, is necessary to enable competitors to enter the market.

B. The existence of potential and actual competitors

The technological possibility of competition for access services is not sufficient to designate the market competitive. The industry recently has witnessed several highly publicized proposed mergers and alliances that have fizzled out before providing the promised consumer benefits. The demise of these arrangements supports MCI's contention that the LECs' contested market theory is as likely to encourage competitive behavior on the part of monopolists as TCI cable customers are to access Bell Atlantic dial tone services. Competition must be actual before it is relevant measure.

C. The extent to which those competitors have the facilities to serve LEC customers

Not only do competitors currently have limited facilities in place, but the magnitude of the investment required is such that it undoubtedly would take years for facilities to be installed that would adequately serve access customers. For example, CAPs represent less than 1% of the access market, and they have fiber rings established around only major metropoli-

tan areas. Nor do proposals to offer competitive services present significant risks to the LEC monopoly stronghold in the near term. For example, MCImetro has announced plans to enter the local exchange arena by building or otherwise obtaining its own facilities. This venture is in the early developmental stages and represents only a $2 billion commitment. This enterprise hardly represents a threat to the incumbent LECs, and thus, will have no meaningful impact on LEC pricing initiatives. Similarly, although CATV may well prove to be a feasible alternative to LEC local service, the technology is not developed, and should not be reasonably considered until it has matured.[113]

D. The willingness of customers to use competitors' service

The only accurate measure of customers' willingness to use competitive services is evidence of actual usage. Statements by customers that they "might" or "would" use a service provide inadequate proof on which to base regulatory relief for LECs. Consumers, however, will resist competitive alternatives that require them to change telephone numbers. Until number portability removes that obstacle, an insignificant number of customers will be willing to use a competitive service.

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[113] Approval has not yet been granted for the joint MCI and Jones Intercable petition to embark upon a Wheaton, Illinois, trial of competitive local exchange service over cable facilities.

E. The competitors' market share

The competitors' market share is a valid measure of customers' willingness to use competitive services. As such, it is a very important factor to be considered. In applying a market share analysis to the LECs, however, the Commission must recognize that the LEC monopolies are geographically based and that a significant degree of competition in one area has no effect whatsoever on the customers' choices in other LEC serving territories.

F. Pricing trends

Historical trends of service prices are a good indicator of the competitive nature of services. Review of the pricing trends in the post-divestiture long distance market in the United States illustrates that the presence of competition "acted quickly to lower prices."[114] Although the price for long distance is no longer falling as sharply as it did immediately following divestiture, price declines have continued.[115]

Within the local exchange industry, pricing trends for DS1 and DS3 services and local switching suggest a similar phenomena. The only limited competition the LECs face is for these high capacity transport services. Comparatively steep decreases in DS1 and DS3 rates and the availability

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[114] Robert E. Hall, Long Distance: Public Benefits from Increased Competition, October 1993, p. 14.

[115] Id.

of term discounts indicate external competitive pressure for these services. Conversely, before the Commission established a trunking basket to separate the switching and transport services, the reductions the LECs made in their local switching rates were modest relative to the reductions in local transport.[116] Clearly, pricing trends are an excellent barometer of the existence of competition.

Further, despite extraordinary levels of 1993 earnings most price cap LECs reported in their 1994 annual access filings,[117] most LECs did not even propose rate reductions equal to the exogenous cost decreases specified under the Commission rules. Such concrete evidence confirms that the level of competition the LECs face overall is insufficient to discipline their access services pricing.

G. The effect of expanded interconnection

The Commission already has granted LECs additional pricing flexibility to respond to the limited competition interconnectors offer. MCI believes that no additional regulatory flexibility is justified under present market conditions.

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[116] Also, the Commission established an Interconnection Charge that is essentially a surcharge assessed on LEC local switching access rates. Such a surcharge could not be sustained in a market where competition existed.

[117] With one exception, earnings at the LEC price cap holding company level were above 12.20%; the highest earned was 15.83%. The one company below 12.20% earned 9.13%, well within the reasonable range of the current LEC cost of capital of 9.54%.

H. Differences in competition in different geographic locations or regions, and differences in demographic characteristics

MCI recognizes that it is unlikely that the roll-out of competitive networks will occur in all geographic regions at the same time. The Commission should grant regulatory relief only in those geographical areas where effective competition exists.

I. Other factors

MCI has not identified any other factors.

Transition Issue 1c: In what circumstances will a LEC no longer control essential "bottleneck" facilities for some or all of its services? How will the Commission be able to identify these circumstances in practice.

MCI believes that rather than searching for signs that effective competition exists in any particular market segment, the Commission should, instead, focus on modifying regulation to allow the benefits of competition to reach the marketplace. If the Commission establishes market and pricing rules that encourage competition, the loss of LEC bottleneck control will naturally follow. The inverse, however, is not true: if the Commission concentrates its efforts on how to identify the elimination of the LECs' stronghold on key network elements, the requisite competition will not likely develop. Rather than commenting on how to identify whether competition exists, MCI focuses its comments on actions that the Commission can take in order effectively to manage the transition from monopoly to effective competition.

MCI urges the Commission to embrace the following regulatory initiatives for establishing a framework that will encourage the development of interstate access competition:

A. Open and equal access to LEC bottleneck networks must be implemented: complete unbundling of functional network components and interconnection wherever technically feasible

The LECs' networks are comprised of a number of different functional components, including those needed for network access (to connect a subscriber to the LEC network or to a CAP),did not r for switching and switch functions (to provide a centralized means of connecting subscribers to one another or to other network components, so that every subscriber does not have to be directly connected to every other subscriber), and for transport (to connect points in the LECs' networks or points in LECs' networks and CAPs' networks). It will become feasible for alternative providers competitively to supply some of these network components before it is possible to competitively supply others. For example, the Commission already allows interconnection between the networks of LECs and CAPs. Currently, however, there is no competitive provision of either switching services or local loop facilities.

The competitive provision of network functions cannot occur unless the competitive providers can interconnect with the LECs' existing ubiquitous local exchange networks on terms that do not place the competitive providers at an artificial disadvantage with the LEC. To ensure

that the competitive providers (or their customers) are not forced to use portions of the LEC network that they do not need, unbundled interconnection must be allowed wherever it is technically feasible, at rates that cover the actual costs to interconnect.

B. Alternate providers must be granted co-carrier status

Historically, different entities have been able to interface with the local exchange network under disparate terms and conditions. On the one hand, contiguous LECs interface with one another essentially as equals -- or co-carriers -- with payment for the termination of calls on one LEC's network that originate on another LEC's network treated the same regardless of which LEC originates or terminates the calls.[118] On the other hand, although the FCC officially granted cellular companies and CAPs co-carrier status, the terms under which cellular companies or CAPs are compensated for terminating calls that originate on LEC networks, and vice versa, were left to negotiations under state oversight and fair and mutual compensation did not ensue. In order for local competition to develop, competitive providers of local exchange services must be able to interface with incumbent LEC networks as true co-carriers.

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[118] Co-carrier status includes having the same status as incumbent local exchange service providers with respect to compensation arrangements for terminating calls, NXX code assignments, interoffice trunking and signalling arrangements, database access arrangements, billing record arrangements, directory listings, access to 911 service, and number portability.

C. Costing and pricing safeguards must be established to protect against price discrimination, price squeezes, and cross subsidization

During the transition from monopoly to effective local competition, incumbent LECs will retain monopoly power in the provision of some of their access services for some time. In the absence of price cap rules, LECs will have both the incentive and the ability to set rates in an anticompetitive strategic fashion. To allow competitive markets to develop, pricing rules must be maintained to provide safeguards against anticompetitive abuses.

LECs must not be allowed to charge discriminatory rates for their monopoly network components. Any rate differentials should reflect only differences in the cost of providing network functions due to demonstrated differences in underlying cost drivers (e.g., differences in density or distance), and not differences in the markup over cost.

When LECs offer services that bundle together one or more monopoly components with other inputs, the price for that bundled services must at least equal the tariffed rates that the LECs charge others for all the monopoly network functions used to provide those bundled services, plus the incremental costs of all the other necessary inputs. This rule is known as the imputation rule. It requires LECs to impute into their own rates, the rates they charges their competitors for essential inputs, plus the cost of

non-monopoly inputs. This rule appropriately protects against LECs placing their competitors in anticompetitive price squeezes.

D. Universal service must be provided in a cost-based, competitively neutral fashion

The parameters of universal service goals must be explicitly defined and the associated costs quantified separately from the revenue requirements of the incumbent LECs. Any charges imposed on alternative providers to fund the universal service subsidy must be limited to the alternative providers' fair share of the explicitly defined, identified, and quantified universal service subsidy. The distribution mechanism used for the universal service subsidy must employ a system under which each customer's choice of service provider receives the subsidy.

E. Regulations must be imposed on local service providers commensurate with their demonstrated level of bottleneck control or market power

As competition will develop at a different pace for different access services (with LECs retaining pockets of monopoly power), regulatory relief for LECs must be commensurate with the reduction in their monopoly power and the development of effective competition. As LECs face effective competition for the provision of an access service, customers for that network component will have options and will no longer be captives of the LECs. Therefore, the price cap limits can be relaxed for that service, but safeguards against cross subsidization must be maintained as long as the LECs have captive ratepayers for any of their other services.

Transition Issue 1d: The ability of CAPs and others to compete with the LECs.

So long as barriers to effective competition exist, the CAPs and other parties are limited in their ability to offer viable alternatives to LEC access services.[119]

Transition Issue 1e: The impact price cap LEC entry into related industries and LEC entry into interLATA marketplaces should have on the LEC price cap plan.

The price cap paradigm is a reasonable regulatory structure for allowing the LECs to expand into other markets. As a tariff review mechanism, how price cap regulation alone cannot guard against LEC abuses as they enter new markets, such as long distance. If the formula is correctly calibrated, however, it can restrict their ability to increase monopoly service rates in order to subsidize competitive ventures.

MCI has argued supra, that the Balanced 50/50 formula is inappropriate for capping common line rates.[120] If the LECs enter the interexchange long distance market, the Balanced 50/50 formula may prove even more harmful to the current IXCs. Under the per-line formula, to the extent that LEC subsidiaries that provide long distance stimulate demand, those subsidiaries would realize all the benefit of

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[119] See Transition Issue 1a, supra.

[120] See Baseline Issue 5a, supra.

those efforts. There is no logic to permit the exchange carrier entities to receive the benefit of demand growth stimulated by their subsidiary IXCs.

TRANSITION ISSUE 2: TRANSITION STAGES

Regulatory methods for reducing price cap regulation or streamlined regulation should be adopted for LEC services as those services become subject to greater competition.

For the foreseeable future, and at a minimum, for the next few years, MCI doubts there will be sufficient competition in the provision of access services to allow streamlined regulation. Even in the unlikely event that there are competitors offering local exchange services, the Commission will need to continue to regulate the rates they charge access users. This is because local exchange providers -- LECs or otherwise -- continue to hold the bottleneck access between the IXC and end users. These firms will have the incentive to compete for local service customers by charging low local service rates while recovering the remainder of their costs from access customers.[121] As long the local service providers continue to control the bottleneck facilities to the end users, the Commission must retain pricing rules to protect access customers.

The Commission's recent expanded interconnection proceeding set the groundwork for the IXCs to purchase local transport access services from

[121] Without controls that ensure that each service recovers its own costs, the industry risks returning to the pre-divestiture, pre-access charge environment where long distance services subsidized local rates, and the benefits realized from competition in the long distance market will be lost.

competitive providers. MCI is skeptical whether the IXCs will ever be able to purchase the local loop or switching services in a competitive access market. The end users will always select the provider of those two services on the basis of the prices charged for local service, and not the access prices the long distance carriers must pay. In fact, competition for local service may result in access prices being set at a level well above cost. Thus, MCI does not believe that conditions in the access market -- with the possible exception for transport services -- will allow the Commission to streamline its regulation of the LECs in the foreseeable future.

TRANSITION ISSUE 3: REVISIONS TO BASKETS

Whether and how the Commission should schedule revisions in the composition of price cap baskets as local exchange access competition develops.

Since there is competition for less than 1% of the access market, it is too early for the Commission to schedule revisions in the composition of price cap baskets. There is simply no way to predict whether or how access competition will develop, or how the Commission will need to modify LEC pricing rules in response to the introduction of competition.

The current basket configuration suitably groups together services that are subject to the same levels of competition. The Commission achieved this result by its recent introduction of the trunking basket. Because it is not clear if or when competition will begin to develop for common line or switching services, there is

no means of predicting whether the LECs will require additional pricing flexibility for those categories of services.

The minimal access competition that has developed is for services in the newly designated trunking basket. Clearly circumstances have not changed sufficiently since the recent Commission restructure of the baskets to support revamping them again. Nor does MCI anticipate any profound transformations of market conditions in the near term that would require further modifications to the baskets.

Substantial competition for LEC access services is not likely to develop over the next four years. Thus, it is premature for the Commission to adopt a set of procedures that would automatically adjust baskets. The current basket configuration will suffice at least until the next review. If the market status warrants consideration of changes to the pricing rules at the Commission's next price cap review, it will be appropriate then to consider modifications to the basket configuration.

TRANSITION ISSUE 4: SERVICE QUALITY, NETWORK RELIABILITY, AND INFRASTRUCTURE

Whether and how the Commission should revise its monitoring of LEC service quality, network reliability, and infrastructure as part of any transition plan.

At this time, MCI does not have any recommendations to offer.

TRANSITION ISSUE 5: FREQUENCY OF REVIEW UNDER PRICE CAP REGULATION

When the Commission should next review the price cap LECs' performance. The frequency with which the Commission should conduct subsequent reviews.

The Commission adopted an initial LEC price cap performance review commencing after three years because such a period was "long enough to allow the effects of incentive regulation to unfold."[122] MCI does not believe that the current review will result in fundamental changes to the overall structure of the price cap plan. Further, MCI avers that the transformation of external market conditions will be slow to develop. Thus, MCI believes that effective competition will not fully evolve within the next four years, and MCI, therefore, recommends that the Commission re-evaluate the LEC price cap plan starting after three years from the completion of this review. The state of competition at the time of subsequent reviews should dictate the proper interval until the next price cap plan evaluation.

TRANSITION ISSUE 6: OTHER TRANSITION ISSUES

Other issues that may be relevant to developing an effective transition plan.

MCI has not identified any other rule or policy changes relevant to the LEC price cap review that the Commission has not already raised.

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[122] LEC Price Cap Order, 5 FCC Rcd at 6834.

CONCLUSION

The LECs, their ratepayers, and the economy as a whole can maximize and share the welfare attainable through LEC price caps only if the plan is properly designed. For the foregoing reasons, MCI urges the Commission to adopt MCI's proposed modifications to the LEC price cap plan.

Respectfully submitted,
MCI TELECOMMUNICATIONS CORPORATION

Elizabeth Dickerson

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May 9, 1994

TABLE 1

COMPARISON OF THIRD AND FOURTH QUARTER INTERSTATE ACCESS EARNINGS

	1992		1991		1990	
	4th Qtr	3rd Qtr	4th Qtr	3rd Qtr	4th Qtr	3rd Qtr
Ameritech	12.13%	13.35%	12.09%	12.89%	12.81%	13.14%
Bell Atlantic	12.00%	12.44%	12.92%	13.48%	11.69%	11.47%
Bell South	12.80%	13.22%	12.50%	12.36%	12.04%	12.04%
Centel	14.08%	15.33%	11.90%	12.17%	11.73%	11.80%
Contel	7.45%	8.95%	10.14%	11.64%	12.17%	12.57%
GTE	11.63%	12.06%	11.25%	11.58%	11.42%	11.49%
Lincoln Tel	12.75%	12.71%	12.11%	11.81%	10.55%	10.68%
NYNEX	13.73%	15.00%	7.94%	11.29%	10.52%	10.44%
Pacific Telesis	12.93%	14.28%	11.86%	12.83%	12.52%	12.51%
Nevada Bell	15.47%	15.55%	12.70%	13.22%	14.36%	5.17%
Rochester	11.28%	10.93%	11.20%	10.23%	10.53%	10.66%
SNET	12.69%	12.98%	9.75%	10.11%	11.57%	12.20%
Southwestern Bell	11.91%	12.30%	10.58%	11.02%	10.48%	11.45%
US West	11.86%	12.36%	11.49%	11.46%	12.26%	12.26%
United	12.17%	13.75%	12.96%	13.06%	12.26%	12.81%

APPENDIX A

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

In the Matter of	)	
	)	**CC Docket No. 94-1**
Price Cap Performance Review	)	
For Local Exchange Carriers	)	

STATEMENT

OF

MATTHEW I. KAHAL

Concerning: Cost of Capital

On Behalf of

MCI COMMUNICATIONS CORPORATION

May 1994

EXETER
Associates, Inc.

10801 Lockwood Drive
Suite 350
Silver Spring, MD 20901

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

In the Matter of	)	
	)	CC Docket No. 94-1
Price Cap Performance Review	)	
For Local Exchange Carriers	)	

STATEMENT

OF

MATTHEW I. KAHAL

I. QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Matthew I. Kahal. My business address is 10801 Lockwood Drive, Silver Spring, Maryland 20901.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND.

A. I hold B.A. and M.A. degrees in economics from the University of Maryland and have completed all course work and examination requirements for the Ph.D. degree in economics. My areas of academic concentration include industrial organization, economic development and econometrics.

Q. PLEASE STATE YOUR PRESENT POSITION.

A. I am a Senior Economist and Principal at Exeter Associates, Inc., a consulting firm specializing in public utility regulation and energy studies. I have held that position since January 1981.

Q. PLEASE DESCRIBE YOUR PAST EMPLOYMENT.

1 A. Prior to joining Exeter Associates, I served on the Economic Evaluation Director-
2 ate of the Aerospace Corporation, a federally-funded research and development
3 center. At Aerospace, I conducted studies for the U.S. Department of Energy's
4 Strategic Petroleum Reserve. From 1977 to 1980, I was employed with a Wash-
5 ington, D.C. consulting firm as a staff economist. In that position I conducted
6 numerous technical studies on topics concerning the electric utility industry.
7 Before entering consulting, I served on the Economics Department faculties of
8 the University of Maryland and Montgomery College teaching courses on econom-
9 ic principles, development and business.
10 Q. DESCRIBE YOUR PROFESSIONAL EXPERIENCE WITH THE PUBLIC
11 UTILITY INDUSTRY.
12 A. I have been almost continually involved with consulting in the area of energy
13 economics and public utility regulation since 1977. Much of that work has
14 involved utility financial analysis and resource planning. I have conducted numer-
15 ous cost of capital studies and other financial assessments. In the resource
16 planning area, I have directed or conducted technical studies in the areas of utility
17 load forecasting, time-of-use pricing, the impact of electric rates on industrial
18 location, uranium pricing, direct load control, weatherization, capacity planning,
19 alternative power supply technologies and environmental controls. I managed a
20 project for the Electric Power Research Institute on the regulatory treatment of
21 fuel expenses.
22 In addition, I have participated in utility rate and other regulatory proceed-
23 ings. I have testified before utility commissions in Maryland, Ohio, Alabama,
24 Oklahoma and Pennsylvania on load forecasting matters, before the New York
25 and Ohio Commissions concerning rate impacts, before the Ohio, Pennsylvania

1 and Alabama commissions on test year costs and revenues, and before commis-
2 sions in Maryland, Pennsylvania, West Virginia, Rhode Island, and the Tennessee
3 Valley Authority on rate structure issues and the PURPA standards. I have
4 testified on issues related to cogeneration and small power production in Mary-
5 land, Delaware, Maine, Pennsylvania and Oklahoma. I have testified in Florida,
6 Illinois, Utah, Oklahoma, Texas, Indiana, Ohio, Rhode Island, Delaware, Idaho,
7 New Jersey, Virginia, Louisiana, Minnesota, South Carolina, Kentucky, Nevada,
8 Pennsylvania and the Federal Energy Regulatory Commission (FERC) on rate of
9 return, capital structure, the accounting treatment of construction work in prog-
10 ress, rate phase-in and other financial issues. I have also testified before the
11 FERC in several of the major electric utility merger cases in recent years on issues
12 of competition, merger benefits and costs and financial impacts.
13 Within the past few years, I have made presentations as an invited speaker on
14 utility issues before conferences, workshops and symposia sponsored by the
15 Nuclear Regulatory Commission, Oak Ridge National Laboratory, the Michigan
16 State University Institute for Public Utilities, the International Association of
17 Energy Economists, the Massachusetts Energy Facilities Siting Council, Rutgers
18 University, NARUC, the Atlantic Economic Society, NASUCA and the State of
19 Maryland. I served as a lecturer on capacity planning issues for the NARUC
20 Advanced Regulatory Studies Program. In October 1989, I testified before the
21 Committee on Ways and Means, U.S. House of Representatives, on proposed
22 legislation governing excess deferred taxes.
23 Q. WHAT ARE YOUR CURRENT RESPONSIBILITIES WITH EXETER
24 ASSOCIATES?

A. For the past decade, I have directed Exeter's extensive work for the Maryland Department of Natural Resources (DNR). Our firm has been serving as DNR's integrator for economic studies, and as the Program Manager, I have chief responsibility for the technical studies performed by Exeter staff and other contractors. Study areas currently include or have included long-range load forecasting, power supply planning, plant licensing, weatherization, cogeneration/independent power, demand-side management and Clean Air Act compliance.

My other main area of responsibility with Exeter concerns rate of return and utility financial issues. I have conducted a number of rate of return and other financial studies relating to electric, water, gas and telephone utilities, and I have submitted testimony on this subject area on over 80 occasions within the past 12 years, including this Commission's 1990 Represcription proceeding (CC Docket No. 89-624). Appendix A accompanying my statement identifies those cases.

II. OVERVIEW

Q. WHAT IS THE PURPOSE OF YOUR STATEMENT IN THIS PROCEEDING?

A. This proceeding is a Notice of Proposed Rulemaking (NPRM) to review the performance of local exchange telephone companies under "price cap" regulation and to determine what changes to the current plan are appropriate. The current price cap regime has been in place since January 1, 1991, and thus there is approximately three years of accumulated experience at the federal level.

I have been asked by MCI Communications Corporation to address one specific issue raised by the NPRM – the need to update the cost of capital. In

1 CC Docket 89-624, completed in 1990, the FCC established a midpoint rate of
2 return for the local exchange companies of 11.25 percent, including a return on
3 common equity of 13.2 percent. The principal purpose of my statement is to
4 document the change in market capital costs since 1990 and to perform an update
5 of this Commission's 1990 cost of capital determination using the most recently
6 available market data.

7 Q. DOES YOUR STATEMENT ADDRESS THE APPROPRIATE METHOD-
8 OLOGY FOR DETERMINING COST OF CAPITAL?

9 A. No, it does not. This Commission conducted a thorough and exhaustive review of
10 cost of equity methodology and capital structure approach in the 1990 proceeding,
11 and based on the record, identified its preferred approach.[1] In my opinion, no
12 important changes have taken place since 1990 which warrant a reexamination or
13 revision of this Commission's approach. Rather, it is sufficient to employ the
14 Commission's established methodology using the latest available data.

15 Although my update follows the Commission's basic cost of equity methodolo-
16 gy, I recommend that certain ad hoc adjustments which the Commission added to
17 its basic discounted cash flow (DCF) formula results are no longer needed. I
18 therefore present the update both with and without those adders.

19 Q. DO YOU HAVE ALL THE DATA YOU NEED TO PRESENT YOUR
20 RECOMMENDED RATE OF RETURN?

21 A. No. My analysis was prepared and completed in April 1994 and relies upon
22 market data extending through March 1994. (Full month data are not yet
23 available for April 1994.) Due to changing market conditions, it is desirable to

[1]The Commission's original findings on cost of equity and capital structure were upheld on reconsideration in that docket. (Opinion and Order, December 6, 1991)

employ the latest market data in determining the cost of equity. For this reason, I intend to submit an update with MCI's Reply Comments, scheduled in June 1994, incorporating market data extending at least through April 1994.

As a result of lags in the filing of financial data, I have not had the opportunity to compile the embedded costs of debt for the Bell operating companies for 1993. I therefore have done so for 1992 on a provisional basis and will reflect the latest 1993 data when available. Because the telephone companies undertook substantial refinancing activity in 1993 in response to lower interest rates, the 1992 cost figures are likely to substantially exceed the current embedded costs of debt.

Q. WHAT ARE YOUR FINDINGS AND RECOMMENDATIONS?

A. Based upon my review of the cost of capital data, my findings and recommendations are as follows:

(1) Using the FCC's basic approach to rate of return, the overall cost of capital declines from 11.25 percent in 1990 to 10.06 percent at the present time.

(2) The FCC's return on equity included a series of adjustments which added about 1.0 percentage point (100 basis points) to the base DCF result. These adjustments are not needed at this time, and I recommend their exclusion. Absent these adjustments, the overall rate of return becomes 9.54 percent.

(3) Using market data for the six months ending March 1994, the DCF cost of equity for the seven Regional Bell Operating Companies (RBOCs) is 11.0 percent.

(4) The average capital structure for the seven RBOCs as of December 31, 1993 is 48.7 percent total debt and 51.3 percent common equity.

(5) The embedded cost of debt for Bell local exchange companies is 8.0 percent for 1992. I would expect the 1993 cost of debt to be even lower.

1 (6) As measured by yields on long-term utility bonds, the cost of capital has
2 declined by at least two full percentage points since 1990.
3 (7) Based upon available standard measures, there appears to be little overall
4 change in investment risk for the Bell companies since 1990. Thus, the Bell
5 companies have enjoyed a decline in capital costs since 1990 comparable to
6 that of other utilities and the market generally. That is, reductions in market
7 capital costs have not been offset by increases in telephone company business
8 risk.
9 (8) I recommend that the Commission recognize the reduction in overall cost of
10 capital from 11.25 percent to 9.54 percent and pass the savings on to custom-
11 ers in the form of lower rates (net of any price cap allowed rate increase). In
12 addition, the earnings sharing thresholds should be revised to take into
13 account the rate of return reduction.
14 (9) The Commission's NPRM inquires concerning a periodic adjustment mecha-
15 nism to reflect possible changes in the cost of debt. While the Commission's
16 concern over changing interest rates is conceptually reasonable, realistically
17 the local exchange companies have only modest exposure to higher interest
18 expense. This is because the embedded cost of debt changes only very
19 gradually, particularly in an upward direction. An interest expense adjustment
20 mechanism is not needed because changes over relatively short time periods
21 (e.g., three to five years) are not likely to be large.
22 Q. DO YOU CONCUR WITH THE FCC'S COST OF CAPITAL METHOD-
23 OLOGY?
24 A. I have reviewed the FCC's approach to the overall rate of return in CC Docket
25 No. 89-624 and find it generally to be reasonable. My only disagreement is that