cost adjustments under the price cap plan were essentially carry-overs from rate of return regulation and have either expired or will expire in the near future.[47] No additional exogenous cost adjustments should be allowed after the expiration of existing adjustments. Clearly, if some event occurs which has a dramatic effect on the telephone industry, whether it be legislation, a natural catastrophe of huge proportions or changes in the Commission's Rules which significantly impact LEC costs with no corresponding increase in revenues/funding, the price cap rules can be waived or modified, as needed, at that time.[48] There is no need to continue to incorporate an exogenous cost adjustment in the LEC price cap mechanism -- it only detracts from the efficiency incentives of the price cap plan.

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[46](...continued)

Subscriber Plant Factor	(40)	(41)	(22)
Dial Equipment Minutes	(20)	(17)	(1)
Long Term and Transitional Support	(1)	(1)	(2)
Inside Wire	(14)	(1)	-
Reserve Deficiency Amortization	(26)	(19)	-
Excess Deferred Taxes	(1)	3	(2)
Investment Tax Credit Amortization	3	5	2
TOTAL	(98)	(71)	(25)

* Sharing amounts and pending, but unapproved, exogenous cost requests (i.e., OPEB) have been excluded.

[47]See 47 CFR § 61.45(d).

[48]For example, if the Commission substantially redefines its view of what constitutes "universal service" and requires LECs to satisfy this expanded definition with no new funding, modifications in the price cap plan would be required.

D. Term

Another critical factor in determining LEC incentives and potential efficiency gains under a price cap plan is the length of the plan. This assumes, of course, that the price cap plan is stable -- remains unchanged -- during the term of the plan. SPR's research and the work of others[49] indicate that efficiency incentives rise significantly as the length of term or review period is increased.[50] However, as with everything else in life, there is a trade-off for greater potential efficiency. That is, the longer the length of the plan, the greater the risk of uncertainty. The Commission's goal should be to balance this risk against potential gains in efficiency in selecting the length of time before the next price cap review. SPR suggests that the review period should be 8-10 years for a pure price cap plan.[51]

While there may have been good reason to establish a conservative or relatively short review period at the commencement of price cap regulation, this justification no longer exists after three full years of experience. U S WEST believes that if the Commission adopts a price cap plan which accommodates competition, eliminates sharing and streamlines the introduction of new services, the plan should remain in place for

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[49]See Paul R. Joskow and Richard Schmalensee, Incentive Regulation for Electric Utilities, Yale J. on Reg., Fall 1986, at 25.

[50]SPR Study at 16-24.

[51]Id. at 20, citing to Richard Schmalensee, Good Reporting Regimes, RAND J. of Econ., Autumn 1989, at 417-35.

six years, with a review beginning at the end of the fifth year. This is a long enough period of time to ensure that the plan includes sufficient efficiency incentives, but not so long as to incur inordinate risk in a rapidly changing environment.

III. COMMISSION INQUIRIES

In this section U S WEST responds to the specific questions raised in the Commission's NPRM.

A. 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?

Response:

U S WEST agrees with the Commission that the basic goals of price cap regulation remain valid.[52] In adopting price cap regulation for LECs in 1990, the Commission's purpose was to replace a "cost-plus" system of regulation with a much more economically efficient form of regulation -- price cap regulation -- and to ensure that LEC prices were reasonable and nondiscriminatory.[53] In doing so, the Commission hoped to encourage LECs to modernize their networks, deploy new technologies and offer new services. As the Commission has noted

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[52] NPRM ¶ 33.

[53] Price Cap Order, 5 FCC Rcd. at 6787 ¶¶ 1-4.

in its NPRM, price cap regulation has largely lived up to expectations.[54]

U S WEST also agrees with the Commission that the price cap goals need to be refined. However, U S WEST does not believe that the basic price cap objectives need to be expanded or supplemented. Price cap regulation is based on the premise that the public interest will be served if LECs have incentives which are as close to free-market incentives as possible. Incentives will be distorted and overall efficiency harmed if the Commission attempts to modify the LEC price cap plan to serve important societal goals such as increasing employment or improving education. Price cap regulation as we know it today is already too complex. If the Commission expands the goals of price caps, it should refrain from making modifications to the plan in an attempt to achieve these goals. Rather than expanding the primary goals, the Commission should concentrate its efforts on removing the remaining inefficiencies and distortions in the current plan.[55]

The Commission has a "success on its hands" with price caps; it should take great care not to let this success slip through its hands by trying to modify price cap regulation to solve a wide range of industry and societal problems. U S WEST believes the goals of this proceeding should be simple:

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[54]NPRM ¶¶ 25-30.

[55]This does not mean that U S WEST does not believe that a more efficient price cap plan will not increase overall employment -- it will -- or that infrastructure investment is not important -- it is. The point is that if the Commission increases existing price cap incentives, increased employment and additional infrastructure investment will be a natural result.

- to remove the last remnants of rate of return regulation from price cap regulation;
- to modify the price cap plan to accommodate competition in those areas where it exists or is evolving; and
- to streamline the rules for introducing new services.

These goals are refinements of the Commission's original goals. Modifying the price cap plan to accommodate these goals would serve the public interest by increasing the efficiency incentives of the current plan.

B. 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 creating 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.

Response:

As the Commission has observed, under the existing price cap plan, LECs have made substantial reductions in access prices,[56]

[56]U S WEST has decreased prices approximately $310 million since Jan. 1, 1991.

continued their ongoing investment in the network infrastructure,[57] deployed new services and technologies,[58] continued to make progress on universal service, and maintained service quality. Each of these achievements by LECs positively influences the overall economy of the United States. The importance of telecommunications to the economy has been addressed by Professor Robert Harris:

> Perhaps even more important than its direct contribution to economic input, telecommunications has made enormous contributions to the performance of user industries. Because telecommunications services can greatly improve the productivity and performance of business enterprises, and because the real prices of telecommunications services have been falling, American businesses have been substituting telecommunications for other goods and services. . . . Over the ten years from 1983 through 1993, purchases of telecommunications services grew, as a percentage of total output in the U.S. economy, by nearly 3% per year.[59]

With respect to the future, USTA has commissioned a series of economic studies to evaluate the economic benefits that would result from the adoption of the USTA price cap reform proposals. These studies include:

> The Economic Benefits of Price Cap Reform, by Professor Robert Harris, University of California, Berkeley and Law & Economics Consulting Group -- Provides an economic rationale for the USTA Proposal and the benefits that may be realized by users and providers of access services.

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[57]U S WEST has invested $6.7 billion, an annual average increase of more than 12 percent from 1990's capital expenditures.

[58]Signaling System 7 and ISDN.

[59]USTA Comments at Attachment 2 (Robert G. Harris, The Economic Benefits of LEC Price Cap Reform ("Harris Study") at Appendix A at A-2.

Price Cap Reform, Financial Incentives and LEC Investment, by Larry A. Darby, Darby Associates -- Reviews the impact that regulation has on LEC investment decisions and concludes that the adoption of the USTA Proposal would likely stimulate LEC investment in the public network by five percent in the first year and as much as 15 percent over the next ten years.

Accelerating Investment in the Telecommunications Network -- Impacts on Technology Adoption and Service Quality, by Lawrence K. Vanston, Ph.D., Technology Futures, Inc. -- Reviews the impact increased investment would have on the adoption of new technologies and concludes that the USTA Proposal would lead to more rapid technology adoption which will result in a one percent to three percent annual increase in telecommunications quality of service over the next ten years.

The Economic Impact of Revising the Interstate Price Cap Formula for the LECs, by the WEFA Group -- Compared the results of its standard 10-year forecast with a modified forecast that assumes the Commission adopts the USTA Proposal for price cap review. The WEFA analysis relies on the work of Harris, Darby and Vanston to estimate the benefits that will result from the adoption of the USTA Proposal.

The WEFA model predicts the following economic benefits will result from the adoption of the USTA Proposal:

- Employment will increase by 0.4 percent -- a gain of 510,000 jobs throughout the economy over the next 10 years.
- Gross domestic product is increased by $278 billion over the 10-year forecast period.
- Inflation declines by 0.15 percent on average per year over the 10-year forecast period. As a result of lower inflation, consumers save $582 billion in total consumer expenditures over 10 years. Disposable income increases by $30 billion in 2004.

U S WEST believes that the WEFA forecast is a reasonable view of the kinds of macroeconomic benefits that will result from the Commission's adoption of a price cap plan that incorporates

the incentives inherent in the elimination of sharing, the adoption of a framework that ties the level of pricing flexibility to the level of competition in a particular market, and the reduction in regulatory risk and delay that is currently encountered as LECs introduce new services and technologies.

C. Baseline Issue 1: Infrastructure Development

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.

Response:

No additional modifications need to be incorporated in the price cap plan solely to support the development of a ubiquitous national infrastructure. U S WEST believes that the best way to incent "economic" infrastructure investment under price cap regulation is to: 1) sever the remaining ties to rate of return regulation (i.e., sharing and low-end adjustments); 2) remove competitive services from price caps; and 3) streamline the introduction of new services. Despite the intentions of the Commission, an inordinate amount of time and effort is required to introduce new services. Section 214 applications, Part 69 waivers, and tariff filing and cost support requirements continue to constitute a formidable obstacle to the introduction of new

services.[60] By removing or lessening these barriers to introducing new services, the Commission can encourage infrastructure investments.

As to "uneconomic" infrastructure investment[61] the question remains as to who is going to pay for it and how. One of the problems LECs continually face as they move into a more competitive environment is how to restructure their prices to reflect costs and remove existing "public policy" subsidies.[62] Both LECs and the Commission have struggled with this problem in

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[60]The Section 214 process has turned out to be an even greater obstacle to introducing video dialtone service than was anticipated when the Commission adopted its Video Dialtone Order in August 1992 (In the Matter of 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 (1992), appeals pending sub nom. Mankato Citizens Telephone Co., et al. v. FCC, Nos. 92-1404, et al. (D.C. Cir. Sep. 9, 1992)). Two years later the Commission has not yet approved a general video dialtone service offering.

Similarly, the time required to obtain Commission approval of Part 69 waivers has been inordinate. For example, on Sep. 30, 1991, U S WEST requested a Part 69 waiver in order to establish an information surcharge rate element within the information category. This request was essentially a "me too" waiver and was unopposed. Despite the simplicity of the request and the lack of opposition, the waiver was not granted until six months later on Mar. 27, 1992 (In the Matter of US West Communications, Inc., Petition for Waiver of Part 69 of the Commission's Rules to Establish an Information Surcharge Element, Order, 7 FCC Rcd. 2139 (1992)).

[61]U S WEST defines "uneconomic" infrastructure investments as investments which may be socially desirable but cannot be justified on economic grounds.

[62]The size of LEC residual interconnection charges after local transport rates were restructured provides a good indication of the magnitude of this problem. The problem of inappropriately assigning costs to achieve social objectives is magnified when LECs are forced to employ unrealistically long service lives for depreciation purposes.

many recent proceedings.[63] The Commission should not exacerbate this already serious problem by revising the price cap plan to encourage socially appealing, but uneconomic, infrastructure investments.

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.

Response:

As stated above, telephone subscribership has increased since price cap regulation was introduced in 1991. Thus, price cap regulation has not had a negative impact on universal service. The goals of universal service, including "providing services of comparable type and quality to all Americans at affordable prices,"[64] are important national objectives which are supported by U S WEST. The present means of supporting universal service, including both explicit support mechanisms and implicit support flows through the LEC pricing structure, are premised on the out-dated assumption of a LEC local monopoly. With increasing competition in the local exchange markets, changes must also be made in the funding mechanisms in order to assure service to high-cost areas and low-income customers. These necessary modifications will require careful analysis of

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[63]Among others -- local transport, depreciation simplification and GSF.

[64]NPRM ¶ 36.

complex social and market conditions which are well beyond the scope of the present price cap review. However, it is clear that it will be easier to maintain the continued provision of universal service to rural and low-income customers if LECs have the freedom to respond to competition in urban areas. The price cap refinements suggested herein would allow LECs this freedom and would, thereby, help to ensure that universal service is preserved.

Baseline Issue 1c:

> [I]nterested parties [are requested to] 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.

Response:

The inquiry in Baseline Issue 1c appears to infer that copper wire and fiber optic cable are mutually exclusive. This is not true. There are circumstances and locations in which U S WEST is still deploying copper wire. Thus, while U S WEST's fiber optic facilities continue to grow at a very rapid rate -- 103 percent increase in fiber sheath kilometers from 1989-1992[65] -- copper wire also has increased, albeit at a much slower rate. Copper sheath kilometers grew by 3.63 percent during the same 1989-1992 period.[66]

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[65] See U S WEST's FCC Reports 43-07, ARMIS Infrastructure Reports for 1989 and 1992.

[66] Id.

With respect to the capacity of copper facilities, U S WEST is not employing signal compression techniques (e.g., ADSL or HDSL) to expand available bandwidth. U S WEST's current plans focus on deploying broadband technologies rather than using signal compression techniques to expand the capacity of metallic facilities.

D. Baseline Issue 2: Composition of Baskets and Bands:

> 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.

Response:

The Commission should revise the existing price cap baskets and service categories/bands. There has been a proliferation of service categories/bands in the period since the adoption of the LEC price cap plan. This has resulted in a price cap structure that is unnecessarily complex and administratively burdensome. This review is an opportune time to revise and simplify the overall structure of price cap baskets and service categories/bands. USTA's access charge restructure proposal both simplifies the current structure and accommodates competition. The Commission should seriously consider the USTA Proposal in this proceeding.

USTA's proposal for basket and band design establishes a framework to adjust the Commission's pricing rules to match the

degree of competition in each access market. This framework has three main elements:

1. the establishment of market areas which correspond to relevant access markets;

2. a trigger mechanism which classifies each market area as an Initial Market Area ("IMA"), Transitional Market Area ("TMA"), or Competitive Market Area ("CMA"), depending on the degree of available alternative supply found in each area -- the proposal includes the criteria on which these triggers would be based; and

3. the pricing rules which would apply in IMAs, TMAs and CMAs -- the more competitive the market area, the greater the flexibility.

Within the switching and transport baskets, sub-indices would be established; these would be called Market Area Band Indices, or MABIs. Services in an IMA would be subject to price caps similar to those in place today. IMA sub-indices would be allowed to increase by five percent or decrease by 10 percent in a given year.[67] New services offered in an IMA would be subject to a 45-day notice period, with a showing that the proposed rates exceed incremental cost.[68]

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[67]U S WEST believes the USTA Proposal is overly conservative in restricting the downward pricing flexibility in IMA and TMA sub-indices. U S WEST believes customers would benefit, and appropriate pricing signals to market entrants would be established, if U S WEST had greater flexibility to lower prices in an IMA or TMA.

[68]IMAs would be established for each zone in a study area. For example, if Colorado had established three zones for special access, there would be three IMAs -- one for each zone. Unlike the current zone plan, which may temporarily result in separate zones for special access and local transport services, U S WEST believes that the initial IMAs in the transport basket should be initialized with local transport and special access services in a single IMA.

Services in a TMA would be subject to similar price cap rules, except that the lower banding restraints would be 15 percent. LECs would also be able to respond to a request for proposal ("RFP") from a customer in a TMA with a contract tailored to the customer's needs. These contracts would be offered under tariff, as AT&T's contracts are today. Tariff notice periods would be shorter than those for services in an IMA.

Services in a CMA would be removed from price cap regulation. Any CMA service could be offered under a customer-specific tariff. However, all CMA services would continue to be regulated as tariffed, Title II services.

The USTA Proposal moves away from the current price cap plan's reliance on service band indices and sub-indices which attempt to control prices for individual services. Instead, the USTA Proposal relies on indices (MABIs) which control the prices of broad categories of services (e.g., switching or transport) within a particular market area. This approach offers several advantages, including: 1) simplifying the price cap mechanics by reducing the number of service band indices and sub-indices; 2) offering greater pricing flexibility within market areas; 3) minimizing the opportunity to cross-subsidize services;[69]

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[69]The USTA Proposal groups a broad category of services (e.g., switching) offered in a given market area (e.g., IMA1, IMA2, IMA3 and TMA). As a result, the proposed structure can better match the level of regulation with the level of competition in a market area. Moreover, this structure also minimizes the opportunity to increase prices in less competitive areas to "cross-subsidize" services offered in more competitive areas.

4) allowing LECs greater freedom to lower prices; and

5) streamlining the introduction of new services.

In order to provide consumers with the full benefit of competition, it is essential that LECs be afforded the opportunity to lower prices in competitive markets. The current plan serves to limit the downward pricing flexibility of LECs. This reduces price cap efficiency and harms customers in low-cost areas. LEC customers in urban, high-density areas are required to pay higher prices for LEC services than they would in the absence of regulation. These inefficient prices effectively establish an "umbrella" under which LEC access competitors price their services. The net result is that customers of both LECs and competitive access providers ("CAP") will pay higher prices.

Another problem with the current plan's reliance on service band indices and sub-indices is the need to develop new indices every time a new service is introduced. In some cases, the resolution of these issues delays the introduction of a new service within the price cap system. For example, U S WEST's Frame Relay Service tariff went into effect on October 12, 1992.[70] The service has yet to be placed within the price cap system. As a result, Frame Relay Service is effectively offered pursuant to traditional rate of return regulation -- with any price change subject to the traditional cost showings. Instead of permitting LECs greater flexibility to deal with new service

[70]U S WEST Tariff FCC No. 1, Transmittal No. 282, filed Aug. 13, 1992.

offerings, the current plan can result in subjecting new services to less flexibility.[71]

E. Baseline Issue 3: Changes in Productivity Factors or Rate Levels

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, commentors 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.

Response:

In determining the level of the productivity offset contained in the original LEC price cap plan, the Commission used total factor productivity ("TFP") for both the telephone industry and U.S. industry as a whole. The LEC price cap productivity offset of 2.8 percent reflected the historical difference between telephone company TFP and that of the overall U.S. economy.

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[71]U S WEST believes the USTA structure should permit LECs to introduce new services without the need to establish new bands and sub-indices for each new service. As is illustrated in Attachment 4, the Commission's establishment of additional price cap bands and indices for many new services has resulted in an incredibly complex maze of indices, sub-indices and bands that can be administered only with the assistance of complex computer simulations.

U S WEST has no quarrel with this approach. The only question is whether the productivity factor should be updated to reflect the experience of price cap LECs since divestiture. U S WEST does not oppose continued use of a 3.3 percent factor, despite the fact that the Christensen study indicates that a lower productivity offset may be justified.[72]

Only limited productivity data was available on the divested LECs when price cap regulation was adopted.[73] Data prior to divestiture was largely influenced by the experience of the Bell System as a whole. With the aggregation of both long distance and local exchange operations, pre-divestiture productivity estimates are of limited applicability in estimating post-divestiture productivity gains for the divested LECs.[74] This uncertainty over LEC productivity levels was the reason the Commission adopted the sharing and low-end adjustments.[75]

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[72]USTA and its members commissioned Christensen and Associates to conduct a TFP study of price cap LECs. This study found that LECs had experienced an average annual TFP growth of 2.6 percent during the 1984-1992 time period. For that same period, the U.S. economy as a whole experienced an average annual growth in TFP of 0.9 percent -- or 1.7 percent less than price cap LECs. Thus, if the original price cap methodology were used, a reduction in the productivity offset would be justified. The Christensen study was conducted using data from Ameritech, Bell Atlantic, BellSouth, GTE, NYNEX, Pacific Telesis, Southern New England Telephone, Southwestern Bell, and U S WEST. The only price cap LECs not included in the study were Sprint (i.e., United Telephone Companies), Lincoln Telephone Company, and Rochester Telephone. TFP Study, Executive Summary at ii.

[73]At the initiation of the price cap proceeding no more than three years' data was available on the LECs divested from AT&T. By the time price cap regulation was implemented in 1991, six years of divested LEC data was available for use in TFP studies.

[74]In fact, the access business, as we know it today, did not exist prior to 1984.

[75]See Price Cap Order, 5 FCC Rcd. at 6801 ¶ 120.

Clearly, these transitional mechanisms are no longer justified or needed. While a productivity offset of 3.3 percent (i.e., including the consumer productivity dividend) represents a formidable challenge to price cap LECs, reducing the productivity offset would provide at least a scintilla of support for continued use of sharing in future price cap plans. As such, U S WEST believes that a better course of action is to leave the productivity factor unchanged and eliminate sharing.

U S WEST is vehemently opposed to a one-time change -- reduction -- in LEC price cap indices. The logic behind this suggestion appears to be the Commission's mistaken belief that "[a]ll the price cap LECs have experienced higher earnings on average under price caps than in earlier periods."[76] Even if this statement were true -- which it is not[77] -- it would not provide a justification for requiring a one-time adjustment in LEC price cap indices.[78]

A one-time reduction in LEC price cap indices is the equivalent of a retroactive recapture of LEC share of efficiency gains under price cap regulation.[79] Not only does such a one-time reduction undermine the incentives in the LEC price cap plan, it sends LECs a message that they should not be too

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[76]NPRM ¶ 44.

[77]Attachment 6, which compares Form 492 interstate rate of return data, demonstrates that this is not an accurate statement.

[78]Nor are changes in interest rates, which are addressed below, a justification for a one-time reduction.

[79]Access customers have already received the benefits of productivity gains, the consumer productivity dividend and any sharing amounts. It would be inequitable to force LECs to retroactively share their efficiency gains with customers.

efficient or their efficiency gains will be subject to a recapture at some time in the future. This concern is further exacerbated by the fact that the Commission continues to measure LEC earnings using traditional rate of return methods and wholly inadequate depreciation rates.[80] Also, those few LECs, such as U S WEST, that selected a 4.3 percent productivity factor in the past would be doubly penalized by a one-time adjustment.[81]

The suggestion that a one-time reduction in LEC price cap indices might be appropriate as a result of LEC earnings levels since the inception of price caps cannot be reconciled with the economic foundations of price cap regulation. Such a one-time adjustment would introduce another "rate of return" overlay into the current price cap plan. This would be a step backward. The Commission should not fool itself -- it cannot have it both ways. The industry will be unable to achieve the efficiency gains that are possible under price cap regulation if the Commission continues to try to restrict LEC earnings through the use of rate of return measures.

The Commission also asks whether it should adopt a mechanism to adjust for changes in interest rates. U S WEST opposes

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[80]The picture of LEC earnings would be quite different, even using traditional rate of return measures, if LECs were allowed to employ realistic depreciation rates. For example, if the Commission had allowed U S WEST to use the same asset lives for regulatory purposes that it currently uses for financial reporting purposes, U S WEST's reported earnings (i.e., rate of return on rate base) over the life of price cap regulation would be approximately 200 basis points less than that reported on Form 492.

[81]Once a LEC adopts a 4.3 percent factor, the effect of the additional 1.0 percent reduction continues for the life of the plan. This effect is compounded if a LEC selects a 4.3 percent factor in subsequent years.

inclusion of such an adjustment in the price cap formula. Any such adjustment would be an exogenous cost adjustment, and the net result would look very much like a rate of return prescription under traditional rate of return regulation. Treating interest rate changes as exogenous costs would be a step backward toward "cost-plus" rate of return regulation. Interest rates are no different than any other endogenous costs and should not be singled out for special treatment. Furthermore, interest rate changes, like any other broad-based economic impact, are reflected in the inflation adjustment factor -- the GNP-PI. Thus, any attempt to adjust the price cap mechanism for interest rate changes would inevitably raise the question of "double counting" since such changes are already reflected in the GNP-PI.

In concluding these comments on interest rate adjustments, U S WEST would be remiss if it did not point out the fact that treating interest rate changes as an exogenous cost introduces a bias into the production functions of telephone companies.[82]

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[82]Economists have developed the concept of a production function to describe the mathematical relationship between a firm's inputs and outputs. For example:

$$Q=f(K,L,M)$$

where:

Q is the output of a particular good during a period;
K represents the cost of capital;
L represents the cost of labor; and
M represents the cost of raw materials.

Production functions are used to predict how a firm will determine the optimal combination of inputs to produce a desired level of output. Production functions are also used to predict how firms will respond to changes in the cost of a particular input -- such as the adoption of regulations that increase the relative cost of one input in the production function.

The fact that the price cap formula would be adjusted to reflect changes in the cost of one input -- the cost of capital or interest -- but not for changes in the cost of labor or other inputs, will distort telephone company decisions on the proper mix of capital, labor and other inputs. It is clear that telephone companies will have an incentive to substitute capital for labor and other inputs if the price cap formula contains an interest rate adjustment. In effect, it is less risky to purchase capital items than other inputs when there is an interest rate adjustment. The net result over time is that LECs will employ fewer employees and use fewer other inputs than they would have in the absence of an interest rate adjustment.[83] This result is at odds with the Commission's proposed goal of "facilitat[ing] economic growth and the creation of jobs for American workers."[84] As such, it would be particularly unwise to adopt a price cap plan which has a bias against the use of labor.

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?

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[83]This is very similar to the Averch-Johnson effect which the Commission referenced in its NPRM in discussing how "'cost-plus' regulation potentially discourages efficient investment." NPRM ¶ 11 & n.2.

[84]NPRM ¶ 33.

Response:

Profits are reasonable as a matter of law since any incremental LEC profits were the result of efficiencies, not higher prices.[85] Under price cap regulation, the relevant question is -- are prices reasonable? U S WEST's prices were not found to be unreasonable at the initiation of price cap regulation.[86] After numerous subsequent reductions under price cap regulation there is no basis for the claim that current prices might be unreasonable.[87]

As to profits, it is a different matter. Clearly, the price cap plan has rewarded LECs for being more efficient. Profit levels for most companies have exceeded the 11.25 percent rate of return which was incorporated into LECs' original price cap rates. Thus, price cap regulation has provided exactly the incentives that the Commission anticipated in its Price Cap Order.[88]

While no one questions that overall profit levels have risen from the 11.25 percent rate of return used to establish initial

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[85] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. 2873, 3299-3300 ¶ 886 nn.1840-41 (1989) ("AT&T Price Cap Order"), citing to Associated Gas Distributors v. FERC, 824 F.2d 981, 1007 (D.C. Cir. 1987), cert. denied, 108 S. Ct. 1468, 1469 (1988); and Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974).

[86] Price Cap Order on Reconsideration, 6 FCC Rcd. at 2731 ¶ 201; Price Cap Order, 5 FCC Rcd. at 6836 ¶ 406.

[87] Since the implementation of price cap regulation, U S WEST has reduced the prices of its interstate access services by approximately $310 million.

[88] Price Cap Order on Reconsideration, 6 FCC Rcd. at 2639 ¶ 2.

price cap rates, there is much debate over the true level of LECs' profits. The Commission's measures of earnings are quite different from those that U S WEST would report if it were allowed to use realistic depreciation rates in calculating regulated earnings.[89] The depreciation rates and service lives of LECs' capital equipment differ significantly from those of nondominant carriers and cable companies. Clearly, with the use of more realistic depreciation practices, LECs would record greater depreciation expense and ultimately have lower rate bases. What the overall impact would be on earnings, as measured by rate of return methods, is unclear over any extended period of time. However, there is no doubt that LECs' earning levels would decline in the near term if LECs were allowed to increase depreciation expense to reflect more realistic service lives.

Baseline Issue 3c:

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

Response:

As discussed in the response to Baseline Issue 3a above, the Commission should use the existing productivity factor. However, if the Commission does conclude that the productivity offset should be changed, it should reflect the difference between LECs' productivity gains and those experienced by the overall U.S. economy. The TFP study conducted by Christensen and Associates

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[89] See supra note 79.

provides an excellent estimate of LECs' productivity change since divestiture.[90] The Commission should use this study if it revises the productivity factor contained in the current LEC price cap plan.

F. 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 should this be done.

Baseline Issue 4b:

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

Response:[91]

The sharing and low-end adjustment mechanisms should be eliminated. These mechanisms are essentially rate of return overlays which dull and distort LEC incentives. The Commission adopted these mechanisms "to compensate for the possibility of an error in the choice of the productivity factor and variations among the different LECs"[92] -- not to regulate LEC earnings. After three years of experience with price cap regulation, there is no justification for continuing to employ these "rate-of-

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[90]TFP Study, Executive Summary at ii.

[91]Also see supra pp. 8-12 for a closely related discussion of sharing.

[92]NPRM ¶ 17.

return" mechanisms in a price cap plan. They only serve to reduce the incentives of price cap regulation. Customers will not be subject to unreasonable prices if the sharing and low-end adjustment mechanisms are eliminated.[93] The price cap plan will continue to ensure that prices are reasonable through the use of a productivity offset, a consumer productivity dividend and other restrictions on LEC pricing behavior (i.e., baskets, service categories and bands).

The research of SPR demonstrates that the existence of sharing significantly reduces efficiency incentives in the LEC price cap plan. SPR estimates that sharing reduces the efficiency incentives in a price cap plan by approximately half of what they would have been otherwise.[94] An indirect but equally troubling aspect of sharing has been its impact on Commission decisions in related proceedings.[95] The Commission has been very reluctant to loosen the regulatory constraints on LECs if there is any possibility that LECs could "manipulate earnings" through the sharing mechanism. While there is little if any basis for this fear, the fact is -- it continues to distort Commission decisions in other proceedings.

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[93]The Commission should not lose sight of the fact that LECs' customers are quite powerful in their own right. AT&T, Sprint and MCI, which account for more than 85 percent of all LECs' access business, exert a significant influence and are not about to allow LECs to engage in unreasonable pricing behavior for any period of time.

[94]See supra note 27.

[95]See supra pp. 9-10, for a discussion of the Commission's actions in the Depreciation Simplification proceeding.