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

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In the Matter of Price Cap Performance Review for Local Exchange Carriers Notice of Proposed Rulemaking	CC Docket 94-1

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REPLY COMMENTS OF BELL ATLANTIC

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TABLE OF CONTENTS

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REPLY COMMENTS OF BELL ATLANTIC[1]

I. Introduction and Summary

Rather than move forward to adapt the current price cap plan for local exchange carriers ("LECs") to rapidly changing and increasingly competitive conditions in the marketplace, some competitors urge the Commission to take giant steps backward. In essence, these competitors urge a full scale return to the outdated rate of return regulatory schemes of old, and an expansion of existing regulatory constraints that impede investment and innovation and deny consumers the benefits of true competition. Not surprisingly, while these competitors are already subject to far fewer regulatory constraints than the LECs, the steps they urge would expand upon the preferential

[1] The Bell Atlantic telephone companies include Bell Atlantic-Delaware, Inc., Bell Atlantic-Washington, D.C., Inc., Bell Atlantic-Maryland, Inc., Bell Atlantic-Pennsylvania, Inc., Bell Atlantic-New Jersey, Inc., Bell Atlantic-Virginia, Inc. and Bell Atlantic-West Virginia, Inc.

treatment they currently enjoy. And it would do so to the detriment of consumers and competition alike.

Rather than catering to the pleas of these competitors for special treatment, the Commission should focus here on modifying its price cap rules to most fully duplicate the incentives and benefits of a truly competitive market. As Dr. Alfred E. Kahn and Dr. James H. Vander Weide explain in their attached affidavits, this will provide LECs with the incentives they need to deploy an advanced infrastructure in a rapidly changing and increasingly risky marketplace, and will deliver to consumers the benefits of true competition. And it will do so by subjecting LECs to the same rules that already apply to their competitors -- <u>not</u> by giving LECs special treatment.

In addition, while adopting an improved price cap plan will promote infrastructure development generally, this proceeding also provides the Commission an opportunity to help ensure that schools, libraries, and health care organizations participate in the benefits that an advanced infrastructure will provide. It should do so by adopting an optional lower productivity offset that LECs can elect in exchange for devoting their resources to targeted, Commission-approved purposes that serve the public interest.

II. Interstate Access Services Already Face Rapidly Increasing Competition

Despite their own presence in the marketplace, a number of competitors make the extraordinary claim that LECs face no competition.[2] In fact, some competitors such as AT&T even go so far as to question whether competition is even feasible.[3] Their arguments ignore reality.

First, the bulk of these commenters focus not on the interstate access services that are the subject of these proceedings, but on the extent to which LECs face competition for basic local exchange services[4] -- services that the LECs are generally forced to provide at artificially low rates to serve universal service objectives. When their focus is corrected, it is apparent that many interstate access services already are fully competitive, and competition for others is steadily increasing.[5] For example, in the limited instances where

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[2] See, e.g., Comments of AT&T at 6-20; Comments of MFS at 32, 37-38; Comments of Time Warner at 7-12.

[3] Comments of AT&T at 15.

[4] See, e.g., Comments of AT&T at 9-14; Comments of MFS at 39-40; Comments of Teleport at 22-23.

[5] E.g., Comments of Bell Atlantic at 3-5, 19-23 (and supporting materials cited therein); see also Robert G. Harris, Reply Report on Price Cap Reforms at 15-23 (attached to USTA Reply Comments) ("Harris Reply Report").

commenters do address the LECs' interstate services -- such as high capacity access and services included in the interexchange basket -- they concede that competition already has produced significant price reductions.[6]

In fact, these very commenters are already competing with LECs for the provision of interstate access services, and are moving aggressively to expand their competitive presence at the same time they seek here to use the regulatory process to their competitive advantage. Interexchange carriers, for example, are expanding their presence in the access business[7] funded in part by pocketing access reductions while increasing

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[6] MCI Comments at 5-6 (conceding that prices have declined in response to competition); Teleport Comments at 5 (conceding that competition for high capacity services has resulted in price cuts); Sprint Comments at 7-8 (conceding that services in the interexchange basket are competitive and should be removed from regulation).

[7] Interexchange carriers already compete for interstate access services through self-supply, and are expanding their presence both directly (as in the case of MCI Metro), and through alliances with a variety of wireless and wireline competitors. See, e.g., Harris Reply Report at 17-19; Bell Atlantic Comments at 5.

their own rates.[8] CAPs, on the other hand, are expanding rapidly with the protection of a regulatorily imposed price umbrella.[9] And cable companies, which already control 50 percent of competitive access revenues, are moving rapidly into local telephone service[10] with the benefit of preferential regulatory treatment.[11]

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[8] Since divestiture, for example, AT&T has passed through only about 80 percent of access reductions from the LECs and pocketed the rest. See Bell Atlantic Comments at 29 & n.95 (and references cited therein). Moreover, despite a continuing decline in access charges, interexchange carriers have increased their prices to residential and small business customers at least twice within the last 12 months alone. See, e.g., "AT&T Raises Long Distance Rates," Wash. Times, at D5 (May 14, 1994); "Long Distance Rates Continue To rise," Telecommunications Alert (March 24, 1994) (15% increase on commercial long distance, second increase in one year). The FCC's Industry Analysis Division found that for the period between March 1993 and March 1994, prices for interstate toll calls increased almost 10%, while inflation increased only 2.5% for the same period. See Trends in Telephone Service, at 7, 8 (May 1994).

[9] See Bell Atlantic Comments at 4 (and sources cited therein); see also, e.g., "Teleport Launches Central N.J. Fiber Optic Net," Reuters News Service (June 20, 1994); Comm. Daily at 7 (June 23, 1994) (Teleport forms joint venture with Times Mirror and TCI to offer local telephone service in Phoenix).

[10] See Bell Atlantic Comments at 4-5 (and sources cited therein); Harris Reply Report at 16-17.

[11] As Bell Atlantic has pointed out previously, examples abound of the preferred treatment that cable operators currently enjoy: cable benefits from pure price caps with no sharing provisions but telephone companies currently do not; cable can set its own depreciation rates subject to the dictates of the market, but telephone companies can not; cable can pass through costs in higher rates that are within its power to control, but telephone companies cannot; and cable stands to benefit from a proposed productivity offset that is more reasonable than the one currently applied to telephone companies. See Petition of Bell Atlantic for Further Reconsideration, MM Dkt Nos. 92-266 and 93-215 at 2-3 (filed May 16, 1994) (and authorities cited therein).

Moreover, the extent of this competition continues to increase rapidly, with major new announcements occurring almost daily in the time since comments were filed.[12] This rapidly changing environment demands a flexible regulatory structure that can adapt to these changes, and that does not artificially favor or handicap one competitor over another.

III. The Commission Should Reject Arguments Urging A Retreat to the Days of Rate of Return Regulation

Some competitors urge the Commission to adopt measures that would effectively result in a full scale return to rate of return regulation, and would destroy any incentive to invest in an advanced infrastructure or to increase efficiency. The result would be to impede investment in an advanced information

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[12] See generally Harris Reply Report at 15-23. To cite a few examples from Bell Atlantic's region, Southwestern Bell announced it will provide local telephone service over its Montgomery County, Maryland cable system, see G. Naik, "Southwestern Bell Plans Phone Service For Its Cable Customers in Sibling's Turf," Wall St. J., at 3 (May 23, 1994); Cox agreed to acquire the Times Mirror cable systems which increases Cox's already significant presence in the Bell Atlantic region, see "Cox Purchase of Times Mirror Cable Said To Position MSO For Telecomm Market," Comm. Daily, at 2 (June 7, 1994); 1994 Cable & Television Factbook at D-1940; and Comcast agreed to purchase Maclean Hunter's cable properties which increases the base of cable properties in Bell Atlantic's region over which it plans to provide telephone service, see "Comcast's $1.27 Billion Bid Is Tops For MacLean Hunter Systems," Comm. Daily, at 1 (June 21, 1994).

infrastructure, as well as the economic development and growth it would produce.[13]

As Drs. Kahn and Vander Weide explain in their attached affidavits,[14] the Commission instead should update its price cap rules to duplicate the incentives and benefits of a competitive market to the fullest extent possible.

A. The Commission Should Adopt Pure Price Caps for LECs Just as it has for AT&T and Cable

As Bell Atlantic and others have pointed out, the sharing and lower bound adjustment mechanisms are holdovers from

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[13] While the more extreme comments go so far as to claim there is no link between regulatory reform and increased investment and economic growth, see Comments of Ad Hoc Telecommunications Users Group at 6-7 and Att. A at 12-28, they are contradicted not only by the extensive record in this proceeding, see, e.g., Robert G. Harris, Economic Benefits of LEC Price Cap Reforms at 2 & Att. A (May 9, 1994) (attached to USTA Comments) ("Harris May 9 Report"); The WEFA Group, The Economic Impact of Revising the Interstate Price Cap Formula, at 1-2 (May 9, 1994); but also by the Council of Economic Advisors, see Executive Office of the President, Council of Economic Advisers, Economic Benefits of the Administration's Legislative Proposals for Telecommunications, at 1-3 (June 14, 1994), the Commerce Department, see, e.g., Testimony of Larry Irving, Assistant Commerce Secretary, Before the Subcommittee on Telecommunications and Finance (January 27, 1994); independent industry organizations, see, e.g., EIA and TIA White Paper, National Information Infrastructure at 6-9 (June 22, 1994), and the Commission itself, see, e.g., NPRM at ¶ 12; Stmt. of Reed E. Hundt Before the Senate Committee on Commerce on S.1822 (Feb. 23, 1994).

[14] See Affidavit of Alfred E. Kahn at ¶¶ 18-28 ("Kahn Aff."); Affidavit of James H. Vander Weide in Support of Reply Comments of Bell Atlantic at ¶ 3 ("Vander Weide Aff.").

rate of return regulation which undermine the very incentives price caps were intended to create.[15]

Nonetheless, some commenters claim that sharing and the prescription of depreciation rates should be retained, while at the same time urging that the lower bound adjustment be eliminated.[16] Remarkably, these commenters would impose on LECs all the risks of a competitive market with none of the benefits, and all the burdens of rate of return regulation with none of the protections.[17] This would have the perverse effect of discouraging investment in the domestic telecommunications infrastructure, and encouraging investment in unregulated and foreign businesses.

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[15] See Comments of Bell Atlantic at 7-12; see also Kahn Aff. at ¶¶ 18-28; Vander Weide Aff. at ¶¶ 12-22.

[16] Comments of AT&T at 36-38; Comments of MCI at 31-32; Comments of Ad Hoc at 24-25. One commenter relies heavily for support on an administrative law judge recommendation in Pennsylvania proposing to include a sharing mechanism in that state's regulatory reform plan. See Ad Hoc Comments at Att. A, pp. 51-52. That recommendation, however, was recently rejected by the full Commission in favor of pure price caps. Bell Atlantic - Pennsylvania, Inc.'s Petition and Plan for Alternative Form of Regulation, Order, at p. 195, No. P-0093075 (Pa. P.U.C. June 28, 1994).

[17] It would do so by denying LECs an opportunity to earn a return in line with the risk involved, while at the same time subjecting LECs to magnified downside risk by eliminating any protection against unreasonably low earnings. See, e.g., Vander Weide Aff. at ¶¶ 16-22.

In contrast, eliminating both the sharing mechanism _and_ the lower bound adjustment (as well as the archaic depreciation practices that go along with them) will provide LECs the same incentives as a competitive market to invest in an advanced infrastructure, while imposing on LECs the full downside risk of loss.[18] It also will provide parity of regulatory treatment with competitors such as AT&T and the cable industry[19] -- something that is critical as these competitors increasingly move into one another's core businesses.

Moreover, claims by opponents that sharing cannot be eliminated because the LECs will "overearn" are wrong.[20] In the first place, mechanisms designed to monitor and control earnings for any purpose are holdovers from rate of return regulation that have no place in a price caps scheme.[21] The Commission itself

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18 _See_ Kahn Aff. at ¶¶ 18-28; Vander Weide Aff. at ¶¶ 16-18.

19 _See_ Kahn Aff. at ¶ 16; Vander Weide Aff. ¶¶ 21, 23-25; Harris Reply Report at 26.

20 _See_, _e.g._, Comments of AT&T at 30; Comments of Ad Hoc at 24-25.

21 The purpose behind price caps is to give LECs an incentive to promote efficiency and innovation by allowing them to keep the benefits of their efforts. Penalizing them for being successful and requiring them to forego some or all of the benefits because of their success destroys these incentives. _See_ Vander Weide Aff. at ¶¶ 16-18; Kahn Aff. at ¶ 20.

apparently recognized this fact when it adopted price cap plans for AT&T and the cable TV industry that contain no such provisions.[22]

But even if LEC earnings are examined, when measured correctly the LECs have consistently _under_- rather than overearned during the price cap period. As Dr. Vander Weide explains, the correct way to measure LEC earnings for purposes of comparison with the Commission's earnings target is to use their _economic_ rates of return[23] -- not accounting returns that have been regulatorily gerrymandered through use of artificially low depreciation rates. Because the Commission's earnings target itself is an _economic_ rate of return number, only the economic return has any real meaning for this purpose.[24] As a result, only the economic return is relevant to determine whether LECs are earning an adequate return as they would be constitutionally entitled to do under traditional regulatory schemes.[25]

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[22] _See_ _Policy and Rules Concerning Rates for Dominant Carriers_, 4 FCC Rcd 2873, ¶¶ 3, 5 (1989) ("AT&T Price Cap Order"); _Implementation of Sections of the Cable Act of 1992 - Rate Regulation_, 8 FCC Rcd 5631, ¶¶ 223-240 (1992).

[23] Vander Weide Aff. at ¶¶ 6-9.

[24] _Id_.

[25] _See generally_ _FPC v. Hope Natural Gas Co._, 320 U.S. 591, 602-603 (1944); _accord_ _Duquesne Light Co. v. Barasch_, 488 U.S. 299, 307 (1989).

In fact, real economic LEC earnings are actually below the level needed to provide an adequate return. As Dr. Vander Weide demonstrates, the average economic return earned by Bell Atlantic during the price cap period was only 8.25 percent, with comparable results for the other price cap LECs.[26] As a result, using a more reasonable -- and economically correct -- measure of earnings, LECs have been earning at a level that would raise serious constitutional issues under a rate of return regulatory scheme.[27]

A comparison to the earnings figures that would result from use of the same depreciation rates as AT&T or the cable industry confirms the extent to which current depreciation practices have artificially inflated LEC earnings compared to their competitors. For example, if Bell Atlantic were permitted to use the same depreciation practices as AT&T, its earning would have averaged only 8.39 percent over the first three years of price caps.[28] And if Bell Atlantic used the same depreciation practices as a group of large publicly traded cable companies, its earnings would have averaged .42 percent.[29] This comparison is particularly revealing given that these competitors

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[26] Id. at ¶ 8.

[27] See supra note 25.

[28] Vander Weide Aff. at ¶ 7.

[29] Id.

increasingly compete with one another using the same types of technologies to provide the same types of services.

By the same token, claims by opponents who urge a one-time adjustment to LEC rates also are wrong.[30] In the first place, such a measure would destroy the very incentives that price caps are designed to create; LECs that failed to become more efficient would be rewarded with higher rates, while those that successfully cut costs and improved efficiency would be denied the benefit of their efforts.[31] But in addition, as Dr. Vander Weide shows, a one-time adjustment here based on an economically correct measure of LEC earnings would actually entitle LECs to raise their prices.[32]

Finally, opponents who argue that the earnings target for the LECs should be lowered also are wrong.[33] While it is true that interest rates are somewhat lower than when price caps first took effect, the intervening period also produced a

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[30] See, e.g., Comments of MCI at 28, Comments of AT&T at 30-33.

[31] Vander Weide Aff. at ¶¶ 12-15; see also Bell Atlantic Comments at 12-13.

[32] Vander Weide Aff. at ¶ 46.

[33] See, e.g., Comments of MCI at 30; Comments of AT&T at 31.

significant increase in the business risk facing the LECs.[34] Competitive pressures have increased steadily for traditional services, and LECs have had to look beyond their traditional regulated services for new business.[35] In particular, LECs have begun the process of upgrading their existing infrastructure to compete head-to-head with the cable industry and others.[36] As a result, LECs face significantly greater risks today than they did in 1990, and this trend will only accelerate.[37]

As Dr. Vander Weide explains, a fundamental flaw in the arguments made by opponents is that they fail to recognize the increasing business risks facing the LECs in both their traditional and new lines of business.[38] When this and other errors are corrected for, the cost to the LECs of attracting capital to finance these businesses is actually higher than the current earnings target.[39]

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[34] Vander Weide Aff. at ¶¶ 31-32; Harris Reply Report at 15-19.

[35] Vander Weide Aff. at ¶¶ 31-32, 35-36; Harris Reply Report at 15-19.

[36] Vander Weide Aff. at ¶ 35.

[37] Id. at ¶¶ 31-32.

[38] Id. at ¶¶ 31-32, 35-36.

[39] Id. at ¶ 42.

B. The Commission Should Adopt a Corrected, Lower Productivity Offset

Some commenters argue that the FCC should increase the productivity offset included in the LEC price cap formula above the current 3.3 percent, and urge an offset as high as 5.9 percent.[40] Ironically, some of the same commenters have urged the use of a lower productivity offset for their own businesses[41] -- despite the fact that they should experience higher future productivity gains than the LECs.[42]

[40] See, e.g., Comments of MCI at 18-27 (5.9%); Comments of Ad Hoc at 21 and Att. A at 58, n.105 and at 59, Table 6 (5.8%); Comments of AT&T at 22-28 (5.47%). Significantly, commenters such as Ad Hoc urging an offset at the top of this range rely heavily on a an ALJ proposal in Pennsylvania that was recently rejected by the full Commission in favor of a lower offset. See supra note 16.

[41] For example, AT&T initially resisted any offset for itself, see Comments of AT&T at 55, CC Dkt No. 87-313 at 55 (filed Oct. 19, 1987), and then argued the offset should not exceed 1.8%, see Comments of AT&T on Further Notice of Proposed Rulemaking at 42-48, CC Dkt No. 87-313 (filed July 26, 1988). Similarly, MCI did not believe an offset was "appropriate or necessary" for interexchange carriers, see Comments of MCI at 33, CC Dkt. No. 87-313 (filed Oct. 19, 1987). And the cable industry has consistently urged a productivity offset of 0% for itself. Comments of NCTA at 31-32, Rate Regulation, MM Dkt No. 93-215 (filed Aug. 25, 1993); Comments of TWE at 41-42, Rate Regulation, MM Dkt. No. 93-215 (filed Aug. 25, 1993).

[42] See Bell Atlantic Comments at 16-17, n.52; see also Harris Reply Report at 26.

More fundamentally, the so-called "studies" that they rely upon are flawed. Both the Commission[43] and some of these same commenters[44] have previously recognized that a total factor productivity study is the correct way to measure productivity. In fact, AT&T has relied in the past on total factor studies performed by the same expert -- Dr. Christensen -- that conducted such a study on behalf of the LECs here.[45] Nonetheless, in an effort to produce their desired result, the commenters here choose to rely instead on indirect measures of LEC productivity that can be manipulated to produce a higher number.

For example, AT&T claims the productivity offset should be increased based on an examination of LEC earnings.[46] But the effect of this would be to return to rate of return regulation through the back door, and to do so erroneously based on a meaningless measure of accounting profits.[47] MCI, on the other

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[43] See AT&T Price Cap Order, 4 FCC Rcd at 2979 (recognizing that "total factor productivity" is the "superior productivity measure").

[44] See, e.g., AT&T Comments at Appendix F, CC Dkt No. 87-313 (filed Oct. 19, 1987).

[45] Id.

[46] AT&T Comments at 22-38 and App. C.

[47] NERA Economic Performance of the LEC Price Cap Plan: Reply Comments, at 33-34 (June 1994) (attached to USTA Reply Comments) ("NERA Reply Study"); Vander Weide Aff. at ¶¶ 12-15.

hand, argues that the studies relied on to set the current offset should be changed to produce a higher result.[48] Its argument was already rejected by the Commission,[49] however, and MCI offers nothing new here. And while use of state specific productivity factors would be inappropriate for use in setting a nationwide offset applicable to interstate services,[50] the unadjusted results of Ad Hoc's own selected group of studies prepared for various parties in state regulatory proceedings would produce a figure lower than the current offset.[51]

In short, the correct way to measure productivity gains is through use of a long term total factor productivity study, and Dr. Christensen's study here shows that an offset for the LECs should be set no higher than 1.7 percent.[52] This figure, moreover, is supported by a wide range of studies which show that

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[48] MCI Comments at 19-27.

[49] See Supplemental Notice of Proposed Rulemaking, CC Dkt No. 87-313 at ¶¶ 82-83 (rel. Mar. 12, 1990)

[50] Id. at ¶ 106, n.191; NERA Reply Study at 10.

[51] NERA Reply Study at 20. While Ad Hoc also argues that the results of these studies should be adjusted upward, it is wrong on this score as well. See infra note 55.

[52] Bell Atlantic Comments at 15; Christensen Study at ii, 2.

the long run average productivity differential between the telecommunications industry and the economy as a whole is 2 percent or less.[53]

Finally, commenters who argue that the productivity differential will increase in the future are wrong.[54] On the contrary, as Bell Atlantic explained in its initial comments, the historical average likely overstates future LEC productivity gains.[55] This is true not only because of the loss of economies of scope as LECs lose business to competition,[56] but also because the economy as a whole is becoming more productive.[57] Since

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[53] NERA Reply Study at 21.

[54] The commenters base their argument on two interrelated claims. First, they claim that technological change will result in productivity gains that exceed the historical average. Ad Hoc Comments at 20-21. Second, they claim that input prices are growing more slowly than the economy as a whole, due in part to changing technology. Id. at 20. But as the Commission has recognized, technology change has been a constant in the telecommunications industry since its inception and its effects are already reflected in the long run historical average. See Supplemental Notice, 5 FCC Rcd 2176 at ¶ 107. In addition, an empirical analysis of the effect of changing technology and the rate at which input prices are growing reveals that there is no foundation for either of these claims. See NERA Reply Report at 17-19.

[55] Bell Atlantic Comments at 15 (and sources cited therein).

[56] Id.

[57] Executive Office of the President, Council of Economic Advisors, Economic Benefits of the Administration's Legislative Proposals for Telecommunications, at 8-9 (June 14, 1994).

these economy wide gains must be deducted out in computing an offset,[58] the result is a corresponding decline in the offset.

C. The Commission Also Should Adopt An Optional Lower Offset To Promote Targeted Spending

Eliminating sharing and adopting a more reasonable offset will strongly promote infrastructure investment generally to the benefit of all consumers. Several commenters, however, also urge the Commission to adopt measures here to provide an incentive to target spending to areas such as education and health care where the public interest benefits could be particularly great.[59]

The best way to do so is to adopt an optional lower productivity offset that the LECs could elect in exchange for devoting the additional revenues they receive as a result to targeted, Commission-approved purposes. This will maintain

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[58] Bell Atlantic Comments at 15; see also Christensen Study at v, 14.

[59] See Comments of the Computer & Communications Industry Assn' at 13-16; Comments of the Council of Chief State School Officers, et al. 3-4; Comments of the American Library Ass'n at 2-3.

pressure on LECs to become more productive, while also providing a strong incentive to pursue socially desirable spending.[60]

D. The Commission Should Reject Use of a Per Line Formula for Carrier Common Line

The interexchange carrier commenters renew arguments they made in earlier proceedings that the 50/50 common line formula should be eliminated in favor of a per line formula.[61] The result would be that the full benefit of any common line growth would accrue to the interexchange carriers -- rather than the half that was intended to go to them under the current formula.[62] These commenters sole argument for making this change, however, is the bald assertion that LECs have no control over common line growth and should receive none of the benefits. This same argument was previously rejected by the Commission,[63]

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[60] Initially, this optional lower offset should be set .5 percent below the generally applicable offset. For example, if the general productivity offset is set equal to the historical average of 1.7 percent, the optional lower offset would be set at 1.2. Based on current interstate revenues of the price cap LECs, this could produce up to $100 million nationwide in the first year alone to be applied based on plans mutually agreed upon by the Commission and individual LECs. And unlike additional access reductions which are pocketed by the interexchange carriers rather than being passed on to consumers, see supra note 8, this spending will directly accrue to the benefit of consumers.

[61] AT&T Comments at 26-27 & App. B; MCI Comments at 35-40.

[62] See Policy and Rules for Dominant Carriers, 5 FCC Rcd 6786, at ¶¶ 69, 73 (1990).

[63] Id.

and these commenters offer nothing new to support their claims here.[64]

In addition, as Bell Atlantic previously explained, the total factor productivity study performed by Dr. Christensen also takes common line growth into account.[65] As a result, the FCC should eliminate the separate common line formula, and apply the same productivity offset that is adopted for other baskets of services.[66]

E. The Commission Should Permit LECs to Pass Through Exogenous Costs to the Same Extent That Its Competitors May Do So

Several commenters claim the FCC should continue its past pattern of denying LECs the ability to pass through many types of costs that are beyond their ability to control.[67] At

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[64] In fact, however, LECs have stimulated increased demand, among other things by pricing below their caps to the tune of a cumulative $1.1 billion. See Harris Reply Report at 13, 28. Moreover, the ability of LECs to influence common line growth is greater now than it was in 1990. As LECs upgrade their existing infrastructure, LECs will be able to provide new services that will stimulate increased common line usage. To the extent the common line formula denies LECs the benefit of this growth, however, it undermines their incentive to do so.

[65] Bell Atlantic Comments at 18 (and sources cited therein); see also Harris Reply Report at 28.

[66] Id.

[67] Comments of MCI at 41-49; Comments of AT&T at 47-52; Comments of Ad Hoc at 25-27. Some of these commenters also claim the Commission should create a separate mechanism to permit third parties to propose exogenous treatment for cost decreases. But the simple fact is that third parties already can and do in response to LECs annual access tariff filings.

the same time, however, competitors of the LECs in the cable industry have sought and in many instances won more lenient rules for themselves.[68] The resulting disparity skews the competitive process by giving cable an artificial advantage in the marketplace.

To address this imbalance, the Commission should adopt a single standard for determining what costs can be passed through as exogenous that applies equally to all price cap regulated entities. Specifically, cost changes that are beyond the control of (and have a disproportionate impact on) the regulated entity should be passed through as exogenous since these are the very costs that would be passed through to consumers in a competitive market.[69] Moreover, this standard should be applied in an even handed manner to produce the same result for all regulated entities.[70]

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[68] See, e.g., Implementation of the Cable Act of 1992 - Rate Regulation, 8 FCC Rcd 5631, 5779 (1993) ("Cable Rate Regulation Order").

[69] Harris May 9 Report at 26.

[70] As a result, to the extent the Commission allows cable companies to pass through exogenous costs such as taxes, franchise fees, and programming costs, see Cable Rate Regulation Order, 8 FCC Rcd 5631, at ¶¶ 241-257, then LECs must be permitted to pass through equivalent types of costs. To cite just one example, equipment costs are no more within the control of LECs than the cost of programming is within the control of cable operators. As a result, if cable can pass through programming costs, LECs should be able to pass through equipment costs.

In addition, the Commission should reject arguments here that the cost of accounting changes should not be treated as exogenous.[71] These arguments fail to recognize that accounting changes required by standards bodies are beyond the control of the LECs, and that they do impose real economic costs.[72] As a result, these same costs would be passed through in a competitive market, and the ability of LECs to pass through these costs as exogenous must be retained.[73]

IV. The Commission Should Provide LECs Greater Pricing Flexibility Now

Some competitors claim that LECs not only should be denied additional pricing flexibility, but that existing constraints should be tightened.[74] In fact, some claim the most competitive services should be subject to the most stringent new constraints.[75]

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71 *See*, *e.g.*, Comments of MCI at 41.

72 Harris May 9 Report at 26.

73 In fact, AT&T has proposed to pass through as exogenous under its price cap plan these and other costs, yet interexchange carriers and others argue LECs should be denied exogenous treatment. For example, AT&T included the cost of accounting changes in its most recent annual access filing, *see* AT&T's 1994 Annual Filing at 7-9 (May 17, 1994) (adjusting price for the impact of SFAS 106 and SFAS 112), and has also adjusted prices to reflect filing fees, *id*. at 9-10. Soon after AT&T adjusted its own prices, the other interexchange carriers followed suit. *See supra* note 8.

74 *See*, *e.g.*, Comments of MCI; comments of AT&T; Comments of MFS Communications; Comments of Teleport.

75 Comments of MCI at 52-56; Comments of MFS at 25-31.

The premise on which these competitors base their entire argument, however, is wrong. They claim LECs should be denied added pricing flexibility for any service until all services, and in particular basic local exchange service, are fully competitive.[76] In the meantime, these competitors would retain the broad discretion to set prices that they have under existing rules.

This type of regulatory favoritism is a prescription for failure.[77] It fails to provide LECs the flexibility they need to compete as new entrants attack the most geographically concentrated and profitable services, while avoiding the high cost services that LECs must provide at artificially low prices for public policy reasons.[78] It also fails to provide consumers the benefits of true competition, and allows access competitors to charge higher than competitive prices under a regulatorily imposed price umbrella.[79]

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[76] Comments of AT&T at 18; Comments of MCI at 55-56.

[77] See Kahn Aff. at ¶¶ 9-17; see also Harris Reply Aff. at 7-10 (describing the harmful effects of regulators' failure to provide the railroads with sufficient pricing flexibility to compete with the trucking industry).

[78] Kahn Aff. at ¶ 11.

[79] Id. at ¶ 12.