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

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JUN 3 0 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

MOTION FOR ACCEPTANCE OF
REPLY COMMENTS

Ad Hoc Telecommunications Users Committee ("Ad Hoc"), by its attorneys, hereby respectfully requests that the Commission accept its Reply Comments in the above-captioned proceeding. The pleading cycle for this proceeding required that interested parties file reply comments on or before June 29, 1994.

However, due to an error by the courier contractor engaged to carry the pleading to the Commission on behalf of Ad Hoc, the Reply Comments were not filed with the Commission, but were instead returned to the offices of Ad Hoc's attorneys. The Reply Comments were prepared for a timely filing with the Commission, and were picked up for delivery from the Ad Hoc's attorney's offices located at 1301 K Street, N.W., ten (10) blocks from the Commission, at 4:50 p.m., on June 29, 1994. Apparently, miscommunication between couriers resulted in the original pleading, with nine (9) copies, being returned to the Ad Hoc's attorneys' offices, rather than being filed with the Commission's Secretary.[1/] Ad Hoc assures the Commission, however, that copies of the Reply Comments were properly served

[1/] Ad Hoc will provide the Commission with Affidavits verifying these facts, should the Commission request it.

in a timely manner on all interested parties who filed Comments in this proceeding and, as a result, no party will be prejudiced by the delay of the Commission's receipt of Ad Hoc's Reply Comments.

Ad Hoc submits that the Commission's acceptance of its Reply Comments is in the public interest. Ad Hoc's Reply Comments address specific matters of critical importance that relate directly to determinations the Commission will make with respect to the price caps review for local exchange carriers.

Accordingly, the undersigned counsel respectfully urges the Commission to accept for full consideration the accompanying Reply Comments.

Respectfully submitted,

Ad Hoc Telecommunications Users Committee

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June 30, 1994

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REPLY COMMENTS OF
THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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June 29, 1994

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SUMMARY

The Commission should strive to refine its LEC price caps rules so that they better simulate the operation of a competitive marketplace. The evidence in this proceeding is clear that the LECs still do not confront effective competition in the access service market. The competition which the LECs confront today and for the foreseeable future is in the nature of fledgling, niche competition. It is not of the kind or level which justifies the *de facto* rate deregulation sought by the LECs in this docket.

The marketplace, not government industrial policy, should define the National Information Infrastructure (NII) and provide the means for building it. Even two of the RBHCs (Ameritech and NYNEX) support the preeminence of the marketplace for infrastructure development purposes. The Ad Hoc Committee fully supports the development of the NII. The Committee, however, objects to LECs having, as a result of a badly specified price caps plan, a preferential, and potentially anticompetitive, position for building of the NII.

Other LECs argue that if the Commission would remove limitations on LEC earnings and the sharing requirements, they would quickly build the NII and thus cause economic growth and job creation. The studies upon which these LECs rely, however, are flawed and unpersuasive. The studies, rely upon assumptions about LEC infrastructure investment levels which are not consistent with historic investment patterns. Moreover, the studies do not establish a cause and effect relationship between

further investment in telecommunications plant in a developed, industrialized country such as the United States and general economic growth. There also is no evidence that allowing the price cap LECs to earn more will produce additional domestic infrastructure investment or that such investment, if it were to occur, would produce greater economic benefit than alternative investments in areas such as education, highways, airports and health care improvement.

Competition, rather than a Commission policy which implicitly favors LECs, is most likely to spawn infrastructure development, innovation and the introduction of services which respond to marketplace demand. The Commission's experience over the last twenty-five years confirms the correctness of this approach, as distinguished from reliance upon *de facto* monopolists to identify and satisfy customer needs. The comments of the LECs provide no reasonable basis for a fundamental shift in approach.

Although they have tried, the LECs have not justified elimination of sharing as a key component of the price caps plan. The LECs would have the Commission believe that they should be allowed to retain indefinitely the benefits of productivity improvements. If as a result of such gains they become more profitable, they assert that their earnings should not be subject to sharing. Apparently, the LECs simply do not understand the operation of competitive markets. In such markets, businesses do not keep productivity gains indefinitely. Competition forces them to give up at least some productivity gains. If they do not, their competitors will underprice them and capture market share. Businesses must surrender productivity gains or perish. The Commission should reject LEC pleas to retain the entire economic benefit of productivity improvements because the price caps regime attempts to simulate the operation of competitive markets.

Additionally, the Communications Act bars the Commission from granting LEC pleas to retain the entire economic benefit of productivity improvements by eliminating the sharing requirement. The price cap plan carefully balances the goal of promoting the more efficient provision of innovative telecommunications service with the statutory requirement that rates for common carrier services be just and reasonable. The general goals of the Communications Act are limited by the more specific requirements of the Act. Recent case law confirms that the Commission may not disregard specific statutory requirements in pursuit of policies which it believes will better serve the general goals of the Act. In this case, the Commission could not reasonably argue that its price caps plan reflects a careful balancing of different goals should it eliminate the sharing requirement. Elimination of sharing would constitute unlawful rate deregulation.

Perhaps of even greater immediate economic importance, is the need to represcribe the industry specific productivity offset (the X factor) to the economy-wide inflation measure which is part of the price caps plan. The X factor should increase from the current level of 3.3% to 5.7% The productivity study on which the LECs rely did not properly account for the fact the LECs' input prices have been rising at a much lower rate than that experienced in the economy as a whole. This difference in input price movement is distinct from measurement of input quantities in a productivity study, and must be separately accounted for. Correction of the LECs' failure to properly account for the industry's lower growth in input prices yields an X factor of 5.7%. An X factor below 5.7% would constitute a massive transfer of wealth from ratepayers to the LECs' shareholders. Additionally, an improperly low X factor would not simulate the operation of a competitive market and would jeopardize emerging competition.

The LECs' request for virtually unfettered pricing flexibility is also without merit. To support this request, LECs advance an "addressability" theory. The addressability theory finds no support in economic literature or antitrust law. Moreover, the theory is not workable, and is not consistent with marketplace reality. With the pricing flexibility which they seek, LECs would be well-positioned to control, and probably prevent, the emergence of competition which could substantially erode their market share and power.

Similarly, the LECs have failed to justify elimination of the cost support requirements for "new services." The average delays which the LECs have experienced in introducing new services have not been excessive, and the Commission's Rules already allow the LECs to attempt to justify a risk premium in proposed rates for new services. Thus, the LECs have incentive to offer new services and the Commission's Rules do not unreasonably impede the introduction of such services.

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REPLY COMMENTS OF
THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

The Ad Hoc Telecommunications Users Committee ("Ad Hoc Committee" or "Committee") hereby replies to the comments submitted by interested parties on the issues raised in the Commission's Notice of Proposed Rulemaking[1/] initiating its fourth year review of the performance of local exchange carriers under price cap regulation.

I. THE BASIC GOALS OF THE LEC PRICE CAP PLAN REMAIN VALID, BUT WILL BE ACHIEVED ONLY IF THE COMMISSION ENSURES THAT PRICE CAPS REGULATION COMES AS CLOSE AS POSSIBLE TO REPLICATING COMPETITION.

Under General Issue 1, the Commission requests comments on whether it should revise the goals of the LEC price cap plan. These goals include ensuring that LEC rates are just, reasonable and nondiscriminatory, and promoting a communications system that offers innovative, high quality services.[2/] The underlying principle of price cap regulation is that "by replicating many of the effects of competition," thereby encouraging price cap LECs to modernize their networks, deploy new technologies, and offer

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1/ In the Matter of Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 94-10, rel. February 16, 1994 (the "NPRM").

2/ NPRM, at para. 31.

new services, these goals will be furthered.[3/] While asserting its belief that the basic goals of the LEC price caps regulatory plan remain valid, and should continue to benefit consumers "in much the same manner as the competitive markets price caps seeks to replicate," the Commission suggested that a "refinement" of these goals might be warranted and, in this regard, that it wished to consider in this fourth year review proceeding "whether the current LEC price cap plan facilitates economic growth and the creation of jobs for American workers."[4/] Accordingly, under General Issue 2, the Commission requested commenters to address the effects 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, and further, to quantify the effects of the existing plan and of possible revisions to the existing plan on consumer welfare, the economy, and the creation of jobs in the future.[5/]

Finally, the Commission expressed its intention to "determine whether the price cap plan furthers the development of the telecommunications infrastructure and services that will be needed in the years ahead"[6/] and, suggesting that the goal of deploying an advanced telecommunications infrastructure may "justify steps to guide LEC investment and other decisions,"

3/ Id.

4/ Id. at para. 33.

5/ Id. at para. 34.

6/ Id.

requested comment under Baseline Issue 1 on "whether and how the LEC price cap plan should be revised to help development of a ubiquitous, national information infrastructure."[7] These goal-related issues, framed as General Issues 1 and 2 and Baseline Issue 1, are closely inter-related and are addressed in this section of the Committee's reply comments collectively.

A. The Commission's Price Cap Goals Are Properly Specified

The basic goals of the LEC price cap regulatory plan, undergirded by the fundamental operating objective of "replicating" competitive markets, remain valid and should not be modified in an effort to achieve national economic employment or production targets or, worse yet, to attempt to "guide LEC investment and other decisions" to direct development of the national information infrastructure. As predicted in the Ad Hoc Committee's initial comments,[8] to some extent the LECs have responded to General Issue 2 with elaborate studies intended to demonstrate the positive impact their investment in the national information infrastructure would have on the nation's economy, depending entirely, of course, on their being given the ability to increase earnings through modification of the existing price caps structure.[9] There are at least several major problems

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[7] Id. at para. 36.

[8] Ad Hoc Committee Comments, at 6.

[9] USTA, for example, submits a study prepared by the WEFA Group which projects wide-spread gains for the economy,
(continued...)

with such studies in general. As further detailed in the Committee's comments, they include: the absence of a clear "cause and effect" relationship between telecommunications infrastructure investment and general economic growth in a mature, highly developed economy such as the United States; and, the need to assess not absolute results but relative gains that might be derived from investment in telecommunications infrastructure as compared with alternative investments (e.g. in education, health, highways, airports, or computer technology) of the same resources.[10/]

The WEFA Group study submitted with USTA's comments suffers from these infirmities as well as other flaws. First, it should be highlighted that the WEFA Study did not respond directly to the Commission's Question in General Issue 2. That question read, "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?"[11/] Rather than respond to this direct question, the entire WEFA

[9/] (...continued) including: housing starts up by almost 30,000 and auto sales increases of over 100,000 units in 2004; balance of trade improvements of almost $6 billion by the same year; an additional 500,000 jobs, spread across all major industry groups, including the service sector, manufacturing, retail and mining; and, an annual inflation rate 0.15 of a percentage point lower on average per year over the next ten years. (USTA Comments, at 100 and Attachment 7, WEFA Group, <u>The Economic Impact of Revising the Interstate Price Cap Formula for the Local Exchange Carriers</u> ("WEFA Study")).

[10/] Ad Hoc Committee Comments, at. 6-9.

[11/] <u>NPRM</u>, at para. 34.

analysis, based on its macroeconometric model, answers an entirely different question: "The WEFA Group has completed an economic impact analysis of revising the interstate price cap formula for the local exchange carriers (LECs)."[12] Thus, the WEFA Study offers no evidence whatsoever regarding the effects of the current plan on the economy over the last three and a half years as requested in General Issue 2. Faced with a question which it could not answer favorably for the LECs, the WEFA Group instead answered a different question. In the task that it did set out to complete, the WEFA Study is also dramatically unsuccessful. The WEFA Study relies upon, but did not independently verify, an unsupported opinion espoused in a second USTA-sponsored study that adoption of the USTA price cap revision plan would stimulate LECs to invest five percent more in the public network than they would otherwise in the first year of the plan, and that the amount of stimulated investment would increase to fifteen percent by the tenth year.[13] Other deficiencies in the WEFA Study include a presumption that network investments are completely undifferentiated and homogeneous (i.e., that a $1 million investment by a price cap LEC operating in rural North Dakota would have the same impact as the same investment by NYNEX in New York City), and the study's failure to consider how the funds used for incremental investments would have impacted the

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[12] WEFA Study, at 1.

[13] WEFA Study, at 5, 7. See, Darby Associates, Price Caps Reform, Financial Incentives and Exchange Carrier Investments (Attachment 3 to USTA Comments), at 24.

economy if given to LEC customers in the form of lower rates. Finally, the WEFA Study, and, indeed, any such projection of national economic benefits to be derived from an enhanced information infrastructure, are flawed to the extent that they assume that the excess profits LECs would earn if their proposed price caps revisions were adopted would, in fact, be invested by the LECs in development of the national information infrastructure. Unfortunately, nothing in the revised price caps structure advocated by the LEC would require such investment, and evidence suggests that investments abroad, or in non-telephone related ventures, might as easily result.[14]

That it would be inadvisable to expand the goals of price cap regulation to include broad economic objectives such as job growth and overall economic productivity is further reflected in the fact that some of the LECs fail to support such an expansion. Thus, although the LEC comments generally support USTA's proposals for specific revisions to the price caps plan (i.e., eliminating the so-called "vestiges" of rate of return regulation, and according LECs additional pricing flexibility), NYNEX, as an example, "believes that the general goals of price caps remain valid" and, while supporting the Administration's goal of constructing a national information infrastructure, appears to acknowledge that attempts to achieve national economic

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[14] See, e.g., discussion concerning RBHC investments at 23 of the Ad Hoc Committee's Comments.

objectives through the LEC price caps plan are overblown.[15] An even more candid approach to this issue is taken by Ameritech which states, in response to Baseline Issue 1:

> The issues of deployment of the national information infrastructure ("NII") and what universal service should look like in the future, however, are much broader than price caps and should be dealt with in a separate docket. Any regulatory changes that come out of that docket could be incorporated into a revised price cap structure at a later time. Ameritech would only note generally that the most economically efficient way to deploy the most advanced services to the most customers is to let the competitive process do the job. The regulatory process is ill-suited to identifying future marketplace needs. Therefore, regulators should refrain from directing the deployment of specific types of advanced technologies or services."[16]

No valid purpose would be served through expansion of the goals of price caps to incorporate national economic objectives.

B. Encouragement Of A Competitive Market Is The Best Means For Development Of A National Information Infrastructure Responsive To Actual Consumer Demand

If anything can be learned from the past twenty five years of telecommunications regulation it is that lower prices, new services, innovation and infrastructure development are most likely to result from regulatory policies that promote competition. Modifying the LEC price cap rules to afford LECs a "leg up" in building the nation's telecommunications infrastructure of the future would reverse the Commission's long standing pro-competitive policies and threaten existing niche

[15] See, NYNEX Comments, at 3.

[16] Ameritech Comments, at 6. (Emphasis supplied).

levels of competition from CAPs in the exchange access market, and would render still-born potential competition from CAPs, cable systems, mobile services providers and others, in what remains today a bottleneck local exchange market.

As discussed in the Ad Hoc Committee's opening comments, because private risk capital and market-based decision making represent the best way to efficiently allocate resources in a market economy, the Commission can most effectively assist in the development of a ubiquitous national information infrastructure by continuing its laudable efforts to promote competition in the local infrastructure.[17/] Neither this Commission, the LECs, nor anyone else can reliably predict what kind of information infrastructure will best and most efficiently satisfy consumer demand. Rather, in the final analysis, consumers will define the demand for broadband and other

[17/] Ad Hoc Committee Comments, at 10-11. The economic validity of this approach is supported by the analysis prepared by Economics and Technology, Inc. (the "ETI Analysis") attached to the Ad Hoc Committee's comments. As shown therein, In a market economy, use of private risk capital and market-based decision making is the most efficient method for allocating society's resources except under very special circumstances; and policies that mandate or encourage centralized monopolistic development of telecommunications infrastructures, whether by private or public entities, can be justified only where one or both of two economic conditions hold true: (1) "natural monopoly" economies of scale and/or scope are sufficient to outweigh dynamic gains available through innovation and competition as well as the societal risks of centralized, non-market based investment decisions; (2) there is insufficient private risk capital available to finance investments required. As demonstrated in the ETI Analysis, neither of these economic conditions apply to the future development of the U.S information infrastructure.

information services and, to the extent feasible, marketplace forces should be allowed to operate so that the competing service providers and alternative technologies proving most efficient in meeting that demand ultimately prevail, thereby defining the parameters of the NII in response to actual demand and marketplace forces rather than according to government fiat or the self-serving preferences of the LECs.

Thus, allowing the LECs to accumulate excessive profits with the idea that they will be thereby enabled, for example, to make the massive investments some of them appear to have decided are necessary to replace existing copper wire pair technology with fiber to the home,[18/] is a fundamentally unsound way to promote development of the national information infrastructure. As stated earlier by the Ad Hoc Committee in its initial comments:

> [I]mplementing price cap plan revisions intended to allow LECs to earn excessive profits with the misguided view that such profits will be employed in development of the NII will only tend to ensure that the LECs will continue to effectively monopolize the local exchange and exchange access markets. By implementing any type of positive, stimulative linkage between the financial constraints of the LEC price cap plan and LEC deployment of advanced network technologies, the Commission would in effect be creating an industrial policy that will take the nation down the road of

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18/ Several pending RBOC applications for Section 214 authority to construct video dialtone facilities exemplify the uneconomic investment problem. See, Ad Hoc Committee Petition to Deny Application of Pacific Bell (W-P-C-6913) filed February 14, 1994; Ad Hoc Committee Petition to Deny Applications of Ameritech (W-P-C-6926 through W-P-C-6930) filed March 11, 1994.

centralized, monopolistic development of the national information infrastructure.[19]

C. **Given Existing Market Conditions, Effectively Replicating A Competitive Market Requires Maintenance Of Constraints On LEC Earnings**

In their comments, the LECs propose a radical "flash cut" from the current hybrid rate-of-return/incentive-based regulation plan to a "pure" price caps plan free of so-called "vestiges" of rate of return regulation. Moreover, they argue that these price cap plan revisions be supplemented by additional rule changes which would give LECs virtually unfettered pricing flexibility.

The Commission should reject the USTA and related LEC proposals. Such proposals, if given effect, would effectively eviscerate the LEC price caps plan, and give LECs free rein to price their services anti-competitively and accumulate excessive profits, removing safeguards vital to replicating competitive market conditions.[20]

At the outset, it bears noting that the LEC position is inherently self-contradictory. On the one hand, the LECs respond to General Issue 2 by describing effusively the beneficial

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[19] Ad Hoc Committee Comments, at 12-13.

[20] It is also apparent from even a cursory review of the NPRM that the Commission does not contemplate inflicting radical surgery on the existing hybrid rate of return/incentive-based regulatory scheme of LEC price caps, and certainly not a "flash cut" to pure price caps. Thus, for example, the Commission seeks comment on "whether to revise the current productivity factor or maximum rate level and the rate of return thresholds in the sharing and low-end adjustment mechanisms." NPRM at para. 35. (Emphasis supplied).

results achieved under the current price caps plan.[21] In the next breath, however, they propose that the Commission turn its back on the experience gleaned under the still relatively new price caps regulatory regime and abandon it altogether for a pure price caps plan. For example, having maintained that the price caps plan has significantly advanced infrastructure deployment and otherwise performed well, USTA argues that the:

> [F]ocus . . . must now shift from a backward-looking review of price caps to a forward-looking assessment of whether the existing plan can accomplish a new and aggressive set of goals for the future. . . . Price caps must, therefore, be modified in order to ensure that it will reflect telecommunication's expanded role in the economy. . . . To achieve [the Clinton Administration's intention to develop a NII] price caps must send the correct market signals to all service providers . . . and must provide the proper incentives to help generate the massive capital investment required by such an effort.[22]

Beyond the essentially vacuous nature of these pronouncements, one might legitimately ask why, if infrastructure development has proceeded apace under the current price caps regime, we are to believe infrastructure development will cease if that regime is not immediately abandoned?

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[21] According to USTA, LECs have continued and, in some cases have accelerated, development of network infrastructure while under price caps. USTA points to the rate of replacement of electromechanical switches with digital switches, and to levels of fiber, ISDN, and SS7 deployment by LECs under price caps regulation. (USTA Comments, p. 14). Similarly, NYNEX reports that under price caps subscribership is up, infrastructure development (fiber, SS7 deployment) has proceeded at a steady pace, and that it has continued to introduce a wide variety of new service. (NYNEX Comments, at 4-10).

[22] USTA Comments, at 19-20.

More importantly, the LECs' request that they be freed from earnings constraints are not consistent with prevailing market conditions which, despite limited inroads achieved by competitive access providers, continue to feature only niche competition in the provision of exchange access services, and virtually no competition in the local exchange market. The Commission should reject such transparent efforts to have it ignore the reality of existing market conditions and embark instead on what may literally be a "forward looking," but nonetheless a blind and essentially mindless, pursuit of a LEC-driven information superhighway.[23/]

As the Commission has recognized, price cap regulations should seek to replicate competitive market conditions. In competitive markets, competition forces companies to continually improve their efficiency. Competitors operating in such markets are not guaranteed enhanced profitability simply because they have become more efficient, but must continue to improve their efficiency to survive. Thus, what the LECs characterize as rate of return "vestiges" in the LEC price caps plan, such as sharing,

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[23/] To provide a veneer of substance to their argument that technology and competitive circumstances have changed sufficiently to warrant completely scrapping the current plan in favor of pure price caps, the LECs misleadingly reference changes occurring over the ten year time frame since the Part 69 interstate access rules were adopted. For example, USTA pleads for "relief from rigid pricing rules that were developed under entirely different market conditions", citing the Commission's 1983 Dkt 78-72 access charge order (USTA Comments, at 42). LEC price cap regulation, of course, has been in effect only since 1991, and the relevant time frame for purposes of this proceeding, therefore, is only four years.

are not inconsistent with a competitive market. In competitive markets, competitors cannot sustain excessive earnings levels and, in effect, are forced to "share" temporarily high earnings which may result, for example, from input price reductions, by lowering prices to their consumers. If they fail to share, they will not survive. The LEC price cap rules should continue to mimic, to the extent possible, the operation of the competitive market by retaining limits such as sharing, on LEC earnings.

1. **LEC Studies Attacking Sharing Are Unpersuasive and Flawed.**

The price cap LECs have taken the position that the sharing and low-end adjustment mechanisms should be entirely eliminated. The LECs contend that the "backstop" protections created by the combination of these mechanisms are no longer necessary, and claim that sharing in particular has several undesirable effects on the incentives faced by carriers and the overall functioning of the regulatory regime.[24] These arguments are not persuasive.

Sharing plays a critical role in maintaining a reasonable balance between the interests of the LECs and their interstate access customers. As explained further below, that balance depends heavily upon the combined effects of the

[24] See, for example, Comments of the United States Telephone Association, at 45-52; Comments of the NYNEX Telephone Companies, at 27-31; Comments of US WEST Communications, at 42-44; Comments of Bell Atlantic, at 7-12; Comments of BellSouth Telecommunications, Inc., at 49-52; Comments of Pacific Bell and Nevada Bell, at 47-49.

productivity offset, including the Consumer Productivity Dividend, and the backstop features of the plan.

The LECs' principal objection to the earnings sharing mechanism is that it allegedly reduces their incentives to make the types of technological and organizational changes that may lead to improved efficiency and productivity. NYNEX claims that "[w]ith sharing, the LECs are permitted to keep only a fraction of their efficiency gains, thereby seriously dulling the LEC's incentives to improve efficiency."[25/] USTA similarly contends that it has shown that "the price cap plan's sharing mechanism severely dampens LEC incentives to operate more efficiently."[26/] The companies assert that doing away with sharing would "dramatically" increase the efficiency incentives created by the price cap plan.[27/]

Several of the LECs have submitted a study by Strategic Policy Research (SPR) that purports to substantiate these claims. The SPR study's conclusions regarding sharing are based on highly idealized comparisons of the efficiency incentives available to a firm operating in (1) an unregulated, competitive market, (2) a "pure" price cap environment, and (3) a price cap system incorporating sharing.[28/] Each scenario is modeled by a single equation that represents the cumulative efficiency gains (i.e., net revenues) that would accrue to the firm over the term of the

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25/ NYNEX Comments, at 28.

26/ USTA Comments, at 45.

27/ See, e.g., NYNEX Comments, at 29.

28/ SPR Study, Appendix ("Measurement of Efficiency Incentives"), at 1-4.

plan. The equation for the "competitive" scenario incorporates the assumption that the competitive firm would retain all of its efficiency gains indefinitely.[29/] The pure price caps equation limits the firm's gains to those made within the terms of the plan, on the grounds that regulators would reset rates to capture 100% of any subsequent gains.[30/] Finally, the equation for price caps assumes that the firm's gains equal the pure price caps scenario results, minus the fraction of gains nominally shared with ratepayers (i.e., 50% under a nominal 50/50 sharing device).[31/] Each of these scenarios is flawed to varying degrees, and in combination these defects have led to results that are misleading and inappropriate to guide the Commission's decision-making.

The most serious defect in the SPR study is the assumption that an unregulated, competitive firm would be able to keep 100% of its efficiency gains indefinitely. This is clearly possible only in the short run: competitive firms are constantly seeking to innovate, improve their efficiency, and reduce their production costs — which is, of course, precisely the types of behavior the price caps system is intended to elicit — and one effect of this activity is to continually erode the gains flowing to any single firm from its particular efficiency measures. While the precise course and timing of this erosion may vary from case to case, there is no basis for ignoring this phenomenon and

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29/ Id. at 2, Equation (1).

30/ Id. at 2, Equation (2).

31/ Id. at 3, Equation (3).

assuming that such gains will be kept indefinitely by the individual firm.

Table 1 illustrates the impact on the SPR results of taking into account the transitory nature of efficiency gains in competitive markets.

TABLE 1

Carriers' Retained Efficiency Incentives Under Sharing Are Significantly Higher Than Shown in SPR Study

	Retained Efficiency Incentives, Relative to Fully Competitive Market	
	Assuming Permanent Gains	Assuming Transitory Gains
Pure Price Cap Plan	35%	86%
Price Cap with Effective 80/20 Sharing (nominal 50/50)	29%	69%
Price Cap with Effective 50/50 Sharing	18%	45%

Notes:

1. All values assume plan with four year term.
2. "Assuming Permanent Gains" uses SPR model as given.
3. All values use SPR assumptions for growth (3%/yr.), discount rate (7%), duration of innovation (8 yrs.)
4. Model for transitory gains includes factor to represent competitive erosion of efficiency gains (see SPR Study, p. 21).

The results in the column labeled "Assuming Permanent Gains" were calculated using the SPR model and assumptions as given,[32] and replicate, for example, SPR's claim that a pure price caps plan

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[32] As explained below, the results labeled "80/20 Sharing" are based on a different sharing fraction than originally assumed by SPR.