of four years' duration would produce only 35% of the efficiency incentives (i.e., gains) accruing to a firm in a nonregulated, competitive environment.[33/] To calculate the values shown in the "Assuming Transitory Gains" column, we added a term to the competitive firm equation (SPR's Equation (1)) to represent the erosion of efficiency gains over time that occurs in a competitive market. This term has the form of the Fisher-Pry technological substitution curve, which has been used to model the dissemination of new technology into a market.[34/] This is reasonable as a first approximation, since we would expect the erosion of a firm's efficiency gains from a particular innovation to roughly track the dissemination of the same or imitative technology into other competing firms' production functions.

Recognizing the impermanence of efficiency gains in this way leads to results significantly different from those generated by SPR: a four-year "pure" price caps plan would produce 86% of the efficiency incentives of the competitive market, and a plan that realized 50/50 sharing would retain fully 45% of the maximum incentive level. While these results are not intended to be definitive, they cast serious doubt on the much lower magnitude incentives that SPR claims for price cap systems.

Moreover, the SPR study's treatment of sharing does not take into account the "no sharing" zone which in the current

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33/ SPR Study at 21, Table 1.

34/ J.C. Fisher and R.H. Pry, " Technological Forecasting and Social Change," Vol. 3, *A Simple Substitution Model of Technological Change*, 1971.

Commission plan extends 100 basis points upward from the benchmark rate of return (i.e., LECs retain all earnings from 11.25% through 12.25% RoR). With this type of sharing arrangement, the sharing with ratepayers may be significantly less than the nominal 50/50 sharing ratio assumed in the SPR model, and in fact, the BOCs have managed to retain fully 80% of their excess earnings during the past three years (See Table 2).

TABLE 2
Sharing Under Price Caps ($000)

	Excess Earnings	Ratepayer Share	% shared with Ratepayers	% Retained by BOCs
1991	$ 95,799	$ 28,798	30.1%	69.9%
1992	$287,978	$ 27,305	9.5%	90.5%
1993	$475,893	$114,726	24.1%	75.9%
Totals	$859,670	$170,829	19.9%	80.1%

When the realized 80/20 sharing ratio is taken into account, the performance of the price caps with sharing scenario is substantially better than claimed by SPR. As shown in the row of Table 1 labelled "Price Cap with 80/20 Effective Sharing," the efficiency gains available to LECs under these conditions may be as high as 70% as those obtainable in a competitive scenario. These results further contradict the parties' claims that sharing greatly undermines the incentives faced by carriers operating under a price caps plan.

2. Elimination of Sharing Under Current Conditions Would Be Unlawful

LEC pleas to be freed from earnings restraints and sharing requirements cannot be accommodated under the Communications Act of 1934, as amended. National telecommunications policy is defined by Congress and the President, as reflected in the Communications Act. The Commission interprets that policy, but its interpretation is constrained by the specific provisions of the Communications Act. Thus, pursuit of the general goals of the Communications Act, as articulated in Section 1 of the Act, is limited by the requirement to enforce other more specific sections which also reflect Congressional intent. Among these specific provisions is Section 201 of the Communications Act which requires that rates for common carrier services be just and reasonable. The Commission has interpreted the just and reasonable standard to mean that,

> [R]ates [must] fall within a 'zone of reasonableness,' an area bounded at the lower end by investor interests in maintaining financial integrity and access to capital markets and at the upper end by consumer interests against non-exploitative rates.

Policy Rules Concerning Rates for Dominant Carriers, (AT&T Price Cap Order), 4 FCC Rcd 2873, 2883-84 (1989), Reconsideration Order, 6 FCC Rcd 665 (1991), remand, 988 F.2d 174 (D.C. Cir., 1992).

The Commission has observed that to fall within the zone of reasonableness, rates must be neither "less than compensatory"

nor "excessive". AT&T Price Cap Order, 4 FCC Rcd 2884, n. 10, citing Jersey Central Power & Light v. FERC, 810 F.2d 1168, 1177-78 (1987); See, also FERC v. Pennzoil Producing, 439 U.S. 508, 517 (1978).

In the LEC Price Cap Order, the Commission sought to balance the statutory requirement that rates for common carrier services be just and reasonable with the goal of encouraging efficiency and reducing the carriers' cost of service. 5 FCC Rcd at 6804.

The Commission struck the balance by opting for price rather than cost-of-service regulation with the possibility of enhanced earnings and by adopting (1) a rate structure (baskets, bands, and service categories); and (2) overall sharing requirements that are keyed to the carriers' earnings. The Court of Appeals found this balancing lawful. National Telephone Cooperative Association v. FCC, 988 F.2d 174, 184 (D.C. Cir., 1993). Abandonment of sharing and realistic limitation on carrier earnings would not constitute a reasonable balance of valid goals, and could not be reconciled with the Commission's earlier reasonings on the need for sharing and earnings limitations. In the LEC Price Caps Order, the Commission stated,

> "In fashioning the backstop plan for LEC price caps, we have sought to balance competing goals. On the one hand, the benefits of increased productivity promised by the price cap program depends upon the creation of new profit incentives for the LECs. A backstop mechanism may dampen the LECs' risks and rewards and thus reduce the incentives of a single "pure" price cap plan. On the other hand, any price cap plan must be

> consistent with the goals of the Communications Act, assuring just and reasonable rates and the continued availability of quality services. A backstop mechanism can help ensure that the plan fairly shares the risks and rewards of future productivity gains between the LECs and customers, even in the unpredictable and unvarying circumstances of future years.

Policy and Rules Concerning Rates for Dominant Carriers (LEC Price Caps Order), 5 FCC Rcd 6786, 6801 (1990). See also paragraphs 145 and 150 of the LEC Price Caps Order. Abandonment of sharing and realistic limitation of carrier earnings would ignore the just and reasonable requirement of Section 201 of the Communications Act. Such action would be an abandonment of rate regulation and would be unlawful under the Communications Act.

3. Modification Or Elimination Of The Sharing Mechanism is Unlikely To Have Any Significant Impact on Price Cap LECs' Investment Decisions.

Several of the LEC parties assert that the sharing mechanism curtails carriers investments in their domestic, regulated operations, and that its modification or elimination would increase the level of those investment. The USTA claims that "[t]he elimination of sharing will improve the incentives to invest domestically, which will spur economic growth."[35/] Bell Atlantic complains that the sharing features "acts as a brake" on these investments, and Southwestern Bell takes a similar position.[36/] In reality, modification or outright abandonment

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35/ USTA Comments, at 46.

36/ Bell Atlantic Comments, at 9, footnote 24; Southwestern Bell Comments, at 44 and 58.

of the sharing mechanism is unlikely to have any discernible impact on the price cap LECs' investment patterns. Under the price caps regime the RBHCs actually increased the proportion of their capital investments made in non-BOC affiliates, relative to the level occurring under traditional rate of return regulation.[37] The widespread pattern of BOC network disinvestment is unlikely to respond to incremental changes to the price caps plan, particularly given the fact that the interstate jurisdiction comprises only one-quarter of the most LECs' regulated operations.[38]

We also take issue with the similar implication of the NYNEX companies' claim that "[t]he sharing mechanism will also encourage investment in the unregulated side of a LEC's business."[39] While we believe that NYNEX exaggerates the magnitude of this effect, we would observe that the unregulated operations of LECS such as NYNEX are precisely the right vehicle for making the types of speculative investments that the LECs wish to make. New investments attributed to a utility's unregulated operations are made - assuming the initial investments and associated costs are properly allocated - at the risk of the utility's shareholders, and not at the risk of ratepayers, and their rewards are distributed accordingly. There

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[37] Ad Hoc Committee Comments, at 23-24; ETI Report at 68.

[38] USTA Comments, at 47, footnote 125.

[39] NYNEX Comments, at 30.

is no assurance of this matching of risks with potential rewards with respect to the LECs regulated investments.[40]

II. ACCURATE CALCULATION OF THE PRODUCTIVITY OFFSET WILL BE THE MOST IMPORTANT ECONOMIC ISSUE OF THIS PROCEEDING.

The Commission's Price Cap Index provides LECs with a rate adjustment mechanism which is intended to protect consumers from high prices, yet replicate competitive market forces to provide carriers with incentives to increase productivity.[41] Pursuant to this Index, rate caps are adjusted based upon a measure of the U.S. economy-wide inflation, or the gross domestic product price index ("GDP-PI"), offset by a factor specifically relevant to the telecommunications industry, known as the "X factor." In addition, the Commission included in the "X factor," an offset of 0.5%, known as the "consumer productivity dividend."[42]

The GDP-PI rate is set by U.S. Department of Commerce. The "consumer productivity dividend," and the balance of the "X factor," however, are established by the Commission. With the opportunity of this proceeding to review where the "X factor" should be set, the Commission will determine an issue of critical

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[40] See, ETI Report, at 30.

[41] Policy and Rules Concerning Rates for Dominant Carriers (hereinafter "Second Report and Order"), 5 FCC Rcd 6786, 6787 (1990).

[42] Second Report and Order, 5 FCC Rcd at 6787. Although the Commission has not amended 47 C.F.R. § 61.44(b), concerning use of the Gross National Product Price Index, Ad Hoc will assume, for this pleading, that because the U.S. Commerce Department is phasing out the GNP-PI in favor of the GDP-PI, that the Commission will also convert, for purposes of the Price Cap Index, to GDP-PI.

economic importance. A reduction in the "X factor" could impose a heavy burden on other (non-telecommunications) sectors of the economy, threaten national competitiveness, diminish investment in adjacent markets which require LEC essential services, and could undermine the future of the U.S. telecommunications infrastructure.[43/]

During the first four years of LEC price caps implementation, the FCC set the "X factor" at 3.3%. In its initial comments to this proceeding, USTA presented a study of LEC productivity (the "Christensen Study") proposing to lower the "X factor" from 3.3% to 1.7%.[44/] USTA's motivation toward lowering the "X factor" to 1.7% is clear: decreasing the "X factor" from 3.3% to 1.7%, as proposed by USTA, results in a direct transfer of wealth from rate-payers to LECs in the amount of 800 million dollars annually. Over a five-year period, the cumulative loss to rate-payers could exceed 12 billion dollars.[45/] Such a windfall in earnings will permit LECs to pursue a variety of pricing, cross-subsidization, and anti-competitive practices that Price Cap regulation was expressly intended to prevent.

[43/] ETI Study, Attachment A, at 16.

[44/] L. Christensen, P. Schoech, and M. Meitzen, "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation," Christensen Associates, submitted as Attachment 6 to the Comments of the United States Telephone Association, CC Docket No. 94-1, released May 9, 1994, at 12.

[45/] ETI Study, Attachment A, at 16.

In contrast with the USTA studies, Ad Hoc and other commenters, argue that the "X factor" should be substantially raised from the Commission's original 3.3%. AT&T and MCI, for example, propose that the "X factor" be increased to 5.47% and 5.9%, respectively.[46] Because Ad Hoc did not have the necessary data pertaining to LEC productivity and inputs, Ad Hoc did not provide a specific numeric increase to the "X factor" in its initial comments to this proceeding. With USTA's recent disclosure of input price data by USTA[47], however, Ad Hoc is now able to provide the analysis necessary to verify that USTA's proposal of a 1.7% "X factor" is far too low, and that the "X factor" should, in fact, be raised to 5.7% with sharing beginning one hundred basis points above the authorized rate of return, or 6.7% with sharing beginning two hundreds basis points above the authorized rate of return.

There are two distinct, yet equally important components to the "X factor:" (i) the productivity offset; and (ii) the input price differential. Because both components represent the economic realities of a competitive marketplace, both must be

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[46] Comments of AT&T at 22, CC Docket No. 94-1, May 9, 1994; and Comments of MCI at 18, CC Docket No. 94-1, May 9, 1994.

[47] The Christensen Study, as filed with USTA comments to this proceeding did not include input price data. Because of this deficiency, Ad Hoc filed its Motion to Compel Production of Supporting Data ("Motion"), on May 27, 1994, to which USTA responded on June 2, 1994, with the requested Supplemental Data (hereinafter "Supplementary Data.") As a result, Ad Hoc withdrew its Motion on June 9, 1994.

included to determine the most accurate computation of the "X factor."[48]

The productivity offset reflects the constant demands that a competitive market exerts on firms to pass on to the consumer, through the prices for goods and services, any gains in productivity.[49] Just as the marketplace will demand that the rewards of improved productivity levels be passed on to the consumer, the marketplace will similarly demand the same rewards of any decreasing input prices necessary to produce a service or product. If a manufacturer is able to produce a product for less because the cost of raw materials or labor has declined, the competitor will be forced by the marketplace to pass on that savings to the consumer to maintain its competitive position in the market.[50] The input price growth, distinct from the productivity offset, measures the actual costs -- the price of labor and materials -- incurred by the LECs in providing their product of telephone service. The costs are comprised of a weighted average of capital, labor and materials, subtracted or offset from the economy-wide rate of inflation, or GDP-PI.[51]

With this proceeding, the Commission now has the opportunity to re-calculate the "X factor" using actual data from LEC productivity and input price growth rates for the post-

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[48] ETI Study, Attachment A, at 1.

[49] ETI Study, Attachment A, at 3.

[50] ETI Study, Attachment A, at 6.

[51] ETI Study, Attachment A, at 7.

divestiture period.[52] This data is contained in the Christensen Study and Supplemental Data and conclusively demonstrates that LEC input prices rose at a pace significantly slower than the economy-wide input prices. Accordingly, the "X factor" should account for this critical difference.

A. THE CHRISTENSEN STUDY PRESENTS AN INSUPPORTABLE AND INACCURATE ANALYSIS OF THE "X FACTOR."

The Christensen Study, submitted as "Attachment 6" to comments by USTA in this proceeding, and relied upon by numerous price cap LECs in their comments in this proceeding,[53] proposes that the "X factor" be lowered from 3.3% to 1.7%.[54] The Christensen Study begins by calculating the LEC productivity growth using measurements of the input units of capital, labor, and materials that are required to produce telephone service. The aggregated weighted average of these three numbers -- 0.9% -- is then offset by the measure of growth in the service actually provided -- 3.5% -- to conclude that LECs experienced a growth in "total factor productivity" during the post-divestiture time period of 2.6%.

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[52] The Christensen Study represents data from Ameritech, Bell Atlantic, BellSouth, GTE, NYNEX, Pacific Telesis, Southern New England Telephone, Southwestern Bell, and U.S. West. [Christensen Study, at i.].

[53] Citations to the Christensen Study appear in comments submitted by: NYNEX Telephone Companies; Southwestern Bell Telephone Company; Bell Atlantic; Rochester Telephone Corporation; BellSouth Telecommunications, Inc.; and GTE Service Corporation.

[54] Christensen Study, at 12.

In determining the productivity offset for LECs, the Christensen Study drew from LEC data measuring productivity in the telecommunications industry. The Christensen Study, however, omitted critical relevant data regarding the input price index in calculating the "X factor." In formulating its 1.7% decrease to the "X factor," the Christensen Study abandons its earlier reliance on actual LEC data when it considers the movement of input prices. Christensen substitutes general U.S. economy-wide figures of input price growth rates for actual LEC input price measurement data. Christensen can then claim that LEC input price growth rate rose at the same pace as economy-wide input prices, 4.6%, or GDP-PI plus the 0.9% economy-wide productivity growth rate.[55/]

Christensen's claim regarding input prices for LECs, however, directly contradicts the industry-specific data which USTA submitted in response to the Ad Hoc Committee's Motion to Compel Supporting Data. The industry-specific data irrefutably shows that LEC input prices rose at a rate of 1.1%, 3.5% below the economy-wide rate.[56/] Moreover, Christensen's methodology of substituting statistics of U.S. economy-wide inputs for LEC industry inputs is refuted in a separate Attachment to the USTA's comments in this proceeding, submitted by the National Economic

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[55/] Christensen Study, at 10.

[56/] USTA Supplementary Data, Table 1.

Research Associates, Inc. ("NERA").[57] The NERA Study notes that the "X factor" should "represent a productivity growth differential between the annual productivity growth of the regulated industry and the U.S. economy, adjusted for differences, if any, between the rate of growth of input prices for the regulated industry and the U.S. as a whole." Further, a footnote to this statement clarifies: "This differential is equal to the difference between the firm and U.S. productivity growth rates if the rates of input price growth are the same for the firm and for the nation." (Emphasis added.)[58] The input price growth rates for LECs and for economy-wide industries are not, however, the same. The data in the Christensen Study and the Supplemental Data prove this.

Returning then to the full "X factor" equation, Christensen uses its assumption that input prices rose at 4.6%, and then subtracts 0.9% from the LEC productivity rate of 2.6% to conclude that the LEC index of rate adjustment should be 1.7%. Christensen's final calculation, however, is fatally flawed by its reliance on estimated input prices that directly contradict -- and inflates by 3.5% -- actual LEC data provided in the Christensen Study and Supplemental Data. Christensen's methodology of using estimated figures to calculate the "X

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[57] National Economic Research Associates, "Economic Performance of the LEC Price Cap Plan" (hereinafter "NERA Study"), Attachment 5 to USTA comments, filed May 9, 1994, CC Docket No. 94-1, at 9.

[58] NERA Study, at 8-9; note 9.

factor" was specifically noted by the Commission as a defect to the "long term historical study" of LEC productivity offset submitted in the Second Report and Order.[59] If the Commission adopts the Christensen Study proposal and lowers the "X factor" to 1.7%, the LECs will realize profits at a rate far greater than a realistic competitive marketplace would allow. If LECs were subject to real competitive pressure, the marketplace would demand that the benefit of the actual adjustment in input prices, rather than an estimate based on nationwide economic standards, be passed on to consumers.

USTA's proposal of a 1.7% "X factor," therefore, contradicts both direct LEC data provided by the Christensen Study and Supplemental Data, as well as the underlying rationale to the Price Caps program which is to "encourage price cap LECs to make economic decisions such as they would make in a fully competitive market."[60] Accordingly, USTA's proposal to lower the "X factor" is insupportable and must be dismissed.

B. RELIABLE METHODOLOGY AND DATA SUPPORTS A MINIMUM "X FACTOR" OF 5.7%.

Pursuant to the Commission's intent to "design a regulatory system that mirrors the efficiency of incentives found in competitive markets, [and] put in place [a Price Cap Index]

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[59] Second Report and Order, 5 FCC Rcd at 6798, where the Commission refused to rely solely on the long-term historical study conducted by FCC staff: "this study also requires assumptions and estimation, for example, to derive interstate productivity from the total industry numbers."

[60] NPRM, at 31.

that will go a long way toward making the LECs stronger, more productive competitors for all of the markets in which they must operate,"[61] the Commission must include representation of all the components to a competitive marketplace in its formula of an "X factor." Thus, the correct calculation must be: the historic post-divestiture LEC productivity growth rate plus a LEC input price differential, plus the appropriate "consumer productivity dividend."

With the LEC data provided by the Christensen Study, the "X factor" formula becomes: a 2.6% productivity factor growth, plus 2.6% input price differential, plus a 0.5% "consumer productivity dividend" with sharing beginning one hundred basis points above the authorized rate of return, or 1.5% with sharing beginning two hundred basis points above the authorized rate of return. The minimum "X factor" for the LEC price cap system must be, therefore, 5.7%. Any value below 5.7% would constitute a direct transfer of wealth from ratepayers to LECs, undermining the policy of price cap regulation, as articulated by the Commission: "to produce lower rates and improved services benefitting customers as well as society and the many businesses that use telecommunications to produce goods and services."[62]

III. THE LECS PROFIT LEVELS HAVE NOT BEEN TOO LOW.

The price cap LECs have not justified the claim that their profit levels under the price cap regime have been too low. USTA

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[61] Second Report and Order, 5 FCC Rcd at 6790.

[62] NPRM, at 2.

claims that LEC earnings have been comparable to those of AT&T, despite differences in depreciation rates that would have depressed AT&T's booked earnings levels.[63] Several LECs contend that their nominal rates of return would have been several hundred basis points lower if "more realistic" and presumably, higher depreciation rates had been permitted.[64]

Contrary to these assertions, LECs' depreciation rates have not been kept artificially low by regulators. As explained in the ETI Study (Attachment A), several of the RBHCs that are alleging that their depreciation rates are too low have nevertheless committed capital to their operating companies at rates <u>even lower</u>, leading to a net disinvestment in their networks.[65] For example, the Pacific Telesis operating companies, Pacific Bell and Nevada Bell, failed to make any net investment in their networks from 1987 through 1991.[66] During this period, however, Pacific Bell sought to increase its depreciation rates and charges during each of the triennial depreciation reviews in 1988 and 1991, arguing that it needed greater cash flow to support accelerated modernization of its network. In the 1988 review, Pacific Bell proposed to increase its annual depreciation accruals by $364.45 million;[67] in the 1991 review, the company proposed $221.1 million in additional

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[63] USTA Comments, at 16.

[64] <u>Id.</u> at 16; Ameritech Comments, at 13; US West Comments, at 41; Pacific/Nevada Bell Comments, at 29-31.

[65] ETI Study, at 67.

[66] <u>Id.</u> at 67.

[67] Pacific Bell Depreciation Study, December 1987, Preface at ii.

depreciation accruals.[68] The disparity in this and other similar cases belies the carriers' claims that their depreciation rates are too low. Consequently, it also invalidates their claims that their excessive booked rates of return are unrepresentative of their actual profitability.

The facts are that under price caps the RBHCs have remained highly profitable companies and extremely attractive to investors. The RBHCs themselves do not deny that their booked earnings have increased every year under price caps.[69] As shown in Table 3, each of the RBHCS continues to be rated as having below-average risk, with a Beta (volatility measure) of less than 1.0, while they enjoy the highest bond ratings awarded by the investment community.

TABLE 3
RBHCs' Financial Strength

	Value Line Rating	Value Line Beta	Moody's Bond Rating
Ameritech	A+	0.75	Aa2
Bell Atlantic	A+	0.90	A1
BellSouth	A+	0.80	Aa1
NYNEX	A+	0.80	A2
Pacific Telesis	A+	0.90	Aa3
Southwestern Bell	A+	0.95	A2
US West	A+	0.80	A3

Source: Value Line Investor's Survey, April 15, 1994 and Moody's Public Utility Manual, 1993.

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[68] Pacific Bell Study, June 1991, Section 1 at 1.

[69] Pacific/Nevada Bell Comments, at 31.

IV. THE LECS HAVE NOT SUPPLIED ANY ARGUMENTS OR EVIDENCE THAT REFUTE MORE NARROWED TREATMENT OF EXOGENOUS COSTS.

Most of the price cap LECs strongly oppose any narrowing of the scope of allowable exogenous cost changes.[70] For example, USTA contends that because the initial price cap rates were based on "accounting costs," any subsequent accounting changes would have to be reflected in the price cap.[71] Ameritech echoes this argument, and opines that "[t]he purpose of exogenous cost adjustments is to permit LECs to recover increases in costs that are beyond their control and to deny them the benefits of cost reductions that they could not have influenced."[72]

None of the LECs' arguments or evidence undercuts the position set forth in the Committee's initial Comments.[73] The only costs that should be considered for exogenous treatment should be economic costs that are directly attributable to regulatory actions that specifically and uniquely affect local exchange carriers. This approach would not prohibit the application of an exogenous adjustment to reflect jurisdictional separations changes, for example (as feared by USTA), but would screen out many of the ill-defined, contentious, and exceedingly difficult to quantify cost changes that have been proposed under

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[70] See, for example, USTA Comments, at 85-86; Ameritech Comments, at 18-19; Pacific/Nevada Bell Comments, at 52-55; Southwestern Bell Comments, at 51-54. In contrast, US West calls for the elimination of the exogenous adjustment mechanism entirely. US West Comments, at 18-19, 44-45.

[71] USTA Comments, at 86.

[72] Ameritech Comments, at 19.

[73] Ad Hoc Comments, at 25-27; ETI Report, at 78-83.

the existing rules, such as changes in tax laws or compliance with new OSHA regulations.

Moreover, narrowing the scope of possible exogenous changes in the manner recommended would limit the bias in the exogenous event identification process toward upward cost impacts. While USTA claims that the net effect of exogenous adjustments has been to lower LEC rates under the price cap plan,[74] the Commission should bear in mind that some of the largest adjustments were initially unreported by the BOCs and had to be pursued by the Common Carrier Bureau.[75]

Finally, the Ad Hoc Committee must strongly disagree with Ameritech's characterization of the exogenous cost adjustment process as a means to insulate LECs from all events beyond their control. In order for the price caps system to come as close as possible to the "competitive result" obtained in non-regulated industries, the operative principle for evaluating exogenous adjustments has to be the response that would been made by a comparable nonregulated firm in a competitive industry.[76]

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[74] USTA Comments, at 88 and Attachment 10.

[75] Six Price Cap LECs failed to make proper exogenous cost adjustments to reflect completion of reserve deficiency amortizations in their price cap filings. "1992 Annual Access Tariff Filings," CC Docket No. 92-141, released June 22, 1992, paras. 29-34.

[76] See, ETI Report, at 78-79 and 81-82.

V. THE COMMISSION SHOULD NOT ADOPT THE LECS PROPOSALS FOR VIRTUAL ELIMINATION OF RATE STRUCTURE RULES AND UNFETTERED "NEW SERVICE " PRICING FLEXIBILITY

USTA and the RBHCs argue in their comments that competition already exists and that competitive alternatives are growing.[77] They urge the adoption of the USTA proposal for market-based pricing flexibility as a means of allowing them to respond to this perceived competition. USTA's proposal involves a "three tier market structure consisting of Initial Market Areas (IMAs), Transitional Market Areas (TMAs) and Competitive Market Areas (CMAs)."[78] Under the USTA proposal, market areas (consisting of wire centers or groups of wire centers) would be classified based on the level of market power exerted by the LEC. The USTA proposal would eliminate the rate structure (baskets, service categories and bands) segments of the Commission's access charge rules, except for "Public Policy" rate elements.

USTA urges use of the concept of addressability, which is based on "physical presence of alternative providers, to assess LEC market power."[79] Under this theory, the determination of whether a LEC possesses market power is based on "...the proportion of access demand in a market area that is 'addressable' by alternative providers" or where "...an

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[77] USTA Comments, at 33-39.

[78] Id.

[79] Id.

alternative provider must already have facilities that can readily extend service to the customer upon request."[80]

USTA proposes that "[a] wire center or group of wire centers within an IMA could be reclassified as a TMA based upon the presence of substitutable access services from another source as determined from information filed with the Commission."[81] According to USTA, this could be shown by "...the existence of an operational expanded interconnection arrangement within the wire center" or "...the offering of a substitutable access service by a CAP, IXC, cable television operator, cellular or PCS provider, private carrier, microwave carrier or other entity within the geographic area served by the wire center."[82] Further, a TMA could also be reclassified as a CMA if (1) "customers within the serving area of the wire center representing at least 25 percent of the demand for the local exchange carrier's interstate access services, or 20 percent of the total market demand of interstate access services within that area, have available to them an alternative source of supply," and (2) those customers or "a single customer whose demand represents at least 15 percent of that total, actively seek to reduce the cost of their access services through the solicitation of bids, use of private networks, or construction of their own facilities."[83]

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[80] Id.

[81] Id.

[82] Id.

[83] Id.

The conceptual basis for USTA's market power classification criteria, the theory of "addressability," has no foundation in economic literature or in antitrust cases. Further, of all the expert documents provided by USTA to address and support its proposal, none provides evidence or citations to the literature in support of the concept of "addressability."[84/] Like the LECs' earlier and largely discredited "pet" theory – "contestability"[85/] – addressability does not examine the actual capability of other suppliers to engage in effective competition with the incumbent LEC. Stripped of its needlessly complex and confusing details, the USTA proposal is simply another attempt by the price cap LECs to reduce regulation to a minimum and give them the freedom to eliminate fledgling competition.

84/ See, for example, "Economic Benefits of LEC Price Cap Reforms," by Robert G. Harris, May 9, 1994, Attachment 2 to USTA's Comments, at 29-30 (Dr. Harris ignores all the economic literature of Industrial Organization which establishes the importance of market share and other structural measures of market power such as the widely accepted Structure-Conduct-Performance paradigm Drs. Schmalensee and Taylor agree, contrary to USTA, with the basic structural criteria in which market share is one important factor to consider when measuring market power; "Comments on the USTA Pricing Flexibility Proposal," by Richard Schmalensee and William Taylor, Attachment 4 to USTA's Comments, at 4. USTA also fails to establish addressability as an indicator of market alternative suppliers and customers. "Competitive market Area Demonstration and Data Reporting Requirements," USTA Position Paper, Attachment 9, at 11-12 and at 58.

85/ See, for example, "Contestability vs. Competition," by William G. Shepherd, The American Economic Review, Vol. 74, September 1984; and "Competitive Market Area Demonstration and Data Reporting Requirements," USTA Position Paper, Attachment 9 at 11.

The LECs provide no useful information on when "substitutable access service from another source" would be found to be present. Such information would be a prerequisite to even considering reclassification of a wire center or group of wire centers within an IMA as TMAs. According to USTA, the necessary information would be filed with the Commission. But what is the information? When would a service available from another source be a "substitutable access service?" It appears highly likely that USTA is asserting that a wide variety of services would qualify as "substitutable access service." Would USTA consider cellular or PCS service to be substitutable for switched accessed service, regardless of the relative prices and without regard to penetration levels? Would USTA argue that CAP-provided T-1 service be substitutable for switched access service or lower speed access service? Inferentially, the answer to these questions seems to be "yes." Should that be the case, USTA's proposal is preposterous on its face.

The LECs also fail to explain to any degree how their addressability proposal could be accommodated in the context of a price cap plan which limits earnings. If and when market areas were reclassified as CMAs, the costs associated with such market areas should become "below the line" costs. The Commission's rules, however, do not require that costs be tracked to a wire center or a group of wire centers. LECs presumably would be required to perform special cost studies to identify the wire center costs to be removed from regulated services costs for

purposes of calculating return and sharing responsibility. Of course, such cost studies would be unnecessary if the Commission eliminates any restraints on LEC earnings. As explained elsewhere in these reply comments, such a Commission decision would be unlawful.

The cost study problem would be even more difficult if only a portion of the costs attributable to a wire center or group of wire centers are removed as CMA costs. USTA envisions this possibility, for it states that, "[L]ECs may satisfy the CMA criteria for access services originating or terminating within a wire center for one or more access categories."[86/]

The LECs proposal that classification of market areas as TMAs or CMAs occur within the context of LEC tariff filings is unrealistic or confirms that the market area classification scheme is predicated on amendment to the price cap rules to eliminate any earnings restraints. The filings that attempt to reclassify market areas will draw vigorous protest. The Commission will not be able to resolve the disputes within the public notice periods for tariff filings. Subsequent investigations will quickly consume the Commission's scarce resources, or encounter long delays not permitted under the Communications Act.[87/] In addition to the classification issues, investigation of cost allocations would also be required.

[86/] USTA comments, n.172.

[87/] Section 204(a)(2)(A) of the Communications Act requires that investigations of tariff revisions be concluded not later than 15 months after initiation of such investigations.

Moreover, the LECs' statement that competitive alternatives for access service can be shown by the, "existence of operational expanded interconnection arrangements within the wire center," has little, or no, meaning in light of the Court of Appeals' ruling vacating the Commission's physical collocation requirement and remanding for further Commission proceedings the virtual collocation requirement.[88/] Whether the Commission can effectively promote the growth of competition in the access service market through expanded interconnection is now very much in doubt. LECs challenged the Commission's expanded interconnection policies and requirements and now cannot ignore the effect of their challenge. The LECs' successful appellate challenge to expanded interconnection will hamper the development of competition in the access service market and undermines their addressability proposal.

The LECs' addressability proposal is bad economics, bad public policy and bad law. It is an administrative sink hole. The Commission should not even seriously consider the addressability proposal, and certainly should not adopt it.

USTA also argues that,

> Because [its] proposal eliminates service category codification as defined by the existing Part 69 rules, the current price cap basket structure is no longer appropriate.[89/]

[88/] Bell Atlantic Telephone Companies v. FCC, DC Cir. No. 92-1619, June 10, 1994.

[89/] USTA Comments, at 66-67.