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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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November 3, 1994

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street NW
Washington, D.C. 20554

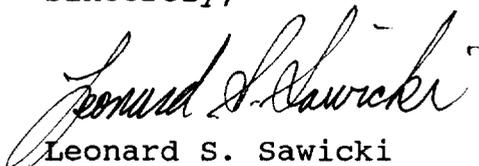
DOCKET FILE COPY ORIGINAL

Re: CC Docket 94-1; Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

Today, members of Customers for Access Rate Equity (CARE) met with Karen Brinkman of Chairman Hundt's staff. Representing CARE were James Blaszk (Ad Hoc Telecommunications Committee), Richard Clark and Bruce Cox (AT&T), Doug Jarrett (API), Brian Moir (ICA), Bradley Stillman (CFA), Debbie Berlyn (NASUCA) and I. The purpose of the meeting was to review CARE's views on this proceeding. The attached information was used during the meeting and the specific topics discussed are listed there.

Sincerely,


Leonard S. Sawicki

Attachments

cc: Ms. Brinkman

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PRICE CAP REGULATION OF THE
LOCAL EXCHANGE CARRIERS FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

PRICE CAP REGULATION OF THE LOCAL EXCHANGE CARRIERS

Federal Communications Commission

CC Docket No. 87-313

Second Report and Order

(October 4, 1990)

Order on Reconsideration

(April 17, 1991)

Prepared by: *Customers for Access Rate Equity*

October 12, 1994

**PRICE CAP REGULATION OF THE
LOCAL EXCHANGE CARRIERS**

VITAL STATISTICS

WHO: Mandatory for the seven RBOCs and GTE
Optional for all other LECs (has been elected by:
SNET, Lincoln, Rochester, United and Centel)

WHAT: All LEC interstate access services

- Switched access
- Special access

All LEC interstate interexchange services

Excluded services:

- One-time or contract-type services
- ICBs, special construction tariffs,
government contracts, etc.

WHEN: January 1, 1991

WHY:

- To improve productivity and efficiency
- Reduce rates to customers
- Simplify regulatory burdens
- Encourage network modernization and
new services

**PRICE CAP REGULATION OF THE
LOCAL EXCHANGE CARRIERS**

PRICING CONSTRAINTS

- LEC interstate services divided into four baskets
- Each basket must be priced at or below its cap
- No service's price within a basket may vary more than +5% / -5% from its previous year's value (adjusted for changes in the basket's cap)

| <u>Baskets</u> | <u>Service Categories</u> |
|-----------------------|---|
| Common Line | None |
| Traffic Sensitive | Local Switching Local Transport Information |
| Special Access | Voice grade, WATS, Metallic, and Telegraph Audio and Video HiCap and DDS - DS1 - DS3 Wideband Analog and Data |
| Interexchange | None |

PRICE CAP INDEX (PCI) ADJUSTMENTS

The average prices charged within each basket (adjusted for exogenous cost changes) may not rise faster than the rate of inflation (GNP-PI) minus a productivity factor (X).

Prices in the Common Line basket have a further adjustment to reflect partially the automatic reduction in common line cost-per-minute that occurs because of growth in minutes of use per access line (g).

GNP-PI: Growth rate in the GNP fixed weight price index

X : Productivity factor
3.3% with standard sharing restrictions
4.3% with looser sharing restrictions
(Because several LEC's have intermittently selected the optional 4.3% factor, the average effective X has been about 3.5%)

g : Growth rate of access minutes per line

COST CLASSIFICATIONS

Endogenous

- Tax law changes
- Equal access costs (ongoing)
- Depreciation rates
- AT&T POP migration

Exogenous

- Separations changes
- USOA / GAAP changes (once FASB has approved)
- Transitional and Long Term support
- Reallocation of regulated and unregulated costs
- Expiration of reserve deficiency amortizations
- Access charges for interexchange service

**PRICE CAP REGULATION OF THE
LOCAL EXCHANGE CARRIERS**

SHARING

- LECs must "share" certain portions of their earnings in excess of 11.25% with customers
- If a LEC elects an $X = 3.3\%$, then:
 - No sharing zone is 1%
 - 50/50 sharing of revenues earned between 12.25% and 16.25%
 - 100% sharing beyond 16.25%
- If a LEC elects an $X = 4.3\%$, then:
 - No sharing zone is 2%
 - 50/50 sharing of revenues earned between 13.25% and 17.25%
 - 100% sharing beyond 17.25%
- "Shared" dollars are returned to customers via a temporary, one-year downward adjustment to PCIs
- If a LEC's earnings have been below 10.25%, the next tariff period's PCI is adjusted upward to yield 10.25%
- Shared amounts are based on a LEC's total interstate earnings reported on Form 492s

**PRICE CAP REGULATION OF THE
LOCAL EXCHANGE CARRIERS**

TARIFF REVIEW STANDARDS

Streamlined (presumed lawful) for:

- Within cap and band (14-day notice)
- Within cap, but below band (45-day notice plus average variable cost showing)
- New services (45-day notice plus cost support)

Not streamlined (not presumed lawful, substantial cost support required) for:

- Within cap, but above band (90-day notice)
- Above cap (90-day notice plus likely suspension)
- Restructured services (45-day notice)

Initial Price Cap prices on January 1, 1991

- Will match 12/31/90 ROR-based prices adjusted downward to reflect new 11.25% ROR

**PRICE CAP REGULATION OF THE
LOCAL EXCHANGE CARRIERS**

REVIEWS AND REPORTS

- Comprehensive performance review to begin 1/1/94
and to be completed by 12/31/94
- Semi-annual service quality reports from
RBOCs and GTE
- Quarterly reports on:
 - installation and repair intervals
 - blocking percentages
 - post-dial delay
 - switch downtime
- Annual reports on investment in:
 - infrastructure
 - research and development
- Data aggregation is at the Study Area level
- No performance standards promulgated

**PRICE CAP REGULATION OF THE
LOCAL EXCHANGE CARRIERS**

UPDATES

- Orders on Expanded Interconnection
(CC Dkt. No. 91-141)
 - instituted zone density pricing for DS1 and DS3 services used for special and switched transport
 - permitted LEC to deaverage these prices by creating up to three zones per study area
 - allowed pricing flexibility of +5% / -10% per zone

- Order on Local Transport Restructure
(CC Dkt. No. 91-213)
 - removed all Local Transport services from the Traffic Sensitive basket
 - created new Trunking basket by combining removed Local Transport with Special Access

**LEC PRICE CAPS:
UNDERSTANDING AN \$8.2
BILLION ISSUE**

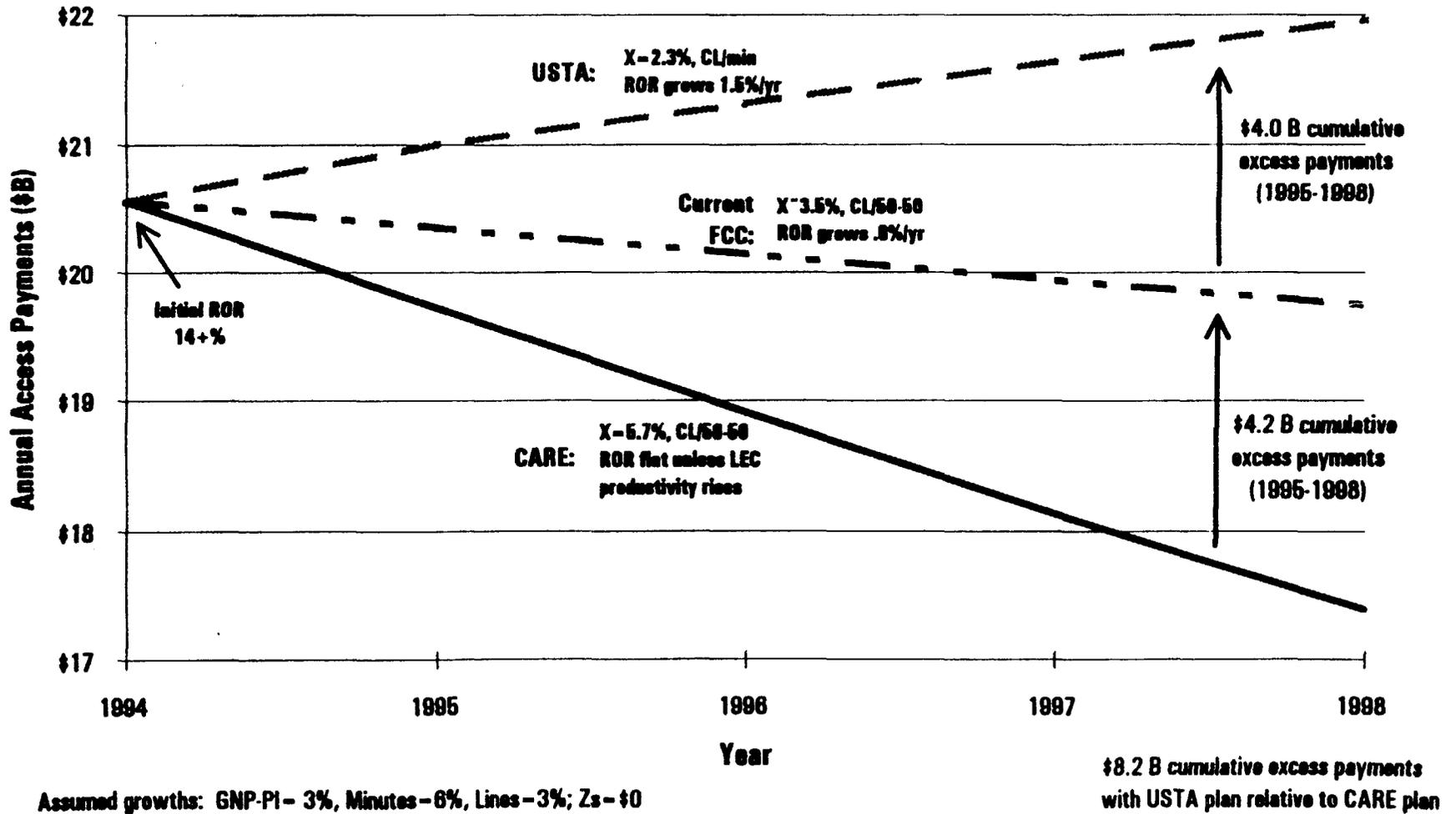
***CUSTOMERS FOR ACCESS RATE
EQUITY (CARE)***

NOVEMBER, 1994

CARE

- Customers for Access Rate Equity
- A coalition created to work for LEC price cap reform.
 - Ad Hoc Telecommunications Users Committee
 - American Petroleum Institute
 - AT&T
 - Consumer Federation of America
 - CompTel
 - International Communications Association
 - MCI
 - National Association of State Utility Consumer Advocates
 - WilTel

ANNUAL ACCESS PAYMENTS TO PRICE CAP LECs



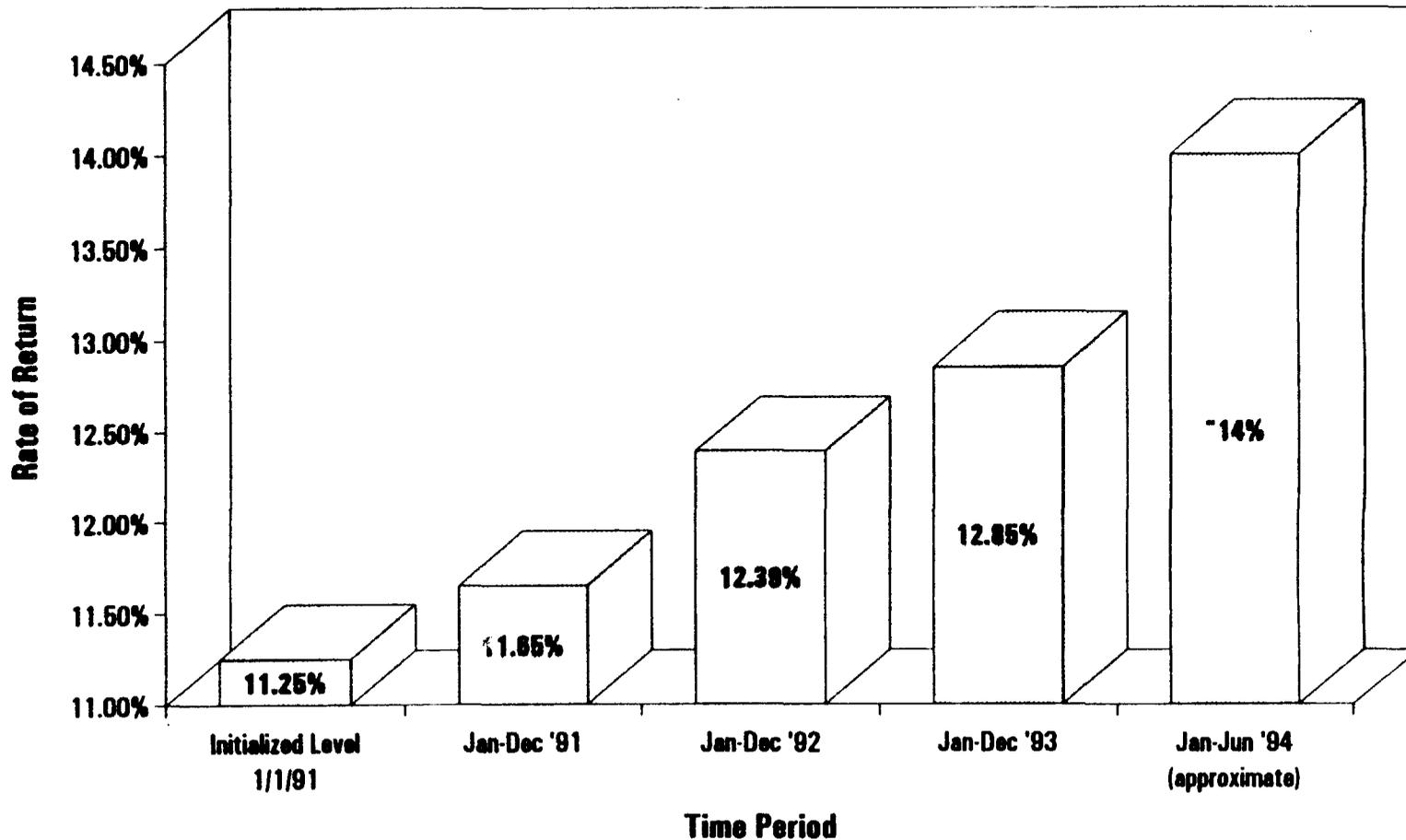
Introduction

- LECs have profited disproportionately from price caps.
- RBOCs have used proceeds for non-regulated ventures.
- FCC can resolve the current disparity between customers and the LECs:
 - Increase the productivity factor.
 - Adjust rates for lower cost of capital.
 - Decrease rates going into next price cap period.
 - Continue sharing.

LECs Have Profited From Price Caps At The Expense of Customers

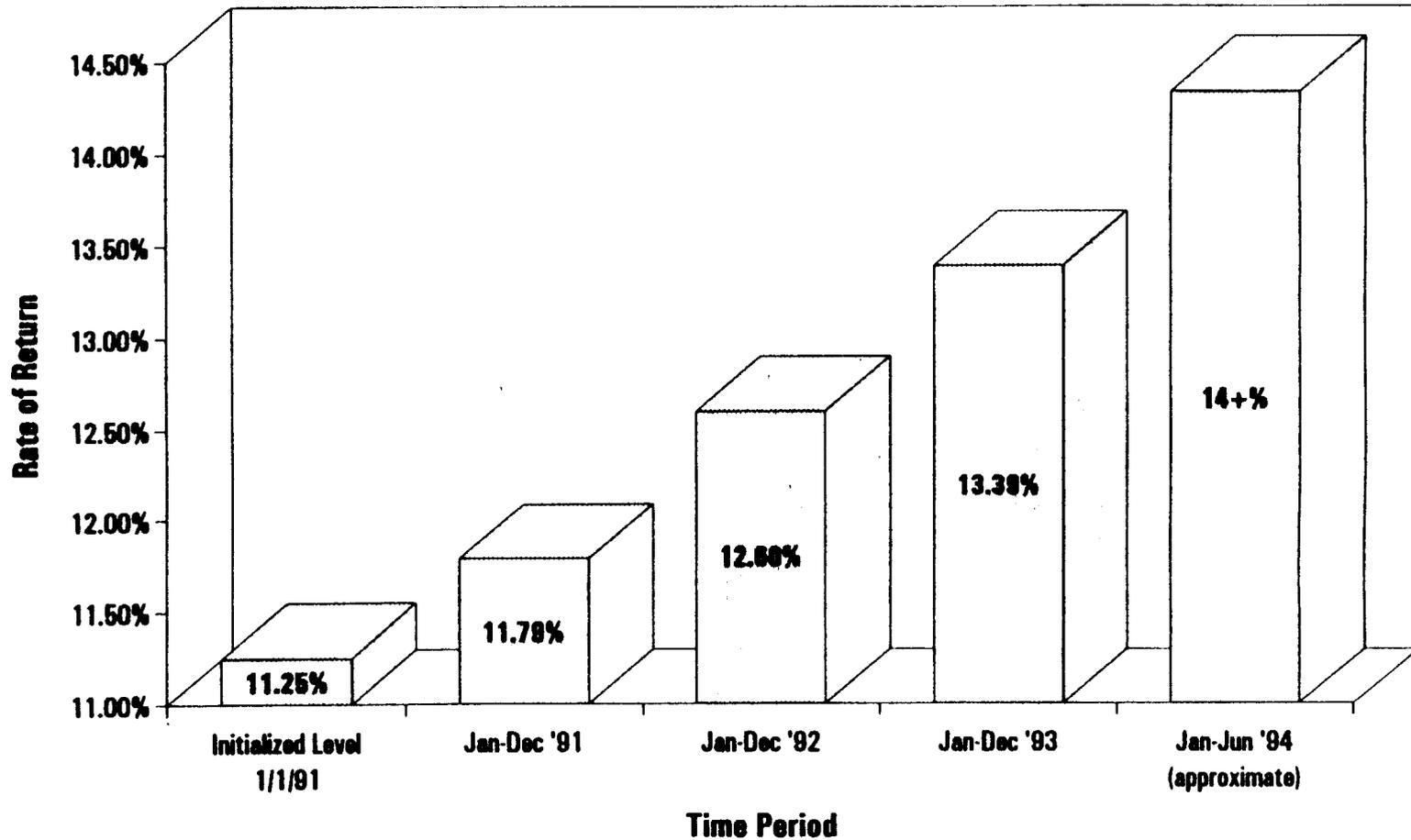
- Rates of Return Have Increased
- Cost of Capital Has Decreased
- Rate Decreases Have Not Approached Those of The Pre-Cap Era

PRICE CAP LEC INTERSTATE RATE OF RETURN: 1991-94



Sources: 1991-93 RORs from FCC Form 492 reports
1994 ROR estimated from FCC ARMIS 43-01 reports

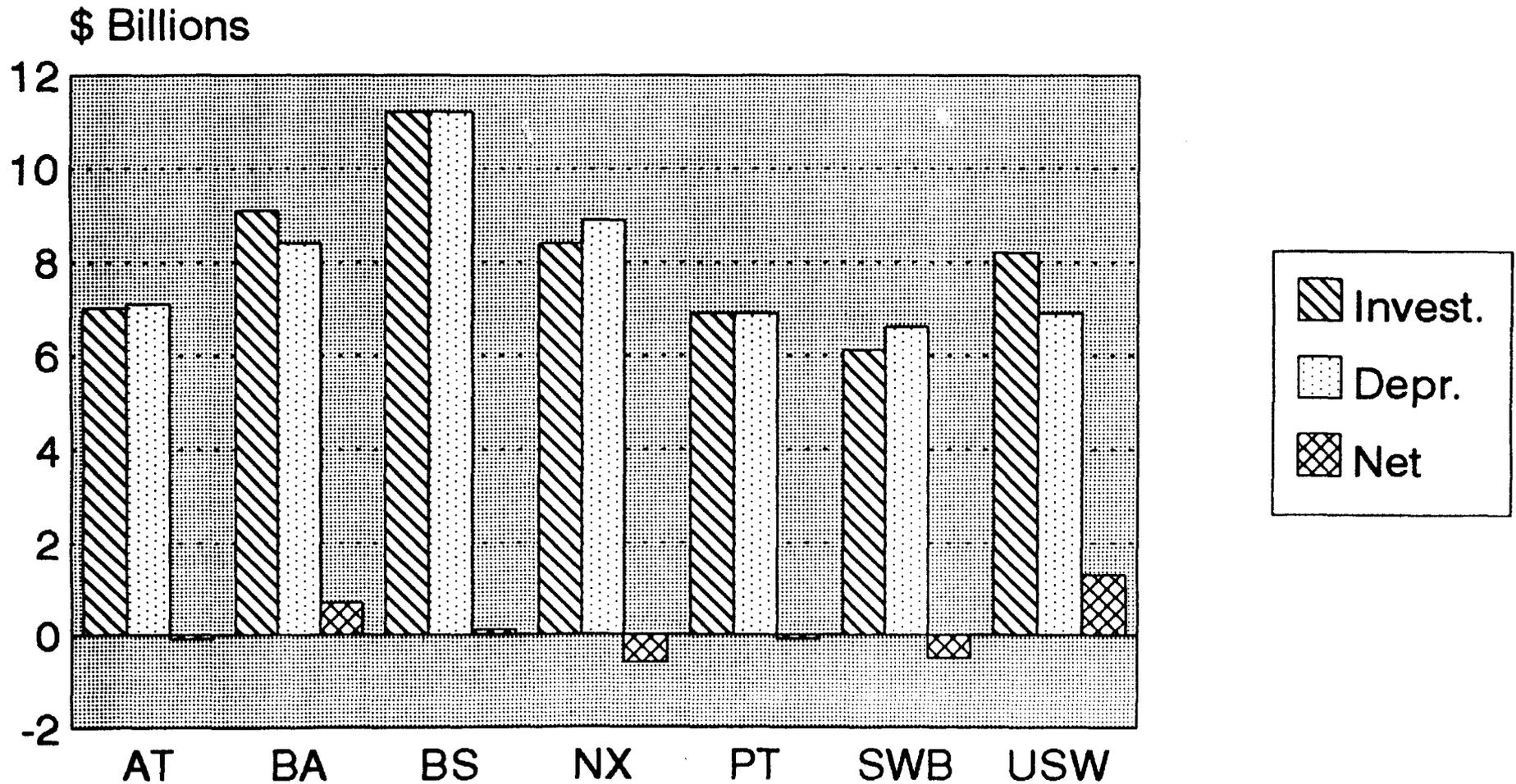
RBOC INTERSTATE RATE OF RETURN: 1991-94



Sources: 1991-93 RORs from FCC Form 492 reports
1994 ROR estimated from FCC ARMIS 43-01 reports

RBHC Investments In BOC Plant

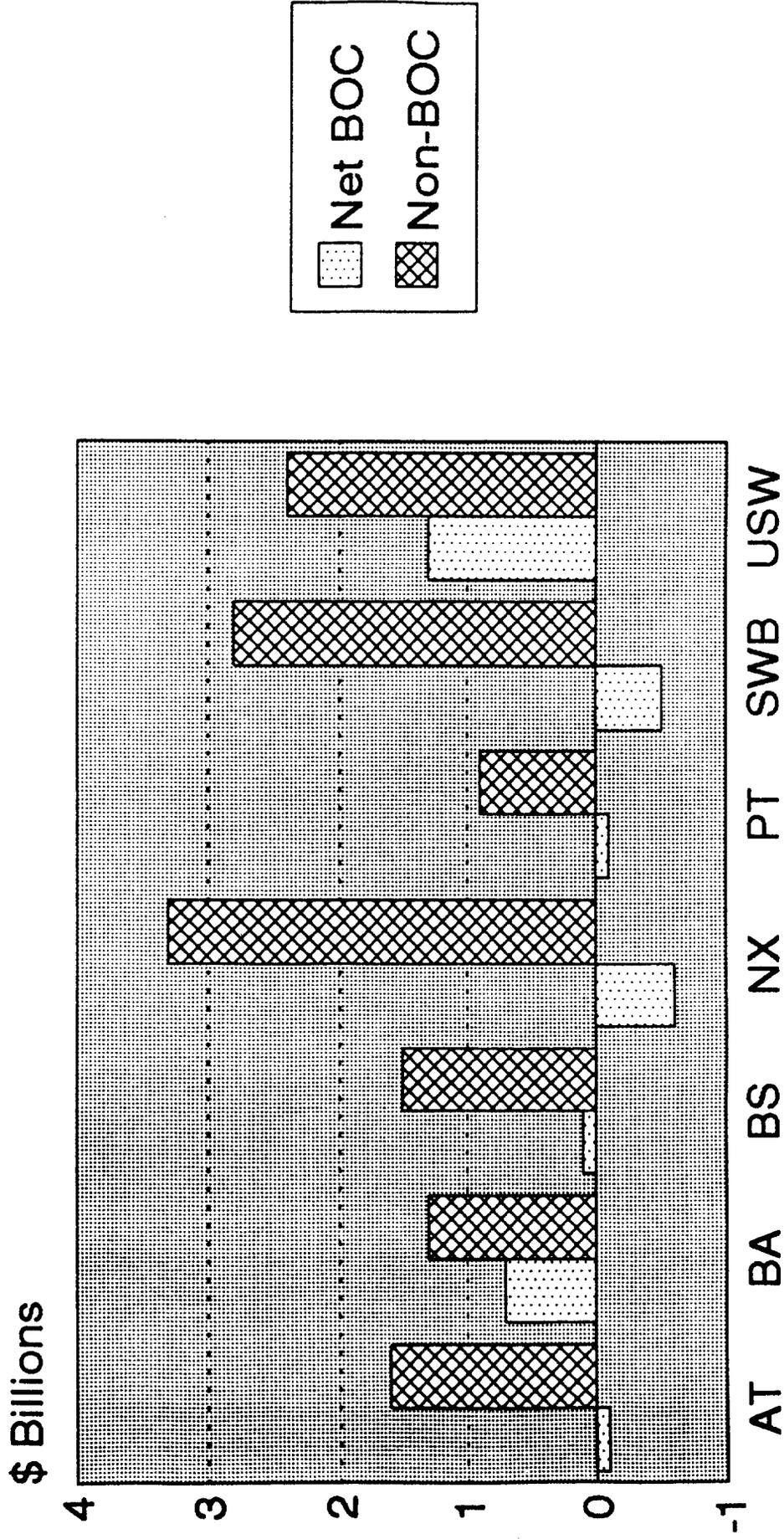
1990-1993



Source: ETI

RBHC Investments

1990-1993



Source: ETI

PRODUCTIVITY FACTOR MUST BE INCREASED

- Current factor was low end of range of FCC options
- In 1990, FCC chose "conservative" figure
- Experience shows FCC's initial reservations were unfounded
- 5.7% or higher factor amply supported in the record
- USTA study misapplies FCC/FU method

LEC "X" Should Be No Less Than 5.7%

- Matches 1991-94 LEC achieved rate of productivity (without the CPD)
- Matches LEC results for 1985-90 under rate of return plus a 0.5% CPD
- Still leaves LECs with \$2.9 billion in excess revenues from 1991-94

The Record on LEC Productivity

- Ad Hoc analysis of productivity and input prices shows X of 5.7% (including 0.5% CPD)
- AT&T Direct Model: 5.6% to 5.8%
 - Understates X: no correction for net demand repression due to excess LEC rates
- FCC Simple Model: 5.2% to 5.5%
 - Underestimates due to "below cap" pricing
 - Corrected per NERA
- MCI estimate: 5.9% using FCC short term method (no 1984)
- FCC study: Over 5% for 1985-90
- Christensen study: Implies 5.2% for 1984-1992
 - Adjusted for differential input price growth

The Record on LEC Productivity, continued ...

- Under price caps, LECs achieved productivity well over 5%, yet decreased rates based on 3.3% basis
- Returns grew 0.80% annually because of the difference between productivity and pricing
- If X not increased, return will continue to grow
- Continued disconnect between cost of capital and monopoly returns

The Record on LEC Productivity, USTA's Low Ball...

- USTA argues for a lower productivity estimate:
 - Shows productivity at 2.67%, and as low as 0.22% in 1991-92
 - LEC performance (returns, profits) contradicts contrived USTA numbers
- USTA number out of range of other estimates
 - X incorrectly calculated (wrong weights)
 - 1984 data point lowers X by about 2%
 - Data not just for price cap LECs
 - 1993-94 data neglected
 - Undocumented: results cannot be duplicated
 - Incorrect demand stimulation

LEC RATES MUST BE ADJUSTED TO REFLECT LOWER COSTS OF CAPITAL

- **Current cost of capital is 10.0%**
- **11.25% allowed now**
- **Much of cost of capital not captured in GNPPI-X (or GDPPI-X)**