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**EX PARTE**

January 20, 1995

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

RECEIVED  
JAN 20 1995

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

**RE: Written ex parte Communication in LEC Price Cap Performance Review, CC Docket No. 94-1**

Dear Mr. Caton:

DOCKET FILE COPY ORIGINAL

This notice of a written ex parte presentation in the above-referenced proceeding and the attached letter with the attached memorandum are provided for inclusion in the public record pursuant to the Commission's ex parte rules at 47 C.F.R. § 1.1200 et seq.

If you have any questions regarding this matter, please do not hesitate to call the undersigned.

Sincerely,



*for* Maurice P. Talbot, Jr.  
Executive Director-Federal Regulatory

Attachment

cc: Richard Welch  
Kathleen Wallman  
Karen Brinkmann  
Lauren Belvin  
Rudolf Baca  
James Casserly  
James Coltharp

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## **EX PARTE**

January 20, 1995

Mr. Richard Welch  
Legal Advisor  
Federal Communications Commission  
1919 M Street, N.W., Room 844  
Washington, D.C. 20554

Re: **LEC Price Cap Performance Review, CC Docket No. 94-1**

Dear Mr. Welch:

During an earlier ex parte presentation by representatives from BellSouth in this proceeding, you asked about the legality of eliminating sharing. More specifically, you asked: Does the Commission have the authority to replace rate-of-return regulation with an alternative method of regulation? Attached is a memorandum which addresses this issue. It concludes "... nothing in the Communications Act, its legislative history, or relevant case law erects any bar to replacing rate-of-return regulation with an alternative method of regulation as long as the Commission continues to meet its statutory obligation to protect customers against unjust and unreasonable rates."

I hope the attached memorandum satisfies any concerns that you may have had regarding this issue. Should you need further information or discussion, please do not hesitate to call me.

Sincerely,

*per* 

Maurice P. Talbot, Jr.  
Executive - Director, Federal Regulatory

### Attachment

cc: William Caton  
Kathleen Wallman  
Karen Brinkmann  
Lauren Belvin  
Rudolfo Baca  
James Casserly  
James Coltharp

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## **MEMORANDUM RE: FCC'S LEGAL AUTHORITY TO IMPLEMENT PRICE CAP REGULATION**

This memorandum briefly addresses whether the Federal Communications Commission has the legal authority under the Communications Act of 1934 to implement a "pure" price cap plan, including but not limited to the elimination of the earnings "sharing" mechanism currently imposed upon local exchange carriers (LECs).

Throughout its administrative proceedings<sup>1</sup> the Commission thoroughly analyzed its legal authority to implement price caps for both AT&T and the LECs and found that it had no statutory obligation to continue using rate-of-return regulation. This memorandum concludes that nothing in the Communications Act, its legislative history, or relevant case law erects any bar to replacing rate-of-return regulation with an alternative method of regulation as long as the Commission continues to meet its statutory obligation to protect customers against unjust and unreasonable rates. This includes elimination of the earnings "sharing" mechanism that the Commission implemented as a "backstop" for its initial LEC price cap plan.

### **I. THE COMMUNICATIONS ACT DOES NOT MANDATE THE USE OF RATE-OF-RETURN REGULATION.**

The Communications Act provides the Commission with various tools to fulfill its obligation of ensuring "just and reasonable" rates, but it does not compel the use of rate-of-return methodology or any other particular regulatory model. Courts have consistently found in the Act's statutory scheme a congressional intent to vest in the Commission broad discretion in selecting regulatory tools. Similarly, the legislative history of the Act does not indicate that Congress intended the Commission to use rate of return or any other particular regulatory method.<sup>2</sup> Nor does the Commission's regulatory history. While rate of return may be considered a "traditional" method of regulation, it was not until 1976 that the Commission relied on formal rate-of-return proceedings.

A review of court decisions involving the Commission and other federal agencies with similar ratemaking authority indicates that courts look to the end result of the rate order, not

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<sup>1</sup> See In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987) (Notice). See Notice, 2 FCC Rcd at 5212; Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 (1988) (Further Notice); Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989) ("AT&T Price Cap Order"), modified on recon., 6 FCC Rcd 665 (1991) ("AT&T Reconsideration Order"); modification remanded in part sub. nom. AT&T v. FCC, 974 F.2d 1351 (D.C. Cir. 1992); 5 FCC Rcd 6786 (1990) ("LEC Price Cap Order"), Erratum 5 FCC Rcd 7664 (1990), modified on recon., 6 FCC Rcd 2637 (1991) ("LEC Reconsideration Order"), aff'd, National Rural Telecom. Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

<sup>2</sup> The legislative history of the Act suggests that the primary impetus for the legislation's passage was the consolidation in a single independent agency the federal regulatory authority over telecommunications services rather than a desire to dictate the way the telecommunications industry was being regulated. See Loeb, The Communications Act Policy Toward Competition: A Failure to Communicate, 1978 Duke L.J. 1, 17 nn.82-83 (1978).

the method that is employed. The Supreme Court recently reaffirmed that "it is not the theory but the impact of the rate order which counts."<sup>3/</sup> Thus, courts evaluate whether the end results fall within a "zone of reasonableness," bounded at the lower end by investor interests against confiscation and at the upper end by consumer interests against exorbitant rates.<sup>4/</sup>

In short, the Commission's substantive mandate requires that it select a method for regulating rates that includes mechanisms capable of keeping rates in the zone of reasonableness or of detecting and correcting for the failure of market forces to achieve this result. Courts have repeatedly made clear that this mandate allows the Commission broad discretion to fashion a regulatory scheme which in the Commission's expert judgment best achieves the Act's goals. Its duty is not to ensure that a certain rate of return is met, but to ensure that rates are just and reasonable.<sup>5/</sup>

## **II. THE LEC PRICE CAP PLAN IS FULLY CONSISTENT WITH THE COMMISSION'S STATUTORY MANDATE TO ENSURE JUST AND REASONABLE RATES.**

The Commission may replace rate-of-return regulation with another regulatory model consistent with the Act's substantive and procedural requirements as long as the Commission finds, based upon an adequately developed administrative record, that the adoption of the alternative would be in the public interest. The question then becomes whether the Commission's adoption of a "pure" price cap plan meets this standard.

Critics of price cap regulation have argued that while the current LEC plan retains enough of rate-of-return regulation to insulate the Commission from challenges, the move to a pure price cap plan is beyond the Commission's legal authority. They maintain that a LEC price cap plan without a sharing mechanism would not withstand judicial scrutiny because it divorces consideration of carrier costs and profits from rates.

The Commission concluded that the present LEC price cap plan was within its legal authority under the Act and will assure just and reasonable rates. The primary reason for this conclusion was that the LEC price cap plan, like the AT&T plan, features a streamlined tariff review process with suspension and no-suspension zones, baskets, service categories, and bands to guard against precipitous price changes for particular services, as well as a price cap formula that is based on existing rates, reflects cost changes, and includes a Consumer Productivity Dividend that requires carriers to increase their productivity above historical levels to take advantage of the increased flexibility provided by the price cap system. As with the AT&T plan, all existing procedures and reporting requirements relating to the monitoring of service quality are retained. Because the Commission decided to initially take a more "cautious and careful approach" with the LECs it made two changes from the AT&T plan: (1) the LECs were assigned a higher productivity offset than AT&T; and (2) the LEC price cap plan included a transitional rate-of-return based "sharing" mechanism to provide a "backstop" measure of protection against excessively high or low earnings.<sup>6/</sup>

The Commission did not include a sharing mechanism in the AT&T plan because it felt there was less uncertainty as to productivity levels. Although it observed that the existence of some unspecified level of competition in the interexchange market provided added assurance that AT&T's rates remain in the zone of reasonableness, the Commission expressly stated that it did not

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<sup>3</sup> Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989) (quoting Hope Natural Gas Co., 320 U.S. 591, 602 (1944)). The court noted, however, that whether a particular rate is unjust or unreasonable depends to some extent on what is a fair rate of return given the risks under a particular rate setting system. Id. at 314.

<sup>4</sup> Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1177 (D.C. Cir. 1987) (en banc) (quoting Hope, 320 U.S. at 15).

<sup>5</sup> AT&T v. FCC, 836 F.2d at 1395 (Starr, J., concurring).

<sup>6</sup> 5 FCC Rcd at 6787. The Commission initially proposed either sharing or a comprehensive short-term review as alternatives which would serve the same safeguard role. See 4 FCC Rcd at 3216-17.

rely on competition as a prerequisite for its legal authority to adopt price caps for AT&T.<sup>7/</sup> When it adopted the LEC plan, the sharing mechanism theoretically served an analogous backstop function as competition in the AT&T plan. The Commission stated that adoption of the sharing mechanism in the LEC plan "directly establishes the added assurances that competition more indirectly provides in the context of the interexchange market."<sup>8/</sup> However, just as the existence of competition in the interexchange market was not a legal basis to block price cap reform for AT&T, neither was it a legal basis to impede price cap reform for the LECs. And neither, it follows, is the presence or absence of a sharing mechanism.<sup>9/</sup>

In this regard, the Commission clearly did not consider the inclusion of the sharing mechanism to be necessary to its legal authority to implement price caps. The Commission specifically rejected the argument that price caps could not be applied to LECs because "if a need to make a predictions were a basis for finding a regulatory process fatally flawed, we would have to abandon rate of return immediately because it is based almost entirely upon predictions."<sup>10/</sup> The Commission also recognized that any sharing scheme would tend to decrease the cost-reducing incentives sought by the price cap scheme.<sup>11/</sup> Indeed, from the outset the Commission saw sharing as an interim safeguard, not a permanent part of the LEC price cap plan: "If a safeguard subsequently proves to be unneeded, it can be removed. As we gain experience with [the] price cap plan. . . it may become possible to eliminate the [sharing mechanism]."<sup>12/</sup>

While the validity of the Commission's decision to move to price caps has never been directly ruled on by a court, MCI recently challenged specific aspects of the LEC price cap plan in National Rural Telecommunications Association v. FCC. The U.S. Court of Appeals for the District of Columbia rejected MCI's challenges to both the sharing rule and the streamlined tariff review procedure. In response to MCI's argument that the Commission's sharing rule was arbitrary because it did not retain as much rate-of-return regulation as MCI's more stringent proposed rule, the court stated: "To the extent that MCI is obliquely making a claim that the statutory 'just and reasonable' rate requirement mandates use of fully distributed costs and bars moves toward inverse elasticity prices, our precedent is squarely against it."<sup>13/</sup> The clear implication of the court's language is twofold. First, it indicates that the Commission clearly has the legal authority to adopt price cap regulation. Second, it strongly suggests that a court will uphold a pure price cap plan as long as the agency supplies a reasoned explanation for eliminating the sharing mechanism.

In short, the elimination of the sharing mechanism, with the appropriate administrative record as support, would not violate the Commission's authority under the Act. On the contrary, it would be fully consistent with the Commission's statutory obligation to further the public interest if it would improve the overall efficiency and performance of LECs to the benefit of consumers.

January 18, 1995

Gary M. Epstein  
James H. Barker  
Melissa A. McGonigal

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7 4 FCC Rcd at 3303 & n.1857.

8 5 FCC Rcd at 6859 n.583.

9 See 5 FCC Rcd at 6836.

10 4 FCC Rcd at 2898.

11 See National Rural Telecom. Ass'n v. FCC, 988 F.2d 174, 183 (D.C. Cir. 1993); see also 5 FCC Rcd at 6801; 4 FCC Rcd at 3216.

12 4 FCC Rcd at 3216.

13 National Rural, 988 F.2d at 183. The court also rejected MCI's claim that the Commission veered impermissibly from prior policy in allowing streamlined review of tariff changes.