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January 11, 1996

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

Re: CC Docket No. 94-1; Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

On behalf of MCI, attached you will find a pleading in the above-captioned proceeding. The text of the document bears the date that it would have been filed at the Commission, had the agency not been closed.

This is to notify you that the document is being filed and served today, the first business day on which the Commission has re-opened.

Sincerely yours,

Chris Frentrup

Chris Frentrup
Senior Regulatory Analyst
Federal Regulatory

Enclosure
CF

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December 18, 1995

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

DOCKET FILE COPY ORIGINAL

Re: CC Docket No. 94-1; Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

Enclosed herewith for filing are the original and four (4) copies of MCI Telecommunications Corporation's Comments in the above-captioned proceedings.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Chris Frentrup
Senior Regulatory Analyst
Federal Regulatory

Enclosure
CF

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20054

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

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EXECUTIVE SUMMARY

The Commission should not base the productivity factor in the long-term price cap plan on a total company TFP methodology. If it chooses to use this methodology because it believes this methodology is more economically correct, it must also take steps to ensure that local exchange carrier (LEC) access rates are first driven down to economic cost. Sharing is an important ratepayer safeguard and should be retained. The Commission should adopt a per-line common line price cap formula, unless the growth in minutes is already reflected in a higher X-factor. The proposed EUCL charges should continue to be used in the CCL formula, and exogenous changes should be limited to those rule changes which move costs into or out of the interstate jurisdiction. Finally, neither the X-factor nor the sharing bands should be tied to the level of competition a LEC faces.

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

COMMENTS

I. INTRODUCTION

MCI hereby submits its comments in the above-captioned docket.[1] The Fourth Further Notice requests comment on several major changes to the price cap regulatory system, e.g., use of a Total Factor Productivity (TFP) model[2] to compute a productivity factor (also called an X-factor) for use in the price cap formulas, and on alternative methods of determining the X-factor. The Commission also seeks comment on whether the sharing mechanism can be eliminated and on other aspects of the long-term price cap plan, including changes to the common line formula and exogenous cost rules. Taken together, these proposals amount to a wholesale revision of the Commission's price cap system governing interstate access.

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1 In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1; Fourth Further Notice of Proposed Rulemaking, FCC 95-406, released September 27, 1995 (Fourth Further Notice).

2 Total Factor Productivity is the ratio of an index of total outputs to an index of total inputs.

As in the case of the initial price cap system, launched in 1991, the Commission needs to recognize explicitly that, whatever changes it introduces in this phase of the docket, it must not create a price cap system that initially or perpetually disadvantages ratepayers by forcing them to purchase interstate services at rates that are far in excess of cost, while creating additional earnings opportunities for the LECs. For example, MCI does not believe the Commission should adopt a TFP method which is based on total company productivity for use in the long-term price cap plan. The Commission is regulating interstate rates, not the entire body of local exchange carrier (LEC) rates. If LEC productivity in providing interstate access services is greater than total company productivity, as appears to be the case based on the record to date in this docket, use of a total company TFP-based X-factor will result in interstate rates which are too high. More specifically, a TFP approach is not likely to cause interstate access prices to fall to at least the same degree that a LEC experiences productivity gains for interstate service, i.e., the LEC experiences a windfall. If the Commission nevertheless wishes to use a TFP-based method for setting the X-factor because it believes that is the more economically relevant measure of productivity changes, then it must first also reinitialize LEC interstate access rates to their direct economic costs, because those are the more economically relevant costs than the LECs' embedded costs of providing access. Strict adherence to economic principles in pursuit of public policy is laudable, but those economic principles can not be followed in

one case and forgotten in the other. While re-establishing interstate access rates at a level equal to their direct economic costs does not directly cure the problem of understating interstate productivity gains, it would mitigate the financial windfall a LEC would experience in switching to a TFP-based system.

If the Commission is not willing to take the step of first setting the LECs' access rates at their direct economic costs, then it should continue to base the productivity factor on changes in interstate productivity. The Commission must select an X-factor which ensures that both LECs and ratepayers benefit from the increased efficiencies that price cap regulation brings forth, not one that simply allows the LECs to earn a higher rate of return while continuing to gouge their customers with rates that are set well above their direct economic cost.

II. BACKGROUND

In 1990, the Commission adopted mandatory price cap regulation for the Bell Operating Companies (BOCs) and GTE Operating Companies, and allowed other carriers to elect price cap regulation at their option.[3] In the LEC Price Cap Order, the Commission scheduled a performance review to evaluate the

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[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786(1990) (LEC Price Cap Order), recon, 6 FCC Rcd 2637 (1991), (LEC Price Cap Reconsideration Order), aff'd sub. nom., National Rural Telecom Assoc. V. FCC 988 F.2d. 174 (D.C. Cir. 1993). Those LECs that have elected price cap regulation are United and Central Telephone Companies, Rochester Telephone Corporation, The Lincoln Telephone and Telegraph Company, and Southern New England Telephone Company.

price cap system it adopted in that order. The Commission completed the first phase of the review in March 1995, adopting several interim revisions to the price cap plan.[4] Among those revisions were a 0.7 percentage points increase in the 3.3 percent minimum productivity factor, and optional productivity factors of 4.7 percent or 5.3 percent. The sharing and low-end adjustment rules were adjusted to change the amount of sharing associated with the productivity factors, including elimination of all sharing obligations if a company chose the 5.3 percent factor. The Commission also revised its exogenous cost rules, and changed the lower limits on price reductions for the service categories.

In the First Report and Order, the Commission concluded that for the long-term price cap plan it should replace the method of calculating the X-factor with a new method, which should be based on an industry-wide measure of performance and include changes in unit costs that occurred since the adoption of the price cap plan.[5] The Commission also made several tentative conclusions: (1) that the X-factor should be based on a moving average rather than fixed for a number of years;[6] (2) that the X-factor should

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4 Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8962 (1995) (First Report and Order).

5 Id.at 9026.

6 Id.

be based on a TFP methodology;[7] (3) that the long term price cap plan should have two or more X-factors.[8] The Commission established a goal of eliminating sharing,[9] and decided that if the long-term plan had multiple X-factors, at least one of those X-factors should have no sharing obligation.[10] The Commission also adopted changes in its exogenous cost rules,[11] but declined to revise the Common Line formula in the interim price cap plan.[12]

The Commission seeks comment on several features of its proposed changes to the price cap plan: (1) the X-factor, including the method of its calculation and whether it should be reviewed and modified periodically or set on a permanent basis; (2) the number of X-factors to be included and the sharing requirements, if any, which should be associated with those X-factors; (3) the common line formula; and (4) the exogenous cost rules.

III. THE EXISTING RECORD DOES NOT SUPPORT A TFP METHOD OR SELECTION OF A TFP-BASED X-FACTOR

The TFP-based studies on the record to date cannot be used to compute the X-factor for the LEC price cap plan. MCI agrees with the Commission's

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7 Id.

8 Id. at 9035.

9 Id. at 9047.

10 Id.at 9049.

11 Id.at paras. 9090-2; 9097-9100; 9104-9107.

12 Id. at 9079-80.

statement in the Fourth Further Notice that any X-factor the Commission adopts must pass through to consumers reductions in LEC costs.[13] However, the TFP studies on the record to date fail to achieve this goal. The studies are based on total company rather than interstate productivity gains, which will be equivalent only by coincidence. In addition, the studies produced by USTA to date have treated such important inputs to the model as cost of money, depreciation rates, and other factors incorrectly. The Commission cannot rely on the TFP models as currently developed to compute an X-factor used to set interstate access rates.

The Commission originally adopted price cap regulation for the LECs because it believed doing so would, inter alia, more closely mirror the efficiency incentives found in competitive markets.[14] Noting that rates produced under rate of return can be uneconomically high, the Commission stated that price cap regulation would force carriers to be more productive than they were under rate of return regulation, and that any inefficiencies embodied in the starting point price cap rates would be eliminated over time, as the LECs improved their productivity due to the incentives under price cap regulation.[15]

The efficiency incentives in a competitive market drive rates toward

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13 Fourth Further Notice at para. 16.

14 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6790 (1990) (LEC Price Cap Order).

15 Id. at 6816.

economic costs. Thus, a properly functioning price cap plan should also drive rates down toward economic costs. The original price cap plan's method for achieving this was to set the X-factor 0.5 percentage points higher than estimated LEC productivity under rate of return regulation.[16] This additional rate cut was intended to balance ratepayer and shareholder interests. The LECs were given the incentive to cut their costs and thereby increase their earnings, and, assuming the X-factor were set at a correct level,[17] ratepayers were guaranteed a rate decrease greater than they could have expected under rate of return. As the Commission recognized in its statement of the necessary characteristics for an X-factor, the price cap plan must ensure that reductions in LEC unit costs are passed through to consumers in lower rates. However, shareholder benefits have stayed the same or increased, as LEC interstate earnings have increased under price cap regulation, while ratepayers have seen little or no additional benefit under price cap regulation, due to the Commission's initial selection of an X-factor that was too low.

In the First Report and Order, the Commission tentatively concluded that,

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16 As the Commission noted in the First Report and Order, that original productivity estimate was erroneously low. See First Report and Order at 9050.

17 The Commission adopted the sharing and low-end adjustment mechanisms to insure against the possibility that the X-factor would not be "...perfectly accurate for the industry as a whole or for individual LECs or market conditions at a given time." LEC Price Cap Order at 6801.

because LEC interstate and intrastate services were largely provided over common facilities and because the record contained no evidence that there was an economically meaningful way to divide and measure the facilities used for interstate and intrastate services, the TFP used to set the X-factor should be calculated on a total company basis.[18]

If the Commission is unable to measure interstate regulated productivity using a TFP study, it cannot simply use total company TFP as a proxy for interstate TFP. That state and interstate services are provided are over common facilities is irrelevant. A TFP-based X-factor is based on usage of all inputs, not just usage of plant. It may be the case that provision of interstate access services uses inputs less intensively than does provision of intrastate services, and thus that interstate productivity is higher than intrastate productivity. For example, local service will require more use of customer service personnel, which must serve all of the LECs' end user customers, than will long distance access services, with its fewer and more sophisticated interexchange carrier (IXC) customers. The Commission cannot simply assume the problem away.

The price cap system caps only interstate rates. The price cap plan must therefore cap rates based on changes in LEC interstate costs. A plan which is based on total company productivity will be correct only if, by

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[18] See Fourth Report and Order at para. 63.

coincidence, the X-factor for total company operations happens to be the same as for interstate operations. The record contains no evidence this is so, and the Commission cannot adopt an X-factor based on total company operations until it determines that it is so.

In the First Report and Order, the Commission tentatively concluded it should base the X-factor in the long term price cap plan on a TFP study.[19] The Commission states that the X-factor it adopts in the long-term price cap plan should have three characteristics.[20] First, the X-factor should be economically meaningful, i.e., it should provide a reliable measure of the extent to which changes in LECs' unit costs have been less than changes in the price level in the economy as a whole. Second, the X-factor should ensure that LEC reductions in unit costs are passed through to consumers. Finally, calculation of the X-factor should be reasonably simple and based on accessible and verifiable data.

The TFP studies previously placed on the record by USTA in this proceeding fail on all three of these counts. They do not provide a reliable measure of the extent to which changes in LECs' unit costs have been less than changes in the price level in the economy as a whole. After reviewing the record in this docket, the Commission determined that its initial choice of X-

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19 First Report and Order. at 9026-7.

20 Fourth Further Notice at para. 16.

factor had been too low and that a higher X-factor was necessary to ensure that the LECs' rates remained reasonable. However, USTA's TFP-based estimates of the X-factor are substantially below the interim X-factors that the Commission adopted, and also well below the X-factors found by other parties in this proceeding that would have justified the Commission in finding that an even greater X-factor was necessary. Thus, USTA's TFP study is not "economically meaningful."

In fact, the X-factor USTA computed in its TFP study found that LEC productivity was even below the Commission's initial choice of X-factor, even though the Commission found that its initial choice of X-factor failed adequately to reflect the LECs' achieved productivity. Thus, USTA's TFP study also fails the second leg of the Commission's requirements, because it would have failed to pass through to ratepayers the LECs' actual reductions in unit costs.

USTA's TFP study also fails to meet the third requirement. For example, as the Commission notes, USTA's study used Telephone Plant Indices to deflate dollar investments in plant and equipment in order to calculate capital stock quantities.[21] These indices, computed by the LECs using internal data, are used to determine the amount of capital used by the company. However, it is unclear that the data necessary to compute these indices is publicly

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[21] See Fourth Report and Order at para. 45.

available, or would be made so by the LECs.

IV. USE OF A TFP-BASED PRODUCTIVITY FACTOR WILL NOT BY ITSELF ENSURE THAT RATES ARE DRIVEN TO ECONOMIC COST

If the Commission adopts the TFP method for setting the X-factor, it must re-address the issue of the starting-point rates. At the start of price caps, the Commission used the then-existing rates determined under rate of return regulation as the starting point rates for price caps, believing that the incentives under price cap regulation would lead the LECs to drive costs out of their networks.

However, recognizing that giving the LECs the incentive to reduce costs was not the same as getting those reduced costs reflected in lower rates, the Commission adopted additional mechanisms in the price cap plan to ensure that reduced costs were reflected in reduced rates. In the initial price cap plan, those mechanisms were the consumer productivity dividend and the sharing mechanism.[22]

Use of a rolling average method for updating the productivity factor will not ensure that rates are cut to economic cost. The rolling average will reflect only the LECs' decisions of how much to cut their costs. Unless there is substantial competition -- which MCI does not foresee -- the LEC will not face a sufficiently strong incentive to cut its rates to economic cost. Thus, there

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[22] The need for a sharing mechanism will be addressed in Section VII infra.

will be no guarantee that rates will be driven down to their true economic cost in any finite time.

If the Commission chooses to use a total company, TFP-based method for updating the X-factor because it believes that is the more economically relevant measure, it must also ensure that rates are driven toward economic cost. The Commission cannot have it both ways; it cannot use rates based on embedded costs as the starting point for price cap rates when those rates are well in excess of the economic cost of providing service, and then base the X-factor on changes in economic costs. Rates must either be reset based on economic cost, and then the price cap adjusted for economic cost changes, or rates can be left as they are now based on embedded costs and the X-factor must be explicitly designed to drive non-economic costs out of access charges. To let rates remain above economic costs, but to adjust rates based on changes in economic cost would be inconsistent and arbitrary.

There is substantial evidence that the LECs' access rates are currently well above economic cost. For example, when the Commission revised the local transport rate structure, it required the LECs to set their switched access trunking rates equal to their special access trunking rates, with the difference between the previously existing switched transport rates and the new rates recovered in an Interconnection Charge. That Interconnection Charge recovers approximately 70 percent of the previous switched transport rates. Similarly, the Benchmark Cost Model filed in the Universal Service Fund docket shows

that current LEC local service rates in most cases recover the entire economic cost of providing the local loop.[23] The LEC price cap plan should thus be designed to drive these non-economic costs out of access rates.

To ensure that this occurs, the Commission must take one of two steps. It must either perform economic cost studies and cut LEC rates to that level, after which it can use a TFP-based X-factor to cap LEC rates, or it must apply an X-factor that is sufficiently stringent to drive rates toward their economic cost in a short period of time. Without substantial competition or some regulatory mechanism, LECs will not have the incentive to drive all non-

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[23] The Benchmark Cost Model, which MCI hereby incorporates by reference, develops cost estimates by Census Block Group (CBG) for placing new loop from currently existing central offices (COs) using today's technology. Every household reflected in the 1990 Census is assumed to be connected to the network in the same time frame and in a uniform manner. Switching costs are calculated using currently available digital technology based upon estimated switching demands of the associated CBGs. Model costs therefore reflect the costs a telephone engineer would face in installing new service to an area. The costs in each CBG reflect the distance from the CO, household density, and the impact of terrain -- depth of bedrock, depth of the water table, hardness of bedrock, and surface soil texture -- on the cost of placing telephone plant. See Ex Parte Letter to William F. Caton from MCI Telecommunications, NYNEX Corporation, Sprint Corporation, and U S WEST, Inc. in CC Docket No. 80-286, filed December 1, 1995.

Using forward-looking cost factors, the BCM found that the current average local service rate of $20, which includes the subscriber line charge, recovers all but approximately $4 billion of the economic cost of loop and switching nationwide. Viewed from this perspective, the $6.7 billion of interstate carrier common line and local switching charges, combined with the local service charges, recover more than the economic cost of providing these services.

economic costs out of their rates.

Substantial competition for the LECs' services is not going to occur in the near term, especially for loop and switching. Competition has not forced the LECs to lower their Local Switching rates. In fact, when the Commission removed local transport services from the Traffic Sensitive basket in the Local Transport proceeding, it did so to prevent the LECs from offsetting rate reductions for transport services with rate increases for Local Switching, which the Commission noted was subject to much less competition.[24] Similarly, competition has not forced the LECs to lower their carrier common line rates. Competition will certainly never force the LECs to lower the Interconnection Charge, because that charge ensures the LECs against loss of revenue in the one area of their access services, Transport, in which they do face limited competition. The Commission must therefore adopt an X-factor that drives non-economic costs out of LEC rates.[25]

V. THE X-FACTOR SHOULD BE UPDATED PERIODICALLY RATHER THAN CONTINUALLY

The Commission tentatively concluded in the First Report and Order that

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24 Transport Rate Structure and Pricing, Second Report and Order, 9 FCC Rcd 615, 622 (1994).

25 The 0.5% Consumer Productivity Dividend reflected in the Commission's current price cap plan forces reductions in rates as the LECs cut costs, but is not adequate to remove the non-economic costs from the LECs' interstate access rates in a reasonable time frame.

it should adopt a moving average X-factor, on the grounds that doing so would eliminate the need to review the X-factor during periodic performance reviews, with attendant savings in administrative costs, and that use of a moving average might allow the Commission to reduce or eliminate sharing by providing an alternative method for flowing through to ratepayers changes in unit costs. The Commission now seeks comment on whether it should adopt a moving average X-factor or continue to perform periodic reviews.

One of the key principles guiding the Commission when it initially adopted price cap regulation was the reduction of administrative burden on both the industry and the regulator.[26] Price caps would allow the LECs to make limited changes to their access rates without having to file extensive cost data, instead computing indexes based on their historical demand data. The Commission now proposes to require the LECs to file extensive data on both their costs and their demand in order to compute a TFP-based X-factor. This represents a sharp departure from the goals that underlie this proceeding, and has not been explained by the Commission. In addition, the Commission has not explained why this additional administrative burden is justified, nor why it is necessary to achieve reasonable rates.

In addition, MCI does not see how revising a productivity study every year results in any administrative savings over a periodic performance review.

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[26] LEC Price Cap Order at 6791.

Indeed, it will raise administrative costs. Performing productivity studies once every four years consumes less resources than doing a study every year.

In addition, use of a rolling-average method will be nothing other than a rate of return filing. The LECs will file data on their costs and demand, and the Commission will have to make judgments, after input from interested parties, on what costs are legitimately included in the TFP studies, and on what depreciation rates and rate of return are properly reflected. The only difference between this process and the old rate of return filings is that the Commission will be examining many years' of historical data, rather than one year of projected data as it did under rate of return regulation.

As were the rate of return filings, the TFP studies are unlikely to be the straight-forward process the Commission apparently hopes they will be. Even if the Commission resolves all the issues regarding cost of capital, depreciation rates, etc. that it seeks comment on in this proceeding, each year will present different issues that the Commission will have to resolve.[27]

MCI believes that review of the productivity factor every four years is sufficient. Such a time period will give the LECs greater incentive to cut their costs, by allowing them to reap the benefits of those cuts. It will also avoid adjustments to the X-factor for minor and one-time changes in productivity,

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[27] For instance, the LECs will continually revise their historical data, and the Commission may have to resolve whether changes in accounting treatment for expenses should be reflected in the productivity factor.

which are likely over time to cancel each other out. It will also allow both ratepayer and LECs some certainty in planning for access changes.

VI. THE COMMISSION NEED NOT "REINVENT THE WHEEL" IN DETERMINING DEPRECIATION RATES AND COST OF CAPITAL FOR USE IN A TOTAL FACTOR PRODUCTIVITY STUDY

The Commission asks specific questions about several factors USTA used in its TFP study. The only factors on which MCI comments in this proceeding are the cost of capital and depreciation rates. In its original TFP study, USTA used a cost of capital based on Moody's Yield on Public Utility Bonds. This cost of capital is incorrect.

The Commission has a long history of determining what the relevant LEC cost of capital should be. The Commission has determined that the cost of capital should reflect a weighted average of the cost of borrowing money from all sources, both debt and equity. The latest study the Commission has completed under that methodology, on which the LECs' initial price cap rates were based, found that the LECs' cost of money was 11.25 percent.[28] Until the Commission determines that either the methodology it has used to set that cost of money was incorrect or that the costs of debt and equity have changed -- and MCI believes it has -- the Commission must continue to use 11.25% as

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[28] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, 5 FCC Rcd 7507,7509 (1990).

the cost of debt in any TFP study.[29]

Similarly, the Commission should use the currently prescribed depreciation rates in any TFP study. Those rates have been determined by the Commission to be the correct depreciation rates for the LECs. Allowing the LEC to use different rates would be an at least implicit determination by the Commission that depreciation rates had changed, without the opportunity for review by the Commission and other interested parties required by the Commission's depreciation prescription rules.

The LECs argue that the Commission's depreciation prescriptions substantially understate true economic depreciation rates, and thus cannot be used in a TFP study. As the attached study by Kenneth Baseman and Harold Van Gieson demonstrates, the Commission's current policy for setting depreciation rates[30] has not led to a significant overvaluation of the LECs' assets, and thus adequately reflect the economic life of the plant.

Baseman and Van Gieson examine data on reserve deficiencies. Reserve deficiencies are the difference between the booked depreciation reserve (the

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29 In Appendix A to its initial Comments in this proceeding, MCI submitted a study which showed that the LECs' cost of capital, computed using the same methodology as the Commission originally used to compute the 11.25% cost of capital, had fallen to 9.54%. MCI hereby incorporates by reference this study.

30 The Commission sets depreciation rates based on depreciation studies filed by the LECs, reflecting both actual plant retirement practices and LEC projections of planned plant retirements. See Appendix A.

sum of depreciation expenses at the depreciation rates previously allowed by the Commission) and the theoretical depreciation reserve (the sum of depreciation expenses that would have been booked at the new depreciation rate the FCC is adopting). Baseman's and Van Gieson's study finds that the reserve deficiency averages about 1.6 percent of the gross book value of the plant. If this deficit was amortized over five years, it would equal approximately 1 percent of the companies' total 1994 revenues.[31] Thus, the Commission's current policy of setting depreciation rates based on a straight-line remaining life methodology has ensured that significant depreciation reserve deficits do not develop.

VII. THE COMMISSION SHOULD RETAIN A SHARING OBLIGATION FOR THE LOWER PRODUCTIVITY FACTOR

The purpose of a price cap plan is to give LECs' greater incentives to control their costs, and to drive rates down to direct economic costs. So long as rates remain above direct economic cost, some mechanism must be in place to force the LECs to lower their rates. To date, the Commission has used the inflation less productivity adjustment to the Price Cap Index (PCI), in conjunction with the backstop sharing mechanism, to force these rate reductions.

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[31] By comparison, the 100 basis points above the 11.25% authorized rate of return that the Commission allowed the LECs to earn under the initial price cap plan before the LECs were required to return those earnings to ratepayers through a sharing adjustment equaled about 2.5% of revenues.