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

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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 OF
THE SOUTHERN NEW ENGLAND TELEPHONE COMPANY

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December 18, 1995

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SUMMARY

SNET's comments respond to the Commission's Fourth Further Notice to address issues of particular importance to SNET due to the unique economic and competitive circumstances in Connecticut. SNET supports the comments and proposals filed today by USTA to calculate the "productivity offset" or "X-factor" by a new moving average total factor productivity ("TFP") method. This method should be used to establish a baseline X-factor as the local exchange carrier ("LEC") average TFP.

Extensive differences between LECs justify establishing a "tiered" long-term price cap plan where a LEC selects from among multiple X-factors. Such differences -- caused by regional economics, the pace of state regulation, and competition -- directly impact LEC productivity. The Commission's rules adopted in this proceeding should permit a LEC to choose an optional X-factor with a competitive showing demonstrating that barriers to entry are eliminated, e.g., by unbundling service offerings, opening a network to interconnection, and offering number portability.

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The Southern New England Telephone Company ("SNET") respectfully submits these comments in response to the Fourth Further Notice of Proposed Rulemaking in the Federal Communications Commission's ("Commission") above-referenced proceeding.[1]

I. Introduction

The Commission reached certain conclusions in the First Report and Order,[2] about the LEC price cap plan. This plan contains a price cap index ("PCI") adjusted each year using a formula where inflation is offset by a "productivity offset" or "X-factor."[3]

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[1] Local Exchange Carrier ("LEC") Performance Review, Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 95-406, (released September 27, 1995) ("4thFN").

[2] Price Cap Performance Review, First Report and Order, CC Docket No. 94-1, FCC 95-132, (released April 7, 1995) ("First Report and Order").

[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 870313, 5 FCC Rcd 6786 (1990), Second Report and Order; Price Cap Performance Review, First Report and Order, CC Docket No. 94-1, FCC 95-132, (released April 7, 1995); and In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1; Treatment of Operator Services Under Price Cap

The Commission concluded that the X-factor should be based on an industry-wide measure of performance, and tentatively decided that this measure should be based on a total factor productivity ("TFP") method and be calculated on a moving average basis.[4] In this 4thFN, the Commission seeks comment on four issues:[5]

a) the X-factor, its calculation, and whether the X-factor should be reviewed and modified periodically, or set on a permanent basis;

b) the number of X-factors to be included in the price cap plan, and the sharing requirements, if any, to be associated with each X-factor;

c) the common line formula; and

d) exogenous cost rules.[6]

SNET concurs with the comments filed today by the United States Telephone Association ("USTA") that respond to issues a), c) and d) above. Specifically, the Commission is urged to adopt those tentative conclusions including a moving average TFP methodology and to rely upon the simplified approach prepared by Christensen Associates for USTA.[7] In these comments, SNET responds to the Commission's questions about issue b), X-factors in the LEC price cap plan.[8]

Regulation, CC Docket No. 93-124; Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393, released September 20, 1995, ("LEC Pricing Flexibility NPRM").

[4] First Report and Order, para. 145.

[5] 4thFN, para. 12.

[6] SNET does not agree that the Commission's "economic cost" standard promulated in the First Report and Order, para. 294 will narrow potential exceptions so that only cost changes that apparently cause rates to fall are accepted, but the symmetrical impact on potential higher rates is excluded.

[7] In particular, SNET joins USTA Comments filed December 18, 1995 addressing the Commission's 4thFN issues 1a through 1n; issues 2a through 2c; issues 3a through 3c; issues 6a through 6c; issues 7a and 7b; and issue 8.

[8] SNET's Comments address issue numbers 4, and 5a through 5f of the 4thFN.

Of prime importance to SNET is the linkage between this 4thFN and the LEC Pricing Flexibility NPRM. On December 11, 1995, SNET filed its Comments with the Commission responding to issues raised in the LEC Pricing Flexibility NPRM urging the Commission to expedite rule changes that relax pricing and rule restrictions that are particularly important to SNET because of Connecticut's unique economic and competitive circumstances. Connecticut permits competition in nearly all aspects of telecommunications, being one of the first states in the nation to permit such a broadbased competition.[9] State regulatory changes in Connecticut are proceeding at a faster pace than federal changes, and customers continue to make decisions regarding the choice of their telecommunications providers and services irrespective of whether those services are regulated in the state or federal jurisdictions. The Commission continues to espouse the continuance of regulation "only until competition emerges in the interstate access market."[10] That day is at hand -- SNET faces competition today. Regulatory rules must provide LECs with nondominant regulation, or at a minimum streamlined regulation, coincident with competitive presence.[11] In addition, SNET urged the Commission to allow LECs nondominant treatment when there is sufficient evidence that LECs no longer have market power.[12]

[9] State of Connecticut, Department of Public Utility Control, ("DPUC") News Line, December 8, 1995, "DPUC Releases Draft Decision - Sets Interconnect Rates SNET Will Charge To Local Exchange Competitors." As of this date, the DPUC has already certified five companies to provide local exchange service; two more applications are pending; and AT&T is expected to file an application by January, 1996.

[10] LEC Pricing Flexibility NPRM, para. 21.

[11] LEC Pricing Flexibility NPRM, SNET Comments, filed December 11, 1995 at p. 2.

[12] Ibid.

Therefore, the Commission's LEC price cap plan must be harmonious with the Commission's goal to replicate the incentives created by competition.[13] To that end, LECs must be given sufficient pricing flexibility, including the option of selecting from among multiple X-factors, determined by a LEC's unique circumstances, until such time as nondominant status is granted by the Commission. During the interim, the Commission's rules adopted in this proceeding should permit a LEC to choose an optional X-factor if barriers to entry are eliminated, e.g. by unbundling service offerings; opening a network to interconnection, and offering number portability. A lower optional X-factor would recognize the impact that competition has on a LEC's productivity.

II. X-Factor Flexibility Is Necessary To Reflect Differences in Economic Conditions Among LECs.

SNET agrees with the Commission's tentative conclusion in the First Report and Order that the LEC price cap plan should include more than one X-factor.[14] Commissioner Barrett states that "any new price cap mechanism should be based on two fundamental assumptions: 1) the individual LECs are less alike due to unique market circumstances and resulting strategies, and 2) the telecommunications industry is very dynamic."[15] The Commission recognizes the need for multiple X-factors because of "heterogeneity of LEC performance under price caps...Indeed, in setting our interim plan, this heterogeneity, coupled with a corresponding need to provide the LECs with reasonable yet challenging productivity alternatives, supports the implementation of three

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[13] 4thFN, para. 108 and First Report and Order at para. 146.

[14] First Report and Order at para. 165.

[15] Commissioner Barrett, Separate Statement, Action in Docket Cases, CC Docket Nos. 94-1, 93-124, 94-197, September 14, 1995.

options."[16] Multiple X-factors, providing LECs with at least three options, similar to the tiered approach in the interim price cap plan, continue to be a necessary component of a price cap plan for the LECs.[17]

A. The USTA - Christensen TFP Study Provides an Economically Sound Basis to Calculate a Baseline X-Factor.

The appropriate baseline X-factor is one determined from an industry-wide measure of performance relying upon a total factor productivity method (TFP).[18] SNET submits that the USTA - Christensen study is soundly based in economic theory and is the most reasonable method of developing both output and input indices to calculate a moving average X-factor.[19] The Commission should affirm its tentative conclusion that an industry average TFP method, calculated on a moving average basis is appropriate.[20] In addition, SNET supports USTA's Comments provided to the Commission to rely upon its "Total Factor Productivity Review Plan" prepared by Christensen Associates as the appropriate new simplified TFP methodology to calculate a baseline X-factor.[21] USTA is correct in rejecting other methodologies to estimate TFP.[22]

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[16] First Report and Order, para. 165.

[17] 4thFN, para. 9 and First Report and Order at para. 145, and para. 215.

[18] First Report and Order, paras. 106 and 145, and FNRPM, paras. 9 and 16.

[19] See USTA Comments, 4thFN, filed December 18, 1995, Attachment A ("Christensen Paper")

[20] First Report and Order, para. 145.

[21] See USTA Comments, 4thFN, Christensen Paper.

[22] See USTA Comments, 4thFN, at pp. 4-13. Alternative methods such as statistical econometric techniques, or the Historical Revenue Method, are not economically meaningful.

B. One-Size Does Not Fit All.

A single, industry X-factor is inappropriate because applying a "one-size-fits-all" approach flies in the face of real differences recognized by the Commission: LECs are fundamentally different from one another because of such factors as regional economics, state regulation, and competitive circumstances.[23] SNET agrees that there are "strong arguments for establishing multiple X-factors in the long-term plan, so that the plan can be made to fit the particular circumstances of each price cap LEC."[24] The Commission was correct in attributing economic variations among LECs because of such factors as the level of economic growth and the level of competition in providing telecommunications services.[25]

To satisfy the Commission's concern that a LEC be encouraged to select an X-factor no lower than their actual X-factor,[26] a LEC would self-select an adjusted, lower X-factor (i.e., lower than the baseline X-factor determined by industry average TFP) if it met certain specified criteria, i.e., a showing of certain competitive circumstances. As an example of proof of competitive circumstances, SNET suggests using such rules as those promulgated by other jurisdictions. Connecticut's current regulatory rules delineated in its Comments in the LEC Pricing Flexibility NPRM offer a reasonable model for interstate services.[27] SNET suggests that a state regulatory body's certification of the

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[23] LEC Pricing Flexibility NPRM, para. 159 and fn. 241.

[24] 4thFN para. 109.

[25] Ibid.

[26] First Report and Order, para. 219.

[27] See SNET Comments filed December 11, 1995, LEC Flexibility NPRM, at pp. 17 to 20.

existence of competition could be accepted by the Commission as such *prima facie* evidence.[28] Once such evidence was accepted, a LEC should be able to self-select an X-factor lower than the baseline X-factor if it had done so in the preceding years access filing.

C. Scale and Scope, and Economic Differences Justify Multiple X-Factors.

Companies that serve geographically concentrated areas (i.e., a single state) are less likely to enjoy the scale and scope benefits of those companies that serve more geographically dispersed areas (i.e., more than one state). In contrast to companies that serve more than one state, an unhealthy state economy (measured by the relative level of business activity and employment) has a "depressing" effect on the output side of total factor productivity growth despite continuing efforts to reduce the cost of inputs by process improvements.

Due to the continuing downturn in the defense industry and consolidation in the insurance industry -- where Connecticut has been a leading state -- economic weakness is expected into the foreseeable future. Despite management activity to cut costs, economic sluggishness continues to have a dampening effect on output growth.

The net effect of these differences is to considerably increase the risk faced by smaller LECs. To ameliorate this higher risk, more flexibility in the form of multiple X-factors is not only desirable but economically necessary.

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[28] LEC Pricing Flexibility NPRM, SNET Comments, filed December 11, 1995 at pp. 24 to 25.

D. Competition Reduces Output Growth and Negatively Impacts TFP.

Competition has a direct impact on slowing the pace of output growth for companies such as SNET. With competition authorized in all aspects of SNET's intrastate services following passage of state legislation in July, 1994. The introduction of one-plus toll parity by December, 1996, adds additional competitive pressures. SNET's market share for state services can be expected to decline as numerous alternative providers enter the marketplace.

The combination of increasing competition and a depressed Connecticut economy can be expected to hold down SNET's output growth for the foreseeable future and will cause TFP growth to decline. This is the just the opposite of a situation where "a rising tide raises all boats" where the number of customers is not growing and SNET will have to fight to hang on to every customer.[29]

Laurits Christensen, *et. al.*, found that:[30]

> "In addition to the rate of growth in total output, the sources of that growth can be an important determinant of TFP growth when economies of density are present. In industries with economies of density (i.e., the LECs) prices are typically set above marginal cost for the various services provided by the firm, in order to generate revenue sufficient to cover total cost. When the markup of price relative to marginal cost varies over the services provided, growth in high markup services contributes more to TFP growth than growth in low markup services. ...Much of the increasing competition for Local Exchange Carriers is focused in markets with high price-to-marginal cost ratios. If competition effectively leads to lower LEC output growth in these high margin markets, LEC TFP growth will also be lower."

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[29] L.R. Christensen, P. E. Schoech, and M. Meitzen, "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation," filed as Attachment 6 on behalf of USTA in CC Docket 94-1, May 3, 1994, updated January 16, 1995, at page 14.

[30] Ibid.

The Commission should recognize that competition will have a significant effect on the ability of LECs to maintain TFP growth and should allow for unique differences as part of its price cap plan.

E. LEC Productivity Differs Substantially

The Commission acknowledged in its Second Report and Order that "assigning one productivity factor on a mandatory basis to all LECs regardless of size, could prove unduly burdensome to smaller and mid-size telephone companies" where such companies "may have fewer opportunities than large companies to achieve cost savings and efficiencies."[31] As evidence of such differences in productivity, SNET submitted a Total Factor Productivity ("TFP") study to its state regulatory commission authored by Dr. Melvyn Fuss, University of Toronto.[32] This TFP study employed a methodology consistent with that submitted by USTA in this proceeding by Christensen Associates.[33] Dr. Melvyn Fuss, University of Toronto, conducted a direct study utilizing a Tornqvist index to aggregate outputs in a like manner to USTA's simplified TFP study. Inputs are aggregated by Dr. Fuss using cost share weights.

Dr. Fuss calculated SNET's TFP as follows:

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[31] Second Report and Order, CC Docket No. 87-313, Released October 4, 1990, at para. 103.

[32] Application of The Southern New England Telephone Company for Financial Review and Proposed Framework for Alternative Regulation, State of Connecticut, Department of Public Utility Control, ("CDPUC"), Docket No. 95-03-01, Interrogatory OC093SAT, Filed August 23, 1995.

[33] Ibid.

SNET TOTAL FACTOR PRODUCTIVITY
Growth Rates

	TFP (% Change)	Output (% Change)	Input (% Change)
1990	1.3	1.4	0.1
1991	-0.2	-1.6	-1.3
1992	-0.9	-3.2	-2.3
1993	3.9	1.0	-2.8
1994	0.6	0.0	-0.6
Average	0.9	-0.5	-1.4

Dr. Fuss also found that the differential between SNET's TFP and the LECs as a whole, quantified by Christensen Associates for USTA, can be explained by the difference in the economic performance: "I conclude that absent the severity of the recession, it's likely that SNET's productivity growth was about average for the LECs over the period."[34]

Additional reasons that SNET's TFP is substantially lower than the LECs as a whole include 1) the differences in scale and scope of advantages of small and mid-size companies like SNET as compared to larger companies; and 2) size and geographic concentration. For example, large companies can spread fixed costs over higher volumes of activities and multiple state jurisdictions through centralization of service operations and workforce consolidations. The implication of this tendency is that small company productivity gains will tend to be lower than that of larger companies.

As a single state company, without geographic diversity, SNET faces significantly more business risk than larger, more diversified companies. Negative economic cycles,

[34] CDPUC, Docket No. 95-03-01, Transcript of Public Hearing, dated October 12, 1995 at page 2031, lines 14-17.

limited scale and scope of operations, and the level of competition all tend to have an exaggerated effect on SNET. The volatility of Connecticut's economy is demonstrated dramatically by comparison with neighboring New England states and the U.S. Trends in Connecticut's broad employment picture are directly linked to Connecticut's economic strength. Connecticut went into the last recession long before the U.S. economy did and has lagged in economic recovery. The employment recovery rate in Connecticut - defined as total jobs gained back since the last recession - is running at 16% versus a 440% gain recorded nationally.[35] Connecticut's localized economic growth is also well below that of neighboring New England states, and is characterized by slim growth in income, lackluster consumer confidence measures, and continued corporate and manufacturing downsizings.[36]

LECs differ not only in demand caused by regional economic conditions, but the degree to which competition has impacted output growth. SNET embarked on the same path as other LECs to aggressively reduce (input) costs.[37] But competition can be expected to focus on high margin business with high usage levels, with the firm then retaining low margin business with lower usage levels. With growing competition, TFP growth is likely to fall. In sum, the likely impact of these factors will be that SNET will not achieve an industry average TFP growth for the foreseeable future.

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[35] SNET Business Outlook, October, 1995. The Connecticut employment recovery rate is defined as total jobs gained back since recessionary lows relative to non-farm jobs lost during the last (1992) recession.

[36] SNET Business Outlook, October, 1995. New York Times reported that a large majority of Connecticut residents think the state's living standards have worsened in the last five years and most expect them to continue declining. (New York Times, December 11, 1995).

[37] Recently, 2,660 bargaining unit employees (31% of total work force) accepted SNET's Early-Out-Offer, negotiated with the Connecticut Union of Telephone Workers, as both part of SNET's overall contract with the union, and as an integral part of the Company's efforts to prepare for a competitive environment.

F. Individual LEC X-Factors Are Inappropriate.

SNET does not advocate a company-specific TFP for inclusion in a price regulation plan, in either the state[38] or federal jurisdictions: "Knowledge that current productivity growth could impact a future productivity target would set precisely the wrong incentives, rewarding low productivity growth and punishing current high productivity growth with a higher productivity target in the future."[39]

A company-specific TFP is not appropriate for two reasons:

1) in a competitive industry, which regulation attempts to emulate, prices change relative to inflation as average productivity changes relative to national average productivity change;

2) distortion would be introduced into a firm's incentive to improve its productivity -- otherwise, a firm would be incented to seek low future productivity if its historical productivity was low, or punished if its current high productivity forces a future high productivity target.[40]

III. Sharing Is Inappropriate In A Properly Constructed Price Cap Plan.

The appropriate baseline X-factor is one representing the long-term differential between *LEC industry* TFP and U.S. TFP. With the baseline X-factor established as the average industry benchmark, at least one lower X-factor is appropriate for those LECs

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[38] Dr. William E. Taylor, prefiled testimony at page 23, State of Connecticut Docket No. 95-03-01. Application of The Southern New England Telephone Company for Financial Review and Proposed Framework for Alternative Regulation. ("Taylor PFT") "Establishing one individually tailored X-factor would introduce a distortion in the incentive for each firms to improve its productivity."

[39] Ibid.

[40] Taylor PFT at pp. 22-23.

that demonstrate unique circumstances due to economics (e.g., economies of scale and scope, and regional diversification), as well as opening up markets to competition. The benefits of competition -- to offer more choices and encourage greater efficiency -- satisfy the Commission's often-stated goals. Lower prices produced by competition in effect pass along to consumers a "share" of increased efficiency.

SNET agrees with USTA's Comments filed in this proceeding, and in USTA's Comments preceding the First Report and Order, that sharing has no place in a properly crafted LEC price cap plan. Sharing dampens the incentives for a LEC to operate efficiently. Moreover, sharing continues rate-of-return regulation with its accounting conventions, rate-of-return methodologies for cost of capital, jurisdictional separations and affiliate transactions rules. Such cost-based regulation has no place in a price cap system. In addition, sharing was originally designed as a "backstop" for the X-factor in case of an error in the Commission's productivity estimates.[41] The plan advocated by USTA provides for annual updates from publicly-available and verifiable sources to accurately measure LEC TFP in a timely basis. Thus, the "backstop" is no longer necessary.

IV. Conclusion

Competition for LECs' services from alternative providers exists today in Connecticut. Alternative providers are not encumbered by artificial pricing rules and regulation; the imposition of rules that shackle the LECs in this competitive environment necessitates immediate response and relief from the Commission.

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[41] First Report and Order, paras. 190-191.

In its Comments to the LEC Pricing Flexibility NPRM, SNET urged the Commission to expedite rules changes that 1) relax unnecessary pricing restrictions placed on price cap LECs; 2) subject LECs to a streamlined form of regulation coincident with the presence of alternative providers for comparable services; and 3) include a mechanism that will allow LECs nondominant status when there is evidence that substitutable services are readily available from sources other than LECs.

Until such time as nondominant status is granted, SNET urges the Commission to adopt rules in the long-term LEC price cap plan USTA's proposal for a baseline X-factor developed with a new simplified TFP methodology, and also adopt multiple X-factors. The Commission's rules should recognize that LECs face unique economic and market circumstances, particularly because of growing competition.

Respectfully submitted

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