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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

April 30, 1996

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

Re: CC Docket 94-1

Dear Mr. Caton:

USTA provided today a letter to Regina Keeney, Chief of the Common Carrier Bureau, which responds to an April 16, 1996, letter from the CARE coalition. Two copies of this letter are attached, to be included in the public record of this proceeding.

Should you have any questions, please contact me at (202) 326-7249.

Sincerely,

Charles D. Cosson
USTA Attorney

0+1

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FEDERAL COMMUNICATIONS COMMISSION
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April 30, 1996

Ms. Regina Keeney, Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 518
Washington, D.C., 20054

Re: CC Docket 94-1
LEC Price Cap Review
Fourth Further Notice

Dear Ms. Keeney:

On April 16, 1996, the CARE coalition filed an ex parte letter replete with misrepresentations of the price cap exchange carriers' recent annual interstate access tariff filings. CARE's arguments essentially seek to reimpose rate of return regulation, ignoring the substantial reductions in prices that incentive regulation has brought to CARE members and other interstate ratepayers. More generally, CARE simply ignores the progress made in telecommunications legislation and regulation that has occurred over the past several years - most notably the implementation of incentive-based regulation and the recent passage of the Telecommunications Act of 1996.

Time and time again, the Commission has reiterated its desire to let competition regulate LECs' prices, and where needed, to impose regulations which emulate competition. Congress has recently directed the Commission to implement a national policy of deregulation and competition. Yet, CARE continues to present misleading arguments and misrepresented facts in an effort to capture for themselves drastic price reductions, at the expense of eliminating the benefits of incentive regulation.

A fundamental defect in CARE's argument is its myopic focus on a single snapshot of price cap regulation - the 1996 annual access tariff filing. Here are the simple facts of the benefits of incentive regulation. Since price caps began in 1991, the LECs have reduced interstate access charges by $9 billion dollars. This represents a decrease of 17%, during a time period when overall inflation increased 20%. Considering this remarkable track record, CARE's harangue against the LECs' negligible (.06%) rate increases proves nothing.

Even if we look only at this year's filing, the negligible 0.06% increase in rates in the 1996 filing amounts to a real savings when inflation is taken into account. That is, in real terms, the 0.06% increase represents approximately a 2.5% decrease after inflation. Moreover, this 0.06% increase was due to accounting changes to adjust for the effect of the prior year's sharing obligations - obligations which represent additional dollars returned to ratepayers.

Under price caps, the LECs' access rates should not necessarily always decrease. The Price Cap Indexes (PCIs) that control those rates are revised annually for changes in inflation, productivity and both increases and decreases in exogneous costs. This year's PCIs changed less dramatically than in the past because of fewer one-time adjustments and the reversal of substantial temporary exogenous cost adjustments. Nonetheless, the LECs' access rates continue to reflect the on-going effects of prior years' productivity offsets and other permanent reductions.

Nevertheless, CARE claims that there is "clear evidence" that "consumers" (i.e., long distance incumbents) have been short-changed by the Commission's price cap regulation. Based on this claim, CARE urges the Commission to quickly and drastically increase the X-Factor to prevent any "future unwarranted LEC price increases." Specifically, CARE encourages the Commission to immediately decrease access rates by nearly doubling the X-Factor. CARE recommends the wrong policy for the present telecommunications environment. CARE's actions attempt to circumvent true price cap reform, achieve additional rate reductions, and cripple its potential competitors by encouraging the Commission to subject price cap LECs to rate of return regulation in a competitive market.

As the Commission has noted, any changes in the price cap plan must be comprehensive and consider the increasing competition faced by LECs. For example, in response to increasing telecommunications competition, the California Public Utilities Commission took appropriate action -- it suspended the entire price cap formula. Yet, faced with similar circumstances of increasing competition and the effects of legislation eliminating entry barriers, CARE advocates precisely the opposite response -- a dramatic, economically unsound *increase* in the X-Factor. As described below, CARE relies on faulty assumptions and erroneous conclusions in attempting to justify this result.

There are three basic reasons the Commission must reject CARE's suggestion to substantially increase the X-Factor: 1) CARE's position is contrary to the primary tenets of incentive regulation, 2) earnings are no substitute for an economically-based productivity study, and 3) CARE's suggested 10% X-Factor would result in an unlawful taking - LEC earnings would drop below any meaningful measure of the cost of capital in a short period of time.

First, using interstate accounting earnings as a "back door" productivity method undermines the very incentives at the heart of price cap regulation. Earlier in this proceeding, Dr. Alfred E. Kahn recognized the Commission's desire to sever the tie between earnings and prices. He specifically stated:

> So long as the price caps continue to be tested from time to time against the rate of return they produce, as they are under the current plan applicable to the LECs, the perverse effects of cost plus regulations on the companies' incentives will not be entirely eliminated.

Additionally, as the Commission has noted, the sharing mechanism for regulating earnings creates "perverse incentives," and therefore the Commission has sought to develop a long-term price cap plan which eliminates the sharing mechanism.
If the Commission were to simply rely on earnings to set a productivity offset as CARE recommends, these perverse incentives will be even further magnified.

Moreover, USTA has demonstrated that the accounting measures of interstate earnings are highly unreliable for assessing LECs' earnings. Dr. James Vander Weide presented evidence that the economic earnings of the price cap LECs averaged only 8.94% over the 1991-94 time period, significantly less than the 12.7% pictured in the accounting reports that conform to the Commission's earning reporting rules. Dr. Vander Weide's calculations are the economically meaningful approach to measuring earnings, and are consistent with the calculations used by investors in determining where to allocate capital.

Second, CARE uses LEC accounting earnings in an attempt to demonstrate that a LEC could anticipate annual productivity gains of 8.54% or more. This is wrong. Rather than rely on a meaningful measure of productivity, CARE forced its desired result (i.e., an increased X-Factor) by assuming the price cap LECs' 1994 earnings had been 11.25%. Thus, CARE's technique assumes that the Commission had already totally recaptured all of the benefits of incentive regulation realized by the price cap LECs down to an earnings level of 11.25%, imposing an imaginary rate-of-return environment in 1994. CARE then takes the LECs' actual accounting earnings and calculates the productivity growth from its arbitrary 11.25% starting point. This numerical chicanery renders any downstream results and recommendations meaningless.

Third, CARE erroneously claims that the LECs can earn a fair return with a 10% X-Factor. Exposing CARE's methods and the evidence on economic earnings shows this is preposterous. When inflation is about 2.5%, a 10% X-Factor requires ongoing price reductions of 7.5% (2.5% inflation less a 10% X-Factor). If prices had been forced down 7.5% annually and accounting earnings held constant at 11.25%, some component of the productivity mix would have needed significant adjustment. For example, an 18% annual growth in minutes -- roughly three times the current average -- would have been required to generate the productivity implied in CARE's 10% X-Factor. Alternatively, this would require massive downsizing and additional expense reductions such as materials and supplies: annual work force reductions of about 12% and additional reductions of 12% annually in materials, rents and services. The magnitude of these alternatives clearly shows the unrealistic nature of CARE's proposal. On this basis alone, the Commission should reject CARE's recommended X-Factor.

To further demonstrate the absurdity of CARE's recommendation, USTA restated the price cap LECs' 1991-95 results using CARE's recommended 10% X-Factor. The attached graph shows the disastrous outcome this X-Factor would have produced over the past five years. Within the initial year of price caps, the price cap LECs (on average) would have triggered the lower formula adjustment mechanism (LFAM) (i.e., returns below 10.25%). By 1995, absent LFAM-related rate increases, the LECs' accounting returns would have fallen to only 3% -- a result totally inconsistent with "incentive" regulation.

The Commission should resist pressure to hastily increase the current X-Factor. Instead it should take the time necessary to objectively evaluate the economically meaningful simplified TFP-based plan proposed by USTA. USTA's rolling average mechanism guarantees the automatic flow through of future efficiency gains to consumers. Additionally, the Commission should keep a close eye on the changing competitive landscape, particularly in light of the 1996 Telecommunications Act. The Commission may also benefit by taking note of the recent price cap changes made by the California Public Utilities Commission. Careful, economically meaningful steps -- not drastic action -- will best serve the transition to even more competitive telelcommunications markets.

Sincerely,

Mary McDermott

Mary McDermott
Vice President, Legal and Regulatory Affairs
United States Telephone Association

cc: Office of the Secretary

Common Carrier Bureau
A. Richard Metzger
Larry Atlas
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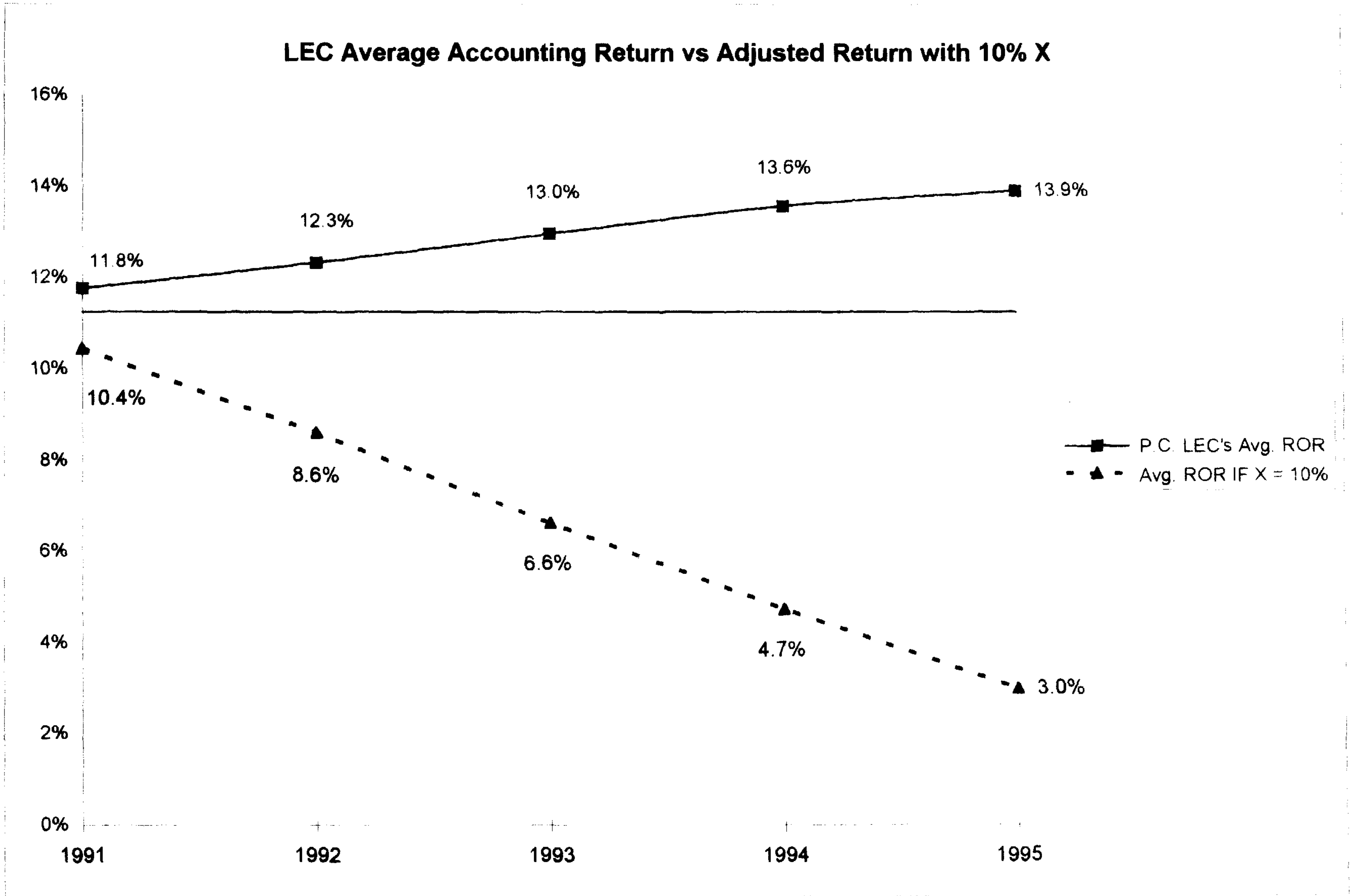
LEC Average Accounting Return vs Adjusted Return with 10% X
16%
14%
12%
10%
8%
6%
4%
2%
0%
1991
1992
1993
1994
1995
11.8%
12.3%
13.0%
13.6%
13.9%
10.4%
8.6%
6.6%
4.7%
3.0%
P.C. LEC's Avg. ROR
Avg. ROR IF X = 10%