in the 1995-96 access period for changes in the cost of capital,[292] the incumbent LECs' cost of capital may now be less than 11.25 percent. Specifically, in the *Represcription Reform Order*, we found that the rate of return prescription may warrant revision if the monthly average on ten-year U.S. Treasury securities changes by more than 150 basis points, and the change continues for six months or more.[293] In February 1996, the Common Carrier Bureau invited comment on whether to initiate a proceeding to represcribe the authorized rate of return for incumbent LECs subject to rate-of-return regulation, pursuant to the trigger mechanism we established in the *Represcription Reform Order*.[294] If that proceeding reveals that the rate-of-return LECs' cost of capital has decreased since we prescribed the current authorized rate of return in 1990, then the price cap LECs' cost of capital may possibly be lower as well. On the other hand, incumbent LECs face potential competition as a result of the Act that they did not face previously. This potential competition could increase the risks facing the incumbent LECs, and thus increase their cost of capital, thus mitigating to some extent the factors suggesting that incumbent LECs' cost of capital has decreased since 1990. We also note that evolving competition may make it appropriate to assign different costs of capital to different services, reflecting differences in competition and higher risks in transport, switching, and loop services respectively.

229. We invite parties to discuss whether our prescriptive regulatory requirements should include reinitialization of price cap indices on any of the above-mentioned bases in this Section or Section VI.C.1. We seek comment on how, if we were to proceed with this approach, to reinitialize price cap indices. We also invite parties to provide estimates of what effect these reinitializations would have on the incumbent LECs' PCIs. In Section III.E above, we solicit comment on whether we should target the effects of any reinitialization to the TIC as a means of phasing out that rate element.

230. While reducing PCIs would clearly reduce access rates, reinitializing indices based on earnings could have a negative effect on the productivity incentives of the LEC price cap plan.[295] Represcribing a rate of return would also be administratively burdensome. We

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[292] *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9063.

[293] Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, 10 FCC Rcd 6788, 6802-03 (1995) (*Represcription Reform Order*).

[294] Common Carrier Bureau Sets Pleading Schedule in Preliminary Rate of Return Inquiry, Public Notice, 11 FCC Rcd 3651 (Com. Car. Bur. 1996).

[295] For example, in its comments preceding the *LEC Price Cap Performance Review Order*, AT&T suggested setting the X-Factor equal to the amount necessary to equate the price cap LECs' average rate of return with 11.25 percent. We found that this method might not create adequate incentives for increasing productivity. *See* Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 13659, 13672 (1995) (*Price Cap Fourth FNPRM*). *See*

invite commenters to discuss whether any such negative effects are likely to outweigh the benefits of moving rates closer to their economic cost, and whether this approach is consistent with the development of efficient competition.

3. Revision of LEC Price Cap Plan

231. In 1990, the Commission adopted mandatory price cap regulation for the BOCs and GTE. Other incumbent LECs may elect to be governed by price cap regulation.[296] In simple terms, price cap regulation permits rates to increase no more than a measure of inflation minus an "X-Factor," that largely reflects a reasonable productivity target.[297] Thus, the higher the X-Factor, the more downward pressure price cap regulation applies to access rates.

232. The X-Factor represents in large part the amount by which carrier productivity has historically exceeded productivity in the economy generally.[298] The X-Factor also includes a 0.5 percent consumer productivity dividend (CPD). The CPD was intended to serve the policy goal of assuring that the first benefits of the incumbent LECs' productivity growth induced by price cap regulation would flow to access customers in the form of reduced rates.[299] A policy-based mechanism similar to the CPD could be used to force price cap incumbent LECs to reduce their rates further. For example, if we can rely on TELRIC studies to estimate the economic costs of access services, as we discuss in Section VI.C.1 above, then we could set this policy-based mechanism at some fraction of the percentage difference between current access rates and rates based on economic costs. Therefore, in this example, setting the policy-based mechanism at 20 percent of the initial difference between current rates and economic cost-based rates should then cause the price cap formula to drive access rates to cost over a five-year period, assuming that costs do not change during that period. We invite comment on the use of such a policy-based mechanism, and on the derivation of such a mechanism.

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also LEC Price Cap Performance Review Order, 10 FCC Rcd at 9034 (tying productivity measure to actual rate of return was a "possible disadvantage" of AT&T's method). In its comments filed in response to the *Price Cap Fourth FNPRM*, AT&T proposed an X-Factor calculation method based on total factor productivity (TFP) instead of the rate-of-return based method it proposed previously.

[296] *LEC Price Cap Order*, 5 FCC Rcd 6786. To date, Citizens, Frontier, Lincoln, SNET, and United have elected price caps.

[297] *LEC Price Cap Order*, 5 FCC Rcd at 6792. For a complete summary of the original price cap plan, *id.* at 6787-89.

[298] *LEC Price Cap Order*, 5 FCC Rcd at 6796.

[299] *LEC Price Cap Order*, 5 FCC Rcd at 6799.

233. In 1995, we adopted the *Price Cap Fourth FNPRM*, in which we sought comment on various proposals for revising the productivity offset component of the X-Factor,[300] and for eliminating sharing obligations and the low end adjustment mechanism.[301] Subsequently, the Customers for Access Rate Equity (CARE) Coalition has filed several *ex parte* statements urging that we complete expeditiously the rulemaking proceeding initiated in the *Price Cap Fourth FNPRM* and adopt a higher X-Factor or set of X-Factor options.[302] AT&T and MCI have also urged us to adopt a higher X-Factor.[303] We solicit comment on whether there is any justification for increasing the productivity offset, either on the basis of the record developed pursuant to the *Price Cap Fourth FNPRM*, or on more recent economic studies. We specifically invite parties to discuss the effects of a forward-looking cost of capital and economic depreciation on TFP measurement.[304] Parties relying on more recent economic studies must comply with the "general criteria" we established for economic studies in the *Price Cap Fourth FNPRM*.[305]

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[300] In particular, we sought comment on basing the X-Factor on some measure of total factor productivity (TFP). TFP is the ratio of an index of total outputs to an index of total inputs. *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9008-09. This output index represents the quantities of goods or services consumed, and the input index represents the quantities of goods or services produced. If an incumbent LEC can increase its outputs without increasing its inputs, it has become more productive. In order to develop these quantity indices, it is also necessary to develop output and input price indices. The input quantity and price indices are composites of indices of capital, labor, and materials. The development of each of these indices raises important issues. In addition to these TFP calculation issues, there are other issues raised by calculation of the X-Factor. Two of the most important of these issues are whether to make an X-Factor adjustment for the difference between incumbent LEC input prices and input prices for the economy as a whole, and whether to make an adjustment for a perceived difference between interstate and intrastate productivity growth. *See Price Cap Fourth FNPRM*, 10 FCC Rcd at 13663-71.

[301] We noted that, although sharing tends to blunt the efficiency incentives otherwise created by the price cap plan, it also serves beneficial functions. We sought comment on eliminating sharing and establishing other mechanisms to serve those functions. *See Price Cap Fourth FNPRM*, 10 FCC Rcd at 13676-80.

[302] *See, e.g.*, Presentation of CARE Coalition in CC Docket No. 94-1, filed April 16, 1996. CARE includes purchasers of interstate access providers and others: the National Association of State Utility Consumer Advocates, the Telecommunications Resellers Association; Ad Hoc Telecommunications Users Committee; MCI Telecommunications Corp.; Consumer Federation of America, LDDS Worldcom; AT&T Corp.; American Petroleum Institute; International Communications Association; and CompTel.

[303] *AT&T November 22 Letter* at 6. *See generally* AT&T Comments in CC Docket No. 94-1, filed Jan. 11, 1996; MCI Comments in CC Docket No. 94-1, filed Jan. 11, 1996.

[304] We stated that the TELRIC-based rates of unbundled network elements should be based on the forward-looking cost of capital. *Local Competition Order* at para. 691. We discuss economic depreciation rates below.

[305] *Price Cap Fourth FNPRM*, 10 FCC Rcd at 13662-63.

234. We also seek comment on whether we should change the rules governing justification of tariff filings that cause the API for a basket to exceed the PCI. The price cap plan does not prohibit above-cap rate filings, but does subject such filings to stringent review standards.[306] An incumbent LEC making an above-cap filing must submit an extensive cost showing that explains all cost allocations down to the lowest possible level of disaggregation. It must also give a detailed explanation of the reasons for the prices of all rate elements to which costs are not assigned.[307] We have stated that we will find such filings lawful only if the incumbent LEC can demonstrate that compliance with the price cap rules would have the effect of denying the LEC the opportunity to attract capital and continue to operate.[308] A LEC that is permitted to charge above-cap rates becomes subject to traditional rate-of-return regulation with respect to those rates.[309]

235. The cost showing contemplated by the price cap rules is, in essence, a traditional, embedded-cost rate case.[310] We seek comment on whether the rules should be changed to require that above-cap filings be justified based on the forward-looking economic cost of providing access service.

4. Rate Prescription

236. The proposals we discuss above, reinitializing price cap indices and increasing the X-Factor, are designed to reduce access rates. None of those proposals would necessarily compel price cap incumbent LECs to adopt efficient rate structures, nor ensure that price cap incumbent LECs allocate common costs in a reasonable manner. In Section III above, we invite comment on revisions to the rate structure rules to require price cap LECs to develop access rates that reasonably reflect the manner in which they incur costs. Here, we seek comment on whether those rules are sufficient to ensure that access rates reflect costs in areas subject to prescriptive access reform. We also seek comment on prescribing forward-looking incremental cost-based access rates as part of our prescriptive approach to access reform.

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[306] *LEC Price Cap Order*, 5 FCC Rcd at 6823.

[307] 47 C.F.R. §61.49(e).

[308] *LEC Price Cap Order*, 5 FCC Rcd at 6823.

[309] *See LEC Price Cap Order*, 5 FCC Rcd at 6836 ("if a LEC has been permitted to charge above-cap rates, the sharing mechanisms no longer apply, and the LEC's rates would be subject to complaint on the basis that they are unjust and unreasonable in light of the current rate of return prescription.")

[310] *See LEC Price Cap Order*, 5 FCC Rcd at 6323 ("A LEC may request an above-cap rate increase by filing a tariff transmittal that complies with specific rules for such filings, a showing that includes but is not limited to the cost support information normally required in annual access tariff filings for LECs subject to rate of return regulation, and other information necessary to establish that the increase is needed if the LEC is to have an opportunity to attract capital.")

237. Basing the prices of discrete unbundled network elements, such as loops and switching, on a forward-looking economic cost methodology may be more economically rational than using the same methodology to price conventional services, such as interstate access. Separate services are typically provided over shared network facilities, the costs of which may be joint and common. For example, interstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long-distance services. Conversely, certain unbundled elements, such as loops and line cards, can be priced individually using a TELRIC methodology, and in those cases the allocation of common costs is less problematic than when pricing services.

238. We invite comment on whether, if we adopt a prescriptive approach to access reform, we should require incumbent LECs to conduct TSLRIC studies, and create new prices for individual interstate access services on the basis of those studies.[311] Under this proposal, we would reset access prices once, and then rely on price cap regulation to keep rates just and reasonable. We also seek comment on how to allocate common costs if we were to adopt this approach, and whether problems raised by allocating a large amount of common costs relative to direct costs outweigh the benefits of this approach.

D. Phases for Prescriptive Approach

239. We are unable at this time to quantify the magnitude of the difference, if any, between current interstate access rates and rates based on forward-looking economic costs. We seek comment on the amount of that difference in Section VII.B below, and the extent to which incumbent LECs should be permitted an opportunity to recover that amount. In this Section of the Notice, we observe only that there may be a substantial cost difference relative to interstate access revenues as a whole. If so, we tentatively conclude that we should include some sort of transition mechanism in the prescriptive access reform plan, comparable to the phases of the market-based access reform plan we discuss in Section V above.

240. One possible transition mechanism could be to establish phases for any reinitialization of price cap indices that we may adopt. In other words, we would implement the reduction in price cap indices through a series of reinitializations rather than a single reinitialization. A second option could be to adopt a policy-based increase to the X-Factor for a number of years, to reduce interstate access gradually, and then reinitialize price cap indices to TSLRIC levels as discussed in Section VI.C.1 above. We could also adopt a policy-based increase to the X-Factor for a number of years, and then prescribe TSLRIC-based access rates. Parties are invited to comment on all these options, and to make suggestions of their own.

[311] AT&T has explained how it would derive access prices from the Hatfield Model. *AT&T November 22 Letter* at Appendix A.

VII. TRANSITION ISSUES

241. In this proceeding, we must address a variety of issues relating to the transition from the regulatory structure that existed before the passage of the 1996 Act to that which will exist after the three proceedings have been completed. In Section VII.A, below, we seek comment on the manner in which the universal service support amounts attributable to the interstate jurisdiction should reduce interstate access rates.[312] In Section VII.B., we address issues relating to the potential difference between the revenues that incumbent LECs generate from current interstate access charges and the revenues that revised access charges are likely to generate. We seek comment on both the estimated magnitude of that difference and the extent to which alternative methods of recovery of that difference should be permitted.[313]

A. Universal Service Joint Board Recommended Decision

242. The 1996 Act states that any federal universal service support provided to eligible carriers "should be explicit"[314] and recovered on an "equitable and nondiscriminatory basis"[315] from all telecommunications carriers providing interstate telecommunications service. In the *Joint Board Recommended Decision*, the Joint Board recommended that the Commission establish a nationwide benchmark to use in calculating the amount of universal service support eligible telecommunications providers will receive.[316] Each eligible carrier would receive revenues from the federal universal service support mechanism based on the amount its forward-looking costs of serving a subscriber, as calculated using a proxy model, exceed the benchmark. The Joint Board advised that the benchmark be based on the nationwide average revenue-per-line, *i.e.*, the sum of the revenue generated by local, discretionary,[317] access services, and others as found appropriate, divided by the number of loops served.[318] Final determination of this issue, however, must also take into consideration

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[312] We sought comment on the Joint Board's suggestions for the common line rate structure in Section III.B, *supra*.

[313] In Section III.E, we explored possible explanations for the sums recovered through the TIC, and on different approaches to phasing out the TIC.

[314] 47 U.S.C. § 254(e).

[315] 47 U.S.C. § 254(d).

[316] *Joint Board Recommended Decision* at para. 309.

[317] Discretionary services include services that are added on to basic local service, *e.g.*, call waiting, call forwarding, or caller ID.

[318] *Joint Board Recommended Decision* at para. 310.

the revenue base for universal service contributions.[319] The Joint Board further advised the Commission to construct two benchmarks, one for residential service and a second for single line business service.[320] The Joint Board recommended that costs in excess of the benchmark be funded through an assessment based either on the interstate revenues of all interstate telecommunications carriers less interstate payments to other carriers, or interstate and intrastate revenues of all interstate telecommunications carriers less payments to other carriers.[321]

243. In its *Recommended Decision*, the Joint Board affirmed the Commission's tentative conclusion that LTS payments constitute a universal service support mechanism that serve to equalize LECs' access charges by raising some carriers' charges and lowering others.[322] The Joint Board concluded that the LTS mechanism is inconsistent with the 1996 Act's requirement that support be collected from all providers of interstate telecommunications services on a non-discriminatory basis. Accordingly, the Joint Board recommended that the LTS system no longer be supported via the access charge regime, and that rural incumbent LECs continue to receive payments comparable to LTS from the new universal service support mechanism.[323] In the event the Commission implements a rule assessing carriers' universal service support contributions based on both interstate and intrastate telecommunications revenues, the Joint Board recommended that there should be a downward adjustment in the residential and single-line business SLC cap and CCL charges to reflect the recovery of LTS from other sources.[324]

244. We recognize that, because of the role that access charges have played in funding and maintaining universal service, it is critical to implement changes in the access charge system together with complementary changes in the universal service system. Regardless of whether features of our access charge system, such as the per-minute CCL charge and geographically-averaged rates, contravene section 254 as discussed in Section III.B., above, we seek comment on whether retaining such features in light of the possible changes in universal service could, in essence, compensate incumbent LECs twice for providing universal service. We ask commenters addressing this issue to identify the circumstances, including assumed structure of the high-cost area support mechanisms, under

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[319] *Joint Board Recommended Decision* at para. 314.

[320] *Joint Board Recommended Decision* at para. 312.

[321] *Joint Board Recommended Decision* at paras. 817-23.

[322] *Joint Board Recommended Decision* at para. 767.

[323] *Joint Board Recommended Decision* at para. 768.

[324] *Joint Board Recommended Decision* at para. 773.

which any "double recovery" may exist. We further seek comment on how we could best address any potential double recovery.

245. We propose that a downward exogenous cost adjustment should be made for price cap incumbent LECs to reflect revenues received from any new universal service support mechanism. We note that the Commission, after receiving recommendation from a joint board, must determine the extent to which universal service support revenues are apportioned to the interstate jurisdiction. In the event the Commission, concludes that high cost universal service support should be allocated to the interstate jurisdiction, how should we adjust the price cap indices to reflect new explicit universal service support? Parties should also comment on whether a downward adjustment to the incumbent LECs' PCIs should be across-the-board, or targeted to a particular basket or service category, *e.g.*, the trunking basket or the TIC, or to the CCL charge or any new mechanism that may replace it. We seek comment on the manner in which we must adjust incumbent LECs' price cap indices to account for the removal of LTS from incumbent LECs' access charges. We tentatively conclude that a downward exogenous cost adjustment should be made to the CCL charge, or to any new mechanism that may replace it, to the extent that the recovery of LTS from other sources is not offset by a SLC cap reduction, and seek comment on this tentative conclusion.[325]

246. For rate-of-return incumbent LECs, interstate costs must be reduced to reflect revenues received from any new universal service support mechanism to the extent allocated to the interstate jurisdiction. We seek comment on how such reductions should be treated in Part 69 for non-price cap incumbent LECs.[326] Finally, we seek comment on how our proposed interstate ratemaking treatment of the new universal service support mechanism affects small business entities, including small incumbent LECs and new entrants.[327]

B. Treatment of Any Remaining Embedded Costs Allocated to the Interstate Jurisdiction

247. A number of IXCs assert that a significant difference exists between the revenues generated by access charges based on embedded costs allocated to the interstate jurisdiction by Part 36, and the revenues that would be produced by access rates based on the forward-

[325] Whether, as discussed above, the SLC cap for single-line business and the primary residential connections should be lowered to reflect part of the recovery of LTS support will be addressed in the universal service proceeding.

[326] As for price cap LECs, whether the SLC cap for single-line business and the primary residential connection should be lowered to reflect part of the recovery of LTS support by non-price cap LECs will be addressed in the universal service proceeding.

[327] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

looking economic cost of providing access services. For example, as of November 1996, AT&T estimated that total interstate access charges collected today from interexchange carriers exceed the forward-looking economic cost of providing access by about $11.0 billion, or nearly 70 percent of that total.[328] Similarly, in October 1996, AT&T asserted that it pays incumbent LECs an average (interstate/intrastate) per-minute access rate of 3.06 cents, and that this rate is more than 7.5 times greater than the TELRIC per-minute access rate of .40 cents.[329] AT&T labels $7.0 billion of the $11 billion as "pure uneconomic subsidy to monopoly incumbent local exchange carriers" caused by overallocation of costs to the interstate jurisdiction, the inclusion of retail and other costs unrelated to the provision of access, the understatement of incumbent LEC productivity, and other historical inefficiencies.[330] AT&T asserts that $4.0 billion of the current access revenues are universal service support amounts and should be recovered through mechanisms under section 254 and not through access charges. In March 1996, MCI estimated that approximately $46 billion (or more than 55 percent) out of $82 billion total network revenues for Tier 1[331] local telephone companies is the difference between the accounting costs and the economic costs of providing those networks as network elements.[332] MCI attributed this gap largely to the inclusion of over-built plant ($17 billion), excess customer operations expenses ($15 billion), excess corporate operations expenses ($8.3 billion), and inefficiencies ($3.8 billion) in network charges. According to MCI, very little of the gap results from under-depreciation ($0.85 billion).[333]

248. Current interstate access service revenues permit recovery of the interstate portion of embedded costs, subject since 1991 to the constraints of price cap regulation. The revenues that would be generated if all access services were priced at forward-looking, economic cost may be much smaller.[334] We generally ask parties to discuss, in light of the

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[328] *AT&T November 22 Letter* at 1-2.

[329] Letter from Bruce K. Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, October 9, 1996, filed in CC Docket No. 96-45.

[330] *AT&T November 22 Letter* at 1-2.

[331] For tariff review purposes, the term "Tier 1 LEC" has traditionally referred to a company having annual revenues from regulated operations of $100 million or more. For accounting purposes, the Commission uses the terms Class A and B companies as defined in Section 32.11(a)(1) and (2) of the Commission's rules to differentiate large and small carriers. 47 C.F.R. § 32.11(a)(1), (2).

[332] *See Hatfield Model.* MCI based its estimate on 1993 data. *Hatfield Model* at 34-35.

[333] *Hatfield Model* at 34-44.

[334] *See AT&T November 22 Letter* at 5; *NARUC October 23 Letter* at 3, 4 (suggesting that we seek comment on this issue).

other reforms discussed in this proceeding and other developments pursuant to the 1996 Act, the following issues: the amount and make-up of the difference between these amounts, whether recovery of the remaining interstate-allocated costs should be permitted, the lawfulness of a denial of such recovery, and possible recovery mechanisms.[335] We also invite parties to comment on the impact of the following proposals on small business entities, including small incumbent LECs and new entrants.[336] In addition to seeking comment on the nature and magnitude of the difference, which could include a portion of the revenues that would remain in the TIC after the steps discussed in Section III.E. above, we seek comment on whether the identification and ratemaking treatment of remaining interstate-allocated costs should vary depending on whether an incumbent LEC is under a market-based or prescriptive approach to access reform.

1. Nature and Magnitude of Any Remaining Interstate-Allocated Costs

249. Some of the difference between the incumbent LECs' interstate-allocated embedded costs and forward-looking costs may be traced to past regulatory practices. For example, interstate access rates may exceed forward-looking economic cost, and thus produce some difference, because of misallocation of costs to the interstate jurisdiction. Historically, some separations rules were designed to shift some costs from the intrastate to the interstate jurisdiction, in order to further universal service goals.[337] For example, in 1987 the Commission agreed with a Federal-State Joint Board's recommendation to exclude interstate access revenues from the allocation factor used to apportion marketing expenses between the interstate and intrastate jurisdictions.[338] The Commission reconsidered its decision, however, and reinstated separations procedures that allocate marketing expenses in accordance with revenues in order to avoid shifting significant amounts of revenue requirement to the intrastate jurisdiction.[339] We note further that, to the extent that unbundled network element revenues are unseparated, a difference between the interstate-allocated embedded and forward-looking

[335] We note that certain parties have referred to those costs to which they assert they are entitled as "residual" or "legacy" costs. *See, e.g., NARUC October 23 Letter* at 3-4.

[336] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[337] *See, e.g.,* 47 C.F.R. § 36.125(f) (requiring triple dial equipment minute (DEM) weighting for carriers with fewer than 10,000 access lines).

[338] Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, Recommended Decision and Order, 2 FCC Rcd 2582 (1987).

[339] MTS and WATS Market Structure, CC Dockets No. 78-72, 80-286, and 86-297, Memorandum Opinion and Order on Reconsideration and Supplemental Notice of Proposed Rule Making, 2 FCC Rcd 5349 (1987).

costs of providing access service may result when these revenues are removed from the interstate jurisdiction.[340]

250. Another possible regulatory cause of any difference between interstate-allocated embedded or accounting costs and forward-looking costs may be under-depreciation of incumbent LEC assets. Our depreciation procedures provide for incumbent LECs to depreciate the total investment in assets over the estimated useful life of the assets at rates we prescribe for each class of assets.[341] Under rate-of-return regulation, the incumbent LECs set rates for their access services that incorporated these depreciation charges; those rates were the foundation for the initial price cap rates. Many incumbent LECs contend that this Commission prescribed depreciation schedules based on relatively long asset lives in order to spread recovery of investment over an extended period and prevent large rate increases.[342] In a monopoly environment, there were no competitive providers that might prevent an incumbent LEC from eventually recovering its entire investment at the end of the prescribed period.

251. Under-depreciation of incumbent LEC capital assets can occur in two ways. First, facilities may be under-depreciated if the useful lives prescribed for regulated facilities exceed the economic lives of those facilities. This under-depreciation often occurs when new technologies are introduced that reduce the remaining economic lives of embedded plant. In that event, the existing depreciation rate will not produce an adequate depreciation charge to account for the shorter remaining lives of the old equipment. In other words, if a new technology shortens the economic life of existing incumbent LEC plant from 25 to 15 years, a prescribed depreciation schedule of 25 years for that plant will not enable the incumbent LEC to recover its investment during the useful economic life of the plant. However, under the remaining life techniques a LEC has the ability to request revised depreciation rates and recover its investment over the expected remaining life.[343]

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[340] We intend, in the near future, to initiate a proceeding to address the separations issues raised by incumbent LEC provision of unbundled network elements.

[341] We plan to initiate a separate proceeding to undertake comprehensive review of our depreciation rules.

[342] *See, e.g.*, Ameritech Reply in CC Docket No. 94-1, filed March 1, 1996, at 3-4; U S West Reply USTA Reply in CC Docket No. 94-1, filed March 1, 1996, at 24-25.

[343] Remaining life depreciation techniques allow a company to increase depreciation expense when it is determined that an asset's economic life is shorter than originally anticipated. By contrast, whole life depreciation techniques do not automatically correct for past underdepreciation. The Commission in the early 1980's began using a remaining life depreciation methodology instead of whole life methods. *See* Amendment of Part 31 (Uniform System of Accounts for Class A and Class B Telephone Companies), 83 FCC 2d 267 (1980), *recon.* 87 FCC 2d 916 (1981), Supplemental Opinion and Order, 87 FCC 2d 1112 (1981).

252. We note that, in response to the *Price Cap Fourth FNPRM*, MCI submitted a study analyzing the depreciation reserve deficiency.[344] The study concludes that changes in the Commission's depreciation practices during the 1980s reduced the reserve deficit from $21 billion in 1983 to only $3 billion in 1994.[345] Incumbent LECs, on the other hand, have claimed that unreasonably low depreciation rates (resulting from life estimates that are too long) have created a large overvaluation of their rate bases and a $40 billion depreciation reserve deficiency.[346] We note that traditional depreciation reserve studies, such as that employed by MCI, do not address the effects of a decline in replacement value during an asset's life, as discussed below.

253. Under-depreciation also can occur if the depreciation procedures do not recognize the decline in the economic value of plant already in service that occurs when the replacement cost is less than the cost of the older equipment. The annual charge to depreciation expense for incumbent LEC assets of different vintages or different technologies of comparable capacity will vary in an industry where the cost of assets is declining over time such as telecommunications. A price based on forward-looking economic cost would be based on the annual economic depreciation expense of the newer facility. Thus, a market characterized by developing competition may no longer support a price designed to recover depreciation expenses based on the Commission's currently prescribed depreciation rates for deployed equipment. In the emerging competitive marketplace that finds incumbent LECs facing competitors using newer, less expensive equipment, some portion of the deployed equipment is arguably under-depreciated by an amount equal to the difference between the current net book value and the forward-looking replacement cost of the depreciable plant.

254. We invite parties to explain in detail the magnitude of any difference between existing interstate-allocated embedded costs and interstate access revenues, on the one hand, and the revenues that would be generated if all interstate access services were offered at forward-looking, economic cost, on the other. We invite parties to submit data quantifying any difference, and explaining in detail to what extent the underlying difference between

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[344] Depreciation reserve deficiencies occur when actual plant retirements occur sooner than the accounting system anticipates. In that event, the reserve deficiency represents the difference between the amount of depreciation expense that a LEC should have charged, based on the actual plant life, and the amount of depreciation charges that the LEC naturally recorded. These deficiencies can result from imperfections inherent in a depreciation method, or by disparities between useful life projections prescribed by a regulatory commission and those used by the regulated carriers. *See* Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to Provide for Nonregulated Activities and to Provide for Transaction between Telephone Companies and their Affiliates, CC Docket No. 86-111, 2 FCC Rcd 1298, 1325 n.331 (1987).

[345] *See* MCI Comments in CC Docket No. 94-1, filed Jan. 11, 1996, at Attachment A at 2.

[346] *See, e.g.*, USTA Reply in CC Docket No. 94-1, filed March 1, 1996, at 17.

embedded and forward-looking costs results from the Part 36 allocation rules, under-depreciation, or other factors. Parties should also specify the methodology used to calculate the amount, and define and show the calculation of economic lives, economic obsolescence, economic depreciation, and actual lives. We seek comment on what effect the significant under-utilization of equipment because of a transition to newer equipment, or because of reduced demand, should have on the calculation of any under-depreciation.

255. We also seek comment on whether the amount of any difference should be determined and fixed as of a date certain, such as the enactment of the 1996 Act. Under such an approach, some or all of unrecovered embedded costs incurred before that date might be eligible for special recovery mechanisms, but all costs incurred after that date would be regarded as incurred under the new competitive paradigm established by the Act and thus entitled to no special treatment. We invite comment as well on whether any special mechanisms would be necessary to ensure that the jurisdictional separations process does not allocate additional residual embedded costs to the interstate jurisdiction during any transitional recovery period. In addition, LECs may be permitted to recover some portion of the difference through explicit universal service support mechanisms adopted in the universal service proceeding. Accordingly, we ask parties, when identifying any difference between interstate-allocated embedded costs and the forward-looking economic costs of access, to take into account the amount of interstate costs that are likely to be recovered through such universal service support flows.

2. Recovery of Remaining Interstate-Allocated Embedded Costs

256. We invite parties to comment on whether, as a matter of law or equity, incumbent LECs are entitled, should be permitted an opportunity, or have already been permitted an opportunity, to recover some or all of the difference between interstate-allocated embedded costs and forward-looking economic costs that might be created by the access reform proposals discussed above in Sections V and VI. We specifically request that parties comment on whether the legal basis for permitting or denying such recovery varies depending on whether an incumbent LEC is under a market-based approach to access reform, as described in Section V, a prescriptive approach to access reform, as described in Section VI, or some combination of these approaches. NARUC has suggested that new sources of revenue from incumbent LEC in-region interLATA market entry may constitute a mitigating factor that should be reflected in the evaluation of any difference between embedded and forward-looking economic costs.[347] We seek comment on whether and how entry into the in-region, interLATA long-distance market or any other additional revenue flows should affect the amount of any remaining interstate-allocated embedded costs that incumbent LECs should have a special opportunity to recover.

[347] *NARUC October 23 Letter* at 4.

257. Some parties have suggested that we should limit recovery to those remaining embedded costs arising from certain sources, *e.g.*, under-depreciation, and deny recovery of remaining embedded costs resulting from over-investment and other inefficiencies.[348] We seek comment on this approach and ask commenting parties to specify those costs that incumbent LECs should be permitted an opportunity to recover and those that should be disallowed. Should incumbent LECs be required to demonstrate the specific costs they seek to recover and satisfy a burden or standard in order to recover some or all of such costs? Should we establish a rebuttable presumption that certain costs are recoverable? We invite parties to comment on this issue and specify any appropriate standard that should be applied and which party should bear the burden of proof. For example, should incumbent LECs seeking such recovery be required to show that their investment in telecommunications plant was prudent at the time it was made and does not reflect over-investment? Or should other parties bear the burden of showing that certain investments are no longer used and useful? If so, how should we determine whether any particular investment was prudent? Are there any legal constraints on where we place the burden? Parties should be specific in addressing these questions.

258. One option is to refer issues relating to the difference between revenues generated by rates based on embedded costs and revenues produced by rates based on forward-looking costs to state commissions to conduct the necessary rate cases and to make recommendations to the Commission on possible disallowances of imprudently incurred investments or excessive expenditures. Once the state commission reported back, we would determine the manner of recovery of the interstate portion of any difference. This approach, which we could implement under section 410(a) of the Act,[349] permits coordinated treatment between the federal and state jurisdictions and assigns the responsibility of conducting such rate cases to state commissions, which have substantial experience with the carriers operating in their respective states. This approach also conserves industry resources, because each state will have to address the issue of embedded cost recovery if it decides to set prices for intrastate services based on forward-looking costs or some basis other than embedded costs. We seek comment on this alternative and invite parties to comment on what, if any, federal guidelines should be established for the conduct of the prudence aspects of any rate cases referred to state commissions under section 410(a).

259. We also invite interested parties to comment on whether the incumbent LECs should be required to mitigate the magnitude of this potential problem by reducing their costs, and if so, how they might do so. We first discuss possible general mechanisms under the market-based and prescriptive approaches to access reform, and then address whether any recovery due to under-depreciation should be treated separately. Interested parties should also comment on how a decision to permit incumbent LECs to recover some or all of the

[348] *See Hatfield 2.2*; *AT&T November 22 Letter* at Appendix A.

[349] 47 U.S.C. § 410(a).

difference between embedded and forward-looking costs would affect small business entities, including small incumbent LECs and new entrants.[350]

3. Recovery Mechanisms

260. In the event we determine that incumbent LECs should be permitted a special opportunity to recover some or all of the difference between revenues generated by access charges based on embedded and forward-looking costs, we invite parties to comment on the various recovery mechanisms discussed below and to propose alternatives. We seek comment on the impact of any particular recovery mechanism on small business entities, including small incumbent LECs and new entrants.[351]

a. Market-Based Recovery

261. As new entrants succeed in attracting incumbent LEC customers, we expect competition gradually to drive access rates to more economically efficient levels. With a gradual transition, our removal of economic regulatory constraints may well give the incumbent LECs ample opportunity to recover any of the difference between embedded and forward-looking costs and therefore obviate any need for a formal recovery mechanism. Price cap incumbent LECs could use pricing and rate structure flexibility to reduce the revenue difference during a transitional period. Incumbent LECs would also have an opportunity, while competition is still developing, to reduce their costs of service to levels consistent with the revenues available to them in a competitive market.[352] We seek comment on this approach. Specifically, does the timing of the proposed stages and the flexibility proposed permit incumbent LECs a reasonable opportunity to recover any of the revenue differential and adjust to a competitive market? On the other hand, we ask parties to comment on whether, to the extent that our separations rules over-allocate costs to the interstate jurisdiction, this market-based approach may not give incumbent price cap LECs a reasonable opportunity to recover some portion of the difference between embedded and forward-looking costs and, if so, what measures would be appropriate.

b. Regulated Recovery

262. We seek comment on two situations under which it might be necessary to establish a separate regulatory mechanism for recovery of some portion of the interstate-

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[350] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[351] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[352] We note that, as discussed in Section III.E, *supra*, several LECs have proposed similar market-based approaches for treatment of the TIC.

allocated embedded costs that might remain unrecovered if access service were priced based on forward-looking cost. First, in the event we determine that the market-based approach discussed above fails to provide incumbent LECs a fair opportunity to recover some or all remaining embedded costs, we invite parties to comment on whether we should implement a recovery mechanism to operate in lieu of, or in conjunction with, the market-based approach. Second, as we discussed in Section VI., above, a separate regulatory recovery mechanism may be necessary to the extent an incumbent price cap LEC is subject to prescriptive access reform. We seek comment on whether, and the degree to which, a separate recovery mechanism is required.

263. If we conclude that a recovery mechanism is necessary, we could design a mechanism to recover a specific, fixed, dollar amount of remaining embedded costs, over a fixed period. We seek comment on this proposal and invite parties to offer possible recovery mechanisms of limited duration. For example, one possible recovery mechanism might be to permit incumbent LECs to "amortize" their recovery of the difference, *i.e.*, to permit incumbent LECs to include in their rates a certain fraction of the difference each year for a certain number of years. The period could be designed to coincide with a gradual phase-out of the TIC, as discussed in Section III.E., above. We discuss issues raised by amortization of remaining embedded costs in more detail below, in conjunction with recovery of costs related to under-depreciation.

264. Another option would be to establish a competitively-neutral recovery mechanism that is separate and distinct from access charges. For example, should we permit incumbent LECs to impose a surcharge, either on all access customers, or on all providers or users of telecommunications services, in order to recover some portion of any remaining interstate-allocated costs?[353] This mechanism could be similar to the mechanism for collecting universal service funds, except that this recovery fund would not be permanent, nor would payments be portable to other eligible telecommunications carriers. We seek comment on when and how such a fund should be terminated. We seek comment on this option and our legal authority to adopt such an option. We ask parties to address, in particular, how to structure any such surcharge so that it is collected in a competitively-neutral manner, such as on the basis of telecommunications revenues, net of payments to other carriers, whether such surcharges should be levied on telecommunications carriers purchasing unbundled network elements, and, if so, how. Parties should also comment on how any surcharge imposed only on access customers could be structured so as not to burden unduly access customers and offer as little impediment as possible to our long-term goal of having access charges consistent with a competitive exchange access market. We invite parties to comment on the impact of this option on investment, innovation, and competition.

[353] *See, e.g.*, Paul L. Joskow, *Does Stranded Cost Recovery Distort Competition?*, The Electricity Journal (April 1996) (supporting a surcharge to recover residual costs in the electricity industry).

265. In the event we adopt one of the special regulatory mechanisms described above or an alternative mechanism advocated by parties in this proceeding, as part of a transition to a competitive environment, we seek comment on whether some limitation on incumbent LECs' earnings is warranted. For example, we invite parties to comment on whether, if we set up a special mechanism that permitted incumbent LECs a reasonable opportunity to recover certain costs, it would be appropriate to limit to a certain prescribed rate of return the incumbent LEC earnings on the investment portion of the costs designated for recovery, or to increase the incumbent LEC's price cap sharing obligations, given the limited risk of non-recovery under such a mechanism. Alternatively, we could permit incumbent LECs to select from two recovery options -- cost recovery through market-based prices to the extent they are able in a competitive market; or cost recovery through a regulatory mechanism, with a greater sharing obligation under the price cap plan.[354] In the event we determine that incumbent LECs should be permitted to select the manner of recovery, we seek comment on whether we should limit the ability to choose only to incumbent LECs that can make a competitive showing, as discussed in Section V., above. We invite parties to comment on this approach and other possible adjustments to the price cap plan that would be appropriate in the event we adopt a regulatory recovery mechanism.

c. Recovery of Difference Caused by Under-Depreciation

266. The portion of the difference between embedded costs and forward-looking costs that is attributable to under-depreciation may warrant separate treatment. Specifically, we must consider the appropriate balance between customer and shareholder risk as telecommunications markets become more competitive. In a competitive market, a firm's ability to raise its rates to recover higher depreciation costs is constrained by the pricing practices of other competitors, some of which may well have cost advantages through use of newer, more efficient equipment. A competitive firm is able to establish its depreciation charges and its prices free of any regulatory constraints, but its shareholders bear the risk of loss if the resulting prices are too high and, consequently, fail to generate revenues sufficient to cover the depreciation charges. The incumbent LEC's ability to recover its investment in a competitive market is dependent in part on depreciation practices that accurately reflect the decline in economic value of the LEC investment. The issue then is whether to permit incumbent LECs any relief with respect to the depreciation of equipment on their books at the time that the regulatory approach changes, whether the depreciation process should proceed unaffected by the shift in regulatory policies, or whether to modify our depreciation procedures.[355] If, for example, the Commission concluded that incumbent LECs have not

[354] *See* Access Reform Presentation, Ad Hoc Telecommunications Users Committee, Oct. 31, 1996.

[355] Our current depreciation prescription procedures were developed in the 1940s, when there was less technological innovation and no competition in the telecommunications industry. As a result, it was necessary to scrutinize supporting data for depreciation rates carefully, to help ensure that ratepayers were charged just and

incurred significant depreciation reserve deficiencies to date, it could continue the current depreciation policies, or reflect small changes through increased depreciation rates in the future.

267. If, on the other hand, we conclude that the public interest would be served by adjusting the customer/shareholder risk levels because of regulatory changes, we could permit the incumbent LECs to adjust their accounts to establish an amortization of plant to reflect some or all of the change in economic value of the equipment installed under the earlier regulatory regime. We invite parties to comment on whether the local competition provisions of the 1996 Act and the competition expected to result from the implementation of those provisions constitute such an unexpected and dramatic regulatory shift that incumbent LECs should be permitted to adjust their accounts to reflect some or all of the change in economic value of their embedded investment. Parties should also address the appropriate balance between customer and shareholder risk entailed in the shift to a more competitive regulatory policy.

268. If we permit incumbent LECs to adjust their accounts in such a way, the depreciation adjustment would presumably take the form of an amortization of these amounts over a prescribed period. An amortization plan would increase access rates in the short-term, but, all other things being equal, would lead to lower access rates after the amortization was completed. We invite parties to comment on the desirability of establishing an amortization plan, under which incumbent LECs could recover more rapidly some or all of any demonstrated under-depreciation costs resulting from economic obsolescence. We also ask whether any such amortization should be recovered in a competitively-neutral manner.

269. If we decide to take some action, we will need to determine the period over which to calculate the amount of the depreciation reserve deficiency. For example, we might measure under-depreciation for a period ending with the enactment of the 1996 Act. In addition, parties should comment on the period over which any amortization should take place. We invite any incumbent LEC, believing that it has facilities that are under-depreciated due to economic obsolescence, to submit a study demonstrating the extent of such under-depreciation and proposing the appropriate time period over which to amortize such amounts. Any incumbent LEC submitting such a study should provide complete details on original cost, salvage value, economic lives, and other relevant factors, for both old and new

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reasonable tariffed rates. *See* Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Report and Order, 8 FCC Rcd 8025, 8031 (1993). As competition grows, it will exert greater downward pressure on the rates LECs charge for telecommunications services, and it will become less important for us to prescribe depreciation rates. The 1996 Act amended Section 220(b) of the Communications Act, so that we are no longer required to prescribe depreciation rates for the LECs. The issue of whether or under what conditions we will discontinue our prescription of depreciation rates is beyond the scope of this Notice. We plan, however, to initiate a separate proceeding to undertake comprehensive review of our depreciation rules.

technologies that are necessary to permit us to make an informed decision. We invite parties to address whether a different rate of economic obsolescence might occur in low-density areas than in high density areas.

270. Price cap incumbent LECs would account for this amortization through an upward exogenous adjustment to the price cap indices. Parties are also invited to suggest procedures for adjusting the PCIs, APIs, and SBIs to reflect the exogenous treatment of any amortization, if we permit incumbent LECs to adopt an amortization plan.

VIII. OTHER ISSUES

A. Regulation of Terminating Access

271. Some analysts have contended that an access provider's market power differs between originating and terminating access service.[356] With originating access, the calling party has the choice of service provider, the decision to place a call, and the ultimate obligation to pay for the call. The calling party is also the customer of the IXC that is purchasing the originating access service. As long as IXCs can influence the choice of the access provider, a LEC's ability to charge excessive originating access rates is limited, as IXCs will shift their traffic from that carrier to a competing access provider. This is particularly true for multi-line customers, who may select one carrier with lower access rates for their out-going interexchange calls and a different carrier with a lower flat monthly rate for local service. For terminating access, the choice of service provider is made by the called party. The decision to place the call and payment for the call lies, however, with the calling party. The calling party, or its long-distance service provider, has little or no ability to influence the called party's choice of service provider.[357] Thus, it appears that even with a competitive presence in the market, terminating access may remain a bottleneck controlled by whichever LEC provides access for a particular customer. As such, the presence of unbundled network elements or facilities-based competition may not affect terminating access charges.

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[356] *See, e.g.*, Joseph Gillan & Peter Rohrbach, The Potential Impact of Local Competition on Telecommunications Market Structure: Diversity or Reconcentration, 1994; Robert W. Crandall and Leonard Waverman, Talk Is Cheap: The Promise of Regulatory Reform in North American Telecommunications, 1995, at 265-66 (*Talk Is Cheap*).

[357] Section 254(g) requires IXCs to integrate and average the rates they charge for service. 47 U.S.C. § 254(g). *See also* Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of Section 254(g) of the Communications Act of 1934, as amended, CC Docket No. 96-61, Report and Order, 11 FCC Rcd 9564 (1996) (*Section 254(g) Order*). Consequently, not only does the call originator not choose the terminating LEC, but because of Section 254(g), the cost of high terminating access rates is spread among all end users.

272. On the other hand, high terminating access rates may create an incentive for IXCs to win the local customer. It is true that winning the end user as customer will allow the IXC to save only a fraction of the total terminating access charges generated by the end user, because the IXC will carry only a fraction of the calls received by the end user. Nevertheless, serving the local customer using unbundled elements will also allow the IXC to collect terminating access charges on calls received by the end user. Thus, in this analysis, it would appear that high terminating access charges may give an IXC an incentive to win an end user as a local customer similar to the incentive created by high originating access rates. In this section, we seek comment on whether and to what extent we should regulate the terminating access services of price cap incumbent LECs and non-incumbent LECs and whether competition will have the same effect on terminating access rates as on originating access rates.

1. Price Cap Incumbent LECs

273. We seek comment on the implications of the above analysis for regulating the terminating access service of price cap LECs and ask parties to address the necessity of continued regulatory oversight of access prices for the termination of interstate calls by price cap LECs in markets where we find originating access services are subject to substantial competition.

274. One possible method of regulating price cap incumbent LECs' terminating access service is to establish a rate ceiling that prevents incumbent LECs from charging more for terminating access than the forward-looking, economic cost of providing the service. We seek comment on whether and how we should require incumbent price cap LECs to price terminating access service at forward-looking, economic costs. Whether an incumbent price cap LEC is offering terminating access at forward-looking economic cost could be measured by the prices in reciprocal compensation arrangements for the transport and termination charges of telecommunications pursuant to sections 251(b)(5) and 252(d)(2). Arbitrated reciprocal compensation rates may not include the NTS costs of either local switching or the subscriber line. Therefore, these NTS costs, which are now recovered in part from terminating access, would have to be recovered solely from originating access or a flat charge. Alternatively, we could ensure that terminating access is priced at its forward-looking economic cost by requiring such prices to be based on a TSLRIC study or other acceptable forward-looking, cost-based model. We invite parties to comment on these and alternative measures of forward-looking, economic costs to be used for terminating access rates.

275. Some observers have suggested that another possible method of regulating incumbent price cap LECs' terminating access service is to require the incumbent price cap LEC to charge the end user for the service.[358] If called parties paid for terminating access, the

[358] *See Talk Is Cheap* at 265-66.

individual who paid for the service would be the same individual who selected the provider. We seek comment on whether requiring called parties to pay for terminating access might encourage competition for terminating access. We note that wireless companies already charge the called parties for receiving calls. Would charging the called party for terminating access result in an increase of uncompleted calls, due to a reluctance by called parties to accept the charges? We invite parties to address how charging the customer receiving the call for terminating access could be accomplished, and whether this approach would be superior to using forward-looking economic cost. BellSouth argues that the availability of transport and termination under Section 251 for local traffic makes unnecessary any special regulation for terminating access that is different from originating access.[359] BellSouth argues that terminating interstate traffic would be disguised as terminating local traffic, resulting in less expensive terminating access. We seek comment on BellSouth's analysis.

276. Alternatively, we could require incumbent price cap LECs to charge nothing for terminating access service and permit them to recover all such costs from originating access charges. We invite parties to comment on the merits of this approach and whether incumbent price cap LECs should be permitted to choose between this approach and some other form of regulation of their terminating access services. Parties should also suggest other possible methods of regulating incumbent price cap LECs' terminating access service not discussed above. We seek comment on whether we should adopt different regulatory mechanisms for terminating access for those incumbent price cap LECs that are subject to the alternative regulatory regime discussed in Section VI, above. Finally, we invite parties to address whether we should keep our rate structure rules for terminating access for incumbent LECs even after we have eliminated such rate structure rules for originating access.

2. Non-Incumbent LECs

277. Between 1979 and 1985, the Commission conducted the *Competitive Carrier* proceeding, in which it examined how its regulations should be adapted to reflect and promote increasing competition in telecommunications markets.[360] In a series of orders, the

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[359] End User Billing of Originating Access, BellSouth, Oct. 30, 1996.

[360] Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, CC Docket No. 79-252, Notice of Inquiry and Proposed Rulemaking, 77 FCC 2d 308 (1979); First Report and Order, 85 FCC 2d 1 (1980) (*Competitive Carrier First Report and Order*); Further Notice of Proposed Rulemaking, 84 FCC 2d 445 (1981); Second Further Notice of Proposed Rulemaking, FCC 82-187, 47 Fed.Reg. 17,308 (1982); Second Report and Order, 91 FCC 2d 59 (1982); Order on Reconsideration, 93 FCC 2d 54 (1983); Third Further Notice of Proposed Rulemaking, 48 Fed.Reg. 28, 292 (1983); Third Report and Order, 48 Fed.Reg. 46,791 (1983); Fourth Report and Order, 95 FCC 2d 554 (1983), *vacated, AT&T v. FCC*, 978 F.2d 727 (D.C. Cir. 1992), *cert. denied, MCI Telecommunications Corp. v. AT&T*, -- U.S. --, 113 S.Ct. 3020 (1993); Fourth Further Notice of Proposed Rulemaking, 96 FCC 2d 1191 (1984); Fifth Report and Order, 98 FCC 2d 1191 (1984); Sixth Report and Order, 99 FCC 2d 1020 (1985), *vacated MCI*

Commission distinguished between two kinds of carriers: those with market power (*i.e.*, the power to control prices) are deemed dominant carriers, and those without market power are deemed non-dominant carriers.[361] The Commission has regulated incumbent LECs as dominant carriers in their provision of interstate access service.[362] The Commission's policy since *Competitive Carrier* has consistently been that a carrier is non-dominant unless the Commission makes or has made a finding that it is dominant.[363]

278. Competitors have begun to provide exchange access services, aided in significant part by our expanded interconnection policies.[364] The pro-competitive policies of the 1996 Act are expected to result in increased entry into the exchange and exchange access markets. To date, the Commission has only applied the interstate access charge rules to incumbent LECs. New entrants into the exchange access market, such as competitive access providers (CAPs),[365] have been presumptively classified as non-dominant because they have been deemed not to have the ability to exercise market power in particular service areas.[366] NYNEX has suggested that there is a need for regulation of certain access services, particularly terminating access, offered by all LECs, including new entrants.[367] In this section, we consider and invite comment on whether, and the extent to which, we should establish any rules for the provision of access services by non-incumbent LECs, or competitive LECs, most particularly terminating access service. We note that we are extremely reluctant to impose

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Telecommunications Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985) (collectively referred to as *Competitive Carrier*).

[361] *See, e.g.*, *Competitive Carrier First Report and Order*, 85 FCC 2d at 20-22; *see also* 47 C.F.R. §61.3(o).

[362] *Competitive Carrier First Report and Order*, 85 FCC 2d at 23-24.

[363] *See, e.g.*, *Competitive Carrier First Report and Order*, 85 FCC 2d at 10-11; 47 C.F.R. 61.3(u).

[364] *See, e.g.*, *Special Access Expanded Interconnection Order*; *Switched Transport Expanded Interconnection Order*. *See also* The NYNEX Tel. Cos. Petition for Waiver, Transition Plan to Preserve Universal Service in a Competitive Environment, Memorandum Opinion and Order, 10 FCC Rcd 7445 (1995), *recon. pending*; Ameritech Operating Companies Petition for a Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, Order, FCC 96-58 (rel. Feb. 15, 1996).

[365] CAPs compete with incumbent LECs in the provision of access and local transport services. Competitive LECs provide local exchange service, in addition to access or transport services, in competition with incumbent LECs.

[366] *See* Tariff Filing Requirements for Nondominant Common Carriers, CC Docket No. 93-36, Memorandum Opinion and Order, 8 FCC Rcd 6752, 6754 (CAPs are nondominant carriers because they have not been previously declared dominant); *vacated in part*, Southwestern Bell Corp. v. FCC, 43 F.3d 1515 (D.C. Cir. 1995); Order, 10 FCC Rcd 13653 (1995).

[367] Access Reform, NYNEX, Sept. 25, 1996 at 5.

price regulation on non-dominant carrier services without a strong showing that such regulation is necessary.

279. The factors that warrant continued regulation of incumbent LECs' terminating access service appear to apply to all access providers, including competitive LECs, because these new entrants appear to possess market power over IXCs needing to terminate calls. As previously discussed, the recipient of a call, the called party, selects the carrier that provides the terminating access for the calls destined for that party. The decision to place the call, however, lies with the calling party, who currently pays for the call. In those cases, the calling party's long-distance service provider appears to have little or no influence on the called party's choice of service provider.[368] Because the paying parties do not choose the carrier that terminates their interstate calls, competitive LECs potentially could charge excessive prices for terminating access.[369] We therefore seek comment on whether there are some aspects of the competitive situation facing non-dominant LECs with respect to terminating access that distinguishes non-dominant from dominant carriers.

280. In the event we conclude that non-dominant carriers have market power with regard to terminating access charges or that market failure would preclude the marketplace from ensuring that terminating access rates are just and reasonable, we also invite parties to comment on whether competitive LECs' terminating access service should be subject to different limits than incumbent price cap LECs' terminating access service, or to similar limits on rate structure or rate level. Parties should address whether the incumbent LECs' terminating access charges should serve as a benchmark to evaluate competitive LECs' terminating rates. For example, we could find a competitive LEC's terminating access charge to be presumptively just and reasonable if the charge is less than or equal to the terminating access charge of the incumbent LEC with which the competitive LEC is competing. If, on the other hand, the competitive LEC's terminating access charge is greater than the incumbent LEC's charge, the competitive LEC could be required to provide cost support for its charge or it could collect the difference from its end users. We seek comment on these proposals, as well as on other less intrusive methods of ensuring a competitive LEC's terminating access charges are just and reasonable. We further invite parties to comment how small business entities, including small incumbent LECs and new entrants will be affected by this tentative conclusion and proposals to regulate terminating access.[370]

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[368] Section 254(g) requires IXCs to integrate and average the rates they charge for service. 47 U.S.C. § 254(g). *See also Section 254(g) Order*. Consequently, not only does the call originator not choose the terminating LEC, but because of section 254(g), the call originator also does not pay the egregiously high terminating access charge.

[369] *See, e.g.*, Joseph Gillan & Peter Rohrbach, The Potential Impact of Local Competition on Telecommunications Market Structure: Diversity or Reconcentration, 1994; *Talk Is Cheap* at 264-65.

[370] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

3. "Open End" Services

281. In some instances, an IXC may not be able to influence the choice of the originating access provider, and, consequently, marketplace forces may be less effective in limiting a competing LEC's ability to charge higher originating access rates. For example, for "open end" originating minutes,[371] such as originating access for 800 service, it is the called party that pays for the call. Thus, while the calling party, who selects the local carrier/access provider, decides to place an individual call, that party pays nothing for the call. For these reasons, the Commission has long treated incumbent LECs' originating "open end" minutes as terminating minutes for access charge purposes.[372] We seek comment on whether this analysis should continue to apply to incumbent LECs' originating access for 800 service and other similar "open end" services for which terminating access rates serve as originating access rates, and whether such regulation should be extended to apply to competitive LECs.

B. Treatment of Interstate Information Services

282. Usage of interstate information services, and in particular the Internet and other interactive computer networks, has increased dramatically in recent years.[373] Such new services create significant benefits for the economy and the American people.[374] The 1996 Act states that it is the policy of the United States "to preserve the vibrant and competitive free market that presently exists for the Internet and other interactive computer services, unfettered by Federal or State regulation,"[375] and we have long sought to avoid unnecessary regulation of information services. As usage continues to grow, such services may have an increasingly significant effect on the public switched network.

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[371] According to Section 69.105(b)(1)(ii): "The term *open end* of a call describes the origination or termination of a call that utilizes exchange carrier common line plant (a call can have no, one, or two open ends)." 47 C.F.R. § 69.105(b)(1)(ii).

[372] WATS-Related and Other Amendments of Part 69 of the Commission's Rules, CC Docket No. 86-1, Report and Order, FCC 86-115 (rel. Mar. 21, 1986) at para. 53 (concluding that "open end" minutes are less subject to uneconomic bypass than originating MTS and MTS-like minutes, and therefore must be treated as terminating access minutes); 47 C.F.R. § 69.105(b)(1)(iii).

[373] According to a study by Find/SVP and Jupiter Communications, the number of U.S. households with Internet access more than doubled in the past year to 14.7 million, and roughly 38.7 million Americans over the age of 18 have accessed the Internet at least once. Jared Sandberg, "U.S. Households with Internet Access Doubled to 14.7 Million in Past Year," *Wall Street Journal*, October 21, 1996 at B11.

[374] *See, e.g.*, Takuma Amano and Robert Blohm, "The Internet Economy" (op ed), *Wall Street Journal*, October 17, 1996, at A22.

[375] 47 U.S.C. § 230(b)(2).

283. Therefore, as part of this comprehensive proceeding, we must consider how our rules can provide incentives for investment and innovation in the underlying networks that support the Internet and other information services. We consider in this section the narrow question of whether to permit incumbent LECs to assess interstate access charges on information service providers. We make no specific proposals, and we tentatively conclude that the existing pricing structure for information services should remain in place at this time. In Section X, we issue a Notice of Inquiry to examine various fundamental issues about the implications of usage of the public switched network by information service and Internet access providers.

284. Beginning with the *Computer II* proceeding in the 1970s, we have distinguished between basic and enhanced communications services.[376] The category of enhanced services, which includes access to the Internet and other interactive computer networks, as well as telemessaging, alarm monitoring, and other services, appears to be quite similar to the term "information services" in the 1996 Act.[377] In the 1983 *Access Charge Reconsideration Order*, we decided that, although enhanced service providers (ESPs) may use incumbent LEC facilities to originate and terminate interstate calls, ESPs should not be required to pay interstate access charges.[378]

285. As a result of these decisions, ESPs may purchase services from incumbent LECs under the same intrastate tariffs available to end users, by paying business line rates and the appropriate subscriber line charge, rather than interstate access rates.[379] Those business line rates are significantly lower than the equivalent interstate access charges, in part because of separations allocations and the access charge per-minute rate structure, and in part because the business lines that ESPs now purchase generally do not include usage-sensitive charges for

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[376] *See* Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), Docket No. 20828, Final Decision, 77 FCC 2d 384, 417 (*Computer II*).

[377] "Enhanced services" are defined in § 64.702(a) of our rules: "For the purposes of this subpart, the term *enhanced services* shall refer to services, offered over common carrier transmission facilities used in interstate communications, which employ computer processing applications that act on the format, content, code, protocol, or similar aspects of the subscriber's transmitted information; provide the subscriber additional different, or restructured information; or involve subscriber interaction with stored information." The 1996 Act defines "information services" as offering the capability for "generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications." 47 U.S.C. § 153(20).

[378] MTS and WATS Market Structure, Memorandum Opinion and Order, Docket No. 78-72, 97 FCC 2d 682, 711-22 (*Access Charge Reconsideration Order*). *See also* Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers, CC Docket No. 87-215, Order, 3 FCC Rcd 2631 (1988) (*ESP Exemption Order*).

[379] *ESP Exemption Order*, 3 FCC Rcd at 2631 nn.8, 53. Most information service providers have deployed points of presence to maximize the number of subscribers that can reach them through a local call.