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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

January 29, 1997

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

CC 94-1

Subject: Access Charge Reform,
CC Docket No. 96-262 et al.

Dear Mr. Caton:

Enclosed please find the original and eighteen copies plus diskette of the General Services Administration's Comments for filing in the above-referenced proceeding.

Sincerely,

Jody B. Burton

Jody B. Burton
Assistant General Counsel
Personal Property Division

Enclosures

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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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In the Matter of	
Access Charge Reform	CC Docket No. 96–262
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94–1
Transport Rate Structure and Pricing	CC Docket No. 91–213
Usage of the Public Switched Network by Information Service and Internet Providers	CC Docket No. 96–263

COMMENTS
of the
GENERAL SERVICES ADMINISTRATION
and the
UNITED STATES DEPARTMENT OF DEFENSE

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January 29, 1997

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Summary

GSA/DOD urges the Commission to address serious infirmities in the structure and level of interstate access charges. These deficiencies impede the development of competition, cause end users to pay too much for many services, promote uneconomic bypass, and place unnecessary burdens on interexchange carriers.

The interstate access rate structure inefficiently recovers billions of dollars in NTS costs through usage–sensitive charges. The Commission should eliminate CCL charges and also make changes in other access rate elements to align traffic sensitive and non–traffic sensitive cost responsibilities. Any increase in the NTS revenue requirement remaining after access reform should be placed on the SLC. In addition, the Commission should eliminate the distinction between SLCs for single line and multi–line subscribers, and introduce a new capped SLC for subscribers with minimal usage of interstate message toll services.

The Commission's proposed market–based approach to access reform has many merits, but it fails to provide timely relief from the high access charges that have resulted in excessive LEC earnings for several years. GSA/DOD urges the Commission to combine the market–based and prescriptive approaches, in order to obtain the advantages of each method.

The Commission should continue earnings sharing and employ some critical prescriptive tools — including initialization of rates based on current capital requirements and an increase in the productivity offset factor. Also, the Commission should implement most of the pro–competitive elements of its market–based approach after the new access rates are established.

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COMMENTS
of the
GENERAL SERVICES ADMINISTRATION
and the
UNITED STATES DEPARTMENT OF DEFENSE

The General Services Administration and the United States Department of Defense ("GSA/DOD"), on behalf of the customer interests of all Federal Executive Agencies ("FEAs"), submits these Comments in response to the Commission's Notice of Proposed Rulemaking ("NPRM") released December 24, 1996. In this NPRM, the Commission requests comments on issues concerning the structure and level of interstate access charges by the incumbent local exchange carriers.

I. Introduction

Pursuant to Section 111(a) of the Federal Property and Administrative Services Act of 1949, as amended 40 U.S.C. 759(a)(1), GSA is vested with the responsibility to represent the customer interests of the FEAs before Federal and state regulatory

agencies. Collectively, the FEAs are probably the largest user of telecommunications services in the nation. From this perspective, GSA/DOD has consistently supported the Commission's efforts to bring the benefits of competitive telecommunications markets to all consumers.

The NPRM observes that the current proceeding is the third major activity in a group of coordinated efforts to accelerate the development of efficient competition in all telecommunications markets pursuant to the requirements of the Telecommunications Act of 1996 ("1996 Act").[1] In this proceeding, the Commission is reviewing its Part 69 interstate access charge rules and its Part 61 price cap rules to identify the actions necessary to accommodate provisions of the 1996 Act, to account for actual and potential increases in competition, to implement the directions of the 1996 Act concerning universal service, and to establish balanced rules for competition in local and interexchange markets.[2]

Soon after the AT&T divestiture, the Commission adopted its Part 69 rules, which established the procedures by which local exchange carriers ("LECs") recover the costs of providing local exchange access. These rules reflected the reality of the telecommunications marketplace in 1983, when the incumbent LECs were the only firms that could provide local exchange and exchange access services. Similarly, the Commission's Part 61 price cap rules were established long before the prospect of local competition had begun to gain momentum.

With the accelerating pace of change in telecommunications markets, the Commission must conduct a thorough review of its access charge and price cap procedures. GSA/DOD appreciates the opportunity to participate in this process

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1 Telecommunications Act of 1996, Pub L. No. 104–104, 110 Stat. 56, to be codified at 47 U.S.C. §§ 151 et seq. ("1996 Act").

2 NPRM, para. 5.

through these Comments, which address rate structure and access reform issues identified in the NPRM.

II. Access Charge Rate Structure

A. Deficiencies in Existing Rate Structure

The interstate access charge system covers common line, local switching, transport, and other services provided by the local exchange carriers. Unfortunately, the rate structures employed to compensate the LECs for these access facilities and services are economically inefficient. The deficiencies in these rate structures harm both carriers and end users. Furthermore, the deficiencies cannot be sustained in a competitive environment, because another carrier will employ its own facilities or lease unbundled network elements to target the incumbent carrier's high–volume customers.

Common Lines

Common line costs are the costs associated with the dedicated facilities connecting the end user's premises with the local switch that have been assigned to the interstate jurisdiction through the separations process. A portion of these costs is recovered through subscriber line charges ("SLC's") — the only access rate element paid directly by end users. At present, the SLC is limited to the actual cost of the interstate portion of the local loop, with a cap of $3.50 per month for residence and single line business users, and a cap of $6.00 per month per line for multi–line business users. Although the requirements for a common line do not vary at all with usage, the present access charge system requires that any costs not recovered through the SLC must be recovered on a usage basis, namely, through per–minute carrier common line ("CCL") charges imposed on interexchange carriers ("IXCs"). This rate structure violates the principle of cost causation.

Local Switching

Local switching costs are associated with line and trunk cards and with central processing equipment that is required to provide interfaces between subscriber lines and interoffice trunks. In 1995, the interexchange carriers paid about $4.2 billion to the major LECs for local switching.[3] Under the present system, all of the local switching costs assigned to the interstate jurisdiction are recovered through per–minute rates. However, this rate structure violates the principal of cost causation.

Local switching costs include both traffic sensitive and non–traffic sensitive elements. For example, the central processing equipment used to route calls through the public switched network and many of the trunk–side ports used to terminate calls are shared facilities. The costs of these facilities are directly attributable to usage and should be priced on a usage–sensitive basis.

In contrast, the requirements for line cards and line–side ports are not usage–sensitive. The costs for this equipment depend on the number of subscribers and the design of the network. The Commission observes that these non–traffic sensitive costs are a "significant portion" of the total local switching costs.[4] The access charge procedure should be modified so that the non–traffic sensitive costs are no longer recovered through per–minute rates.

Transport

Transport refers to the facilities required for transmission between the end offices of local exchange carriers and the points of presence of interexchange carriers. Transport rates are designed to recover the costs associated with this component of interstate switched access service.

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3 *Id.*, Table 1, page 18.

4 *Id.*, para. 72.

In late 1993, the Commission restructured interstate transport rates for the incumbent LECs. The Commission created facilities–based rates for dedicated transport, established tandem switching rates, and instituted a new rate element called the transport interconnection charge ("TIC"). The Commission established the TIC as a transitional measure to make the transport rate structure revenue neutral under the conditions existing when the rates were restructured. The per–minute TIC is assessed on all switched access minutes regardless of the facilities that they use. The TIC accounts for nearly three–quarters of the LECs' total transport revenues, but it bears no causal relationship to the costs of any LEC facilities. Therefore, this charge artificially suppresses demand for all interexchange services and encourages customers to bypass the LEC switched access network, particularly through switched facilities operated by carriers other than the incumbent LEC.

Signalling

Signalling System 7 ("SS7") is now the international standard network protocol for common channel signalling. SS7 networks consist of packet switches and dedicated circuits used to establish connections, to obtain billing information from remote databases, and to transmit the instructions necessary to provide local services such as automatic callback and caller ID. Under the present rate structure, the incumbent local exchange carriers bill IXCs and other access customers a flat charge for the use of dedicated facilities to connect to the LECs' signalling networks. Other SS7 costs, including those for switching messages at the local signal transfer point, are not recovered through these charges. These remaining costs, mostly usage–related, are embedded in the transport interconnection and local switching charges.[5] Thus, while the variable nature of the switched signalling cost is recognized by default,

5 *Id.*, para. 126.

the overall effect is to understate signalling costs in the aggregate and require users of other access services to pay for capabilities that they do not need.

Impact of Existing Rate Structures

Competition highlights and magnifies the distortions in the current access charge rules. These distortions harm local carriers by encouraging bypass of their facilities when it is not the best economic alternative. Also, the distortions harm interexchange carriers by forcing them to make uneconomic choices and to employ rate schedules which are not efficient for their own subscribers. Furthermore, the inefficient rates send the wrong signals to end users, forcing many of them to pay too much for their telephone services.

Data in the NPRM shows that the size of the market distortion is staggering.[6] For interstate access costs, the total misallocation probably exceeds $7 billion — $3.7 billion for improper recovery of fixed costs through CCL charges, $2.9 billion for artificially structured transport interconnection charges, and additional amounts because of defects in the local switching and signalling access rate elements noted above. Furthermore, because regulators in many states have adopted intrastate access charge plans that mirror the interstate system in structure, if not in the exact charges employed, there is an additional distortion of several billion dollars in the intrastate access arena. Customers should not be expected to continue to support a massive misallocation of telecommunications resources which threatens to deny the benefits of efficient competition that otherwise would develop in all telecommunications markets.

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6 *Id.*, page 18.

B. GSA/DOD Recommendations to Revise Rate Structure

More than two years ago, Commissioner Quello recognized the need for economic efficiency in recovering loop costs, when he stated:

> [W]hen costs that are not traffic sensitive – such as local loop plant – are recovered through usage–based rates, the high usage, high margin customers are ripe for cream skimming. So, the Commission needs to get on with the business of removing some subsidies, and reforming and reducing access prices by assigning and recovering costs more appropriately.[7]

GSA/DOD concurs with this view and urges the Commission to use this proceeding as the platform to address features of the access rate structure that impede the development of competition. Specific ways for the FCC to accomplish this are discussed below.

Eliminate Recovery of NTS Costs through Usage–Based Charges

To address the most critical defect in the existing access charge system, the Commission should remove the revenue responsibility for all non–traffic sensitive ("NTS") costs from usage–based charges. The costs of local loops, as well as many of the facilities used for switching and transport, do not depend on usage. These NTS costs should be recovered through flat monthly charges.

The CCL charge is the most important access element for the Commission to address in aligning rate and cost structures. Since the CCL charge is designed only to recover NTS costs, this rate element must be eliminated completely.

California regulators recently eliminated the intrastate CCL charge in the nation's most populous state. In taking this action, the California Commission correctly noted that the usage–sensitive CCL was not matched to the structure of costs, and that

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7 Remarks of Commissioner James H. Quello before the United States Telephone Association, October 12, 1994.

this charge encouraged interexchange carriers to bypass the LECs' local exchange networks.[8]

GSA/DOD urges this Commission to act similarly with respect to the CCL charge. The Commission should also change the interstate structure to reflect the presence or absence of usage sensitivity in the costs of switching and transport functions.

The per–minute local switching rate should be changed so that it recovers only the usage–sensitive costs of switching, such as central processors and trunk–side ports. The cost responsibility for facilities which vary only with the number of subscriber lines should be removed from the per–minute local switching rate.

The Commission should also eliminate the per–minute transport interconnection charge, which is not designed to cover the costs of any specific facilities or resources. The usage–variable charge for transport should be structured to recover only the revenue requirement for traffic–sensitive transport functions such as tandem switching.

Place NTS Revenue Requirement on SLC

The local exchange carriers' NTS revenue requirements will increase when non–traffic sensitive costs are no longer recovered through usage charges. In the NPRM, the Commission describes several alternatives for meeting this increased revenue requirement. These procedures focus primarily on replacing the CCL with non–usage related charges on interexchange carriers.

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8 Decision 96–02–023, California Public Utilities Commission, *In the Matter of Alternative Regulatory Frameworks for Local Exchange Carriers*, Docket I.86–11–033 et al., issued February 7, 1996, pp. 29–31.

According to one proposed plan, a flat charge replacing the CCL charge would be imposed on the IXCs based on the number of presubscribed lines.[9] An alternative approach would be a "capacity charge" on the IXCs based on the number and type of trunks that interexchange carriers obtain from incumbent local exchange carriers.[10]

GSA/DOD strongly recommends that any additional NTS revenue requirement be recovered directly from end users in the form of flat, per–line charges. Recovery of these costs from interexchange carriers, even on a per–line basis, will ultimately distort the market in an economically inefficient manner. The interexchange carriers recover the costs of their message telephone services to end users through usage–based rates. Therefore, any increase in the access charges that the interexchange carriers pay, no matter how they are structured, must eventually be passed on to end users in the form of higher per–minute charges.

The incentive for interexchange carriers to pass on increased access charges, in any form, through per–minute charges on their own end users potentially cancels the benefits of aligning non–traffic sensitive rates and costs. In the first place, the Commission must ensure that costs are flowed through completely so that end users receive the rate reductions they deserve. However, even if interexchange carriers flow through cost reductions in the aggregate, the failure to recover non–traffic sensitive costs completely through flat charges unfairly shifts the revenue burden among groups of end users.

The distorting effect of increasing the charges to interexchange carriers will be to discourage service to low–usage customers because such service will be unprofitable. Conversely, interexchange carriers will be encouraged to target high–

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9 NPRM, para. 60.

10 *Id.*, para. 61.

volume customers because they will appear very profitable, notwithstanding the fact that the per–line cost to serve both low– and high–volume customers is the same.

In comments addressing recommendations by the Federal–State Joint Board on Universal Service, some consumer advocates and state regulatory authorities opposed any increase in the interstate residential SLC because of concerns that it would adversely affect subscribership. However, as GSA explained in its Comments in that proceeding, these concerns are unfounded.[11]

Major local exchange carriers have provided evidence that past increases in the SLC have not reduced subscribership and that there are "safety nets" in place to prevent such adverse effects. For example, Southwestern Bell Telephone Co. observed that household penetration rates increased from 91.6 percent in 1984, when the SLC was implemented, to 93.1 percent in 1989, when the SLC was capped. This local exchange carrier referenced studies showing that toll usage costs, not monthly charges, are primarily responsible for customers leaving the network. Therefore, rate rebalancing that reduces the interexchange carriers' costs — and presumably their rates — may be expected to increase subscribership.[12]

In its comments in the same proceeding, Bell Atlantic articulated the same position as Southwestern Bell, adding that for low–income subscribers, Lifeline assistance is available to defray the higher SLC charges, and that other subscribers should be able to absorb increases, especially when the absence of CCL charges is reflected in lower message toll rates.[13]

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11 CC Docket No. 96–45, Reply Comments of GSA, May 7, 1996, pp. 8–9.

12 CC Docket No. 96–45, Comments of Southwestern Bell, April 12, 1996, p. 6.

13 CC Docket No. 96–45, Comments of Bell Atlantic, April 12, 1996, p. 13.

Change SLC Caps

GSA/DOD recommends that the existing caps on the SLC be removed so that the SLC can recover the full NTS revenue requirement. However, as discussed later in these Comments, GSA/DOD strongly recommends that the Commission pursue access reforms that will substantially reduce the aggregate revenue requirement for interstate access charges. GSA/DOD urges the Commission to credit all reductions in the total revenue requirement resulting from these access reforms to the NTS component in order to minimize any required increases in charges paid directly by end users.

. GSA/DOD also urges the Commission to take this opportunity to address an infirmity in the present cap structure. The existing bifurcated SLC cap structure — a $3.50 monthly cap for residence and single line business service and a $6.00 monthly cap for multi–line businesses — has no economic justification. The loop costs for multi–line business subscribers are no greater than the loop costs for residence and single line business users.[14]

Since the SLC will be used to recover all NTS costs, a single monthly charge for all types of lines is the only structure that is economically efficient. A single SLC also conforms with the realities of the telecommunications marketplace. The distinction between "residence" service and "business" service is becoming almost totally obscured as more individuals telecommute and as they employ modems in their homes and offices for both "personal" and "business" use.

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14 In fact, if there is any statistical variation in loop costs among type of subscribers, the costs for multi–line business users are probably less on average that the costs for residence and single line business users. Local loop costs depend on factors such as loop length (or distance between the end user and the serving wire center), the loop technology (*i.e.* buried cable, aerial cable), the size of the cables used for the loop, and whether subscriber carrier systems are employed to meet the requirements for multiple loops on a single facility. In combination, these factors result in much lower loop costs for business as compared with residential users.

Although a single national SLC is justified, the Commission may wish to minimize any potential increase for low volume interstate MTS users. In this case, GSA/DOD recommends that the Commission employ an optional capped low–volume SLC. All types of subscribers — residence, single line businesses and multi–line businesses — would be eligible for the low–volume capped rate if their interstate toll usage does not exceed a specified message–minute limit for three consecutive months. GSA/DOD suggests that the Commission consider a low volume capped SLC of $4.00 monthly to implement a moderate increase over the existing cap for most lines. For all other lines, the SLC would be uncapped, and would be set at a uniform value established to meet the total interstate NTS revenue requirement after access charge reform.

The proposal by GSA/DOD to recover all NTS costs through the SLC contains several levels of protection for end users. First, any increase in the NTS revenue requirement would be minimized by flowing to this rate element the benefits of access reform, as discussed subsequently in these Comments. Second, a rate available to all low volume users would be set only slightly above the current residence–single line business cap.

Universal Service plans provide an additional level of protection for end users. In CC Docket No. 96–45, GSA urged the Commission to accept recommendations by the Federal–State Board on Universal Service to extend the existing Lifeline and Linkup programs.[15] This support to low–income consumers should be available to mitigate impacts on households for which any increases in the costs of local telephone services represent a true economic hardship.

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15 CC Docket No. 96–45, Comments of GSA, December 19, 1996, pp. 7–8.

III. Need for Access Reform

A. Excessive LEC Access Charges

As the NPRM states, an "overriding goal" in this proceeding is to adopt revisions to the access charge rules that will foster competition and allow market forces to replace price regulation of interstate services.[16] The need for access reform is most pressing for the large local exchange carriers soon to be subject to more competition because of the availability of unbundled network elements to their potential competitors. The large incumbent local exchange carriers subject to price cap regulation receive about 91 percent of total interstate access charge revenues. Therefore, the Commission proposes to focus this proceeding on these carriers.[17]

The interstate price cap plan was designed to ensure just and reasonable rates. The Commission has explicitly recognized the nexus between earnings levels and price caps. In CC Docket No. 93–179, the Commission noted that:

> Under the LEC price cap system of regulation, we have designed our sharing and low–end adjustment mechanisms around benchmark earnings levels.[18]

A review of the requirements to change the sharing levels for price cap local exchange carriers is overdue. In September 1992, GSA recommended that the Commission initiate a rate of return proceeding when the yield on ten–year United States Treasury securities ("T–Bonds") changed by 150 basis points.[19] The Commission accepted GSA's recommendation, and initiated a proceeding, AAD 96–

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16 NPRM, para. 140.

17 *Id.*, paras. 50–51.

18 Price Cap Regulation of Local Exchange Carriers, Rate–of–Return Sharing and Lower Formula Adjustment, CC Docket No. 93–179, Report and Order, FCC 95–133, released April 14, 1995, para. 17.

19 CC Docket No. 92–133, Comments of GSA, September 11, 1992, pp. 8–10.

28, when this condition was met. GSA submitted comments in that case explaining the need to recalibrate the interstate price cap formulas.

There is ample evidence of high earnings by the Bell operating companies. The Commission's 492A Reports show 1995 returns ranging from 11.6 percent to 16.8 percent for the Bell companies, as revealed by the table below.

Interstate Earnings of Bell Regional Holding Companies

Regional Holding Company	Rate of Return
Ameritech	16.78%
Bell Atlantic	13.73%
BellSouth	15.75%
NYNEX	12.13%
Pacific Telesis	15.18%
SBC	13.37%
U.S. West	11.61%
Total	13.99%

The Commission prescribed the existing 11.25 percent rate of return in 1990.[20] This reference point was based on a six–month average of 8.64 percent for T–Bond yields existing at that time.[21] The low–end trigger point for earnings sharing was set at 7.14 percent and the high end trigger point at 10.14 percent.

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20 Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89–624, Order, FCC 90–315, released December 7, 1990, para. 1.

21 Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return, Represcription and Enforcement Process, CC Docket No. 92–133, Report and Order, FCC 95–134, released April 6, 1995, para. 42.

In its March 1996 Comments in AAD 96–28, GSA demonstrated that low yields are continuing. The yields on T–Bonds have been below the reference point since October 1990 and below the low–end trigger point for nearly two years.[22]

The continuation of an outmoded rate of return target has resulted in interstate access charges which are not just and not reasonable. The Commission must protect the interests of users of regulated telecommunications services and not permit this condition to continue any longer.

B. Approaches to Reform

In its NPRM, the Commission suggests two alternative approaches to access reform.[23] The first is called a "market–based" approach and the second is called a "prescriptive" approach.

Market–Based Approach

The market–based approach would be designed to allow marketplace pressures to move interstate access prices to competitive levels. The proposed approach would be implemented incrementally. First, the Commission would eliminate certain regulatory constraints as incumbent LECs demonstrate that the conditions necessary for efficient local competition exist in their service areas. The Commission would remove additional regulatory constraints, including mandatory rate structures, when incumbent LECs prove that actual competition has emerged. Finally, the Commission would eliminate price regulation when full competition was demonstrated.

In the NPRM, the Commission suggests a number of specific tests to demonstrate that competition exists. For example, the Commission suggests a set of

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22 AAD 96–28, Comments of GSA, March 11, 1996, Attachment A. The yield on T–Bonds was only 6.30 percent in December 1996.

23 NPRM, para. 140.

four tests to trigger the regulatory changes proposed in the initial phase of the market–based approach:[24]

- unbundled network elements are available at their Total Element Long Ruin Incremental Cost, plus a reasonable allocation of common costs;
- transport and termination are available for local traffic at cost–based rates;
- retail services are offered to resellers at wholesale prices reflecting avoidable costs; and
- competitors are able to order and receive the requested quantities of services in a commercially reasonable manner.

The NPRM states that other objective tests might be employed in addition to these measures or in conjunction with them.[25] The NPRM also describes a number of alternative geographic deaveraging conditions that may be used in measuring whether or not the LEC has met the required tests in all or part of its total service area.[26]

Prescriptive Approach

Under the Commission's prescriptive approach, access charges would be moved to forward–looking costs in a more predictable and uniform manner.[27] The Commission observes that while this approach would have the same ultimate goals as the market–based approach, it would require regulators to play a greater role in the marketplace.[28]

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24 NPRM, paras. 140–175.

25 *Id.*, paras. 176–179.

26 *Id.*, paras. 180–186.

27 *Id.*, para. 218.

28 *Id.*

The NPRM outlines a number of possible actions that could be taken under the prescriptive approach.[29] One action would be to readjust rates to economic cost levels indicated in long–run incremental cost studies.[30] To implement this readjustment, the Commission would require incumbent price cap LECs to reduce their price cap indices so that revenues matched Total Service Long Run Incremental Costs ("TSLRIC") for the services in each basket. In the alternative, price cap indices could be reduced to a level targeted to yield a rate of return of 11.25 percent, the current reference value for LECs.[31] This procedure would avoid the requirement for TSLRIC studies.

Another prescriptive tool at the Commission's disposal is to adjust the parameters of the LEC price cap plan in one of several ways. The NPRM suggests alternative adjustments, such as increasing the productivity offset factor or adopting stringent rules governing the justification of tariff filings that cause a specified change in the price index for a market basket.[32]

An additional action identified in the NPRM is direct rate prescription.[33] This approach would require incumbent LECs to conduct TSLRIC studies, and set prices for interstate access services in accord with the indicated costs. The Commission would rely on the operation of price cap regulation to maintain the rates at the cost–based levels.

C. Merits of Alternatives

Both the market–based and the prescriptive approaches have the same ultimate goal — the greatest possible variety of telecommunications services at the

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29 *Id.*, paras. 223–238.

30 *Id.*, paras. 223–227.

31 *Id.*, paras. 228–230.

32 *Id.*, paras. 231–235.

33 *Id.*, paras. 236–238.

lowest possible prices for all consumers. As paths to this goal, both approaches have strong positive features, but both have major drawbacks as well.

The market–based approach will require less regulatory oversight by the Commission. This approach is more "in tune" with competition in the sense that it is consonant with the view that market forces rather than regulatory forces should shape telecommunications services and networks.

The NPRM identifies four very important steps that the Commission plans to take when Phase 1 triggers for the market–based approach are achieved.[34] These steps concern geographical deaveraging, volume and term discounts to interexchange carriers, contract tariffs, and deregulating new services. As discussed later in these comments, GSA/DOD believes that these steps are important to foster additional competition.

Since the prescriptive approach necessarily includes only actions that may be taken in the interstate arena, the market–based approach has one additional advantage that may be less evident. A market–based approach more clearly reflects the fact that markets for telecommunications services will develop without geographical boundaries. There are no intrinsic cost or operational differences between interstate, intrastate and local traffic — only regulatory boundaries that are becoming increasingly blurred.

While the market–based approach has many positive features, it has some major drawbacks. In the first place, the market–based approach does not address the critical problem of excessive earnings by the LECs, discussed previously in these comments. While market factors may alleviate this problem over time, end users

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34 *Id.*, paras. 180–200.

deserve more immediate relief from the requirement to fund excessive LEC earnings through unnecessarily high charges for interstate telecommunications services.

Also, from their experience in regulatory proceedings throughout the nation, GSA/DOD is convinced that the market–based approach will not provide sufficient control over LECs pricing activities, particularly in the next few years. These transition years are critical. To date, competitors have only established toeholds in many markets.

Furthermore, excessive flexibility in pricing interstate access services in the near term will impede the development of more competition. While some interexchange carriers may chose to bypass LEC access capabilities — albeit inefficiently from an economic standpoint — excessive rates will lead to reduced demand. Each reduction in switched or special access demand will result in less use of some telecommunications service, and fewer opportunities for new competitors to develop additional markets.

In summary, since both the market–based and the prescriptive approaches have strong and weak points, GSA/DOD recommends that the Commission adopt a plan with the best features of each. The following section of these Comments describes this plan.

IV. GSA/DOD Recommendations for Access Reform

A. Continue Earnings Sharing and Employ Prescriptive Tools

Continue Earnings Sharing

GSA/DOD recommends that the Commission continue the existing earnings sharing framework for price cap LECs until the full–competition criteria for Phase 3 of the market–based approach are achieved. The price cap framework should not be changed while competition develops in the meantime. However, the Commission

should proceed expeditiously with two important prescriptive actions — reinitialization of rates and adjustment of the productivity offset factor.

Reinitialize Rates

In the LEC Price Cap Performance Review, GSA and other parties recommended that the Commission reinitialize LEC access charges on the basis of a newly prescribed rate of return that reflects current debt and equity return requirements.[35] The NPRM recognizes that to the extent current price cap rates reflect a cost of capital greater than needed to attract investors, these rates may not represent the most reasonable balance between ratepayer and stockholder interests.[36] In view of the changes in T–Bond returns, as mentioned above, GSA/DOD continues to recommend that the Commission initiate a proceeding to establish new reference and trigger points for the interstate price cap plan. The Commission should initiate this proceeding as soon as possible so that end users do not continue to pay the penalties of unnecessarily high rates.

The Commission now has many obligations to develop the procedures required to implement the provisions of the 1996 Act. Therefore, GSA/DOD recognizes that it may be some time before an investigation to establish new price cap parameters is completed, even if it is conducted on an expedited basis. Therefore, as an interim measure, GSA/DOD urges the Commission to immediately require all incumbent price cap LECs to reduce price cap indices to a level that would produce rates targeted to yield a rate of return of no more than the 11.25 percent return prescribed by the Commission in CC Docket No. 89–624..

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35 LEC Price Cap Performance Review Order, 10 FCC Rcd at 9064–65.

36 NPRM, para. 228.

Adjust Productivity Offset

The second prescriptive action that the Commission should take is to increase the productivity offset in the earnings sharing plan. Price cap regulation permits rates to increase by no more than a measure of inflation minus an "X–Factor".[37] The X–Factor is intended to represent the amount by which improvements in the productivity of LECs and their suppliers have exceeded productivity improvements for the general economy. The X–Factor also includes a 0.5 percent consumer productivity dividend.

The X–Factor in the price cap procedures plays a critical role in maintaining the balance between the interests of ratepayers and investors, even if earnings targets are recalibrated to reflect current capital requirements. If the X–Factor is not sufficiently large to account for the subsequent improvements in LEC productivities, an increasing gap between actual earnings and required earnings will emerge.

The NPRM observes that the Customers for Access Rate Equity Coalition, and several interchange carriers, have recently recommended that the Commission adopt a higher X–Factor.[38] The NPRM asks for comments on the most appropriate responses to these recommendations.[39] Specifically, the NPRM invites comments on whether it should change either the magnitude of the X–Factor or the method of computing the factor.

GSA/DOD recommends that the Commission conduct an expedited investigation of the appropriate magnitude of the productivity differential at this time. Since the LECs have continued to enjoy excessive returns, it is likely that the productivity offset factor is not fully accounting for the actual productivity growth in the local exchange industry during the past few years. Also, the Commission should

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37 *Id.*, para. 231.

38 *Id.*, para. 233.

39 *Id.*