system as a condition precedent to Phase 2 implementation. The statutory responsibility for implementing such a system is that of the regulatory agencies, not the carriers.[18]

The Citizens LECs believe that, for purposes of interstate access charges, the presence of a competitor for access transport services in an exchange area of a rural price cap LEC is sufficient to trigger two events: (i) Phase 2 treatment of all access services in that exchange area; and (ii) consideration of whether the particular service or services subject to competition should be deregulated and detariffed. The triggering event in a rural price cap LEC exchange area should be either the presence of a single interexchange carrier or other competitor securing access transport services in the exchange area through its own facilities, those of a competitive LEC or those of the incumbent LEC, either through expanded interconnection or unbundled transport network elements. This competitive presence is evidence that competition exists in one product market, and that, overall, there is some level of competition in that geographic market. The key feature of Phase 2 relief for a rural price cap LEC should be the opportunity for differential pricing of access to different classes of customers. This feature would allow the rural price cap LEC the necessary flexibility to meet competition for multi-line business access customers, for example, while still maintaining a greater degree of regulatory control over prices of services not yet subject to a significant degree of competition, *e.g.*, residential and single-line business customers.

The same event that should trigger Phase 2 regulatory relief in a rural price cap LEC exchange area -- the presence of transport competition -- is the same event that should trigger

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[18] Similarly, the suggestion that enforcement of pro-competitive rules should be a factor in determining whether implementation of Phase 2 is inappropriate. *Access Reform NPRM* at ¶ 208. Whether or not such rules are implemented is purely in the hands of the FCC and state commissions.

consideration of complete deregulation and detariffing of the particular service or services for which the competition exists. The likelihood is that, in a rural price cap LEC exchange area, competition in interstate services will first emerge for the access usage generated by multi-line business customers. For this class of customers, at least in the territories of a rural price cap LEC, any competition is, by definition, substantial competition that should trigger deregulation and detariffing of relevant interstate access services.

C. Deregulation And Detariffing Of Rural Price Cap LEC Markets And Services Subject To Substantial Competition

1. Barriers To Competitive Entry Must Be Removed And The Tools For Competitive Entry Now Exist

Sections 251, 252, 253 and related sections of the Communications Act require the removal of barriers to competitive entry and create the tools that competitors may choose to use to achieve such entry. These statutory provisions, in and of themselves, are sufficient to lead to the conclusion that all products in the rural price cap LEC subject to potential competition.[19] No additional requirements should be imposed to trigger market-based Phase 1 regulatory treatment for all rural price cap LECs. All local exchange markets are, by law, open to competition and the tools exist for market entry.

The degree to which competitors have entered into a market is the appropriate focus of inquiry in determining two issues: (i) whether Phase 2 regulatory treatment should be triggered

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[19] The fact that the Citizens LECs are price cap carriers that, perhaps uniquely among price cap carriers, fall under the Section 251(f)(1) interconnection exemption does not detract from this proposition. That exemption is not absolute in that it may be terminated by state commissions. Even if continued in the face of a *bona fide* interconnection request, the Section 251(f)(1) exemption does not bar competitive entry; it only allows deviation from some interconnection requirements under Sections 251(c) and/or 252. Also, the fact that the Citizens LECs and a few other price cap LECs have the right to request suspension or exemption from statutory interconnection requirements under Section 251(f)(2) offers no assurance that the requested treatment will be granted by state commissions. See Access *Reform NPRM* at fn. 90.

in the geographic and service market at issue; and (ii) whether specific services within a geographic market, or the geographic market in its entirety, should be deregulated and detariffed. The Citizens Companies showed in Section III(B), above, that the unique nature of the markets served by rural price cap LECs suggests that competition for <u>any</u> access transport service in an exchange area is sufficient to trigger Phase 2 treatment in that exchange area. That same uniqueness of the rural market also dictates examination of whether the same access transport competition that should trigger Phase 2 treatment in the entire exchange area is sufficient to trigger deregulation and detariffing of the rural price cap LEC's access services for the class of customers that is being addressed by competition.

2. Standards For Consideration Of Deregulation And Detariffing Of <u>A LEC Market Or Service</u>

The Citizens Companies believe that the issues to be addressed in determining whether a market or service is subject to substantial competition and should be deregulated and detariffed are as follows:

1. Are the incumbent LEC's customers demand responsive?

a. Do the incumbent LEC's customers seek alternative pricing or physical access arrangements to those offered in the incumbent LEC's access tariff?

2. Supply responsiveness:

a. Are there alternative sources of supply in the market?

b. Do providers of alternative sources of supply in the market have the capacity and ability to readily absorb additional customers?

c. Are the products and services offered by providers of alternative sources of supply essentially substitutable for those offered by the incumbent LEC?

d. Can customers readily shift from one source of supply to another without difficulty or disruption?

The Citizens Companies do not view the *Access Reform NPRM's* suggestions of possible competitive factors,[20] other than the question of demand and supply responsiveness, to represent correct elements for inclusion in competitive analysis. Market share[21] and pricing of incumbent LEC services under price cap regulation,[22] at best, merely suggest that competition exists. They are not and cannot be dispositive of the issue of whether substantial competition is present. The dispositive criteria are inherent in the *Access Reform NPRM's* concept of demand[23] and supply responsiveness,[24] as more fully articulated herein.

Demand responsiveness, i.*e.*, the sensitivity of the quantity of a service demanded to price changes, or the elasticity of demand,[25] is the first critical measure of the existence of substantial competition in incumbent LEC markets. The second critical measure is the degree to which supply responsiveness exists, *i.e.*, the sensitivity of the quantity of a service provided to price changes, or the elasticity of supply.

In the case of rural price cap LECs, the Citizens Companies have already shown that, in those exchanges where a competitor is using transport access alternatives to those of the LEC,

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[20] *Access Reform NPRM* at ¶¶ 156-160.

[21] *Id.* at ¶ 158.

[22] *Id.* at ¶ 159.

[23] *Id.* at ¶ 156.

[24] *Id.* at ¶ 157.

[25] *Id.* at fn. 215.

demand for access services to multi-line business customers, at a minimum, must be presumed to be elastic. The tiny proportion of large business customers in relation to residential customers in the preponderance of the Citizens LECs' exchange areas, for example, suggests that the presence of a competitor demonstrates the availability of a ready alternative to the Citizens LEC for at least access to multi-line business customers. In the case like that of the Citizens LECs, where relatively few customers account for the bulk of their access demand, little point would be served by requiring any further demonstration of demand responsiveness.

The *Access Reform NPRM* correctly reaches the tentative conclusion that the ready availability of unbundled network elements at forward-looking economic costs indicates a high supply elasticity in the access market.[26] However, this tentative conclusion falls short by failing to recognize the existing supply of alternatives to incumbent LEC exchange access services. For example, in the unique case of rural markets of the type served by the Citizens LECs, a competitor's penetration into at least the multi-line business customer base of access usage is relatively easy without use of unbundled network elements. The availability of incumbent LEC special access services, competitive LEC provision of alternative access transport services and the ability of interexchange carriers to build their own dedicated transport facilities all make entry into competition for large volume access customers relatively easy. The availability of unbundled network elements augments the supply of alternatives to incumbent LEC access services offerings. In the case of rural price cap LECs, these factors support deregulation and detariffing of at least multi-line business-related access services when a competitor for such services is present.

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[26] "A high supply elasticity indicates that [competitive] entry is relatively easy and that any attempt by an incumbent [LEC] to raise prices will result in new [competitive] entry." *Access Reform NPRM* at fn. 216.

3. In The Case Of Rural Price Cap LECs, Phase 2 Regulation In An Exchange Area Should Trigger Deregulation And Detariffing Of, At A Minimum, Access Services To Multi-Line Business Customers

The Citizens Companies have shown that, at least in the case of the type of rural markets served by the Citizens LECs, the existence of an access competitor offering at least transport access services in an exchange area is evidence of the competition sufficient to trigger Phase 2 treatment for that exchange area.[27] Further, the Citizens Companies believe that entry into Phase 2 regulation in a price cap rural LEC exchange area should be coupled with deregulation and detariffing of at least multi-line business customers' access services.

In the circumstance of a rural price cap LEC exchange area subject to competitive entry, the small proportion of multi-line business customers should make unnecessary a formal showing of demand responsiveness or elasticity. The only test should be one of whether comparable access services are available from a competitor. A strong presumption should exist that this test is met by the fact that the competitor is offering exchange access service alternatives to those of the incumbent LEC.

On the issue of supply responsiveness or elasticity, the presence of the competitor in the rural market shows an alternative source of supply, at least for multi-line business customer access services. That competitor's capacity and ability to absorb additional customers is really not an issue because the incumbent LEC's plant and facilities used in directly providing access services is the same plant and facilities that can provide unbundled network elements and interconnection services to the competitor. The access services that the competitor offers to the customer base in

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[27] *See* Section III(B), *supra.*

question is identical to and substitutable with that of the incumbent LEC. Finally, the Commission's interconnection rules require that incumbent LECs create the technical means for customers to shift to alternative sources of supply where the supplier is using the LEC's underlying network elements and services.[28]

The unique status of a rural price cap LEC group like the Citizens LECs suggests that the Commission must give singular consideration to that uniqueness in crafting the course of future price cap regulation. Key among the factors that the Commission must consider in this regard is that the "some competition" in a rural exchange area that should trigger Phase 2 treatment is also substantial competition for the relatively high volume of access traffic that is generated by a proportionately small number of business customers. At a minimum, the presumption should exist that Phase 2 regulation of a rural price cap LEC exchange area should bring with it deregulation and detariffing of the multi-line business customer access services that will be the focus of competition in that rural exchange for the foreseeable future.

IV. Rate Structure Modifications

A. Common Line

The Citizens Companies support the Joint Board's proposal to recover that portion of interstate non-traffic sensitive ("NTS") loop costs not recovered from the federal Subscriber Line Charge ("SLC") from flat-rate, per-line charges assessed upon end users' Primary Interexchange Carriers ("PICs").[29] This endorsement includes the Joint Board's suggestion that incumbent

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[28] *See, generally* Part 51 of the Commission's Rules.

[29] Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision, FCC 96J-3 (rel. Nov. 8, 1996) ("*Joint Board Recommended Decision*") at ¶ 776.

LECs be allowed to assess the flat-rate charge to those end users who do not make a PIC selection.

B. The SLC Portion Of Interstate Subscriber Loop Costs

The proposal to increase the cap on the SLC for the second and additional lines for residential customers and all multi-line business customers to the level of per-line loop costs assigned to the interstate jurisdiction is,[30] on the surface, attractive to the Citizens Companies. However, it has a practical shortcoming that must be addressed in order to be workable.

A mandatory increase in non-primary and multi-line business line SLCs to the level of per-loop costs assigned to the interstate level could send incongruent economic signals to the marketplace. At the current time, the jurisdictional separations process assigns incumbent LEC embedded costs, on a fully distributed basis, to the different jurisdictional levels. Although the dust has yet to settle on the Commission's rule that would require unbundled loops to be priced TELRIC,[31] it appears that many states are pricing this element at TELRIC or some variant of forward-looking economic cost. The Citizens Companies fear that in the type of rural, high-cost areas they typically serve, mandatory assessment of dramatically increased SLC charges on the relatively few multi-line business customers they serve could create an incentive to inefficient entry into access competition through purchase of unbundled loops and other network elements. Stated another way, mandatory assessment of a multi-line SLC equal to the level of per-loop costs assigned to the interstate level might serve to skew artificially the relationship between the

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[30] *Access Reform NPRM* at ¶ 65.

[31] *See* Subpart F of Part 51 of the FCC's Rules.

book cost-derived SLC and TELRIC-based unbundled loop charges. The problem could be particularly acute in rural, high-cost areas. The marketplace should be sufficient to determine the pricing of non-residential SLC pricing.

The Citizens Companies suggest that incumbent LECs be accorded the right, but not the requirement, to raise non-primary residential and the multi-line business line SLC up to a maximum of the level of interstate per-loop cost. This would give incumbent LECs the necessary flexibility to recover the costs of multi-line business customer loops consistent with the market discipline inherent in the ability of interexchange carriers to purchase cost-based unbundled loops and other network elements.

The *Access Reform NPRM* also solicits comment on whether incumbent LECs should be permitted or required to deaverage SLC charges.[32] The Citizens Companies believe that if the Commission's rule requiring states to deaverage unbundled loop charges withstands judicial scrutiny,[33] incumbent LECs will, of necessity, need the opportunity to deaverage SLC charges. The SLC price level, like all other interstate access elements, cannot be considered in isolation from pricing of its underlying network elements.

C. Local Switching

1. Non-Traffic Sensitive Charges

The Citizens Companies agree with the *Access Reform NPRM's* proposals for flat-rate pricing of dedicated line card costs and ports for dedicated transport.[34]

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[32] *Access Reform NPRM* at ¶ 67.

[33] Section 51.507(f) of the FCC's Rules.

[34] *Access Reform NPRM* at ¶¶ 72-73.

2. Traffic-Sensitive Charges

The Citizens Companies agree with the *Access Reform NPRM's* proposal for a per-call set-up charge.[35] Because the cost of call set-up is incurred on all calls, whether completed or not, it should be charged accordingly.

Another major component of local switching is the central processing portion of the switch and trunk-side ports that are not associated with dedicated transport.[36] These components are shared facilities and should continue to be priced on a usage-sensitive basis.

The Citizens LECs do not believe that peak and off-peak pricing for switching should be mandated. Peak and off-peak pricing is primarily a pricing decision made by carriers to influence demand patterns. Interexchange carrier access customers do not choose the demand pattern for network usage, but attempt to influence end users through their pricing policies. Further, significant investment would be required in order to enable LEC billing of peak and off-peak access pricing. Peak and off-peak pricing, if allowed at all, should be at the LEC's option.

D. Transport

1. Entrance Facilities and Direct-Trunked Transport Services

The Citizens Companies endorse the *Access Reform NPRM's* tentative conclusion that entrance facilities and direct-trunked transport services should be flat-rated.[37]

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[35] *Id.* at ¶ 75.

[36] *Id.* at ¶ 73.

[37] *Id.* at ¶ 86.

2. Tandem-Switched Transport Services

The Citizens Companies endorse what is, in essence, the *Access Reform NPRM's* third option for pricing tandem-switched transport services: (i) usage-sensitive rates for shared facilities, *e.g.*, the tandem switching functions and the ports on the end office side of the tandem switch; and (ii) flat-rated charges for dedicated facilities on the serving wire center side of the tandem switch.[38] They believe this structure to be the most economically efficient and simplest to administer.

E. The Transport Interconnection Charge

The Citizens Companies' analysis of the current TIC suggest that it includes the following costs that should be properly be assigned elsewhere:

1. 80% of tandem revenue requirement - The current tandem switching rate reflects 20% of its revenue requirement. The remaining 80% is located in the TIC.[39] The portion of tandem switching costs now included in the TIC should be reassigned immediately to the tandem switching element.

2. SS7 costs presently included in the TIC - As suggested in the *Access Reform NPRM*,[40] the TIC presently includes a portion of the tandem switching revenue requirement associated with SS7 signaling, LIDB and other related signaling services. These costs should be reassigned immediately to the SS7 cost recovery elements discussed in Section IV(F), below.

3. The current tandem-switched transport rate structure - The current tandem-switched transport rate structure is flawed because: (i) tandem transport from the access tandem

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[38] *Id.* at ¶ 89.

[39] *Id.* at ¶ 102.

[40] *Id.* at ¶ 103.

to the IXC POP, which is actually dedicated, is treated as shared; and (ii) tandem transport from the access tandem to the end office, while correctly usage-rated, relies upon an overstated assumption of 9,000 minutes of tandem usage. These flaws should be cured by the restructure of tandem-switched transport discussed in Section IV(D)(2), above; inclusion of appropriate multiplexing costs;[41] and use of carrier-specific minutes of use assumptions for rate calculation.

4. Host-remote trunking costs - Currently, host-remote trunking costs are not correctly recovered. Only a portion of these costs are recovered from where they should be -- through the tandem transport element; the remainder is currently recovered in the TIC. Host-remote trunking costs should be immediately moved to the tandem transport element.

Further, the Citizens Companies find the following jurisdictional misallocation problems inherent in the current TIC:

a. Anomalies caused by the averaging of transport rates by geography, technology, services and jurisdictional separations.

b. Current treatment of analog end office trunk switch ports - Calls carried on DS1 transport need to be muxed to the DS0 level to carry switched traffic. Accordingly, 48 terminations are associated with such facilities. This function is not required in the special access environment and two DS1 terminations are associated with DS1 special access circuits. Typically, analog switch investment is treated as transport, and digital switch investment is treated as local switching. These processes have resulted in an under-allocation of multiplexing costs to direct-trunked transport and their recovery through the current TIC.

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[41] *Id.* at ¶ 106.

c. Central office termination counts - Circuit termination costs can be directly assigned for jurisdictional purposes. However Part 36 of the Commission's Rules currently dictates that circuit equipment be allocated to categories based on average cost per-termination.

d. Central office maintenance misallocations - Expenses related to central office switching, operator systems and central office transmission are currently apportioned among the combined central office investment accounts instead of matching the expense apportionment to the investment apportionment.

e. Interexchange cable and wire investment - Cable and wire basic studies are currently used to jursidictionally separate investment between message telephone and private line. However, Part 36 currently dictates that the cost of Category 3 interexchange C&W investment be assigned to the above categories by average cost per-equivalent telephone circuit kilometer, thus assuming all classes of interexchange circuits have the same cost characteristics.

The Citizens Companies believe that those costs now recovered in TIC that can be readily associated with an appropriate element in the access structure should be moved immediately to that element. Further, costs that are now included in the TIC as a result of incorrect allocation and separations procedures, should, upon completion of reallocation and separations reform, be moved to discrete rate elements. During the pendency of the reallocation and separations reform processes, should continue to be recovered in what should be a dramatically smaller TIC.

F. SS7 Signaling

The Citizens Companies endorse the *Access Reform NPRM*'s proposals to: (i) flat-rate dedicated links between an SS7 customer's network to a dedicated port on a LEC's STP; (ii) flat-rate dedicated ports on LEC STPs; (iii) assess usage-sensitive charges for shared circuits between LEC STPs, switches and SCPs; and (iv) assess a per-query charge for STP processing and switching.[42]

The usage-sensitive elements of the proposed SS7 signaling structure obviously will require the installation of metering equipment on LEC networks. The costs of installing such capability should receive exogenous cost treatment because those costs could not have been anticipated by price cap LECs and would make SS7 provision more efficient and useful to LEC customers.

V. Treatment Of Any Remaining Embedded Costs Allocated To The Interstate Jurisdiction

A. Introduction

This section of the *Access Reform NPRM* addresses a matter of paramount importance to the Citizens LECs. The Citizens LECs and their ultimate owners, the shareholders of Citizens Utilities Company, have invested substantial dollars in carrying out carrier of last resort obligations in reliance upon the historic regulatory promise that they would have the opportunity to recover those investments over time. It now appears that regulators may have only a short period of time left in which to deliver upon their end of the regulatory bargain. The regulatory compact is a long standing, implicit contract that should be honored despite recent changes in legal framework. While the length of the window for consummation of the regulatory bargain may be somewhat

[42] *Id.* at ¶¶ 127-133.

greater for the Citizens LECs than for more typical price cap carriers, it cannot be assumed that competition will be so long in coming to rural, high cost exchange areas that time will make this issue go away. This is particularly true at the interstate level because interexchange carriers generally do not necessarily even require any of the Telecommunications Act's interconnection tools to find access alternatives for customers that generate large volumes of access usage.

The Citizens Companies believe that the Commission (as well as state commissions) must establish a fair, equitable and competitively neutral mechanism by which incumbent LECs are given an opportunity to recover investments, during a limited transition period, that were deferred through the historic regulatory framework. Incumbent LECs were historically required to make investments in facilities and incur costs as part of their carrier of last resort obligations within their established service areas. In return, state commissions adopted, formally or otherwise, regulatory policies that precluded competitors from providing local exchange service within an established incumbent LEC exchange area as long as the incumbent LEC provided adequate service at reasonable rates. There can be no question that incumbent LECs made significant investments in reliance upon these policies.

Further, the historic universal service system had at its core the maintenance of low, often below-cost, residential rates. One of the means regulators used to maintain low residential rates was to prescribe depreciation schedules that shifted the timing of capital recovery to future accounting periods. This regulatory practice restricted the amount of depreciation expense an incumbent LEC could accrue each year, creating significant depreciation reserve deficiencies. These deficiencies represent regulatory assets created in a monopoly environment in furtherance of regulatory policies. Because incumbent LECs will not be able to recover these deficiencies in a

competitive market, a transitional mechanism is necessary to allow the LECs an opportunity to recover these mandated deferrals of investment recovery incurred to maintain basic residential rate levels.

Under the old regulatory framework, regulators established rates by determining a revenue requirement that included an allowance for depreciation expense. A causal relationship exists between the amount of revenue that an incumbent LEC is and was authorized to collect through the rates it is authorized to charge and the pattern of depreciation used in determining revenue requirements. In contrast, in a fully competitive market, prices are determined by supply and demand without regard to how the firm chooses to measure its costs of production. The interstate price cap regulatory scheme did not fully break the chain of causality between regulatory depreciation practices and investment recovery because caps on earnings prevent the subject LEC from recovering its costs of production in the same manner that prevails for unregulated businesses.

Past regulatory extensions of depreciation schedules postponed capital recovery beyond the normal time for recovery in a competitive marketplace. The prescribed depreciation rates simply shifted the timing of capital recovery to a future time period. Even as they set depreciation rates below market-based levels, at no time did regulators contemplate denial of a full return of incumbent LECs' full investments. With the advent of competition, the "future time period" for recovery disappears. Thus, without a transition mechanism by which incumbent LECs can recover this "deferred recovery," the advent of competition will force incumbent LECs either to: (i) bear the losses from unrecovered investment; or (ii) be forced to price at or above total average costs (including depreciation reserve deficiency recovery) while unregulated competitors are free to price as low as marginal cost.

Alfred E. Kahn has developed a simple example that illustrates this problem. It is illustrated in the table below:[43]

	INCUMBENT LEC	COMPETITIVE ENTRANT	INCUMBENT LEC-RESPONSE WITHOUT TRANSITIONAL MECHANISM FOR RECOVERY OF DEPRECIATION RESERVE DEFICIENCY
AVC	$7.00	$4.50	$4.50
AFC	$3.00	$2.00	$5.00
ATC	$10.00	$6.50	$9.50

AVC = average variable costs; AFC= average fixed costs; ATC= average total costs

In this illustration, the assumption is made that the variable costs of existing LEC equipment are $7.00 per unit and the average fixed costs of that equipment (depreciation and return on the unamortized investment) are $3.00 per unit. In the next column, the assumption is made that, with new technology, a competitor can build a comparable systems with a variable cost of $4.50 per unit and fixed costs of $2.00 per unit, for an average total cost of $6.50.

In a fully competitive market, competitive market pressures will drive prices toward marginal cost. However, in the above example, the incumbent LEC, even if it decides to adopt the new technology (or is forced by regulators to price its services assuming use of new technology), will not be able to bring the fixed cost down as the competitor would be able to do. This is so because the incumbent LEC will still be carrying forward the fixed cost of the old technology (*i.e.*, return and depreciation) as a result of past regulatory mandate. Therefore, when the incumbent LEC combines the old fixed cost, carried forward, and the new fixed cost of the new technology, it

[43] Alfred E. Kahn, The Economics of Regulation: Principles and Institutions. John Wiley & Sons, Inc., New York, 1970.

results in a $5.00 fixed cost, as shown in the third column of the foregoing illustration. Thus, the competitor has the advantages of initially pricing above its costs and garnering substantial profit margin while still being able to price below the incumbent LEC.

The market becomes efficient only as the price reaches, or nears, $6.50, and will remain inefficient as long as the price is over $6.50. However, the inefficiency is caused only because of past regulation of the incumbent LEC that mandated the deferred recovery of investment. If the goal is to create an environment where customers quickly realize the benefits of competition, it is imperative that regulators develop an interim, transitional mechanism that allows the incumbent LEC to recover the depreciation deficiency that should have been recovered.

It would be naive to assume that customers will receive the benefits of competition in the foregoing example if the incumbent LEC prices the service at the $9.50 example (*see* column three of the foregoing illustration). Under this circumstance, the competitor will, in all likelihood, price just enough below the incumbent LEC "umbrella" price to attract market share, but not at anything close to its $6.50 marginal cost level. Until the incumbent LEC is able to recover its deferred amounts, the price is not likely to approach marginal cost for the market. The customers who do switch will be providing the competitor with windfall profits.[44] The customers that cannot or do not switch will be further burdened with the continued recovery of the incumbent LECs deferred amounts of depreciation.

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[44] This also explains why it is naive to suggest that, in a competitive environment, competitors consciously strive to price at marginal cost. Instead, they strive to price just enough below their competitors to gain market share. While the process of competition drives prices toward marginal costs, it cannot be said that entrepreneurs enter into a market with a goal of pricing at the marginal cost level.

Allowing recovery of the deferred amounts over a limited transition period would benefit all customers by providing an environment conducive to fostering competition. Referring to the foregoing table, using a marginal cost of $6.50 as the base for pricing, plus $1.00 to allow recovery of the deferred amounts, means that all customers would pay $7.50. This is above the marginal cost, but well below the $9.50 incumbent LEC umbrella that might otherwise prevail if the incumbent acquired new technology and carried over the unrecovered fixed cost of its old technology. While all customers might have to pay something above marginal cost for a short period, those customers would also benefit. First, those customers that cannot switch carriers would pay prices lower than the incumbent LEC would otherwise have to charge to recover the amounts deferred under regulation. Second, customers that do switch to a competitor will not have to pay the higher prices that the competitor might charge under an artificial LEC umbrella price. Therefore, a limited transitional period for recovery of incumbent LEC deferred depreciation amounts would provide all customers with benefits from competition sooner than they otherwise might.

B. Quantifying The Amount To Be Recovered In An Interim Transitional Recovery Mechanism

Particularly in the case of a rural price cap LEC, a transitional mechanism is needed to smooth the impact of movement from a heavily regulated to a competitive environment. This requirement is basic concept of equity and fairness as a result of the abrupt termination of the regulatory contract. The mechanism should establish the amount of the incumbent LEC's under-recovered service value in order to quantify the cash flows no longer guaranteed as a part of the compact concerning the return of investment. The objective of measurement at the interstate level should be to equate fairly the current market value of those assets associated with the

provision of access services that were previously regulated and now have their future revenue streams exposed as a result of competition.

The Citizens Companies' proposal for performing such a calculation is consistent with the intention embraced in concept by the Financial Accounting Standards Board's ("FASB") pronouncements for Statement Nos. 71 and 101. The need for specialized accounting for regulated enterprises stems from the fact that the rate actions of a regulator have created assets or liabilities that would not be recognized in the present accounting framework for nonregulated enterprises. To the extent that it is no longer reasonable to assume that competition will provide the opportunity for full capital recovery assured under regulation, it is critical that the Commission acknowledge and consider these financial accounting standards in developing the procedures for quantification of this state of change.

The process of performing such a calculation is difficult, but necessary, particularly in the case of a rural price cap LEC. It must start with a basic understanding of the concept of depreciation of incumbent LEC assets. It is:

> the loss not restored by current maintenance, incurred in connection with the consumption or prospective retirement of telecommunications plant in the course of service from causes which are known to be in current operation, against which the company is not protected by insurance, and the effect of which can be forecast with a reasonable to accuracy. Among the causes to be given consideration are . . . changes in demand and requirements of public authorities [emphasis added].[45]

The depreciation reserve deficiency issue is a product of past regulatory depreciation practices that did not and could not have anticipated either changes in demand due to competition or passage of the Telecommunications Act. Thus, the currently-recorded incumbent LEC

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[45] Glossary of Terms in Part 32.9000 Part 32 of the Commission's Rules.

depreciation losses in investment value are the subject of past regulatory agency-prescribed recovery mechanisms that assumed continuation of local exchange monopolies. The calculation that must be made to quantify an incumbent LEC's regulatory-driven depreciation reserve deficiency is an exercise in identifying the remaining depreciation "loss" to the carrier that now has to be made up in a period shorter than originally contemplated by the regulators.

The Citizens Companies' quantification method would start with the identification of incumbent LEC services presently subject to competition and those that will become subject to competition in the foreseeable future. The expected loss of demand and volume for those services will have a clear, measurable impact upon the revenue streams that are the source of recouping the losses in plant investment value associated with depreciation. After identifying the services that are and will become competitive and quantifying the potential loss of associated revenues, the quantification process then must identify the physical assets (by allocation in the case of common plant) used in the provision of those services. The net book value of those assets (gross investment less depreciation reserves) would then be calculated. Next, a comparison would be made between the net book value of the assets, plus carrying charges, and the expected future cash flows (undiscounted) of the now competitive services using those assets. Any shortfall represents the regulatory-driven depreciation reserve deficiency. Absent a transitional recovery mechanism, the shortfall cannot be readily recovered because the incumbent LEC's associated cash flow will not, because of competition, be what it was expected when the underlying depreciation practice was mandated.

Once the amount has been calculated at this asset level, the transitional recovery mechanism would allow this shortfall to be recovered through additional depreciation expense

being taken for those assets linked with the competitive services. The allowable period for such treatment would be pre-determined and a function of the nuances of the specific market being examined. These steps are critical in ascertaining a present value measurement of the expected shortfall in capital recovery attributable to competitive pricing.

The Citizens Companies believe that the interim transitional recovery mechanism should take the form of assessment of a discrete rate element upon telecommunications end users. At the federal level, incumbent LECs have few, if any telecommunications end users. Accordingly, the interstate, transitional recovery mechanism would, of necessity, involve assessment of interexchange carriers.

The Citizens Companies can readily anticipate the argument that interexchange carriers may raise against a federal transitional recovery mechanism -- that it appears to be an incumbent LEC revenue replacement guarantee. There are two elements to this expected argument, each of which can be readily rebutted. First, a transitional recovery mechanism is not synonymous with revenue replacement due to competition. Instead, it seeks only to consummate the past regulatory bargain that can no longer be delivered upon due to changes in the law. Moreover, the amounts that can be recovered will be identified as part of a rigorous quantification process that will ensure recovery of only what was deferred by past regulatory practices. That amount should be dramatically less than what the incumbent LEC might have earned in the long run if the "rules of the game" had not changed.

Second, there is a way to address the "guarantee" aspect of the argument against a federal transitional recovery mechanism. Although the Citizens Companies believe it economically less correct than a direct assessment upon interexchange carriers, another method

of addressing the issue is through suspension of the "sharing" element of the price cap formula. The suspension period would need to be tailored on a LEC-by-LEC basis to the amount of recovery and the competitive conditions in the marketplace. In the case of a rural price cap LEC with its higher cost structure than more typical price cap LECs, it is less likely that efficiency increases, alone, can be achieved fast enough to allow a chance to recover the amounts involved. Consideration must be given to also suspending the productivity factor for rural price cap LECs.

An approach involving suspension of price cap mechanisms has several attractive features. First, it gives an opportunity, not a guarantee, of recovery to the incumbent LEC. That opportunity is meaningful only to the extent that the LEC achieves the necessary operating efficiencies. Second, a "ratcheting down" of access rate levels through price cap mechanisms is only postponed for an interim period.

A strong argument can be made that the sharing obligation should be permanently deleted. The predicate for the existing sharing mechanism was, in the absence of competition, a regulatory allocation of the benefits of increased LEC efficiency between the price cap LEC's shareholders and its customers. The development of competition, particularly in interstate access services, dictates another look at the present allocation of benefits inherent in price cap regulation. Competition drives efficiency and, in and of itself, serves as the necessary risk allocation factor. An extrinsic sharing mechanism is an unnecessary form of rate of return regulation. Simply put, if a LEC attempts to maintain access rates substantially above economic costs, the means exist for competitive entry.[46]

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[46] While the Citizens Companies have not offered detailed discussion on potential changes to the "X-factor," they recommend that the FCC keep in mind the differences in cost structure, operations and capitalization

C. An Interim Transitional Recovery Mechanism Is Legally Required

The threat to incumbent LEC recovery of depreciation reserve deficiencies arises from the Telecommunications Act of 1996 and the growth of local exchange and exchange access competition. These legal, economic and technological changes have greatly affected the expectations of actual and potential investors in incumbent local exchange entities. That notwithstanding, incumbent LECs and their shareholders must be allowed at least the opportunity to recover costs incurred in reliance upon the previous regulatory system. The Citizens LECs, like all incumbent LECs, were charged with the obligation to serve all customers within a defined service area and were, and still continue to be, restricted in the rates they can charge. The consideration for this obligation was the right of the incumbent LECs to earn a reasonable return upon the investment made in meeting the service obligation. This was the regulatory compact. As Judge (now Justice) Scalia explained, "the very nature of government rate regulation [is] a compact whereby the utility surrenders its freedom to charge what the market will bear in exchange for the state's assurance of adequate profits." *New England Coalition on Nuclear Pollution v. Nuclear Regulatory Comm'n,* 727 F.2d 1127, 1130 (D.C. Cir. 1984).

A rich body of case law stands for the proposition that the concept of just and reasonable rates that utilities are allowed to charge must be sufficient to allow the opportunity for cost recovery and a return on investment. *See, e.g., Duquesne Light Co. v. Barasch,* 488 U.S. 299, 307, 314 (1989); and *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of W. Virginia,* 262 U.S. 679, 692-93 (1923).

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between rural price cap LEC like the Citizens LECs and the larger, more typical price cap LECs. *See Access Reform NPRM* at ¶¶ 231-233.

It is necessary for the Commission and state regulators to deliver upon their end of the regulatory compact at the cusp of the new competitive era. In reliance upon their historic obligations to serve, the Citizens LECs made substantial investments in plant and facilities in extremely rural, high-cost areas. Their owners, the shareholders of Citizens Utilities Company, were willing to underwrite these long-term investments in reliance upon the regulatory promise of cost recovery and an opportunity to earn a reasonable return. Despite recent changes in regulatory policy, the regulatory compact remains a quasi-contractual agreement that cannot be breached without remedy. *United States v. Winstar Corp.*, ____ U.S. _____, 116 S. Ct. 2432 (1996).

Winstar involved the impact of statutory changes in regulatory accounting treatment of "regulatory goodwill" in the imperiled savings and loan industry. The legislation reduced the book value of institutions that had acquired insolvent savings and loans in reliance upon a regulatory agency's then existing policies embodied in a written agreement. The new legislation changed the ground rules to the point where the acquiring institutions were in violation of regulatory capital requirements, if not rendered insolvent. The Court found the existence of an enforceable contract between the acquiring institutions and the government agency, holding that:

> [It] would have been irrational in this case for [the acquiring institution] to stake its very existence upon continuation of current [regulatory] policies without seeking to embody those policies in some form of contractual commitment. This conclusion is obvious from both the dollar amounts at stake and the regulators' proven propensity to make changes in the relevant requirements . . . Under the circumstances, we have no doubt that the parties intended to settle regulatory treatment of these transactions as a condition of their agreement. 116 S. Ct. at 2449.

The fact that the regulatory compact was never reduced to a formal contract is irrelevant. It derives from long-established regulatory policies and practices. The obligation of the Commission and the state regulators to honor their regulatory commitments flows from the relationship between