B. No New End User Fees That Raise Telephone Rates

Congress intended the Telecommunications Act of 1996 to result in increased competition, which would result in lower costs and lower rates for customers. It would be contrary to this intent if the result of the FCC's universal service and access reform proceedings were an increase in end user fees so as to protect subsidies that should be eliminated. In addition, shifting existing costs onto end user charges would serve to insulate these excessive charges from competition. This would ensure that rates remained higher than they should. Thus, the consensus proposal reflects no new end user charges.

Proposals that would either create new or increased end user fees, or shift current access revenues from per minute charges to per line charges that would likely be passed on to end users in the form of line items on our bills, are regressive. Such charges or end user fees would create a greater burden on low volume users like low-income consumers and those on fixed incomes and small businesses. This is the case because the long distance rate reductions flowed-through to low volume consumer and business customers would be far outweighed by the increases caused by new end user charges or per line assessments. It is anticipated that the FCC will require that the net long distance carrier savings that result from access charge/universal service reform are passed through to consumers on an equitable basis. This would require a showing by long distance carriers that: the average charge per minute has been reduced sufficiently to account for any net reduction in long distance access charge/universal service payments, and any net reductions are reasonable allocated to all categories of customers.

We want to make certain that all classes of consumers benefit from access and universal service reform and we believe our proposal assures such an outcome.

C. The FCC Has Authority and an Ample Record to Reinitialize Interstate Access Rates and Increase the LEC Productivity Factor

The first step of the plan can be accomplished by relying on the existing record in the LEC price cap and access reform proceedings, creating approximately $2 billion in reductions in the first year.

When the LEC Price Cap was created, the FCC did not make a specific finding that rates were just and reasonable or set at economically efficient levels.[1] The goal was for the price cap to bring rates down toward economically efficient levels over time.[2] In the initial price cap decision, the FCC recognized the need to periodically "true-up"or reinitialize LEC interstate access rates to reflect productivity gains and correct rates when necessary based on LEC earnings.[3] The price cap included provisions for "sharing" which provides that once certain earnings targets are reached, part and eventually all profits had to be shared with customers. The LECs have consistently achieved returns above 11.25%, and sharing has forced the LECs to reduce rates to consumers as a result. The LECs had an option to use a 3.3% or 4.3% productivity adjustment, with different amounts of sharing required under the different productivity adjustments. Most LECs chose the 3.3% productivity factor. The price cap decision has been upheld on appeal. See, 988 F.2d. 174.

When it was clear that rates were consistently yielding returns in excess of 11.25% under the price cap, the FCC initiated the Price Cap Performance Review in 1994.[4] In 1995, the FCC entered an interim order that was supposed to operate for one year while overall reform was completed. In that interim order, the FCC recognized that price cap LEC productivity far out paced the productivity factor in the price cap mechanism. As a result, the FCC ordered price cap LECs to recalculate rates based on a higher productivity adjustment retroactive to the initial price

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[1]"...we are not making a finding that existing rates are just and reasonable, but only that they are a reasonable starting point for price cap..." Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order 5 FCC Rcd 6786 at para. 241 (1990) (LEC Price Cap Order)

[2]Id. at para. 242. "While we agree that rates produced by a rate of return system can be uneconomically high, it is the ongoing operation of price cap regulation that will produce lower rates..."

[3]Id. at para. 389. "The FCC has stated its intention to consider price, quality of service, earnings, and technological progressiveness in the review of LEC performance under price caps." (emphasis added). See also, para. 394. "At [the] time [of performance review] we will evaluate all aspects of the price cap plan and of LEC performance."

[4]Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961; March 30, 1995.

cap order from 1990.[5] The FCC rejected LEC claims that such an adjustment was a recapture of productivity gains[6] or retroactive rate making.[7]

- **Now Is The Time To Reform Price Caps.**

The overall access reform effort has been pushed off consistently until now. The LECs have pushed very hard to eliminate the sharing requirements. As part of the interim price cap decision, the LECs were given an option to take a 4.0%, 4.7% or 5.3% productivity adjustment. The highest productivity factor of 5.3% would allow the LECs to avoid sharing obligations. As expected, due to their consistently high earnings, virtually all of the large LECs chose this option and the trend of higher earnings has continued unabated.

Most recently, the ex parte filing by AT&T/Bell Atlantic/NYNEX advocated price cap reinitialization to 11.25%. Around the same time, the first information was filed as part of the annual access filing. This latest information shows that in 1996, the large LECs earned an average of 14.99%. This is yet another strong indication that current price cap levels are far too high and the productivity factor is too low and must be adjusted to yield reasonable returns.

- **The Price Cap Record Easily Supports LEC Productivity Adjustment of More Than 7.5%**

Several documents have been placed on the record which demonstrate that the actual productivity of the price cap LECs is in the range of 10%. These include Total Factor Productivity studies prepared by ETI and Ad Hoc Telecommunications Users Group economists. In addition, a coalition of residential and business long distance users and long distance companies, Customers for Access Rate Equity (CARE) also performed an analysis of the LEC

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[5]Id. at para. 247. "Specifically, for each year that a LEC elected an X-Factor of 3.3 percentage points, we conclude that the X-Factor for that LEC was 0.7 percentage points too low. Therefore, we require LECs to multiply their current PCIs [Price Cap Indices] for the current common line basket, traffic sensitive basket, and trunking basket by a factor equal to the following equation: 1 - (0.007n) where n is the number of years the LEC elected to use an X-Factor of 3.3 percent. We find this reinitialization necessary for the trunking basket as well...)

[6]Id. at para. 252. "We disagree with USTA and others who characterize a one-time adjustment to the rates of price cap LECs as a recapture of productivity gains...The one time adjustment merely ensures that, in the future, higher earnings must be attained through actual improvements in productivity and will not continue to accrue as a result of administrative error."

[7]Id. at para. 253. "...the rule against retroactive rate making does not preclude the FCC from looking back, as we have done here, at the results of past applications or our rate formulas in order to determine whether those formulas will continue to produce reasonable rates in the future."

financials illustrating that a 10% actual productivity factor for the price cap LECs was the "break-even" point that would lead carriers to select the 5.3% productivity adjustment option. This analysis was put on the record in the price cap proceeding after the interim price cap order was adopted.

Even the LEC studies, if done properly, would show productivity in excess of 7.5%. The Total Factor Productivity (TFP) studies performed by the LECs incorrectly exclude the input price differential and do not limit their analysis to the interstate services which will be regulated under price caps. AT&T performed a TFP study correcting these two errors and found the LEC productivity differential to be 8.5%. This result is reinforced by the choice of productivity factor made by the LECs. As previously demonstrated by MCI, for the LECs to have chosen a 5.3% productivity factor, as most of them did, they would have had to expect to achieve productivity in excess of 8.4%.

- **Reductions in TIC and Terminating Access Can be Done Before TELRIC Studies are Complete**

The FCC has failed to demonstrate that the transport interconnection charge (TIC) is cost justified. In Competitive Telecommunications Association v. FCC et.al.,[8] the Court remanded back to the FCC the decision creating the TIC. The Court found that the FCC "must either establish a cost-based alternative to the [T]IC, or provide a reasoned explanation why a departure from a cost-based system is necessary and desirable." Since the FCC will not be able to demonstrate that the TIC is necessary it would be appropriate and pro-competitive to apply per minute access reductions to ultimate elimination of the TIC. While the FCC may determine that it needs a more complete record before eliminating the TIC, both NYNEX and Bell Atlantic, in their joint ex-parte proposal with AT&T on access reform filed April 4, 1997 admit that at least 80% of the current TIC is unjustifiable and should be eliminated. This would be an important first step while the FCC builds a more complete record on which to eliminate the TIC completely.

- **Subsequent Reductions Based on TELRIC Methodology Are Authorized By Law and Would Not Constitute a Taking.**

Both the 1996 Telecommunications Act itself and the implementation of it by the FCC and the states mandates moving access charges toward forward-looking costs. This is the price a competitive market would yield and the FCC's regulations as the access market is opened to competition should set rates at this level. Competition cannot develop properly if any one segment of the industry is benefiting from large, uneconomic subsidies as is the case with inflated access charges. Leaving these overcharges in the hands of the ILECs will allow them to delay competition in the local market by strengthening their grip on the local market while permitting them to enter the long distance market once the competitive checklist is met with an unfair competitive advantage. For consumers, at minimum, this means bills that are too high.

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[8] 87 F.3d 822 (1996)

Moreover, the 1996 Act has also opened up long distance to competition from the RBOCs. In order to prevent unfair competition in this market, it is essential that the RBOCs not be allowed to charge higher access charges to competitors than they will incur in providing access to themselves or an anti-competitive price squeeze is inevitable.

Moving access prices to TELRIC would by no means constitute an unconstitutional "taking" under the Fifth Amendment.[9]. The FCC did an excellent job laying out exactly why this argument is unsustainable in its brief to the 8th Circuit in appeal of the Interconnection Order.[10] In the brief, the FCC points out that the Supreme Court has found that "a state scheme of utility regulation does not 'take' property simply because it disallows recovery of [prudently made] capital investments that are not 'used and useful in service to the public.'" Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989). The same Court notes that reproduction cost rate making has always been a permissible form of regulation that "gives utilities strong incentives to manage their affairs well and to provide efficient service to the public." Id. at 309. The FCC also points out that it is free to change rate making methodologies without unconstitutionally undermining reasonable investment-backed expectations because regulated companies have no vested interest in any particular regulatory regime. See e.g., General Tel. Co. of the Southwest v. United States, 449 F.2d 846 (5th Cir. 1971).

The FCC also points out in its 8th Circuit brief that the large ILECs have been operating under "price cap" rules at the federal level and the link between rates and historic or embedded costs has been weakened or perhaps even severed. Furthermore, the FCC points out that the record demonstrates that a majority of the investments on ILEC books were made after price caps were implemented.[11] In any case, the FCC points out, if any burden at all is placed on ILECs, it would not be a taking. TELRIC-based rate making is intended to replicate the rates that would be charged in a competitive market. Given that the Fifth Amendment does not insulate carriers from competitive losses, neither should it protect them from having to charge competitive rates.[12] TELRIC rates for access in general and this proposal in particular strikes the proper balance between the interests of consumer and investor, which is the essence of the rate-making process.[13]

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[9]U.S. Const. Amend. V ("nor shall private property be taken for public use, without just compensation").

[10]See, Brief of Respondents Federal Communications FCC and United States of America, No. 96-3321, United States Court of Appeal for the Eighth Circuit, December 23, 1996.

[11]See, Reply Affidavit of W. Baumol, et. al., at para. 7 (App. 354); Affidavit of L. Selwyn & P. Kravtin, at para. 5 (App. 295-96), and accompanying ETI Study at 18-22 (App. 330-334).

[12]See, Public Service Comm'n of Montana v. Great Northern Utilities Co., 289 U.S. 130, 135 (1933).

[13]See, Federal Power FCC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

D The FCC Must Determine That Access Charges Should Reflect Total Element Long Run Incremental Cost (TELRIC)

The goal of the consensus proposal plan is to provide a path to economic cost for access without increasing current end user charges or creating new ones. The proposal's interstate access reform plan would be a 5-year transition from current rates to forward-looking economic cost. The Chairman of the FCC has recognized that "[o]nly forward-looking cost concepts are consistent with a competitive market, because any other approach either makes the new entrant pay a tribute to the incumbent for the privilege of entry, or creates disincentives for the incumbent to invest in the network." September 17, 1996, Speech by Chairman Hundt before the Media & Communications '96 Conference. p. 4.

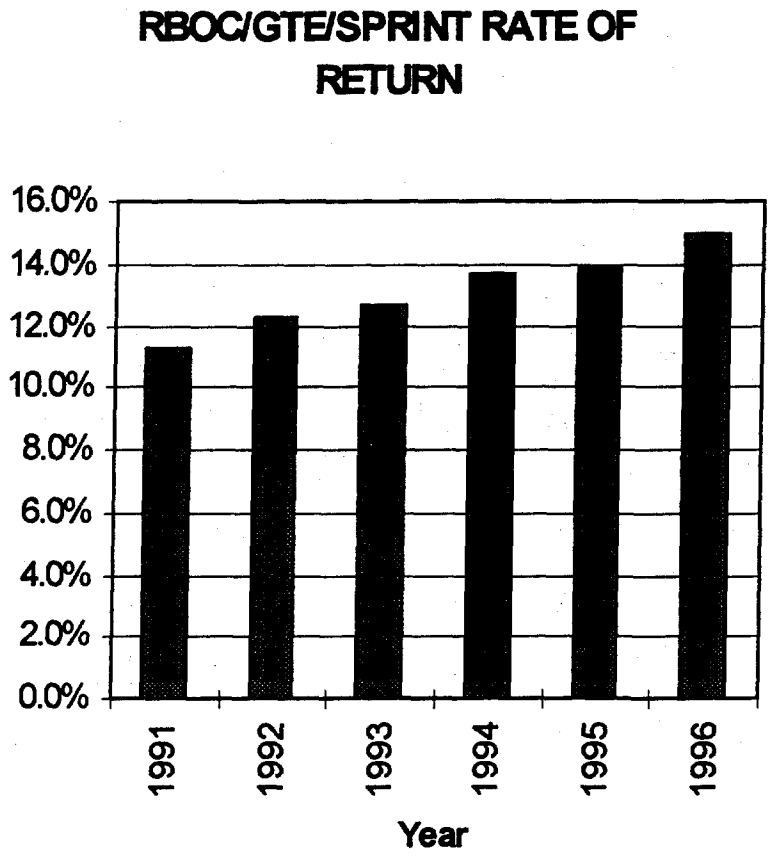
In the Interconnection Order, the FCC determined that total element long run incremental cost, or TELRIC, is a forward-looking, cost-based pricing standard, that allows incumbent LECs to recover a reasonable return on investment, recover joint and common costs, while taking into account changes in input prices and technologies, incremental costs, and competitive markets. In short, it emulates competitive market prices. In addition, the Federal/State Joint Board on Universal Service has endorsed the forward-looking costs to size the Universal Service fund.

It is important that the FCC explicitly adopt TELRIC in this proceeding as the basis for determining interstate access charges. First, it would ensure a fundamental consistency between access rates and local interconnection rates, significantly reducing the risks of arbitrage and inefficient investments. Second, as the FCC already determined in the Interconnection Order, TELRIC-based rates allow the incumbent local exchange carriers the opportunity to recover a reasonable return, without creating an environment in which new entrants are required to fund their largest competitors' -- the LECs -- war chest. Thus TELRIC is necessary to maximize competition.

The consensus plan includes significant reductions in the first year using price cap mechanisms with further reductions down to TELRIC coming after the FCC has chosen a forward-looking cost model. The model would need to be in place and operational by July 1, 1999. The plan would not lead to rate increases or new or increased end-user charges. While the FCC may not be able to identify exactly what the TELRIC price of access is today, it should explicitly adopt the TELRIC pricing principle as a goal, and move toward that goal within two years. Adopting TELRIC as the basis for access charges is consistent with FCC precedent, offers increased certainty in the market place, and sets guidelines that state regulators can follow, if they desire.

E. The Consensus Plan's Proposed Cuts Do Not Impair the Financial Health of the Incumbent LECs

In 1996, the Regional Bell Operating Companies (RBOCs), GTE, and Sprint reported their highest earnings as a group since the FCC adopted price cap regulation of interstate services in 1991. As the graph below depicts, despite increased price cap productivity adjustment, over $1 billion of monopoly "excess profits" that the FCC ordered these carriers to return to access customers in 1995, and the passage of the 1996 Telecommunications Act, these local exchange carriers continue to earn increased levels of profit.



The FCC has determined that 11.25 percent is a reasonable rate of return for price cap services. However, since 1992, these local exchange carriers have earned more than $3.8 billion above this rate on interstate price cap services. The table below shows that the RBOCs, GTE, and Sprint are clearly earning more than they need to recover their investments. Moreover, these

tables show that the current price cap system must be corrected, as it yields ever-increasing excess profits for the incumbent local exchange carriers.

Rate of Return

	1991	1992	1993	1994	1995	1996
RBOC/SPR/GTE	**11.2%**	**12.3%**	**12.7%**	**13.7%**	**13.9%**	**15.0%**
Ameritech	12.1%	12.1%	13.9%	12.5%	16.8%	18.3%
Bell Atlantic	12.1%	11.6%	13.0%	13.9%	13.7%	11.3%
BellSouth	12.5%	12.8%	13.5%	19.3%	15.8%	16.2%
NYNEX	7.9%	13.7%	13.5%	11.8%	12.1%	13.7%
Pacific Telesis	11.8%	13.0%	13.0%	15.4%	15.2%	17.9%
SBC	10.6%	11.9%	12.4%	12.4%	13.4%	11.6%
US West	11.7%	11.9%	13.0%	12.5%	11.6%	13.6%
Sprint	11.8%	12.6%	13.4%	16.6%	18.8%	19.7%
GTE	11.1%	11.0%	9.9%	11.7%	12.1%	17.6%

Notes: 1991, 1992, 1993 are based on ARMIS
1994, 1995, 1996 are based on Initial 492A Forms

Nevertheless, incumbent local phone monopolies are concerned that FCC action resulting in immediate access charge reductions will hurt their stock values. This concern is without support. As is demonstrated below, many Wall Street analysts have already factored in significant access rate reductions, and continue to look at the incumbent local phone companies' stocks in a favorable light:

CS First Boston stated on March 27, 1997 that:

> [M]ost investors seem to be aware of a likely cut in access charges (net of universal service collections) of $1 to $2 billion. No one seems to be clinging to the hope that access reform will be a "revenue neutral" event as some were espousing earlier.

Morgan Stanley stated on April 3, 1997 that:

> We have assumed the RBOCs will be subject to a $2 billion up front cut in access, net of universal service."

Merrill Lynch stated on April 3, 1997 that:

> With current P/E's averaging 12.3x '98 EPS (a 25% discount to the S&P 500's), we believe RBOC/GTE shares are overly discounted for the regulatory uncertainties. The group offers significant investment attraction given above market EPS growth, over 2x S&D dividend yields, and more defensiveness than the average company."

Smith Barney stated on February 3, 1997 that:

> In our opinion, the telcos are 30% undervalued presently. . . [T]he telco universe has already experienced the correction that we believe other sectors of the economy will experience when their growth is called into question.

Lehman Brothers stated on January 19, 1996 that:

> Universal Service and access reform will be designed to prevent significant profit shifts between RBOCs and IXCs. Any changes will be phased in over 2-5 years and probably would not result in a net revenue reduction to the RBOCs beyond the historic access reduction of $500 million per year."

Additionally, as recently as April 11, 1997, Goldman Sachs issued "First Calls" rating SBC, US West, Ameritech, Bell Atlantic, and BellSouth as "Market Performers." This rating is despite Goldman Sachs' recognition of SBC's "increasing vulnerability to competition, especially in highly-urban California," and that US West's "costs and access prices are among the highest in the nation, making it more vulnerable than it otherwise would be to competitive inroads and FCC-mandated access reform."

The FCC should not be concerned that local phone company stock values will plummet if immediate access reductions are ordered for purposes of setting regulatory policy. Even so, Wall Street recognizes that current access rates are inflated, and expects the FCC to order significant access reductions. The stock prices of incumbent local telephone companies reflect these expectations.

E. The FCC has Authority and an Ample Record to Adopt the Universal Service Aspects of the Proposal

The Telecommunications Act of 1996 requires the FCC to initiate a single proceeding to implement the recommendation from the Joint Board and to complete that proceeding by May 8, 1997. Further, the Act states that the rules established by the FCC shall define the services supported by the federal universal service fund and establish a specific timetable for the implementation of universal service. The Act also requires that universal service support by sufficient, explicit, and funded by interstate carriers. The instant proposal complies with these requirements.

In this proposal, all elements of universal service are funded at sufficient levels; support would be explicit; and support would be funded by all interstate carriers based on interstate revenues. This eliminates a potential area of conflict between regulatory authorities at the federal and state levels. By funding universal service, including schools and libraries, rural health care and expanded Lifeline programs out of interstate revenues, the FCC can avoid a potential jurisdictional fight with the states. Furthermore, it gives states the flexibility to augment the federal universal service program if they so choose. Most importantly, there is ample evidence on the record to support adoption of the proposal.

Under this proposal, the FCC would adopt the recommendation of the Joint Board and find that universal service support should be based on the forward-looking economic cost of providing supported services as determined by a proxy model. The size of the federal fund would be based on a $30 benchmark rate (a lower benchmark could make purely interstate funding prohibitive), which is in the same range as Joint Board recommendation. Not only was this finding adopted by the Joint Board in its Recommended Decision, it is supported by a majority of commenters, including local exchange carriers. However, because there are still a number of concerns with the two primary models on the record--Hatfield 3.1 and the Benchmark Cost Proxy Model-- and with the effect of the models for rural areas, the use of the proxy models should be implemented over the following time line: support for large LECs would be based on the model effective July 1, 1998 and support for rural LECs would be based on the model effective July 1, 2001.

Until support is determined based on the model, carriers would continue to receive the support that they receive today. Thus, until July 1, 1998, large LECs would receive approximately $300 million in support through access charges. Similarly, rural LECs would continue to receive support on the same basis and for all lines, as they do today, until July 1, 2001, at which time, support for rural LECs would be based on the proxy model. Once support is based on the proxy model, triple DEM weighting, long term support and the universal service fund would be eliminated and instead support determined by the proxy model would be funded through the federal universal service fund.

- **Schools and Libraries Are Fully Funded**

The FCC also could adopt the recommendation of the Joint Board to fund universal service support for schools and libraries up to $2.25 billion per year. Under the proposal, support for schools and libraries could be implemented during 1997 or 1998 without raising prices to consumers. However, because the Joint Board found that the bulk of the $2.25 billion was necessary to fund internal connections, the proposal reduces the amount of universal service support for schools and libraries once the internal connections have been funded. We estimate that only $500 million will be necessary on an annual basis for the ongoing universal service costs for schools and libraries.

- **Expanded Lifeline Programs**

The Coalition's proposal for universal service for low-income consumers also follows the recommendation of the Joint Board, but with a phased-in approach. Under the proposal, universal service for low-income consumers would continue to be funded as it is today until July 1, 1999, at which time, the federal contribution would increase by $300 million. The maximum federal contribution would increase again on July 1, 2000 by an additional $300 million. A phase-in of the increased level of support for low-income consumers is justified based on the mixed record of the need for any increase in support, and because it will take some time for states to implement the new Lifeline plans.

- **Rural Health Care Providers**

The proposal also supports universal service for rural health care providers beginning on July 1, 2000 in the amount of $400 million, which is sufficient to provide T-1 service to rural health care providers. The record evidence demonstrates that universal service for rural health care providers can be achieved with T-1 service.

G. Consumer/Business Coalition Proposal Provides Clear Path To Flexibility and Deregulation for LECs

The Consumer/Business Coalition compromise provides significant benefits to incumbent LECs, IXCs and consumers alike. It is a true Win/Win/Win proposal:

- **Complete Pricing Flexibility in 5 years**

The incumbent LECs have been pushing very hard for increased pricing flexibility for interstate access services. This flexibility they seek includes downward pricing flexibility, deaveraging of switched access services, volume and term discounts, contract tariffs and others. This plan would preserve the FCC's recent decision to allow complete downward pricing flexibility for incumbent LECs while at the same time laying out a time line for further flexibility and ultimately, total deregulation of access. Under the consumer/business coalition compromise, incumbent LECs will get complete pricing flexibility for access in just five years without having to petition the FCC or make specific showings of actual competition.

- **LECs Keep More Earnings**

At the same time, the incumbent LECs have been pushing the FCC to eliminate the sharing requirements which provide that an incumbent LEC must share some or all of its earnings above certain prescribed levels with customers. Sharing applies to those companies that elect a productivity adjustment of 4.0% or 4.7%. It was originally established as "an insurance policy" for access customers in case the FCC's price cap rules failed to properly reflect the costs of the incumbent. It has been invoked frequently and consumers have seen extensive benefits from it. The Consumer/Business Coalition plan would provide additional regulatory relief for the incumbent LECs through the elimination of the current sharing requirements. After adoption of the 7.5 percent x-factor and the path to TELRIC pricing of access, the incumbent LECs would be able keep all of their earnings from access, no matter how great.

- **Regulatory Certainty for All Parties**

All parties benefit from regulatory certainty. The Consumer/Business Coalition plan sets out the path and determinative timeline toward complete deregulation of access services for everyone. As all industry parties complete their business plans for entry into new lines of business, a clear understanding of the regulatory landscape can be extremely valuable. For consumers, this will lead to more vigorous competition in all markets sooner rather than later, without things getting bogged down in court and at the regulatory agency.