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ORIGINAL

April 14, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie R. Salas
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: EX PARTE in CC Docket No. 94-1, Price Cap Performance Review for Local Exchange Carriers;
RM 9210, Consumer Federation of America, International Communications Association and National Retail Federation Petition Requesting Amendment of the Commission's Rules Regarding Access Charge Reform and Price Cap Review for Local Exchange Carriers

Dear Ms. Salas:

Attached please find an ex parte letter sent today from Mary L. Brown, Senior Policy Counsel, MCI, to Richard Metzger, Chief, Common Carrier Bureau. Please include this letter in the record of the above-captioned proceedings.

Four copies of the letter are being submitted pursuant to Section 1.1206(b)(1) of the Commission's Rules, 47 C.F.R. §1.1206(b)(1).

Respectfully submitted,

Alan Buzacott
Regulatory Analyst

Enclosure

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List ABCDE

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April 14, 1998

Mr. Richard Metzger
Chief, Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: EX PARTE in CC Docket No. 94-1, Price Cap Performance Review for Local Exchange Carriers; RM 9210, Consumer Federation of America, International Communications Association and National Retail Federation Petition Requesting Amendment of the Commission's Rules Regarding Access Charge Reform and Price Cap Review for Local Exchange Carriers

Dear Mr. Metzger:

In their 1997 Form 492A rate of return reports, filed on April 2, 1998, the price cap local exchange carriers have reported that their interstate rate of return increased yet again in 1997, from 14.98 percent in 1996 to an unprecedented level of 15.52 percent (see Attachment A). The pattern is clear. Sustained earnings growth over the past few years, coupled with a significant jump in earnings in a year in which the price cap was purportedly "corrected" to more accurately reflect interstate productivity, demonstrates that, once again, the Commission has failed to take a sufficient bite out of above-cost access charges.

The significant increase in 1997 earnings over 1996 levels confirms that the 6.5 percent X-Factor selected by the Commission in the 1997 Price Cap Review Order continues to substantially underestimate incumbent local exchange carrier (ILEC) productivity growth. Had the 6.5 percent X-Factor been sufficient to correct for an existing productivity factor that was too generous to the ILECs, as the Commission claimed, ILEC earnings as a group would have certainly not increased, and should have moved closer to the most recently prescribed rate of return (11.25 percent) or the ILECs' long term cost of capital. Instead, we again witnessed a sharp and substantial rise in earnings performance, demonstrating that the mid-1997 correction to the price cap formula was far too insignificant to even check earnings at 1996 levels.

The Commission's conservative X-Factor choices, in both the 1997 Price Cap Review Order and earlier price cap orders, have contributed substantially to the inflated level of

interstate access charges. In the Access Reform Order, the Commission recognized that interstate access charges are well above forward-looking economic cost, and that above-cost access charges are harming consumers and distorting the market for interstate long distance services. A significant portion of the gap between forward-looking economic cost and the current level of access charges is due to the miscalibration of the price cap plan. As shown in Attachment A, the price cap ILECs are now earning $2.3 billion more than is required to achieve the Commission's most-recently prescribed rate of return of 11.25 percent.

As shown by studies of ILEC productivity submitted by MCI, AT&T, Ad Hoc, and other parties in CC Docket No. 94-1, an X-Factor that accurately reflected ILEC productivity growth would be at least 8.5 percent. Because of the elimination of the "backstop" sharing mechanism, consumers will be protected only if the X-Factor is changed to reflect accurately the rate of LEC productivity change. A properly-calibrated price cap system would not reduce interstate access charges to forward-looking economic cost, but would at least prevent the gap from widening.[1]

Accordingly, the Commission should grant AT&T's pending petition for reconsideration of the 1997 Price Cap Review Order and revise the X-Factor upward to at least 8.5 percent. In addition, in recognition of its own conclusion that the X-Factor in effect during 1995 and 1996 understated ILEC productivity growth, the Commission should require the price cap ILECs to adjust their July 1, 1998 price cap indexes (PCIs) to the level that would have resulted from the introduction of the 8.5 percent X-Factor on July 1, 1995. Unless the Commission takes these steps, the price cap ILECs' earnings will continue their upward path, benefiting ILEC shareholders at the expense of consumers.

The adoption of the 8.5 percent X-Factor, combined with the reinitialization of PCIs to the level that would have resulted had the 8.5 percent X-Factor been adopted for the July 1, 1995 annual access filing, would reduce access charges by an additional $1.8 billion over and above the reductions that would occur under the present plan. Even with these changes, the price cap ILECs would still be earning at least 12.2 percent.

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[1]MCI has advocated that the Commission use its Section 201-205 powers to prescribe access at forward-looking levels -- a reduction of approximately $9 billion. In this letter, we limit our comments to crafting a properly calibrated price cap system, which takes embedded rates as a starting point. In no way do we mean to imply that by correcting the price cap system the Commission should ignore the important goal of moving access to cost.

I. The 1997 Earnings Increase Shows that the 6.5 percent X-Factor is too Conservative

The Commission has consistently recognized that a substantial increase in earnings, such as that experienced by the price cap ILECs between 1996 and 1997, is a clear indicator that the X-Factor is too conservative. In the 1995 Price Cap Performance Review Order, the Commission increased the X-Factor after concluding that the rapid growth in ILEC earnings between 1990 and 1994 suggested that "the productivity offset may have been too low, resulting in a price cap plan that was not as challenging as the Commission intended it to be."

The 1996-97 earnings increase shows that the price cap plan is still not sufficiently challenging. Despite the adoption of the 6.5 percent X-Factor and the one-time adjustment to correct for understatement of the 1996 PCIs, ILEC earnings increased again by a substantial margin. In fact, the rate of earnings increase between 1996 and 1997, 0.54 percentage points, is the same as the 1990-94 rate of earnings growth that compelled the Commission to increase the X-Factor in 1995.

Moreover, the unprecedented 15.52 percent average rate of return figure indicated by the Form 492As filed on April 2, 1998 may even understate the price cap ILECs' earnings level. All three SBC companies, SWBT, Pacific Bell, and Nevada Bell, are showing substantial earnings declines that require further scrutiny. The earnings declines reported on SBC's Form 492As are clearly inconsistent with SBC's statement, in the press release accompanying its most recent quarterly earnings report, that it enjoyed a "terrific 1997." SWBT appears to admit that its 1997 earnings will have to be revised upwards, stating that it will refile its Form 492A after reprocessing its ARMIS reports. Because Pacific Bell is showing the same anomalous increase in expenses as SWBT -- over 9 percent -- it appears likely that Pacific Bell's rate of return figures will also have to be revised upwards.

It is apparent, therefore, that the new 6.5 percent X-Factor, which the Commission described in the 1997 Price Cap Review Order as "challenging," is actually too conservative. An X-Factor that in fact corrected the price cap formula to reflect actual ILEC productivity growth would have at least prevented the ILECs' earnings from increasing. A true "correction" of the price cap plan should have reduced the ILECs' earnings to a level closer to the most-recently prescribed rate of return of 11.25 percent, with only those ILECs that had achieved true productivity improvements realizing an earnings increase.

II. The X-Factor Should Accurately Reflect ILEC Productivity Changes

Under the Commission's price cap plan, the X-Factor is intended to reflect changes in ILEC unit costs, including productivity growth and changes in input costs. In CC Docket

No. 94-1, several parties submitted studies to the Commission that demonstrated that an X-Factor that accurately reflected changes in ILEC interstate unit costs would exceed 8.5 percent. AT&T submitted a study showing that the X-Factor should be set at 9.0 percent, while Ad Hoc and MCI submitted studies showing that the X-Factor should be set at 9.4 percent and 8.5 percent, respectively. The Commission, however, selected a lower X-Factor of only 6.5 percent, in large part because it decided to rely on total company, not interstate-only, productivity.

The significant earnings growth experienced by the price cap ILECs in 1996-97 corroborates the productivity studies submitted by AT&T, Ad Hoc, MCI, and other parties, and shows that, once again, the Commission has chosen an X-Factor that it is too conservative. As in the original LEC Price Cap Order and the 1995 Price Cap Performance Review Order, the Commission selected an X-Factor in the middle of the range indicated by the productivity studies on the record.

The effect of these conservative X-Factor choices has been to skew the price cap plan decisively in favor of the ILECs. ILEC earnings have increased every year since the inception of price cap regulation, to 11.83 percent in 1991, 12.34 percent in 1992, 13.09 percent in 1993, 13.74 percent in 1994, 13.89 percent in 1995, 14.98 percent in 1996, and now 15.52 percent in 1997 (see Attachment B). While some improvement in earnings would be consistent with the incentive regulation principles of the price cap plan, the magnitude of the price cap ILECs' gains shows that the Commission has consistently selected a low productivity hurdle that the ILECs were able to clear with ease. In particular, GTE, which argued in its opposition to petitions for reconsideration of the 1997 Price Cap Review Order that the 6.5 percent X-Factor was "excessive" and that a higher X-Factor would cause "further serious damage to GTE and its shareholders," saw its rate of return increase from 17.55 percent to an unheard-of 20.13 percent.

In the first few years of price cap regulation, the Commission stated that a conservative X-Factor choice was appropriate due to uncertainty about ILEC productivity. Now, seven years after the start of price cap regulation, a conservative X-Factor choice does not strike a reasonable balance between ILEC shareholders and consumers. Instead, it simply permits the ILECs to overcharge for interstate access, and increase their earnings to levels further and further above the Commission's most-recently prescribed rate of return. Because the price cap ILECs are already earning 15.52 percent, and because the 1997 earnings increase demonstrates that the 6.5 percent X-Factor underestimates ILEC productivity growth, the Commission should set a productivity target that is consistent with the AT&T, Ad Hoc, and MCI studies on the record.

A properly-calibrated price cap system is essential because the ILECs continue to exercise monopoly control over the market for access services. It is clear that competitive entry is not occurring on a scale sufficient to discipline access prices -- with very few exceptions, the price cap ILECs continue to price at the maximum allowed by the price

cap index in every basket. Moreover, there is no reasonable prospect that competitive forces will discipline access charges in the foreseeable future. Events of the past year have invalidated the assumptions underlying the Commission's choice of a "market-based" approach to access reform. In particular, as a result of LEC intransigence and restrictive court interpretations of the Telecommunications Act of 1996, it is now clear that the Commission cannot rely on unbundled network element-based competition to reduce ILEC access rates. For the foreseeable future, price cap regulation will be the only constraint on ILEC access pricing.

III. The Commission Should Grant AT&T's Petition for Reconsideration

In its July 11, 1997 Petition for Partial Reconsideration of the 1997 Price Cap Review Order AT&T asks the Commission to reconsider its reliance on "total company" data in measuring ILEC productivity and its failure to require the ILECs to adjust their PCIs to the levels that would have been in effect had the new X-Factor been adopted for the 1995 annual filing. Because the 1997 earnings increase confirms that the 6.5 percent X-Factor adopted in the 1997 Price Cap Review Order is too conservative, the Commission should grant AT&T's petition.

The Commission's choice of the conservative 6.5 percent X-Factor was, in large part, the result of its decision to rely on total company, not interstate-only, productivity measurements. The Commission used total company data after finding that there would be "no systematic bias" in relying on total company productivity. However, this conclusion is contradicted by the Commission's statements in the original LEC Price Cap Order, in which it adjusted the X-Factor to reflect interstate-only productivity growth. The Commission's conclusion is also contradicted by the AT&T, Ad Hoc, and MCI studies on the record, which show that an interstate-only X-Factor would be significantly higher, at least 8.5 percent. Because the 1997 earnings increase demonstrates that these productivity studies provide a much more accurate picture of ILEC interstate productivity growth than the Commission's total company study, the Commission should grant AT&T's petition and revise the X-Factor upward from at 6.5 percent to at least 8.5 percent.

Several other factors outlined in the 1997 Price Cap Review Order justify an increase in the X-Factor to 8.5 percent. First, the Commission found that there was a "strong upward trend in productivity growth" from 1992 to 1995. The significant earnings growth reported for 1997 demonstrates that this upward trend has continued. Second, the Commission recognized the sharing mechanism and other components of the original price cap plan may have operated to suppress ILEC productivity growth. The Commission observed that "measured LEC TFP may not measure the actual productivity growth that incumbent LECs can achieve, but rather reflects the productivity growth LECs were encouraged to achieve under our original and interim price cap plans." Finally, the Commission noted that it expected the Access Reform Order to lead to more

efficient use of the ILEC network.

The revised 8.5 percent X-Factor should be effective on July 1, 1998. In addition, as requested by AT&T in its petition for partial reconsideration, the ILEC PCIs should be reinitialized to the level that would have resulted had the 8.5 percent X-Factor been adopted for the July 1, 1995 annual access filing. This one-time adjustment is necessary to prevent the ILECs' PCIs from permanently reflecting the understated productivity factors in effect in 1995 and 1996. As the Commission discusses in the 1997 Price Cap Review Order, it repeatedly emphasized that the X-Factors adopted in the 1995 Price Cap Performance Review Order were "interim" and subject to upward revision.

The adoption of the 8.5 percent X-Factor, combined with the reinitialization of PCIs to the level that would have resulted had the 8.5 percent X-Factor been adopted for the July 1, 1995 annual access filing, would reduce access charges by an additional $1.8 billion over and above the reductions that would occur under the present plan. Even with these changes, the price cap ILECs would still be earning at least 12.2 percent.

IV. Conclusion

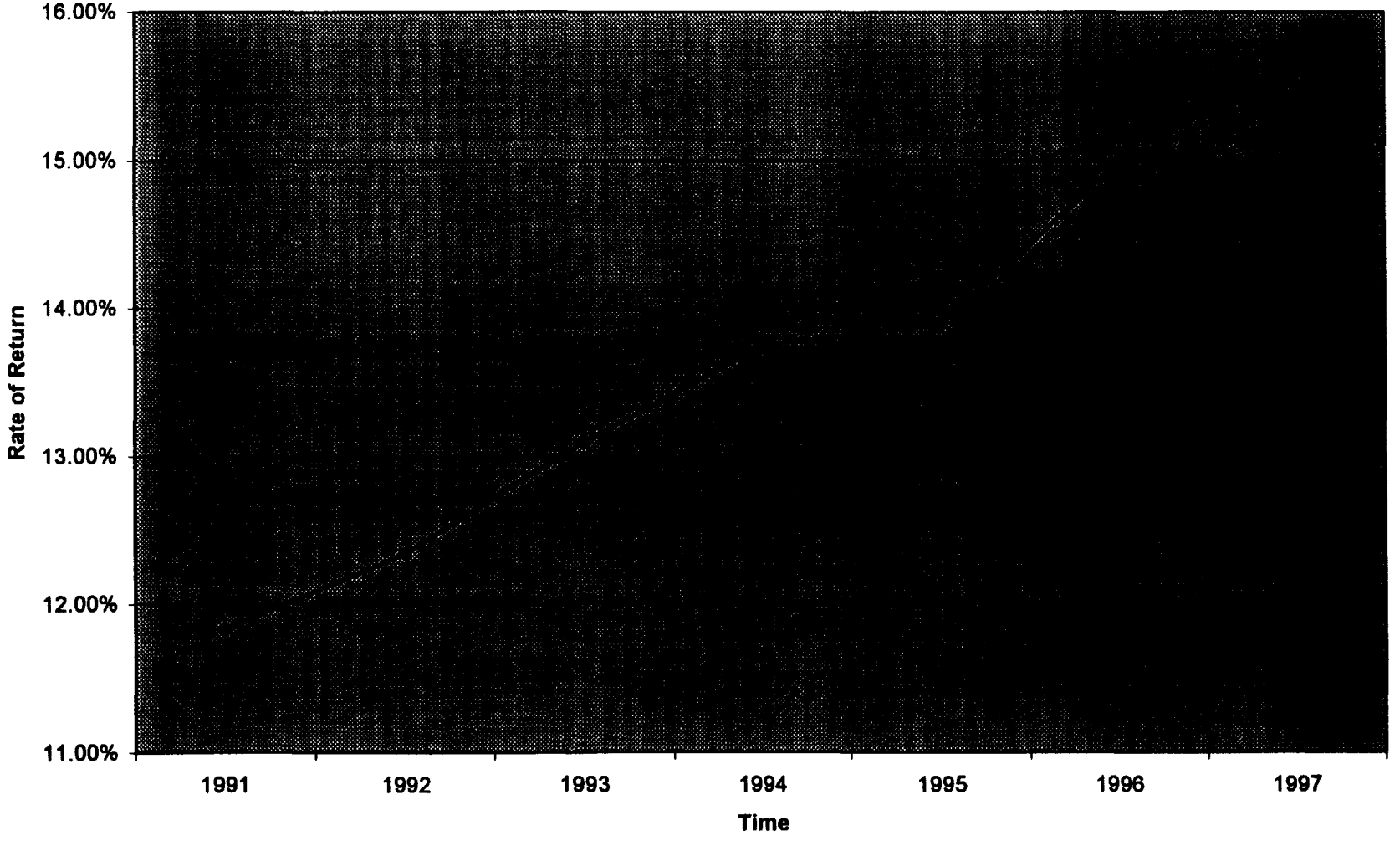
The 1997 earnings increase shown on the price cap ILECs' Form 492As confirms that the X-Factor adopted in the 1997 Price Cap Review Order in CC Docket No. 94-1 is too conservative. Without immediate recalibration of the price cap plan, the ILECs will continue to enjoy a substantial windfall at the expense of consumers of interstate long distance services. Accordingly, the Commission should grant AT&T's petition for partial reconsideration of the 1997 Price Cap Review Order. The Commission should revise the X-Factor upwards to at least 8.5 percent, and correct the price cap ILECs' PCIs for past understatement of the X-Factor.

Sincerely,

Mary L. Brown

cc: Tom Power
Kyle Dixon
Paul Gallant
James Casserly
Kevin Martin
James Schlichting
Jane Jackson

Attachment A

	1990 EARNINGS	1991 EARNINGS	1992 EARNINGS	1993 EARNINGS	1994 EARNINGS	1995 EARNINGS	1996 EARNINGS	1997 EARNINGS	Amount to Reset earnings to 11.25%
AMERITECH	12.76%	13.00%	12.66%	14.40%	13.96%	16.78%	18.27%	18.22%	330,197
BELL ATLANTIC	11.48%	12.83%	12.50%	14.01%	14.66%	13.73%	11.31%	14.75%	252,076
BELL SOUTH	12.04%	12.62%	13.03%	13.68%	15.97%	15.75%	16.24%	17.90%	527,762
NYNEX	9.92%	9.35%	12.50%	12.55%	11.82%	12.13%	13.67%	13.73%	154,680
PACIFIC BELL	12.18%	11.85%	12.68%	12.89%	15.29%	15.12%	17.76%	11.90%	29,779
NEVADA BELL	14.28%	12.98%	14.51%	17.44%	18.22%	17.26%	22.84%	19.46%	10,176
SBC	10.52%	10.75%	11.80%	12.91%	13.43%	13.37%	11.60%	9.30%	(113,074)
US WEST	12.19%	12.40%	12.05%	13.62%	12.46%	11.61%	13.57%	15.39%	254,176
ALIANT	10.66%	12.11%	12.81%	14.72%	15.93%	16.09%	14.95%	12.27%	888
SNET	12.00%	9.68%	12.69%	11.52%	11.34%	11.58%	10.29%	12.70%	11,949
FRONTIER	10.80%	9.72%	12.11%	13.46%	14.27%	11.87%	16.44%	19.84%	22,336
GTE	11.60%	11.99%	11.22%	10.90%	11.44%	11.70%	17.55%	20.13%	636,827
SPRINT	11.80%	13.09%	13.62%	14.14%	16.48%	18.78%	19.50%	18.76%	218,882
CITIZENS	13.17%	12.73%	14.51%	13.26%	18.77%	19.05%	15.42%	10.90%	(2,046)
TOTAL RBOC	11.53%	11.81%	12.49%	13.47%	13.97%	13.99%	14.41%	14.63%	1,445,771
TOTAL PRICE CAP COMPANIES	11.57%	11.83%	12.34%	13.09%	13.74%	13.89%	14.98%	15.52%	2,334,608

Attachment B
Total Price Cap Company Earnings