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April 21, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

HAND DELIVERY

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, N.W. — Room 222
Washington, DC 20554

RE: Ex Parte Meeting in CC Docket No. 94-1 and RM 9210

Dear Ms. Salas:

Today, Cathy Hotka of the National Retail Federation, Doug Jarrett on behalf of the American Petroleum Institute, Brian Masterson of AT&T, Chris Frentrup of MCI, Carl Tuvin on behalf of America's Carriers Telecommunications Association, and myself on behalf of the International Communications Association met with Commissioner Furchgott-Roth and Paul Misener of his office regarding matters already raised on the record of the above referenced proceedings.

In accordance with Section 1.1206(a)(1) of the Commission's rules, two (2) copies and the original of this notice are being submitted to your office today.

Sincerely,

Brian R. Moir
Counsel, ICA

Attachment

FEDERAL PRICE CAP REGULATION

OF THE

LOCAL EXCHANGE CARRIERS

January 22, 1998

INTRODUCTION

- Price cap regulation is a form of incentive regulation.

- Ceilings are imposed on rate levels rather than on rate of return.

- A price cap index is established to represent the aggregate price level of the regulated services and then adjusted for inflation and other factors each year.

- Advantages over traditional rate-of-return regulation:

  * Carriers have incentives to reduce costs and improve efficiency.

  * Rates to customers can be reduced.

  * Administrative burdens on carriers and regulators are reduced.

VITAL STATISTICS

- Federal price cap regulation initiated on January 1, 1991.

- Mandatory for the RBOCs and GTE. Optional for all other LECs [has been elected by SNET, Aliant (formerly Lincoln), Frontier (formerly Rochester), United/Central, Citizens]

- Applies to:

  All LEC interstate access services:
  * Switched access
  * Special access

  All LEC interstate interexchange services

  Excluded services:
  * One-time or contract-type services
  * ICBs, special construction tariffs, government contracts, etc.

PRICE CAP FORMULA

Average prices may not exceed the price cap index (PCI), which is initially set at 100 and adjusted each year for recent inflation and other factors:

$$PCI(t) = PCI(t-1)\,[1 + w(GDPPI - X) + Z/R]$$

where:

- PCI = Price cap index: An index that represents the maximum overall level of prices permitted.
- PCI(t) = New PCI
- PCI(t-1) = Old PCI
- GDPPI = Per cent change in GDP (Gross domestic product) Price Index
- X = Productivity factor (currently 6.5%)
- Z = Exogenous cost change
- W = (R+Z)/R (reflects interaction between the GDPPI and Z adjustments)
- R = Total revenue in base period.

PRICE CAP INDICES

Prices are presumed lawful if a carrier's API (actual price index) does not exceed its PCI.

The API is initially set at 100 and updated for each price change as follows:

$$API(t) = API(t\text{-}1) \sum V(i) * \frac{P(t)}{P(t-1)}$$

where:

- $V(i)$ = Current revenue share for rate element i
- P = Price of rate element i.

COMPONENTS OF PCI FORMULA

<u>GDPPI</u>

- Gross domestic product price index, measured as a percentage change over the past 12 months
- Broad-based index of prices in the economy
- Includes both consumer and investment goods
- Less volatile than CPI (Consumer Price Index) or PPI (Producer Price Index)

<u>Productivity offset (X-Factor)</u>

- Recently set at 6.5%
- Productivity growth in telecom. exceeds productivity growth for the entire US economy.
- Telecom prices should therefore decline relative to the overall price level (GDPPI) for the economy.

<u>Exogenous costs (Z)</u>

- Cost changes caused by regulatory, legislative, or judicial action, beyond the control of carriers.
- Examples include changes in tax laws, USOA/GAAP, Separations, Long Term Support.

PRICE CAP STRUCTURE
BASKETS

- The LECs' regulated interstate services are categorized into several "baskets".

- Each basket has its own PCI and API and must be priced at or below its cap.

- This means that price reductions in one basket can not be offset by increases in another basket.

- The baskets consist of:
  * Common line
  * Traffic sensitive
  * Trunking
  * Marketing expense (established on 1/1/98)
  * Interexchange

- The same general price cap formula is used for each basket, except:
  * A special formula is used for the Common line basket.
  * The interexchange basket has a 3.0% X-factor.

COMMON LINE FORMULA

- Rates in the Common line basket (SLC, CCLC, PICC) recover the interstate costs of subscriber lines.

- Revenues are a function of both lines and access minutes.

- Costs, however, are mainly a function of lines.

- As usage per line increases, per minute rates should decline.

- This is partially accomplished by a separate formula for the common line basket:

$$PCI(t) = PCI(t\text{-}1)\ [1 + w[(GDPPI - X - (g/2))/(1 + (g/2))] + Z/R]$$

where g is recent growth in minutes per line.

- Impact of the g/2 term is to reduce the CCLC by one half of growth in minutes per line.

- Once the CCLC is phased out, the same formula as for the other baskets will apply.

PRICE CAP STRUCTURE
SERVICE CATEGORIES

Service categories and sub-categories limit the extent to which prices within a basket can be changed from one year to the next.

The price level of each service category (as measured by an index similar to the API) may not increase by more than the basket's PCI plus 5% during the tariff year.

Traffic sensitive basket - service categories

- Local switching
- Information
- 800 database access
- Billing name and address
- Local switching trunk ports (as of 1/1/98)
- Signaling transfer point port termination (as of 1/1/98)

Trunking basket - service categories

- Transport interconnection charge (TIC)
- Tandem switched trandsport
- Voice grade/WattsMetallic/Telegraph
- Audio & video
- High cap & DDS
- Wideband
- Signaling interconnection

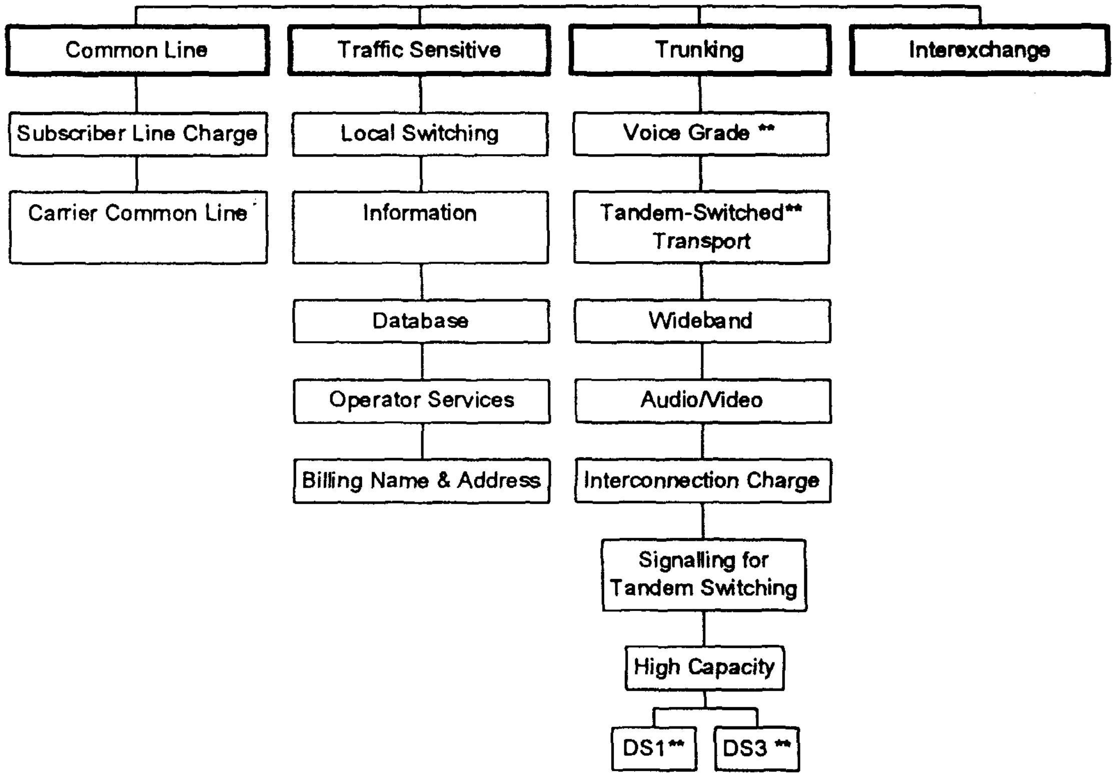
PRICE CAP STRUCTURE
SUB-CATEGORIES

Sub-categories further limit the extent to which prices within a service category can be changed from one year to the next.

Existing sub-categories include:

- 800 vertical services sub-category within he Database access category
- DS1 and DS3 sub-categories within the High cap/DDS category
- Sub-categories for density zones

LEC Price Cap Plan



** Disaggregated to Zone 1,2 & 3

To be updated

A BRIEF HISTORY

<u>Original LEC price cap plan</u>

- Effective 1/1/91
- Earnings above certain thresholds were shared with customers via subsequent price cap reductions.
- Earnings below 10.25% resulted in subsequent price cap increases.
- LECs had a choice of 2 X-factors, 3.3% and 4.3%, with less sharing under the 4.3% option.

<u>First price cap review</u>

- Effective 7/1/95 on an interim basis.
- FCC determined original X-factors were too low.
- 3 X-factor/sharing options: 4.0%, 4.7%, and 5.3%.
- No sharing under the 5.3% option.

<u>Subsequent price cap review</u>

- Effective 7/1/97.
- Established single 6.5% X-factor with no sharing.
- Low end adjustment retained if earnings drop below 10.25%.
- Higher X based on studies of LEC productivity growth.

FCC PRICE CAP PERFORMANCE REVIEW ORDER (5/21/97)

Raised X-factor to 6.5%.

- Based on a combination of trends in LEC productivity and input prices for 1985-95.
- Growth in LEC productivity (ratio of total inputs to total outputs) exceeded that for the entire economy. LEC input prices declined relative to economy-wide input prices.
- X also includes a 0.5% "consumer productivity dividend."
- 1997 price caps set at the level they would be if a 6.5% X had been used for 1996 tariffs (reinitialization), since prior Xs were determined to be too low.

A single X-factor applies to all price cap LECs.

- Sharing is eliminated, so that LECs can no longer choose among different X-factor/sharing options.
- Establishing different X-factors for different types of LECs is not considered feasible.
- Differences among LECs accommodated by "low end adjustment," whereby rates can be increased if earnings fall below 10.25%.

X-factor will be updated after next performance review, to be initiated in 2 years.