Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Prescribing the Authorized	)	CC Docket No. 98-166
Unitary Rate of Return for	)	
Interstate Services of Local	)	
Exchange Carriers	)	

NOTICE INITIATING A PRESCRIPTION PROCEEDING AND NOTICE OF PROPOSED RULEMAKING

Adopted: September 8, 1998 **Released:** October 5, 1998

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NPRM Comment Date: December 3, 1998
NPRM Reply Comment Date: February 1, 1999

By the Commission: Commissioner Furchtgott-Roth dissenting and issuing a statement.

TABLE OF CONTENTS

I. INTRODUCTION

1. The Commission is required by Section 201 of the Communications Act of 1934 to ensure that rates are "just and reasonable."[1] To ensure that their rates for interstate access are just and reasonable, the Commission prescribes an authorized rate of return for the approximately 1300 incumbent local exchange carriers (ILECs) that are subject to rate-of-return rather than price cap regulation.[2] This Notice initiates a proceeding to represcribe the authorized rate of return for interstate access services provided by ILECs.[3] It marks the first prescription proceeding since we revised the rules governing procedures and methodologies for prescribing and enforcing the rate of return for ILECs not subject to price cap regulation,[4] and the first prescription proceeding since the Commission

[1] 47 U.S.C. § 201(b).

[2] The prescribed rate of return for interstate access is currently 11.25%. *See* Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, *Order*, CC Docket No. 89-624, 5 FCC Rcd 7507, 7509 para. 13 (1990) (*1990 Rate of Return Order*).

[3] We intend to codify the rate of return determined here in Part 65 of the Commission's rules, 47 C.F.R. Part 65.

[4] Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, *Report and Order*, CC Docket No. 92-133, 10 FCC Rcd 6788 (1995) (*1995 Rate of Return Represcription Procedures Order*).

adopted its price cap rules for local exchange carriers.[5] In this Notice, we seek comment on the methods by which
we could calculate the ILECs' cost of capital. In the Notice of Proposed Rulemaking (NPRM), attached to the end of the Notice, we propose corrections to errors in the codified formulas for the cost of debt and cost of preferred stock and seek comment on whether this proceeding warrants a change in the low-end formula adjustment for local exchange carriers subject to price caps.

II. INITIATING A RATE-OF-RETURN PRESCRIPTION

A. Background

2. The rate of return we prescribe for ILECs' interstate operations links our regulatory processes and carriers' actual costs of capital and equity. The Commission periodically represcribes this rate to ensure that the service rates filed by incumbent local exchange carriers subject to rate-of-return regulation continue to be just and reasonable.[6] In its *1995 Rate of Return Represcription Procedures Order*,[7] the Commission revised its prescription procedures to require that it consider commencing a new rate-of-return prescription proceeding whenever yields on 10-year U.S. Treasury securities remain, for a consecutive six-month period, at least 150 basis points above or below a certain reference point (the "trigger point"). The reference point is the average of the average monthly yields for the consecutive six-month period immediately prior to the effective date of the current rate-of-return prescription. That reference point is currently 8.64 percent.[8] For the consecutive six-month period immediately following the release of the *1995 Rate of Return Represcription Procedures Order*, the yields were more than 150 basis points below this reference point. Accordingly, on February 6, 1996, the Bureau issued a Public Notice seeking comment on whether to

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[5] Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, CC Docket No. 87-313, 5 FCC Rcd 6786, 6804 para. 147-49 (1990) (*LEC Price Cap Order*), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), *modified on recon.*, 6 FCC Rcd 2637 (1991); *aff'd sub nom.* National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993). We note that SBC Communications, Inc. recently filed a Petition for Section 11 Biennial Review in which it argues that our rate-of-return represcription procedures are a "vestige of rate of return regulation which is no longer needed under price cap regulation." *See* 1998 Biennial Regulatory Review--Petition for Section 11 Biennial Review filed by SBC Communications, Inc., Southwestern Bell Telephone Company, Pacific Bell, and Nevada Bell). This and other proposals made by SBC will be addressed in a future proceeding.

[6] 47 U.S.C. § 201(b).

[7] 10 FCC Rcd 6788 (1995).

[8] This figure is based on the average monthly yields for the months of March 1990 through August 1990.

commence a rate-of-return prescription proceeding.[9] Eleven parties filed comments;[10] five parties filed replies.[11]

B. Position of Parties

3. In response to the Public Notice, the commenting ILECs and the organizations representing their interests urge the Commission not to conduct a rate-of-return proceeding. These commenters offer three primary arguments to support their view that the Commission should not begin a rate-of-return prescription proceeding now. First, they assert that the rate-of-return prescription process is designed to target the return on ILEC investments to the risk of the local exchange business and the current cost of capital and that realistic evaluation of the new risk level is not yet possible because of the uncertain impact of the Telecommunications Act of 1996[12] and the introduction of competition in the local exchange and exchange access markets.[13] Second, these commenters argue that current volatility in the financial markets contributes to the uncertainty faced by ILECs.[14] Finally, they argue that conducting a rate-of-return proceeding would require extensive analysis and place substantial demands on the Commission when the Commission is least able to commit the staff and time needed to conduct the analysis required by a prescription effort.[15] Therefore, the commenters conclude, considering the demands of implementing the 1996 Act and the small segment of the

[9] Common Carrier Bureau Sets Pleading Schedule in Preliminary Rate of Return Inquiry, *Public Notice*, AAD 96-28, 11 FCC Rcd 3651 (1996). We note that since the Bureau issued the Public Notice, the yields on the relevant bonds have remained more than 150 basis points below the reference point.

[10] Comments were filed by AT&T Corp. ("AT&T"); Cincinnati Bell Telephone ("Cincinnati"); General Services Administration ("GSA"); MCI Telecommunications Corporation ("MCI"); National Exchange Carrier Association, Inc. ("NECA"); National Rural Telecom Association ("NRTA"); National Telephone Cooperative Association ("NTCA"); Organization for the Promotion and Advancement of Small Telecommunications Companies ("OPASTCO"); Pacific Bell and Nevada Bell ("Pacific/Nevada"); Pacific Telecom, Inc. ("PTI"); and United States Telephone Association ("USTA"). Additionally, Frontier Corporation ("Frontier") filed an Entry of Appearance.

[11] Replies were filed by GSA; MCI; NECA; NTCA; and USTA.

[12] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) ("1996 Act").

[13] NRTA Comments at 2; Pacific/Nevada Comments at 1. *See also* Cincinnati Comments at 4; NECA Comments at 2-3; NRTA Comments at 2; NTCA Comments at 3; OPASTCO Comments at 2-3; Pacific/Nevada Comments at 1; USTA Comments at 2-6; NTCA Reply at 2 (stating generally that the 1996 Act created a great deal of uncertainty with respect to overall competition and the financial position of ILECs).

[14] NECA Comments at 4.

[15] NECA Comments at 5; NTCA Comments at 2-3; PTI Comments at 2-3; USTA Comments at 6; NTCA Reply at 3-4. *See also* AT&T Comments at 2-3; Cincinnati Comments at 3; NRTA Comments at 3; Pacific/Nevada Comments at 1.

telecommunications industry affected by rate represcription,[16] the Commission should decide against proceeding with represcription.

4. Two commenters, MCI and GSA, support initiating a rate-of-return prescription proceeding. GSA disagrees that the 1996 Act has created uncertainty for the ILECs by opening local markets to competition, and argues that the Act has in reality reduced uncertainty by establishing the rules under which competition will be permitted.[17] MCI argues that the Commission should examine the relevant data to determine whether and how passage of the Act affected the ILECs' business risk.[18] MCI estimates that the ILECs' current cost of capital has fallen to 9.48%, and concludes that a represcription is warranted.[19]

C. Discussion

5. We agree with MCI and GSA that we should initiate a rate-of-return prescription proceeding at this time. The sustained low yields of the U.S. treasury securities strongly suggest that the current prescribed rate of return is much higher that the rate required to attract capital and earn a reasonable profit. Our duty to ensure that service rates are just and reasonable requires that we undertake a prescription proceeding at this time. Although the ultimate impact of the 1996 Act on the telecommunications industry is not yet known, this does not preclude us from commencing a prescription proceeding. Our rate prescriptions are always prospective, and there is always some degree of uncertainty about the future. Market-based cost-of-capital methodologies incorporate the capital markets' assessment of all the forms of risk, including risk associated with a changing legal and regulatory environment.

6. Furthermore, contrary to the contention of the ILECs, a rate-of-return prescription proceeding would not unduly tax the Commission's resources. In addition, the *1995 Rate of Return Represcription Procedures Order* significantly streamlined the rate-of-return prescription process by eliminating our trial-type procedures that included discovery, possible cross-examination, proposed findings of fact and conclusions, reply findings and conclusions, possible oral argument, and use of a separated trial staff at the discretion of the Common Carrier Bureau.[20] Moreover, despite the burden that a prescription proceeding would impose on the Commission, we have an overarching duty under the Act to ensure that the rate-of-return ILECs' rates are just and reasonable.

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[16] The commenters argue that the carriers who remain subject to rate of return regulation account for only 6-7% of the total ILEC revenue and access lines. AT&T Comments at 3; Cincinnati Comments at 3; NECA Comments at 5; NRTA Comments at 3; NTCA Comments at 2-3; Pacific/Nevada Comments at 2; USTA Comments at 6 (citation omitted).

[17] GSA Reply at 5.

[18] MCI Reply at 3.

[19] MCI Comments at Attachment A.

[20] *1995 Rate of Return Represcription Procedures Order*, 10 FCC Rcd at 6808 para. 43.

7. For the reasons described above, we are not persuaded by the commenters that we should delay commencing a prescription proceeding. It is important that our prescribed rate of return correspond to current market conditions. The recent yields on 10-year U.S. treasury securities have remained more than 150 basis points below the reference point, suggesting that the prescribed rate does not coincide with current market conditions. Therefore, we conclude that we should begin a rate-of-return prescription proceeding.

III. PRESCRIBING THE RATE OF RETURN

A. General Considerations

8. We prescribe a rate of return in order to ensure that rate-of-return carriers' rates for interstate access services are "just and reasonable." Carriers subject to rate-of-return regulation, however, may also provide interstate interexchange services. For such carriers, our prescribed rate of return is applied to their interexchange access services as well. We seek comment on whether the same prescribed rate should be applied to rate-of-return carriers' interstate access and interexchange services, or whether the prescribed rate should be adjusted when applied to provision of interexchange services. Commenters supporting the application of different rates should indicate how the prescribed rate for interstate interexchange services should be determined. We also seek comment on whether the rate of return prescribed for interstate access should also be used for other purposes, including determination of universal service support.

B. Weighted Average Cost of Capital

9. The weighted average cost of capital is used to estimate the rate of return that the ILECs must earn on their investment in facilities used to provide regulated interstate services in order to attract sufficient capital investment. Our rules specify that the composite weighted average cost of capital is the sum of the cost of debt, the cost of preferred stock, and the cost of equity, each weighted by its proportion in the capital structure of the telephone companies.[21] The formulas for determining the cost of debt, cost of preferred stock, and capital structure are codified in sections 65.302, 65.303, and 65.304, respectively of the Commission's rules.[22] Each of these components are calculated using routinely collected data from the Automatic Reporting Management Information System (ARMIS) reports.[23] The rules do not include a formula for calculating the cost of equity. Instead, they state that "the cost of equity shall be determined in prescription proceedings after giving

[21] *See* 47 C.F.R. § 65.305.

[22] *Id.* §§ 65.302-304.

[23] ARMIS is the automated system developed in 1987 for collecting financial and operating information from certain carriers. The data used for purposes of determining the cost of debt, cost of preferred stock and capital structure are contained in the FCC ARMIS Report 43-02.

full consideration to the evidence in the record, including such evidence as the Commission may officially notice."[24]

C. Capital Structure

10. Prior to the *1995 Rate of Return Represcription Procedures Order*, Part 65 of the Commission's rules prescribed a method of computing the capital structure of all ILECs based on a composite of the capital structures of the Regional Bell operating companies (RBOCs).[25] In the *1995 Rate of Return Represcription Procedures Order*, the Commission revised its methodology to use instead the capital structure of all ILECs with annual revenues of $100 million or more. This capital structure methodology was codified in order to "simplify future represcription proceedings without sacrificing needed accuracy."[26] The proportion of each cost-of-capital component in the capital structure is equal to the book value of that particular component divided by the book value of the sum of all components.[27] For example, the proportion of debt in the capital structure is equal to the book value of debt divided by the sum of the book value of debt, equity, and preferred stock.

11. In Appendix B, we calculate the ILECs' capital structure based on 1997 data contained in the ARMIS 43-02 reports. Based on ARMIS data, the ILECs' capital structure is 42.88% debt, .14% preferred stock and 56.98% equity.[28]

D. Embedded Cost of Debt

12. The cost of debt is based on the sale of bonds and other debt-related securities to finance telephone operations.[29] Prior to the *1995 Rate of Return Represcription Procedures Order*, Part 65 of the Commission's rules required each of the RBOCs to perform detailed calculations to determine their embedded cost of debt based upon data contained in their Form 10-K or 10-Q statements filed with the Securities and Exchange Commission. In the *1995 Rate of Return*

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[24] 47 C.F.R. § 65.301.

[25] 51 FR 1808 (January 15, 1986) as amended 51 FR 4598 (February 6, 1986).

[26] *1995 Rate of Return Represcription Procedures Order*, 10 FCC Rcd at 6841 para. 121.

[27] The formula for calculating the particular component in the capital structure is

$$\frac{\text{Book Value of particular component}}{\text{Book Value of Debt + Book Value of Preferred Stock + Book Value of Equity}}$$

[28] During this proceeding, we plan to use the most recent available ARMIS reports to calculate the ILECs' capital structure.

[29] The debt of a company may be long-term (*i.e.*, debt with a term of one year or more) or short-term (all debt other than long-term). Under the Commission's rules for calculating the cost of debt, the cost of short-term and long-term debt can be combined.

Represcription Procedures Order, the Commission altered the methodology to be used in a prescription proceeding for calculating the embedded cost of debt, using data submitted in ARMIS report 43-02 by all ILECs with annual revenues of $100 million or more. The Commission defined embedded cost of debt to be the total annual interest expense divided by average outstanding debt.[30]

13. In Appendix B, we calculate the ILECs' embedded cost of debt based on 1997 data contained in the ARMIS 43-02 reports filed by reporting ILECs.[31] Based on this data, the ILECs' cost of debt is 7.35%.[32]

14. In response to the Public Notice, USTA observed that the total debt calculation as contained in the Appendix to the Public Notice was performed incorrectly.[33] USTA pointed out that Unamortized Debt Issuance Expense should be deducted from, rather than added to, total debt.[34] We tentatively conclude that USTA is correct. The calculations contained in Appendix B reflect this tentative conclusion. We seek comment on this tentative conclusion.

E. Cost of Preferred Stock

15. The *1995 Rate of Return Represcription Procedures Order* revised the methodology for calculating the cost of preferred stock to be consistent with the calculation of the cost of debt and directed that the calculation be based on data routinely submitted by ILECs with annual revenues of $100 million or more rather than by the RBOCs, as was done in the 1990 rate-of-return

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[30] $$\text{Embedded Cost of Debt} = \frac{\text{Total Annual Interest Expense}}{\text{Average Outstanding Debt}}$$

Total annual interest expense is defined as the total interest expense for the most recent two years for all local exchange carriers with annual revenues of $100 million or more (*see infra* para. 51 for a tentative conclusion on the need to correct this definition). Average outstanding debt is defined as the average of the total debt for the most recent two years for all local exchange carriers with annual revenues of $100 million or more. 47 C.F.R. § 65.302.

[31] 47 C.F.R. § 65.302.

[32] During this proceeding, we plan to use the most recent available ARMIS reports to calculate the ILECs' embedded cost of debt.

[33] USTA Reply at 6.

[34] This account is reported under "Noncurrent Assets" in Table B-1 (Balance Sheet), Row 1407 of ARMIS 43-02. Based on this tentative conclusion, total debt would be calculated as the sum of Rows 420 (total long-term debt), 4020 (notes payable), 4050 (current maturities - long-term debt), and 4060 (current maturities - capital leases); less the amount in Row 1407.

proceeding. The methodology for calculating the cost of preferred stock is to divide total annual preferred dividends by the proceeds from the issuance of preferred stock.[35]

16. In Appendix B, we calculate the ILECs' cost of preferred stock based on 1997 data contained in the ARMIS 43-02 reports.[36] According to this ARMIS data, the ILECs' cost of preferred stock is 3.52%.[37]

F. Cost of Equity

1. Background

17. Prior to the *1995 Rate of Return Represcription Procedures Order*, Part 65 of the Commission's rules required the RBOCs to prepare two historical discounted cash flow estimates and submit state cost-of-capital determinations to assist the Commission in calculating the ILECs' cost of equity.[38] In the *1995 Rate of Return Represcription Procedures Order*, the Commission concluded that the methodology for estimating equity costs, as well as the data to be used in applying particular methodologies, flotation costs, and periods of compounding, should be determined anew in each proceeding. Accordingly, Part 65 no longer prescribes a methodology for determining ILECs' cost of equity.[39]

18. In this section, we propose several methods for estimating the cost of equity for interstate services. We seek comment on each of these methods and invite commenters to propose additional methodologies. Commenters should discuss whether in this proceeding we should use only one or more than one methodology to estimate this component of the carriers' cost of capital. Commenters preferring the use of more than one methodology are requested to specify how we should weigh the results of these methods to estimate the cost of equity. We expect that in the direct cases,

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[35] $$\text{Cost of Preferred Stock} = \frac{\text{Total Annual Preferred Dividends}}{\text{Proceeds from the Issuance of Preferred Stock}}$$

Total annual preferred dividends is defined as the total dividends on preferred stock for the most recent two years for all local exchange carriers with annual revenues of $100 million or more (*see infra* para. 52 for a tentative conclusion on the need to correct this definition). The term "proceeds from the issuance of preferred stock" is defined as the average of the total net proceeds from the issuance of preferred stock for the most recent two years for all local exchange carriers with annual revenues of $100 million or more. 47 C.F.R. § 65.303.

[36] 47 C.F.R. § 65.303.

[37] During this proceeding, we plan to use the most recent available ARMIS reports to calculate the ILECs' cost of preferred stock.

[38] Part 65 formerly required RBOCs to provide each state cost-of-capital determination that is applicable to that firm's intrastate exchange carrier operations as of the date of the filing and include a copy of the state decision and any exceptions with that filing.

[39] *1995 Rate of Return Represcription Procedures Order*, 10 FCC Rcd at 6830-31 paras. 90-91.

parties will use the results from the cost of equity methods they propose. We note that we will use Standard and Poor's Compustat PC Plus database[40] as our source for financial data in this proceeding.

2. Surrogate Companies

19. The methods of estimating the cost of equity that we identify in this *Notice* use stock prices and other measures of investor expectations regarding the ILECs' interstate services.[41] Because ILECs do not issue stock or borrow money solely to support interstate service, investor expectations that would affect the cost of equity for interstate services cannot be measured directly. For this reason, we must select a group of companies facing risks similar to those encountered by the rate-of-return ILECs[42] in providing interstate service for which we can estimate the cost of equity.[43] Risk is the uncertainty associated with the ability of an investment to generate the return expected by investors.[44] As was done in the 1990 proceeding, once the surrogates are selected, their firm-specific data are applied to the cost-of-equity methodologies selected herein, and average or median returns for the surrogate group are calculated in order to determine a zone of reasonableness for cost of equity.

20. We seek comment on what group of companies we should select as appropriate surrogates for estimating the cost of equity for interstate services. In 1986, the Commission adopted the RBOCs as a surrogate group of firms for the interstate access industry.[45] In 1990, the Commission again concluded that, despite their diversification into nonregulated businesses, the RBOCs were still the most appropriate surrogates.[46] Further, the Commission concluded that most competitive, nonregulated businesses are riskier than the regulated interstate access business and therefore, the RBOCs are riskier as a whole than their regulated telephone operations. As a result, the Commission determined that the cost-of-equity estimate for an RBOC as a whole may overstate the cost of equity for interstate access alone and considered this potential overstatement when determining the cost-of-equity estimates.[47] In the *1995 Rate of Return Represcription Procedures Order*, the

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40 Compustat PC Plus is provided by Standard & Poor's Compustat, Englewood, Colorado.

41 *Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, Notice of Proposed Rulemaking*, MM Docket No. 92-133, 7 FCC Rcd 4688, 4694 para. 48 (1992) (*1995 Rate of Return Represcription Procedures NPRM)*.

42 This group would include price cap ILECs to the extent they receive universal service distributions calculated on a rate of return basis.

43 *1995 Rate of Return Represcription Procedures NPRM*, 7 FCC Rcd at 4694 para. 48.

44 Roger A. Morin, REGULATORY FINANCE UTILITIES' COST OF CAPITAL, pp. 46 & 287 (Public Utilities Reports, Inc., 1994) ("Morin").

45 *1990 Rate of Return Order*, 5 FCC Rcd at 7516 para. 76.

46 *Id.* at 7517 para. 85.

47 *Id.* at 7517 paras. 84-86, 178.

Commission found that the level of risks that RBOCs face was no longer similar to the risk confronting carriers subject to rate-of-return regulation and therefore the RBOCs' risk may not provide the best data upon which to base a uniform rate-of-return prescription.[48] With the uncertainty following the passage of the 1996 Act, however, the RBOCs' cost of equity may no longer overstate that of rate-of-return carriers. As a result, we tentatively conclude that the RBOCs, more than any other group of companies, once again constitute the best surrogate for carriers subject to rate-of-return regulation. We tentatively conclude that the RBOCs' current risk most closely resembles the current risk encountered by the rate-of-return carriers. The RBOCs and rate-of-return ILECs both provide interstate services, their primary business is still the provision of telephone service and neither is subject to any meaningful competition for regulated telecommunications services in their service area. We seek comment on this tentative conclusion. In addition, we seek comment whether we should incorporate the financial data of any other publicly traded ILEC in the cost-of-equity analysis.

21. In the 1990 proceeding, although we concluded that the RBOCs were the most appropriate surrogate, we made a downward adjustment to the estimated cost of equity to account for the fact that the RBOCs' interstate access business was less risky than their business as a whole. We seek comment on whether a similar adjustment should be made in this proceeding. Specifically, we seek comment on whether the RBOCs' interstate access business today is more or less risky than their operations as a whole. In the 1990 proceeding, ILECs submitted stock analysts' reports in support of their argument that the proposed DCF formula did not account for the growth in cellular operations.[49] In responding, commenters should submit stock analysts' reports indicating the relative riskiness of the RBOCs' lines of business.

3. Discounted Cash Flow Methodology

22. Under the Discounted Cash Flow (DCF) methodology, a firm's cost of equity is calculated according to a formula involving the annual dividend and price of a share of its common stock, along with the estimated long-term dividend growth rate. The standard DCF formula is the annual dividend on common stock divided by the price of a share of common stock (termed the "dividend yield") plus the long-term growth rate in dividends.[50]

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48 *1995 Rate of Return Represcription Procedures Order*, 10 FCC Rcd at 6818 para. 63.

49 *1990 Rate of Return Order*, 5 FCC at 7518 para. 90.

50 The general equation is:

$K_e = D/P + G$, where:

K_e = cost of equity
D = annual dividend on a share of common stock
P = price of a share of common stock
D/P = dividend yield on a share of common stock
G = long-term growth rate in dividends

23. *Growth Rate.* The DCF method requires an estimate of the long-term growth rate. In both the 1986 and 1990 proceedings, the Commission used the Institutional Brokers Estimate Service ("IBES") as the source of the median forecast of long-term growth.[51] In this proceeding, the Commission will use the S&P Analysts' Consensus Estimates ("ACE") of growth in long-term earnings per share as part of the database we obtain from Standard & Poor's. We seek comment on whether ACE provides information comparable to IBES and whether ACE estimates should be used for purposes of this proceeding.

24. *Quarterly Dividend.* In both the 1986 and 1990 proceedings, we rejected the ILECs' arguments that the quarterly dividend should be compounded to account for the payment of dividend on a quarterly, rather than annual, basis for three reasons: (1) compounding is reflected in the revenue requirement because the Commission uses a mid-year rate base; (2) the adjustment adds a complexity that is not offset by increased accuracy; and (3) the parties did not establish that analysts and investors actually use quarterly compounding models nor did the parties demonstrate how using the quarterly model may affect the market price.[52] For these reasons, we tentatively conclude that we should not use quarterly compounding in the DCF formula. We seek comment on this tentative conclusion.

25. *Flotation Costs.* Flotation costs are the out-of-pocket expenses associated with issuing stock as well as any temporary reduction in the market value of the stock attributable to the issuance of additional shares.[53] In the 1986 proceeding, the Commission provided a one-time. cost-of-equity adjustment of ten basis points for flotation costs, but stated that no subsequent upward adjustments should be permitted.[54] In the 1990 proceeding, the Commission concluded that it would not include an adjustment for flotation costs for three reasons: (1) the RBOCs were not issuing stock at that time; (2) no evidence suggested that past costs remain unrecovered; and (3) the Commission's treatment of flotation costs had not adversely affected the carriers' stock prices.[55] We concluded that if carriers were concerned about recovery of flotation costs, they could seek a change in the Commission's prescribed accounting system.[56] We reaffirm these prior decisions, and tentatively conclude that in this proceeding we should make no adjustments to our estimate of the cost-of-equity

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51 *1995 Rate of Return Represcription Procedures NPRM*, 7 FCC Rcd at 4696 para. 63.

52 *Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Memorandum Opinion and Order on Reconsideration*, CC Docket No. 84-800 Phase II, 104 FCC 2d 1404, 1431 (1986) (*Phase II Reconsideration Order*); *1990 Rate of Return Order*, 5 FCC Rcd at 7515 para. 72.

53 *1990 Rate of Return Order*, 5 FCC Rcd at 7515 para. 73.

54 Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, *Report and Order*, CC Docket No. 84-800, Phase II, 51 Fed. Reg. 1795 at para. 43 (Jan. 15, 1986) (*Phase II Order*); *see also Phase II Reconsideration Order*, 104 FCC 2d at 1432, para. 62.

55 *1990 Rate of Return Order*, 5 FCC Rcd at 7516 para. 75.

56 *Id.*

component of ILECs' cost of capital to compensate for flotation costs. We seek comment on this tentative conclusion.

26. *Classic DCF Calculation.* The "classic" DCF method uses the expected annual dividend for the next year, the current share price and the current-expected long-term earnings growth rate to calculate the cost of equity. In the *Phase II Reconsideration Order*, the Commission adopted this version of the DCF methodology.[57] In 1990, the Commission required the RBOCs to submit the "classic" DCF methodology as applied to the RBOCs, the S&P 400, and a group of large electric utilities and this method was given the greatest weight in calculating the cost of equity in the 1990 proceeding.[58] The S&P 400 and large electric utilities were used as equity market benchmarks to determine whether the estimates calculated for the RBOCs were reasonable. We tentatively conclude that this "classic" form of the DCF should also be applied to the group of surrogate companies selected as a result of this proceeding. Consistent with our analysis in 1990, we tentatively conclude that the "classic" DCF formula more accurately estimates the cost of equity than does the historical DCF method, discussed below. We seek comment on this tentative conclusion and ask the parties to comment on the weight to be given to this methodology. In addition, we tentatively conclude that the S&P 400 (now termed the S&P Industrials) and the large electric utilities should be used as equity market benchmarks against which the RBOCs' cost-of-equity estimates can be evaluated. We seek comment on this tentative conclusion. Finally, in the 1990 proceeding, for purposes of our cost-of-equity benchmark analysis, the S&P 400 and large electric utilities groups were screened to exclude those companies that did not pay dividends, had less than five analyst estimates of long-term earnings growth reported by IBES, and had DCF cost-of-equity estimates less than the yield on 10-year treasury bonds.[59] We seek comment on whether these screens are still appropriate and, if not, what screens, if any, should be used and why.

27. In 1990, the primary cost-of-equity conclusions were based on a series of then-recent monthly DCF estimates for the RBOCs.[60] The Commission used the average of the monthly high and low stock prices for each month of the period under analysis to establish the current stock price. The Commission found that "these monthly periods are sufficiently long to eliminate the possibility that a particular price may be an aberration, but recent enough to assure that data from past periods do not obscure trends."[61] We tentatively conclude that using the average of the monthly high and low stock prices as inputs to the "classic" form of the DCF will provide reliable estimates of the current stock price. We seek comment on this tentative conclusion. In reacting to this tentative

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[57] *Phase II Reconsideration Order*, 104 FCC 2d at 1407.

[58] *1990 Rate of Return Order*, 5 FCC Rcd at 7512 paras. 42-43.

[59] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, *Order*, CC Docket No. 89-624, 5 FCC Rcd at 544. (Com. Car. Bur. 1990)

[60] *1990 Rate of Return Order*, 5 FCC Rcd at 7528-9 para. 187. The Commission gave the most weight to the monthly DCF estimates for January through July 1990.

[61] *Id.* at 7514 para. 63.

conclusion, commenters should discuss the time for which the DCF calculation should be made. For example, the commenters might propose the most recent quarter available or each month's estimate during the pendency of the case as was done in the 1990 proceeding.[62]

28. Finally, as part of the specification of the "classic" DCF model in the 1990 proceeding, we determined that the expected dividend should be calculated by multiplying the current annualized dividend by one plus one-half the analysts' estimated long-term growth rate due to timing differences among the companies as to the date of their dividend increases.[63] The Commission concluded that if the dividend yield was to be determined "at a point during the year just before the carriers were to announce a dividend increase, it might be accurate to grow the dividend rate by a full year's expected growth."[64] The Commission, however, found that RBOCs' dividends had "been increased in the six months prior to the analysis and the stock prices used in the analysis reflected these higher dividends."[65] Multiplying the dividend by the full growth rate would overstate the estimated annual growth in dividends and increase the DCF estimated cost of equity. Because we have no reason to believe that all companies in the surrogate group will declare dividend increases simultaneously, we tentatively conclude that we should increase the dividend by one-half the estimated annual growth. We seek comment on this tentative conclusion.

29. *Historical DCF Calculation.* At least two other variations of DCF that in the past we have considered using to estimate ILECs' cost of equity rely upon historical data to compute that cost. In both variations, the cost of equity is calculated as the sum of D/P + G, where D is the average annual dividend during the two calendar years preceding the prescription filing and P is the average daily price of the RBOCs' common stock during each trading day during the two calendar years preceding the prescription proceeding.[66] In the first variation, G would be the annual rate of growth in dividends derived from the slope of the ordinary least squares linear trend line of quarterly dividends that were declared during the two calendar years preceding the prescription proceeding. In the second variation, G would be the simple average of the IBES median long-term growth rate estimates of earnings during the two calendar years preceding the prescription filing.[67] In the 1990 and 1995 proceedings, the Commission rejected both these variations of the historical DCF methodology because they average inputs over a period neither short enough to reflect current market

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[62] *Id.* at 7512 para. 42.

[63] Under this methodology, the expected dividend is calculated by D*(1+.5G). *Id.* at 7514 paras. 64-66. For the source of the growth rate *see supra* para. 23.

[64] *1990 Rate of Return Order*, 5 FCC Rcd at 7512 para. 42.

[65] *Id.*

[66] *Id.* at 7511 para. 36. Before they were amended, the Part 65 rules required a prescription filing on January 3, or the next regular day of business when January 3 fell on a Saturday or Sunday, of every even-numbered year. Former § 65.102 (c).

[67] *1990 Rate of Return Order*, 5 FCC Rcd at 7511 para. 36.

conditions nor long enough to reveal historical trends.[68] For these reasons, the *1995 Rate of Return Represcription Procedures Order* does not mandate use of historical DCF as part of a rate-of-return proceeding.[69] We tentatively conclude that this DCF methodology should be given no weight in this proceeding. We seek comment on this tentative conclusion.

30. In the 1990 proceeding, parties presented several variations of the general DCF formula.[70] We seek comment on whether there are other variations to the DCF methodology that we should now consider using in this proceeding. Commenters proposing different versions should explain in detail how the various parameters would be estimated, including how long the period from which we draw data for analysis should be, why they believe this is a reasonable period to use and identify the source of the data on which the DCF calculation would draw. Finally, commenters should indicate the weight to be given the methodology they propose.

4. Risk Premium Methodologies

31. Risk premium methodologies can also be used to calculate the cost of equity. In this section we discuss two types of risk premium methodologies. The first was termed traditional risk premium analysis in the 1990 proceeding and we will continue to use that term.[71] The second type of risk premium analysis is the Capital Asset Pricing Model ("CAPM"). These two methods share fundamental similarities in that they select a "risk free" investment such as long-term United States Treasury bonds and add a risk premium to return on that "risk free" investment to derive a cost-of-equity estimate. The differences between the two methods arise in the manner by which the risk premium is calculated. Under a more traditional risk premium methodology, the risk premium is typically estimated as the historical or estimated spread between equity security returns and bond yields. Under the CAPM methodology, the risk premium is formally quantified as a linear function of market risk (beta).[72]

32. *Traditional Risk Premium Analyses*. This methodology estimates the cost of equity as the current yield on a "risk free" investment, such as long-term U.S. Treasury bonds, plus an historical or expected equity risk premium.[73] As noted in the *1995 Rate of Return Represcription*

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[68] *Id.* at 7512 paras. 47-48. *See also 1995 Rate of Return Represcription Procedures NPRM,* 10 FCC Rcd 4695 para. 56.

[69] *See* former 47 C.F.R. § 65.303.

[70] *1990 Rate of Return Order*, 5 FCC Rcd at 7520-21 paras. 121-132.

[71] *Id.* at 7522-23 para. 135.

[72] Morin at 305.

[73] *1990 Rate of Return Order* at 7522 para. 133; *1995 Rate of Return NPRM,* 7 FCC Rcd at 4697 para. 68. Under the historical risk premium methodology the cost of equity estimate (K_e) = K_d + historical bond-equity spread, where K_d is the incremental cost of debt. The expected risk premium methodology is $K_e = K_d$ + expected risk premium. Morin at 271-278.

Procedures NPRM, "[t]raditionally, such analyses have determined the risk premium by comparing historically realized returns on stocks and bonds."[74] In the 1990 Order, we stated:

> A bond's yield is simply the discount (interest) rate that makes the present value of its contractual cash flow equal to its market value. Since the cash flows are fixed, if the bond goes up in price, the yield must go down. An increase in the price of the stock, however, may leave the stock's expected return unchanged if the price rose to adjust for higher anticipated profits rather than lower investor perceived risk. Risk premium analyses solve this problem by comparing the past returns (capital gains, dividends and interest, divided by the market price) on stocks and bonds. The historic premium in return on stocks over bonds is assumed to be a stable and accurate forecast of investor's expectations about the future premium.[75]

33. *Capital Asset Pricing Model (CAPM)*. Under the CAPM, the variance of the company's stock price is measured relative to the market as a whole to adjust the premium. Similar to traditional risk premium methodologies, the CAPM calculates a cost of equity equal to the sum of a risk-free rate and a risk premium. In the CAPM formula, however, the risk premium is proportional to the security's market risk and the market price of the risk.[76]

34. *Historical Risk Premium.* In the *1995 Rate of Return Represcription Procedures NPRM*, the Commission found that risk premium analyses, including the CAPM, could be used to estimate the cost of equity for interstate access. The Commission, however, was concerned about the use of historical stock and bond yields to estimate the risk premium.[77] The Commission found that the results obtained from a historical analysis depend on the period chosen and therefore questioned whether the Commission should rely on historical stock and bond yields to calculate a risk premium.[78] We seek comment on whether such historical data should be relied upon in this proceeding. Commenters supporting the use of historical data should clearly indicate from what time period such information should be drawn, explain why they believe this is a reasonable period to use,

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[74] *1995 Rate of Return Represcription Procedures NPRM*, 7 FCC Rcd at 4697 para. 68.

[75] *1990 Rate of Return Order*, 5 FCC Rcd at 7522 para. 133.

[76] $K_e = R_F + \beta(R_M - R_F)$, where:

K_e = cost of equity estimate
R_F = risk free rate
R_M = required return of the overall market
Beta(β) = an estimate of the difference in risk of the stock for which the cost of equity estimate is being made and the overall risk of stock market investments.

Morin at 302-3.

[77] *1995 Rate of Return Represcription Procedures NPRM*, 7 FCC Rcd at 4697 paras. 71-72.

[78] *Id.* at 4697 para. 72.

and identify the source of these data. Commenters should also indicate the appropriate weight to be given such analyses.

35. *Expected Risk Premium.* With regard to the issue of expected risk premiums, we seek comment on how such estimates should be determined. In the *1995 Rate of Return Represcription Procedures NPRM*, we suggested that relying on stock market data such as the DCF cost-of-equity estimates for the S&P 400 may provide a forward-looking risk premium for purposes of calculating both the traditional risk premium cost of equity and the CAPM cost of equity.[79] Commenters proposing the use of expected risk premiums should clearly specify how they would determine the expected risk premium estimates. In addition, commenters should identify from what period such information should be drawn, explain why they believe this is a reasonable period to use, and identify the source for these data. Commenters proposing the use of expected analyses should indicate the weight they would give to these analyses.

36. *Risk-Free Rate.* As indicated above, both models require the selection of a risk-free rate. United States Treasury securities are regarded as virtually risk free.[80] We seek comment on whether we should use U.S. Treasury securities as the investment we use to define risk free for purposes of calculating the Risk Premium and CAPM cost-of-equity estimates. On the one hand, the yields on short-term U.S. Treasury bills (with maturities from 90 days to one year) may measure the risk-free rate but may not consider long-term inflationary expectations that are embedded in bond yields and stock returns.[81] On the other hand, long-term U.S. Treasury bonds (maturities from 10 to 30 years) incorporate long-term inflationary yields, but because of their long maturities, also include an interest-rate risk premium that is not embodied in the more short-term securities such as T-bills.[82] We seek comment on how we should set the risk-free rate. In responding, commenters should state the length of maturity for U.S. Treasury securities that should be used in this calculation and explain why securities of this maturity length should be used. Commenters should also indicate whether the data used to compute the risk-free rate should be historical or forward-looking.

37. *Beta.* The CAPM methodology also requires the estimation of a security's risk, or "beta." Beta is a measure of a security's price sensitivity to changes in the stock market as a whole. In the 1990 proceeding, parties proposed using betas calculated by *ValueLine*.[83] The Commission found that because *ValueLine* betas are adjusted to raise the level of betas less than one and lower the level of betas greater than one[84] such betas were not consistent with the theory of

[79] *Id.* at 4698 para. 74.

[80] Morin at 35.

[81] *Id.* at 279.

[82] *Id.*

[83] *1990 Rate of Return Order*, 5 FCC Rcd at 7523 para. 139.

[84] The betas are adjusted on the theory that the beta will regress towards the market mean value of 1.0 over time and represents an attempt to estimate a forward-looking beta.

CAPM.[85] We seek comment on whether we should reconsider the use of adjusted betas for purposes of the CAPM methodology. We seek comment on whether S&P betas should be used for this proceeding.

G. Other Cost-of-Capital Showings

38. In the 1990 Rate of Return proceeding, state cost-of-capital determinations were used as a check on the results obtained through our quantitative analysis.[86] Although state cost-of-capital determinations are no longer required filings in a federal prescription proceeding, we tentatively conclude that such information continues to serve as a valuable check on the results obtained by applying the methods described above to the surrogate group of companies selected. Therefore, we plan to consider the information contained in the most recent National Association of Regulatory Utility Commissioners ("NARUC") publication "Utility Regulatory Policy in the United States and Canada."[87] Specifically, this resource provides the overall rates of return on rate base for telecommunications companies prescribed recently by the state commissions as well as the related prescribed cost-of-equity returns. We seek comment on our proposed use of this source. In responding, commenters should indicate any concerns they may have regarding the validity of the information contained in the document. Commenters should file any data that they believe are more reliable.

H. Other Factors to Be Considered in Determining the Allowed Rate of Return

39. As part of this proceeding, the Commission will identify a "zone of reasonableness"[88] for the cost of equity and the overall cost of capital for interstate access services. Once these "zones of reasonableness" have been determined, the Commission will prescribe an authorized rate of return that lies within the cost-of-capital "zone of reasonableness." In determining the "zone of reasonableness" for cost of equity in the 1990 proceeding, the Commission reviewed the range of DCF estimates among the RBOCs to ensure that all ILECs had adequate access to capital, and concluded that the range of reasonable cost-of-equity estimates should be bounded on the lower end by the RBOC average DCF estimate for the month with the highest RBOC average DCF estimate, and by that estimate increased by 40 basis points as the upper bound.[89] This resulted in an estimated cost-of-equity range based on unadjusted RBOC data of 12.6% to 13.0%. The Commission also accepted the parties' argument that, while the RBOCs' prices reflected the growth potential of their

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85 *1990 Rate of Return Order*, 5 FCC Rcd at 7523 para. 139.

86 *Id.* at 7511 para. 40, 7513 paras. 50-53, 7528 para. 180.

87 UTILITY REGULATORY POLICY IN THE UNITED STATES AND CANADA, COMPILATION 1995-1996, 1996 Washington, D.C. National Association of Regulatory Utility Commissioners, tables 115-116.

88 As noted in the *1990 Rate of Return Order*, "[t]he courts have also recognized that there is a zone of reasonableness within which reasonable rates may fall, and that we are entitled to exercise our judgment in selecting a rate of return within that zone." *1990 Rate of Return Order*, 5 FCC Rcd at 7532 para. 213.

89 *Id.* at 7528-29 paras. 187-188.

cellular radio services, analysts' earnings growth estimates did not, resulting in understated DCF estimates. Accordingly, the Commission adjusted the DCF inputs to address this concern.[90] The Commission offset this adjustment because the interstate access business was expected to be less risky than the RBOCs' business as a whole.[91] As a result of these three adjustments, the Commission established a "zone of reasonableness" for interstate access cost of equity of 12.5% to 13.5% and a "zone of reasonableness" for cost of capital of 10.85% to 11.4%.

40. In determining the authorized rate of return to be set within the cost-of-capital "zone of reasonableness," the Commission also considered two other factors. First, the Commission made an allowance for infrastructure development after noting that concern over investment in new telecommunications technologies warranted selecting an authorized rate of return in the upper range of the zone of reasonable cost-of-capital estimates.[92] Second, the Commission considered the ILECs' argument that competition in interstate access increased the ILECs' risk, but was only partially reflected in the quantitative cost-of-capital analysis. The Commission concluded, however, that the market-based cost-of-capital estimates captured risks from competition in interstate access, and therefore declined to make an adjustment on this basis.[93] Based on these factors and a concern that capital costs could fluctuate in the future, the Commission prescribed a rate of return of 11.25%, which was located near the upper end of the "zone of reasonableness."[94]

41. Similar to the 1990 proceeding, the Commission will consider other factors in determining the "zone of reasonableness" of cost of equity. Specifically, we seek comment on whether an adjustment should be made to account for actual or potential changes in the telecommunications marketplace as a result of the 1996 Act. We seek comment on how we should calculate such an adjustment. We also ask commenters to propose other adjustments deemed necessary in determining the cost-of-equity "zone of reasonableness" and to explain why they believe these adjustments to be necessary. Commenters should also propose where within the cost-of-capital "zone of reasonableness" the authorized rate of return should be set and why. For example, we note that mergers have occurred among the telecommunications companies.[95] We seek comment on whether adjustments should be made to account for the effects of proposed or completed mergers. In addition, we seek comment on whether we should consider adjustments to account for the ILECs' entry (or anticipated entry) into the long distance market. Finally, we note that the 1996 Act creates an exemption from obligations

[90] *Id.* at 7528 para. 178.

[91] *Id.* at 7517 para. 86.

[92] *Id.* at 7530 para. 203.

[93] *Id.* at 7531, para. 207.

[94] *Id.* at 7531 para. 215-6.

[95] Most notably, on April 1, 1997, Pacific Telesis Group was acquired by SBC Communications, Inc., and on August 19, 1997, the NYNEX Telephone Companies merged with the Bell Atlantic Telephone Companies.

otherwise imposed by the Act for qualifying ILECs serving rural areas.[96] We seek comment on whether the rural exemption should be a factor we weigh in determining whether any adjustment should be made.

42. We also seek comment on whether any of the adjustments made in the 1990 proceeding are still necessary in estimating the current authorized rate of return for interstate access services. Commenters arguing in favor of retaining one or more of these adjustments should state whether the level of adjustment should increase, decrease, or remain the same and identify the characteristics of the current market for telecommunications that warrant our making such adjustment.

I. Procedural Matters

1. *Ex Parte* Presentations

43. This is a permit-but-disclose notice and comment proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided that they are disclosed as provided in the Commission's rules. See generally 47 C.F.R. Sections 1.1202, 1.1203, and 1.1206(a).

2. Procedures For Filing Rate-of-Return Submissions

44. All relevant and timely direct case submissions, responses, and rebuttals will be considered by the Commission. In reaching its decision, the Commission may take into account information and ideas not contained in the submissions, provided that such information or a writing containing the nature and source of such information is placed in the public file, and provided that the fact of the Commission's reliance on such information is noted in the final Order disposing of this proceeding.

45. Pursuant to applicable procedures set forth in Sections 65.103(b)(c) and (d) of the Commission's rules, 47 C.F.R. § 65.103, interested parties may file direct case submissions on or before December 3, 1998, responsive submissions on or before February 1, 1999 and rebuttal submissions on or before February 22, 1999. Pursuant to Section 65.104, 47 C.F.R. § 65.104, the direct case submission of any participant shall not exceed 70 pages, responsive submissions shall not exceed 70 pages, and rebuttal submissions shall not exceed 50 pages. Comments may be filed using the Commission's Electronic Comment Filing System (ECFS) or by filing paper copies. See Electronic Filing of Documents in Rulemaking Proceedings, 63 Fed. Reg. 24,121 (1998). In addition, a copy of each rate-of-return submission, other than the initial submission, shall be served on all participants who have filed a designation of service notice pursuant to § 65.100(b).

46. Comments filed through the ECFS can be sent as an electronic file via the Internet to <http://www.fcc.gov/e-file/ecfs.html>. Generally, only one copy of an electronic submission must be filed. If multiple docket or rulemaking numbers appear in the caption of this

[96] 47 U.S.C. § 251(f)(1).

proceeding, however, commenters must transmit one electronic copy of the comments to each docket or rulemaking number referenced in the caption. In completing the transmittal screen, commenters should include their full name, Postal Service mailing address, and the applicable docket or rulemaking number. Parties may also submit an electronic comment by Internet e-mail. To get filing instructions for e-mail comments, commenters should send an e-mail to ecfs@fcc.gov, and should include the following words in the body of the message, "get form <your e-mail address." A sample form and directions will be sent in reply.

47. Parties who choose to file by paper must file an original and four copies of each filing. If more than one docket or rulemaking number appear in the caption of this proceeding, commenters must submit two additional copies for each additional docket or rulemaking number. All filings must be sent to the Commission's Secretary, Magalie Roman Salas, Office of the Secretary, Federal Communications Commission, 1919 M St. N.W., Room 222, Washington, D.C. 20554.

48. Parties who choose to file by paper should also submit their comments on diskette. These diskettes should be submitted to Warren Firschein of the Common Carrier Bureau's Accounting Safeguards Division, 2000 L Street, N.W., Room 257, Washington, D.C. 20554. Such a submission should be on a 3.5 inch diskette formatted in an IBM compatible format using WordPerfect 5.1 for Windows or compatible software. Spreadsheets should be saved in an Excel 4.0 format. The diskette should be accompanied by a cover letter and should be submitted in "read only" mode. The diskette should be clearly labelled with the commenter's name, proceeding (including the docket number in this case [CC Docket No. 98-166]), type of pleading (comment or reply comment), date of submission, and the name of the electronic file on the diskette. The label should also include the following phrase "Disk Copy - Not an Original." Each diskette should contain only one party's pleadings, preferably in a single electronic file. In addition, commenters must send diskette copies to the Commission's copy contractor, International Transcription Service, Inc., 1231 20th Street, N.W., Washington, D.C. 20037.

49. In accordance with Section 65.102 of the Commission's rules, petitions for exclusion from unitary treatment and for individual treatment will be granted for a period of two years if the cost of capital for interstate exchange service is so low as to be confiscatory because it is outside the zone of reasonableness for the individual carrier's required rate of return for interstate exchange access services. Such petitions must plead with particularity the exceptional facts and circumstances that justify individual treatment. The showing shall include a demonstration that the exceptional facts and circumstances are not of transitory effect, such that an exclusion for a period of at least two years is justified. While a petition for exclusion from unitary treatment may be filed at any time, when such a petition is filed at a time other than that specified in Section 65.103(b)(2) of the Commission's rules, the petitioner must provide compelling evidence that its need for individual treatment is not simply the result of short-term fluctuations in the cost of capital or similar events.

3. Further Information

50. For further information concerning this proceeding, contact Warren Firschein, Accounting Safeguards Division, Common Carrier Bureau at (202) 418-0844.

IV. NOTICE OF PROPOSED RULEMAKING

A. Discussion

1. Changes to the cost-of-debt calculation

51. Section 65.302 of the Commission's rules states that the cost of debt shall be calculated by dividing the total annual interest expense by average outstanding debt.[97] Total annual interest expense is defined as the total interest expense for the most recent two years[98] for all local exchange carriers with annual revenues of $100 million or more. Average outstanding debt is the average of the total debt for the most recent two years[99] for the same group of companies. In the Public Notice issued February 6, 1996, the Commission stated its belief that the formula as currently written overstates the cost of debt because it erroneously adds interest from a two year period in calculating the total annual interest expense.[100] We tentatively conclude that our existing rule does not result in the correct cost of debt. In the Public Notice we tentatively concluded that the intent of the *1995 Rate of Return Represcription Procedures Order* was that the numerator be defined as the "total annual interest expense for the most recent year for all local exchange carriers with annual revenues of $100 million or more."[101] We propose to amend Section 65.302 of our rules accordingly to reflect this more reasonable method of calculating the cost of debt.[102] For purposes of clarification, we also conclude that the denominator of the equation, average outstanding debt, be modified to reflect that the average total debt for the most recent two years is based on year-end data. Appendix A shows the revised cost-of-debt formula incorporating the corrected definitions. We seek comment on this proposed revision.

2. Changes to the Cost-of-Preferred Stock Calculation

52. Similarly, Section 65.303 of our rules states that the cost of preferred stock shall be calculated by dividing the total annual preferred dividends by the proceeds from the issuance of preferred stock. Total annual preferred dividends, however, is defined to be the total dividends on preferred stock for the most recent two years[103] for all local exchange carriers with annual revenues of

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97 47 C.F.R. § 65.302.

98 That is, the total interest expense for 1996 and 1997 would be summed.

99 For example, in order to obtain the average outstanding debt for 1997, we would sum the total outstanding debt on December 31, 1996 with total outstanding debt on December 31, 1997 and divide by two.

100 Common Carrier Bureau Sets Pleading Schedule in Preliminary Rate of Return Inquiry, *Public Notice*, AAD 96-28, 11 FCC Rcd 3651 (1996).

101 *Id.*

102 The calculation of the cost of debt contained in Appendix B uses the corrected formula.

103 That is, the total dividends on preferred stock for 1996 and 1997 would be summed.

$100 million or more. The proceeds are defined as the average of the total net proceeds from the issuance of preferred stock for the most recent two years[104] for the same set of companies.[105] By dividing the sum of two years of preferred dividends by one year of proceeds, the resulting cost of preferred stock is overstated. We propose to correct Part 65 by changing the phrase "total dividends on preferred stock for the most recent two years" to "total dividends on preferred stock for the most recent year" in the definition of "Total Annual Preferred Dividends."[106] For purposes of clarification, we also conclude that the denominator of the equation, proceeds from the issuance of preferred stock, be modified to reflect that the proceeds for the most recent two years is based on year-end data. Appendix A includes the revised cost-of-preferred stock calculation incorporating the corrected definitions. We seek comment on this proposed revision.

3. Changes to the Low-End Adjustment for Price Cap LECs

53. The Commission's recent price caps performance review[107] eliminated sharing obligations and set a new, higher productivity factor (X-Factor) for local exchange carriers subject to price caps regulation. We retained the low-end formula adjustment mechanism to ensure that the new X-Factor would not require individual local exchange carriers to charge unreasonably low rates.[108] The low-end formula adjustment mechanisms permits incumbent price cap local exchange carriers with rates of return less than 10.25 percent to increase their price cap indices (PCIs) to a level that would enable them to earn 10.25 percent.[109]

54. The *LEC Price Cap Order* stated that the low-end formula adjustment threshold of 10.25 percent was below the range identified for the interstate cost of capital in the *1990 Rate of Return Order* and above the marginal cost of long-term telephone debt. The Commission reasoned that a return of 10.25 percent "is not likely to be confiscatory, because it should still allow most companies to continue to attract capital and maintain service."[110] The Commission concluded

[104] For example, in order to obtain the average net proceeds for 1997, we would sum the net proceeds from the issuance of preferred stock for the year ending December 31, 1996 with the net proceeds from the issuance of preferred stock for the year ending December 31, 1997 and divide by two.

[105] 47 C.F.R. § 65.303.

[106] The calculation of the cost of preferred stock contained in Appendix B uses the corrected formula.

[107] Price Cap Performance Review for Local Exchange Carriers, *Fourth Report and Order*, CC Docket No. 94-1, 12 FCC Rcd 16642 (1997).

[108] *Id.* at 16649 para. 11.

[109] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6804 para. 147-49 (1990) (*LEC Price Cap Order*), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), *modified on recon.*, 6 FCC Rcd 2637 (1991); *aff'd sub nom.* National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

[110] *LEC Price Cap Order*, 5 FCC Rcd at 6807 para. 165.

that setting the low-end formula adjustment threshold at 10.25 percent provided "the proper balance of incentives and safeguards to our price caps plan."[111]

55. We seek comment on whether we should change the low-end formula adjustment for local exchange carriers subject to price caps regulation. Currently, the low-end formula adjustment is 100 basis points below the authorized unitary rate of return. We tentatively conclude that the low-end formula adjustment should remain 100 basis points below the rate of return to be prescribed in this proceeding. We seek comment on this conclusion. Parties should address the reasonableness of setting the low-end formula adjustment at 100 basis points below the unitary authorized rate of return that will be prescribed in this proceeding. Commenters asserting a different methodology for determining the low-end formula adjustment should define the factors upon which their recommendations are based--for example, the cost of capital--and should provide data or cite to specific data in the record that support their position.

B. Initial Regulatory Flexibility Analysis

56. Pursuant to Section 603 of the Regulatory Flexibility Act, the Commission has prepared the following initial regulatory flexibility analysis (IRFA) of the expected impact of these proposed policies and rule changes on small entities. Written public comments are requested on the IRFA. These comments must be filed in accordance with the same filing deadlines as comments on the rest of the *NPRM*, but they must have a separate and distinct heading designating them as responses to the regulatory flexibility analysis. The Commission will send a copy of this NPRM, including this IRFA, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with Section 603(a) of the Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. Section 601 *et seq.* (1981).

57. *Need for, and Objectives of, the Proposed Rules.* The Commission's rules require us to initiate a prescription proceeding whenever the yields of U.S. treasury securities reach a certain threshold. With this *Notice*, we initiate a prescription proceeding. Currently, local exchange carriers subject to price caps may increase their price cap indices (*i.e.*, make low-end adjustments) according to a formula based in part on our prescribed rate of return. In this *NPRM*, we seek comment on whether we should adjust this formula in accordance with the ultimate outcome of this prescription proceeding. We also tentatively conclude that we should correct mathematical errors in two codified formulas used to represcribe the rate of return.

58. *Legal Basis.* The proposed action is authorized under Sections 4(i) and 4(j) of the Communications Act of 1934, as amended.

59. *Description and Estimate of the Number of Small Entities to Which the Proposed Rules Will Apply.* For purposes of this *NPRM*, the Regulatory Flexibility Act defines a "small business" to be the same as a "small business concern" under the Small Business Act (SBA), 15 U.S.C. § 632, unless the Commission has developed one or more definitions that are appropriate to its activities. Under the SBA, "small business concern" is one that: (1) is independently owned and

[111] *Id.*

operated; (2) is not dominant in its field of operation; and (3) meets any additional criteria established by the SBA. The Small Business Administration defined a small business for Standard Industrial Classification (SIC) category 4813 (Telephone Communications, Except Radiotelephone) to be small entities when they have fewer than 1500 employees.

60. The proposal in this *NPRM* to alter the formula for calculating the low-end adjustment, if adopted, would affect all LECs that are regulated by the Commission's price cap rules. Currently, 11 incumbent LECs are subject to price cap regulation. We tentatively conclude that all price cap carriers have more than 1500 employees and therefore are not small entities.

61. In paragraphs 50 and 51 of this *NPRM*, we conclude that two formulas contained in Part 65 of the Commission's rules contain mathematical errors and propose corrections to these formulas. These proposals, if adopted, would affect all incumbent LECs subject to the Commission's rate-of-return regulations. Some of these carriers may not qualify as small entities or small incumbent LECs because they are not independently owned or operated. Because the small incumbent LECs that would be subject to these rules are either dominant in their field of operations or are not independently owned and operated, consistent with our prior practice, they are excluded from the definition of "small entity" and "small business concerns." Accordingly, our use of the terms "small entities" and "small businesses" do not encompass small incumbent LECs. Out of an abundance of caution, however, for regulatory flexibility analysis purposes, we will consider small incumbent LECs within this analysis and use the term "small incumbent LECs" to refer to any incumbent LECs that arguably might be defined by SBA as "small business concerns."

62. *Local Exchange Carriers*. Neither the Commission nor the Small Business Administration has developed a definition of small providers of local exchange service. The closest applicable definition under Small Business Administration rules is for telephone telecommunications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of incumbent LECs nationwide appears to be the data that we collect annually in the provision of Telecommunications Relay Service (TRS). According to our most recent data, 1347 companies reported that they were engaged in the provision of local exchange service. As mentioned above, 11 of these are subject to price caps. Although it seems certain that some of these carriers are not independently owned and operated, or have fewer than 1500 employees, we are unable at this time to estimate with greater precision the number of incumbent LECs that would qualify as small business concerns under the Small Business Administration's definition. Consequently, we estimate that there are fewer than 1347 small incumbent LECs that may be affected by the proposals in this *NPRM*. We seek comment on this estimate.

63. *Description of Projected Reporting, Recordkeeping and Other Compliance Requirements*. The proposals in this *NPRM* would not increase not decrease incumbent LECs' administrative burdens.

64. *Federal Rules that may Duplicate, Overlap, or Conflict with the Proposed Rule.*. None.

65. *Any significant alternatives minimizing impact on small entities and are consistent with stated objectives.* None.

C. Comment Filing Procedure

66. Pursuant to Sections 1.415 and 1.419 of the Commission's rules, 47 C.F.R. §§ 1.415, 1.419, interested parties may file comments on or before December 3, 1998, and reply comments on or before February 1, 1999. Comments will be limited to 50 pages, not including appendices. Reply comments will be limited to 30 pages, not including appendices. We invite parties to submit comments on these issues in conjunction with comments to the *Notice Initiating a Prescription Proceeding*. Comments may be filed using the Commission's Electronic Comment Filing System (ECFS) or by filing paper copies. See Electronic Filing of Documents in Rulemaking Proceedings, 63 Fed. Reg. 24,121 (1998).

67. Comments filed through the ECFS can be sent as an electronic file via the Internet to <http://www.fcc.gov/e-file/ecfs.html>. Generally, only one copy of an electronic submission must be filed. If multiple docket or rulemaking numbers appear in the caption of this proceeding, however, commenters must transmit one electronic copy of the comments to each docket or rulemaking number referenced in the caption. In completing the transmittal screen, commenters should include their full name, Postal Service mailing address, and the applicable docket or rulemaking number. Parties may also submit an electronic comment by Internet e-mail. To get filing instructions for e-mail comments, commenters should send an e-mail to ecfs@fcc.gov, and should include the following words in the body of the message, "get form <your e-mail address." A sample form and directions will be sent in reply.

68. Parties who choose to file by paper must file an original and four copies of each filing. If more than one docket or rulemaking number appear in the caption of this proceeding, commenters must submit two additional copies for each additional docket or rulemaking number. All filings must be sent to the Commission's Secretary, Magalie Roman Salas, Office of the Secretary, Federal Communications Commission, 1919 M St. N.W., Room 222, Washington, D.C. 20554.

69. Parties who choose to file by paper should also submit their comments on diskette. These diskettes should be submitted to Warren Firschein of the Common Carrier Bureau's Accounting Safeguards Division, 2000 L Street, N.W., Room 257, Washington, D.C. 20554. Such a submission should be on a 3.5 inch diskette formatted in an IBM compatible format using WordPerfect 5.1 for Windows or compatible software. Spreadsheets should be saved in an Excel 4.0 format. The diskette should be accompanied by a cover letter and should be submitted in "read only" mode. The diskette should be clearly labelled with the commenter's name, proceeding (including the docket number in this case [CC Docket No. 98-166]), type of pleading (comment or reply comment), date of submission, and the name of the electronic file on the diskette. The label should also include the following phrase "Disk Copy - Not an Original." Each diskette should contain only one party's pleadings, preferably in a single electronic file. In addition, commenters must send diskette copies to the Commission's copy contractor, International Transcription Service, Inc., 1231 20th Street, N.W., Washington, D.C. 20037.

D. Further Information

70. For further information concerning this proceeding, contact Warren Firschein, Accounting Safeguards Division, Common Carrier Bureau at (202) 418-0844.

V. ORDERING CLAUSES

71. Accordingly, IT IS ORDERED that, pursuant to sections 1, 4, 201-205, 218-220, 303(r), 403, of the Communications Act of 1934, as amended by the 1996 Act, 47 U.S.C. §§ 151, 154, 201-205, 218-220, 303(r), 403, that NOTICE IS HEREBY GIVEN of commencing a prescription inquiry as described in this NOTICE OF INITIATING A PRESCRIPTION PROCEEDING.

72. IT IS FURTHER ORDERED that, pursuant to sections 1, 4, 201, 202, 203, 205, 218-220, 303(r), 403, of the Communications Act of 1934, as amended by the 1996 Act, 47 U.S.C. §§ 151, 154, 201, 202, 203, 204, 205, 218-220, 303(r), 403, that NOTICE IS HEREBY GIVEN of proposed amendments to Part 65 of the Commission's Rules, 47 C.F.R. Part 65, as described in this NOTICE OF PROPOSED RULEMAKING.

73. IT IS FURTHER ORDERED that the Commission's Office of Public Affairs, Reference Operations Division, SHALL SEND a copy of this NOTICE OF PROPOSED RULEMAKING, including the Initial Regulatory Flexibility Certification, to the Chief Counsel for Advocacy of the Small Business Administration.

FEDERAL COMMUNICATIONS COMMISSION

Magalie Roman Salas

Magalie Roman Salas
Secretary

APPENDIX A -- PROPOSED RULES

PART 65--INTERSTATE RATE OF RETURN PRESCRIPTION PROCEDURES AND METHODOLOGIES

SUBPART C -- EXCHANGE CARRIERS

1. Section 65.302 of Title 47 of the Code of Federal Regulations is proposed to be amended to read as follows:

The formula for determining the cost of debt is equal to:

$$\text{Embedded Cost of Debt} = \frac{\text{Total Annual Interest Expense}}{\text{Average Outstanding Debt}}$$

Where:

"Total Annual Interest Expense" is the total annual interest expense for the most recent year for all local exchange carriers with annual revenues of $100 million or more.

"Average Outstanding Debt" is the average of the year-end total debt for the most recent two years for all local exchange carriers with annual revenues of $100 million or more.

2. Section 65.303 of Title 47 of the Code of Federal Regulations is proposed to be amended to read as follows:

The formula for determining the cost of preferred stock is equal to:

$$\text{Cost of Preferred Stock} = \frac{\text{Total Annual Preferred Dividends}}{\text{Proceeds from the Issuance of Preferred Stock}}$$

Where:

"Total Annual Preferred Dividends" is the total dividends on preferred stock for the most recent year for all local exchange carriers with annual revenues of $100 million or more.

"Proceeds from the Issuance of Preferred Stock" is the average of the year-end total net proceeds from the issuance of preferred stock for the most recent two years for all local exchange carriers with annual revenues of $100 million or more.

Local Exchange Carrier Cost of Debt, Cost of Preferred Stock and Capital Structure for the Year 1997*

(Dollars in thousands)

	Total Debt			1997	Cost of	Total Preferred Stock (2)			Annual	Cost of
			Average	Interest	Debt for			Average	Pref. Div	Pref. Stk.
Local Exchange Carrier (1)	12/31/96	12/31/97	for 1997	Expense	1997	12/31/96	12/31/97	for 1997	1997	for 1997
	a	b	c=(a+b)/2	d	e=d/c	f	g	h=(f+g)/2	i	j=i/h
Illinois Bell	$1,781,375	$2,073,289	$1,927,332	$118,556	6.15%					
Indiana Bell	287,918	274,348	281,133	18,293	6.51%					
Michigan Bell	1,235,415	1,146,581	1,190,998	84,461	7.09%					
Ohio Bell	910,633	1,025,549	968,091	65,762	6.79%					
Wisconsin Bell	449,133	497,295	473,214	30,811	6.51%					
Bell Atlantic-Washington D.C.	289,736	251,807	270,772	20,121	7.43%					
Bell Atlantic-Maryland	1,030,800	1,095,705	1,063,253	71,786	6.75%					
Bell Atlantic-Virginia	996,367	1,054,643	1,025,505	71,596	6.98%					
Bell Atlantic-West Virginia	263,512	263,636	263,574	18,746	7.11%					
Bell Atlantic-Delaware	133,908	150,856	142,382	9,795	6.88%					
Bell Atlantic-Pennsylvania	1,621,919	1,685,744	1,653,832	121,621	7.35%					
Bell Atlantic-New Jersey	1,524,578	1,688,532	1,606,555	112,737	7.02%					
Bell Atlantic - New England Tel.	2,167,259	2,174,183	2,170,721	151,775	6.99%					
Bell Atlantic - New York Telephone	3,897,352	3,795,009	3,846,181	354,228	9.21%					
BellSouth Corporation	8,064,527	7,951,669	8,008,098	548,595	6.85%					
Southwestern Bell Tel.	5,185,458	5,469,104	5,327,281	369,802	6.94%					
Pacific Bell - California	5,625,800	5,808,362	5,717,081	477,668	8.36%					
Nevada Bell	94,364	102,147	98,256	8,302	8.45%					
U S WEST Communications	6,049,931	5,367,346	5,708,639	430,153	7.54%					
Alltel of Pennsylvania	77,639	68,083	72,861	5,409	7.42%					
Alltel Georgia Comm.Corp.	194,651	198,901	196,776	12,966	6.59%					
The Western Reserve Telephone	63,521	65,471	64,496	5,220	8.09%					
Cincinnati Bell	277,670	284,016	280,843	20,390	7.26%					
GTE California, Inc.	1,471,114	1,709,094	1,590,104	110,208	6.93%	81,866	49,983	65,925	2,399	3.64%
GTE-Florida	893,216	975,588	934,402	63,781	6.83%	60,096	21,195	40,646	1,084	2.67%
Hawaiian Telephone	663,895	558,177	611,036	38,896	6.37%					
GTE of The Midwest, Inc.	357,524	372,200	364,862	29,128	7.98%					
GTE of The North, Inc.	1,765,181	1,760,856	1,763,019	129,599	7.35%	46,024	31,517	38,771	1,450	3.74%
GTE of The Northwest	735,743	774,114	754,929	56,099	7.43%					
GTE of The South	712,851	745,463	729,157	57,113	7.83%	3,151	3,090	3,121	150	4.81%
GTE of The Southwest	864,918	1,024,939	944,929	63,994	6.77%	14,050	9,110	11,580	446	3.85%
Contel of The South dba GTE	82,211	74,587	78,399	4,359	5.56%					
Contel of Minnesota dba GTE	39,236	48,931	44,084	3,186	7.23%					
GTE Arkansas, Inc.	74,208	76,794	75,501	6,300	8.34%					
Aliant Telecommun. Co.	43,907	43,935	43,921	4,561	10.38%	4,499	4,499	4,499	225	5.00%
Rochester Telephone	66,353	28,306	47,330	3,750	7.92%					
Southern New England Tel	742,097	663,296	702,697	49,202	7.00%					
Sprint - Florida, Inc.	575,805	479,076	527,441	43,839	8.31%					
Carolina Tel & Tel of NC	335,616	349,633	342,625	21,679	6.33%					
United of the Southeast, Inc.	117,700	122,306	120,003	9,373	7.81%					
Central-Virginia	106,684	118,469	112,577	6,876	6.11%					
United Tel of Ohio	179,562	199,359	189,461	13,686	7.22%					
United Tel of Indiana	62,214	61,016	61,615	4,560	7.40%					
United Tel of Missouri	116,115	139,108	127,612	9,598	7.52%					
Central Telephone Co.	314,267	399,307	356,787	25,630	7.18%	3,760	3,415	3,588	165	4.60%
United Tel of Texas	57,161	69,188	63,175	5,344	8.46%					
United Tel of New Jersey	53,109	60,774	56,942	4,443	7.80%					
United Tel of Pennsylvania	116,170	116,311	116,241	8,997	7.74%					
United Tel of the Northwest	58,806	61,891	60,349	4,212	6.98%					
TOTAL	$52,829,129	$53,524,994	$53,177,062	$3,907,206	7.35%	$213,446	$122,809	$168,128	$5,918	3.52%

*** Sources:**

Columns a & b: 1996 and 1997 ARMIS 43-02, Table B-1, Rows 420+4020+4050+4060-1407.

Column d: 1997 ARMIS 43-02, Table I-1, Row 7500.

Columns f & g: 1996 ARMIS 43-02, Table B-14, Column h less Column j for issuances with dividend rates.

Column i: The total dividend** paid on a given issue was calculated using data taken from Table B-14 of 1996 and 1997 ARMIS 43-02. Where the dividend for a given issue is stated in dollars, the total dividend was calculated by the following: [dividend amount per share * ((dollar amount of stock issued and outstanding/par or stated value) -number of treasury shares)]. Where the dividend of a given is stated a percent of par or stated value, the total : dividend was calculated by the following: [(percent per share * par or stated value) * ((dollar amount of stock issued and outstanding/par or stated value)-number of treasury shares)].

** For purposes of the analysis, it is assumed that amount stock issued and outstanding includes treasury stock.

Local Exchange Carrier Cost of Debt, Cost of Preferred Stock and Capital Structure for the Year 1997*

(Dollars in thousands)

	Total Common Equity						
Local Exchange Carrier (1)	**12/31/96** k	**12/31/97** l	**Average for 1997** m=(k+l)/2	**Total Capital** n=c+h+m	**Debt Ratio** o=c/n	**Pref. Stock Ratio** p=h/n	**Common Equity Ratio** q=m/n
Illinois Bell	$1,321,224	$1,403,581	$1,362,403	$3,289,735	58.59%		41.41%
Indiana Bell	658,358	686,836	672,597	953,730	29.48%		70.52%
Michigan Bell	1,393,137	1,467,013	1,430,075	2,621,073	45.44%		54.56%
Ohio Bell	911,975	947,771	929,873	1,897,964	51.01%		48.99%
Wisconsin Bell	538,426	556,092	547,259	1,020,473	46.37%		53.63%
Bell Atlantic-Washington D.C.	412,058	464,616	438,337	709,109	38.18%		61.82%
Bell Atlantic-Maryland	1,440,941	1,290,088	1,365,515	2,428,767	43.78%		56.22%
Bell Atlantic-Virginia	1,234,493	1,074,207	1,154,350	2,179,855	47.04%		52.96%
Bell Atlantic-West Virginia	371,526	374,364	372,945	636,519	41.41%		58.59%
Bell Atlantic-Delaware	202,000	206,794	204,397	346,779	41.06%		58.94%
Bell Atlantic-Pennsylvania	2,265,440	1,987,374	2,126,407	3,780,239	43.75%		56.25%
Bell Atlantic-New Jersey	2,332,170	2,123,767	2,227,969	3,834,524	41.90%		58.10%
Bell Atlantic - New England Tel.	3,208,128	3,171,236	3,189,682	5,360,403	40.50%		59.50%
Bell Atlantic - New York Telephone	4,736,261	4,504,160	4,620,211	8,466,391	45.43%		54.57%
BellSouth Corporation	10,956,042	10,872,273	10,914,158	18,922,256	42.32%		57.68%
Southwestern Bell Tel.	6,859,107	6,767,301	6,813,204	12,140,485	43.88%		56.12%
Pacific Bell - California	7,256,863	6,219,442	6,738,153	12,455,234	45.90%		54.10%
Nevada Bell	131,051	157,564	144,308	242,563	40.51%		59.49%
U S WEST Communications	7,849,900	7,852,592	7,851,246	13,559,885	42.10%		57.90%
Alltel of Pennsylvania	122,864	139,319	131,092	203,953	35.72%		64.28%
Alltel Georgia Comm.Corp.	318,638	321,118	319,878	516,654	38.09%		61.91%
The Western Reserve Telephone	97,781	98,544	98,163	162,659	39.65%		60.35%
Cincinnati Bell	450,558	439,587	445,073	725,916	38.69%		61.31%
GTE California, Inc.	2,485,238	2,304,214	2,394,726	4,050,755	39.25%	1.63%	59.12%
GTE-Florida	1,128,465	1,059,805	1,094,135	2,069,183	45.16%	1.96%	52.88%
Hawaiian Telephone	598,623	614,901	606,762	1,217,798	50.18%		49.82%
GTE of The Midwest, Inc.	536,869	516,706	526,788	891,650	40.92%		59.08%
GTE of The North, Inc.	2,404,499	2,427,788	2,416,144	4,217,933	41.80%	0.92%	57.28%
GTE of The Northwest	992,282	1,039,233	1,015,758	1,770,686	42.63%		57.37%
GTE of The South	1,161,033	1,084,540	1,122,787	1,855,064	39.31%	0.17%	60.53%
GTE of The Southwest	1,339,217	1,285,587	1,312,402	2,268,911	41.65%	0.51%	57.84%
Contel of The South dba GTE	116,071	99,539	107,805	186,204	42.10%		57.90%
Contel of Minnesota dba GTE	54,517	59,005	56,761	100,845	43.71%		56.29%
GTE Arkansas, Inc.	70,457	80,832	75,645	151,146	49.95%		50.05%
Aliant Telecommun. Co.	168,271	175,955	172,113	220,533	19.92%	2.04%	78.04%
Rochester Telephone	294,802	352,647	323,725	371,054	12.76%		87.24%
Southern New England Tel	1,276,103	1,256,780	1,266,442	1,969,138	35.69%		64.31%
Sprint - Florida, Inc.	925,800	926,133	925,967	1,453,407	36.29%		63.71%
Carolina Tel & Tel of NC	527,552	534,465	531,009	873,633	39.22%		60.78%
United of the Southeast, Inc.	155,430	163,884	159,657	279,660	42.91%		57.09%
Central-Virginia	140,755	154,139	147,447	260,024	43.29%		56.71%
United Tel of Ohio	281,590	287,349	284,470	473,930	39.98%		60.02%
United Tel of Indiana	101,172	92,997	97,085	158,700	38.82%		61.18%
United Tel of Missouri	155,638	157,426	156,532	284,144	44.91%		55.09%
Central Telephone Co.	1,283,403	1,304,890	1,294,147	1,654,521	21.56%	0.22%	78.22%
United Tel of Texas	91,964	90,707	91,336	154,510	40.89%		59.11%
United Tel of New Jersey	97,421	96,403	96,912	153,854	37.01%		62.99%
United Tel of Pennsylvania	186,731	189,122	187,927	304,167	38.22%		61.78%
United Tel of the Northwest	79,532	89,608	84,570	144,919	41.64%		58.36%
TOTAL	**$71,722,376**	**$69,570,294**	**$70,646,335**	**$123,991,524**	**42.88%**	**0.14%**	**56.98%**

***Source:**

Columns k & l: 1996 and 1997 ARMIS 43-02, Table B-1, Row 440.

Notes:

1) Citizens Telecom of New York was removed because the data, as reported, indicated an implausibly low of Cost of Debt (0.07%).
   Puerto Rico Telephone Company was removed because the data, as reported, indicated an implausibly high Cost of Debt (54.28%) and the majority of its interest expense related to customer deposits.
   Central Telephone of Illinois was removed because the majority of the company was sold to Ameritech in 10/97.
2) United Tel. Of the Northwest, Preferred Stock was deleted from both the industry dividends and the industry 2 year average because dividends could not be calculated in either year.

DISSENTING STATEMENT OF
COMMISSIONER HAROLD FURCHTGOTT-ROTH

Re: ***Prescribing the Authorized Rate of Return for Interstate Services for Local Exchange Carriers and Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 98-166***

I dissent from today's Notice of Proposed Rulemaking initiating a rate of return prescription proceeding for local exchange carriers (LECs) still subject to rate of return regulation and proposing corresponding changes to the price cap regulatory regime. On several occasions, I have expressed my continued concern with the Commission's micromanagement of LECs in general. The Commission's authority to prescribe new rates for the LECs still classified as dominant carriers and to propose changes to the low-end adjustment for price cap LECs is a mere vestige of outdated rate of return regulation. In today's increasingly competitive environment, the Commission should be focusing its efforts on transitioning to a more competitive environment for both rate of return and price cap LECs.

For example, I note that the Commission has initiated a proceeding to modify the access rules of the rate of return LECs in some minor ways to conform to the price cap rules; I supported that proceeding. In contrast, I believe that today's proceeding merely perpetuates an outmoded form of regulation. The Commission's resources would be better spent pursuing the subsequent phases alluded to in our earlier proceeding that would afford additional pricing flexibility to these carriers and propose alternative regulatory regimes that would offer additional incentives for rate of return LECs to become more efficient.

Moreover, the amount of detailed information and regulatory scrutiny required under our current price cap rules is inordinate and should be reduced. This seemingly anachronistic regulatory regime should be reformed to provide further pricing flexibility, eliminating altogether such relics as the low-end adjustment. I continue to await anxiously the opportunity to address more fully these issues and the circumstances under which dominant LECs should be accorded a simpler form of price cap regulation.

I am becoming increasingly convinced that the current regulatory mechanisms -- and certainly the level of detail -- are no longer necessary in today's increasingly competitive environment. We must develop a more forward-looking blueprint to guide the transition from regulation to competition. As I have stated previously, regulation is merely designed, to the extent possible, to replicate a competitive marketplace, but any form of regulation is an imperfect surrogate for full-fledged competition. I believe the Commission should be at least considering even further deregulation so that these cumbersome regulations are unnecessary.