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

In the Matter of Access Charge Reform	)	**CC Docket No. 96-262**
In the Matter of Price Cap Performance Review for Local Exchange Carriers	)	**CC Docket No. 94-1**
In the Matter of Consumer Federation of America, International Communications Assoc., and National Retail Federation Petition Requesting Amendment of the Commission's Rules Regarding Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers	)	**RM No. 9210**

REPLY COMMENTS OF CINCINNATI BELL TELEPHONE COMPANY

Cincinnati Bell Telephone Company ("CBT"), an independent, mid-size local exchange carrier, files these reply comments in response to the Commission's October 5, 1998 Public Notice and to initial comments filed in the above-referenced proceeding. In the Public Notice, the Commission directed parties to update and refresh the record on access charge reform, pricing flexibility and the proper X-factor. In this reply, CBT primarily addresses AT&T's comments regarding CBT's Petition for Reconsideration ("PFR") of the 6.5% X-factor for mid-size LECs as well as parties' claims that LEC interstate earnings justify a higher X-factor.

I. AT&T'S COMMENTS FAIL TO REFUTE CBT'S CONTENTION THAT A SEPARATE, LOWER X-FACTOR IS JUSTIFIED FOR MID-SIZE LECS.

In its comments, AT&T once again contends that there is no substantive basis for setting a separate, lower X-factor for elective price cap LECs.[1] AT&T adds nothing new to the record, except to cite CBT's reported interstate rate of return for 1997. AT&T's arguments are as misplaced and self-serving now as they were when first made in this proceeding. Furthermore, the level of CBT's earnings is irrelevant to whether a separate, lower X-factor is justified for CBT and other mid-size LECs.

There is ample evidence in the record of these proceedings that a separate, lower X-factor is justified for mid-size LECs. As CBT indicated in its PFR, the Commission has repeatedly acknowledged that there are differences between the large and small LECs that indicate a lower X-factor is warranted for the smaller companies. CBT has already demonstrated that AT&T's contention that the Commission has rejected these differences is without merit. CBT will not reiterate its reply to AT&T's contention here, but rather refers the Commission to its Reply to AT&T's Opposition.[2] In addition, since the submission of CBT's PFR, additional evidence has been added to the record further substantiating the justification for a lower X-factor for mid-size LECs.[3]

In its Reply to AT&T's Opposition, CBT also addresses AT&T's claim that CBT's election of price caps, after adopting the 6.5% X-factor, implicitly suggests that a 6.5% X-factor is correct. As CBT stated in its Application for Special Permission[4] and further explained in its PFR, the Commission's decision to delay access reform for non-price cap LECs, concurrent with the

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[1] AT&T Comments at p. 15.
[2] See, CBT Reply to Opposition to Its Petition for Reconsideration of the Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Report and Order, filed September 3, 1997.
[3] See, Ex Parte on CC Docket No. 94-1, filed by the Independent Telephone and Telecommunications Association on May 14, 1998.

development of competition in CBT's territory, left CBT with little choice but to elect price caps in spite of the onerous 6.5% X-factor. The only way for CBT to avail itself of the new, more economically efficient access rate structure was to become a price cap LEC.[5]

II. THE PRICE CAP SYSTEM IS WORKING AS INTENDED

A. Earnings Are Irrelevant in a Price Cap System

AT&T and MCI WorldCom ("MCI") contend that because LEC interstate earnings are above the 11.25% rate of return prescribed for rate-of-return LECs, the productivity factor should be increased to drive price cap LEC earnings back to 11.25%. This suggestion should be rejected. To agree with AT&T and MCI's suggestion would be to reimpose rate-of-return regulation on all carriers. The basic premise of price cap regulation is to encourage carriers to become more productive by allowing them to retain profits at levels above what is prescribed for rate-of-return carriers. Taking away the incentive to improve productivity would undermine the primary objective of price cap regulation. This in turn would stymie price cap LECs' investment in their local networks and hamper their ability to offer new and innovative products and services. As the Commission itself has observed, "(i)ncentive regulation, by creating incentives for carriers to become more productive, generates powerful motives to innovate."[6]

The parties that advocate increasing the X-factor to reduce LEC profits have only one self-serving motive (i.e., to further enrich their shareholders). As evidenced by the apparent failure of IXCs to pass through the access rate reductions of the past two years to their customers, very little, if any, of the suggested X-factor increase would benefit consumers. The Commission's job is not to

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[4] See, CBT Application for Special Permission No. 118 filed June 13, 1997.
[5] Over 18 months have passed since the Commission revised the access charge structure for price cap LECs, and the Commission has not yet adopted an access reform plan for non-price cap LECs.
[6] Policy and Rules for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, Released October 4, 1990, at para. 32.

redistribute wealth, but to protect the public interest by ensuring that common carriers operate in a just, reasonable and nondiscriminatory manner until the competitive marketplace can serve that function. Price cap regulation is designed to replicate the competitive marketplace. In a competitive marketplace, firms that are more efficient than the average in the industry earn higher profits than less efficient firms. Even AT&T recognizes that "...any attempt to eliminate or recapture the profits resulting from such higher efficiency would not only breach the promise of price cap regulation, but destroy the incentive to make the difficult decisions necessary to yield additional efficiency gains in the first place."[7] A competitive marketplace does not dictate a prescribed rate of return; nor should the Commission.

AT&T also cites the LECs' interstate rate of return, as reported on Form 492, as justification for an increased productivity factor. Earnings reports are based upon accounting costs rather than economic costs and, therefore, are inappropriate tools for analysis of a price cap regime. As noted above, price cap regulation is designed to replicate a competitive environment that operates based upon economic costs. By eliminating sharing in the price cap plan, the Commission recognized the problems inherent in continuing to measure accounting returns under a price cap regime intended to facilitate the "competitive paradigm of the 1996 Act."[8]

B. There Is No Economic Rationale for an Interstate-Only X-Factor

AT&T and MCI also contend that the true average productivity factor for the LEC industry is in the range of 9.2 to 10 percent. AT&T arrives at this range by an approach contrived solely to

[7] See, AT&T Comments in Price Cap Performance Review for AT&T, CC Docket No. 92-134, filed September 4, 1992.

[8] CC Docket No. 94-1, Fourth Report and Order, at para. 152.

achieve what it has determined to be an appropriate rate of return for LECs. AT&T continues its attempt to introduce an interstate-only productivity offset using the same argument with updated numbers, but no differences in methodology or logic. The Commission has previously recognized that interstate and intrastate services are generally provided over common facilities and that there is no way to quantify any differences in productivity growth, even if a logical explanation for such differences existed.[9] As USTA explains, because the inputs of telecommunications firms are not deployed by jurisdiction, any claims regarding interstate productivity are not meaningful.[10]

C. Access Charges Are Falling

In spite of AT&T's and MCI's attempts to justify additional access charge reductions through their disingenuous examination of LEC earnings and their suggestion to introduce an interstate-only X-factor, the basic fact remains (i.e., that the current price cap regime is reducing access charges while still providing incentives for LEC investment and innovation). As USTA's comments indicate, access charges for price cap LECs have fallen a cumulative $11 billion since 1990, when price cap regulation was first implemented. CBT's access charges have dropped by over $43 million since July of 1993. Of that total reduction, $25 million relates to interstate access while $18 million relates to intrastate access. Almost one-half of CBT's interstate reduction has occurred since July 1, 1997, when CBT elected price cap regulation. Moreover, in its recent Ohio alternative regulation plan, CBT agreed to implement further significant reductions in its intrastate access charges. The current price cap plan will force additional reductions in access rates, as intended. In fact, CBT anticipates that its per minute access rates will reach economically efficient levels in 2000, well in advance of the Commission's scheduled review in 2001. This underscores the need for the

[9] CC Docket No. 94-1, Fourth Report and Order, at para. 107-111.
[10] USTA Comments, at pp. 24-26.

Commission to promptly implement a pricing flexibility plan to enable carriers to price their services according to market conditions.

While these reductions are being implemented, universal service goals continue to be maintained and enhanced. CBT's contribution increased from $2.9 million for long-term support to $5 million under the new interim universal service plan. Until the new universal service plan is implemented, removing all remaining subsidies in access rates, it would be inappropriate to prescribe additional access charge reductions. Doing so would endanger the attainment of various universal service goals.

In addition to providing for access charge reductions while maintaining universal service, the current system benefits customers in other ways. First and foremost, CBT's customers have received exceptional service quality. CBT has been ranked by J. D. Power and Associates as the number one independent LEC in the country in customer satisfaction for the past two years.[11] CBT's customers also have benefited from CBT's state-of-the-art network. For example, CBT’s network is almost 100% digital and CBT was one of the first LECs in the country to introduce SONET technology. Similarly, just this past month CBT introduced ADSL service, becoming one of the front runners in the industry to offer dramatically increased bandwidth to its customers. Furthermore, since 1997, CBT has significantly increased construction spending. In fact, construction spending for 1997 and 1998 accounts for approximately 30% of total spending from 1990 to 1998.

CBT's strong performance over the past few years is due in part to the strong economy and in part to its ability to achieve efficiency improvements. To penalize CBT and its customers by prescribing access charge reductions designed to drive earnings down to 11.25 percent or lower would be entirely contrary to the theory of price cap regulation. Furthermore, several factors lead to the conclusion that a 6.5% X-factor is inappropriate for CBT. First, as noted in the SPR study accompanying CBT's PFR, a low-cost company like CBT will have a more difficult time achieving further productivity gains than less efficient companies.[12] Second, as a result of the strong national and local economies, CBT has experienced strong access line growth and minutes of use ("MOU") growth over the past few years. However, with an expected economic slowdown, this growth is not expected to be as robust in 1998. Mid-size companies like CBT are often more susceptible to downturns in the economy due to their limited size and resources. For example, during the 1991 recession, CBT's rate of return dropped to about 9% and SNET, which was already under price caps, filed for a low-end adjustment. These impacts are further exacerbated in CBT's case because it operates in a single, compact geographic area.[13] Finally, competition is likely to have a more significant impact on mid-size LECs, particularly one like CBT operating in a single urban area. In addition to bearing the impact of competition on its entire geographic market at one time, CBT has borne the full costs of complying with the mandatory market-opening provisions of the 1996 Act.

III. CONCLUSION

All of the factors discussed above will influence CBT's ability to maintain the 6.5% productivity growth established by the Commission. As CBT and others have repeatedly demonstrated, a separate, lower X-factor is warranted for mid-size LECs. Under price cap

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[11] J.D. Power and Associates 1997 Residential Local Telephone Study, released August 18, 1997 and the 1998 Study released August 6, 1998.

[12] "One Size Does Not Fit All: The Inadequacy of a Single X-Factor for All Price-Cap Companies" Jeffery H. Rohlfs and Kirsten M. Pehrsson submitted on July 11, 1997 as an attachment to CBT's PFR at p. 7.

[13] CBT's territory is only 2,400 square miles, covering a single LATA and covering a single MSA.

regulation, there is no economic rationale for tying the level of the X-factor to LEC earnings. This would eliminate the incentives that are crucial to the effective and efficient operation of price cap regulation, and would constitute a return to rate-of-return regulation.

Respectfully submitted,

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