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NOVEMBER 19, 1998

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OFFICE OF THE SECRETARY

Magalie R. Salas, Esq.
Secretary
Federal Communications Commission
1919 M St., NW, Room 222
Washington, DC 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments in CC Docket No. 94-1

Dear Ms. Salas:

I have enclosed, pursuant to the Commission's ex parte rules at 47 C.F.R. § 1.1206(a)(1) and § 1.1206(b)(1), an article sent to the persons designated in the attached letters and related to the above-captioned proceeding.

Please let me know if you have any questions.

Sincerely,

Gregory Vogt

Enclosures: "Cap-Sized: How the Promise of the Price Cap Voyage to Competition Was Lost in a Sea of Good Intentions" (2 copies).
Cover letters to 15 FCC staff members (2 copies).

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November 19, 1998

Kathryn C. Brown
Chief of Staff
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear Ms. Brown:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

Because the article is related to ongoing FCC proceedings, I have included a copy in relevant FCC dockets in order to comply with the ex parte rules. Please let me know if you have any comments or questions.

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November 19, 1998

James L. Casserly
Senior Legal Advisor to Commissioner Ness
Federal Communications Commission
1919 M Street, N.W., Room 832
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Casserly~~ Jim:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Kyle D. Dixon
Legal Advisor to Commissioner Powell
Federal Communications Commission
1919 M Street, N.W., Room 844
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Dixon~~ Kyle:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Paul Gallant
Legal Advisor to Commissioner Tristani
Federal Communications Commission
1919 M Street, N.W., Room 826
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Gallant~~ Paul:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Jane E. Jackson
Chief, Competitive Pricing Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 518
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Ms. Jackson~~ Jane:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Kevin J. Martin
Legal Advisor to Commissioner Furchtgott-Roth
Federal Communications Commission
1919 M Street, N.W., Room 802
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Martin~~ Kevin:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Kenneth P. Moran
Chief, Accounting Safeguard Division
Federal Communications Commission
2000 L Street, N.W., Room 812
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Moran~~ Ken:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Thomas C. Power
Legal Advisor to Chairman Kennard
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Power~~ Tom:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

William P. Rogerson
Chief Economist
Federal Communications Commission
1919 M Street, N.W., Room 838-D
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear Mr. Rogerson:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Dr. Robert Pepper
Chief, Office of Plans & Policy
Federal Communications Commission
1919 M Street, N.W., Room 822
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Bob

Dear ~~Dr. Pepper~~:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

James D. Schlichting
Deputy Bureau Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 500
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Schlichting~~ Jim:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Lenworth Smith
Branch Chief, Legal Branch
Competitive Pricing Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 528-B
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Smith~~ Len:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Steven Spaeth
Attorney Advisor, Legal Branch
Competitive Pricing Division
Federal Communications Commission
1919 M Street, N.W., Room 518
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Spaeth~~ Steve:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Donald Stockdale
Chief Economist and Associate Bureau Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 500
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Stockdale~~ Don:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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November 19, 1998

Lawrence E. Strickling
Bureau Chief, Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 500
Washington, D.C. 20554

Re: Ex Parte Presentation regarding Public Notice requesting updated comments on Access Charges

Dear ~~Mr. Strickling~~ Larry:

Enclosed is a copy of an article that I prepared that might be of interest to you. In particular, it has relevance to the recent public notice seeking updated comments on access charges, including the price cap X-factor, in CC Docket Nos. 96-262, 94-1 and 97-250. Based in part on my own Commission experience in helping to implement price caps, the article evaluates the last eight years of LEC price cap regulation. The article concludes that, although progress has been made, certain important adjustments should be implemented to allow price caps to achieve their full potential. These changes are consistent with the original theory of price caps and will help speed the transition to competition.

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CAP-SIZED: HOW THE PROMISE OF THE PRICE CAP VOYAGE TO COMPETITION WAS LOST IN A SEA OF GOOD INTENTIONS

by Gregory J. Vogt[1]

[1] Gregory Vogt is currently a partner of Wiley, Rein & Fielding practicing in communications law. From 1992 - 1994 he was responsible for AT&T and LEC price cap implementation, as well as beginning the first four-year review of LEC price caps as chief of the Tariff Division, Common Carrier Bureau, Federal Communications Commission and otherwise spent 14 years at the FCC as Chief of Enforcement and Mobile Services Division and Deputy Chief of the Cable Services Bureau. I would like to thank R. Michael Senkowski, head of Wiley, Rein & Fielding's telecommunications practice, for his advice and assistance. I would also like to acknowledge the substantial contributions to this article of Bryan N. Tramont and Howard Radzely, both associates at Wiley Rein & Fielding. In addition, I would like to thank three of the Firm's 1998 summer associates, Chandra Mitchell, Robert Rogers and Joshua Turner. Without their tireless efforts, this article would not have been possible. The views expressed in this article are entirely my own. Wiley Rein & Fielding does represent local exchange carriers on price cap issues.

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Introduction

The "telecommunications revolution" has moved from cliché to reality. It is now transforming how people live and work. Telephone service is now available through a computer terminal over the Internet, through wireless handsets, and through good old fashioned wireline telephones. And service is now available from more providers than ever: competitive carriers now challenge the long distance, local, and even Internet incumbents with aggressive pricing and innovative products. Thousands of new competitive players have entered the communications arena, an industry that is now worth more than $298 billion annually in the United States alone.[2] This revolution is worldwide, promising to bring the world closer together through communications that are faster, cheaper and more reliable.

As this revolution, fueled by amazingly rapid technological advances, transforms our lives, regulators face a difficult task. They must ensure that government rules do not fall behind the swiftly advancing technology and marketplace, lest regulation frustrate these advances that give consumers needed services at reasonable prices.

Against this backdrop of revolutionary change and regulatory challenge, the Federal Communications Commission (hereinafter "Commission" or "FCC") has struggled with the regulation of rates, termed access rates, charged by local telephone companies to long-distance carriers needing to interconnect to local networks. All too often, the task has involved an anachronistic regulatory regime that is being rapidly outdated by marketplace developments.

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[2] $298 billion figure is for 1996. JOHN W. WRIGHT, THE NEW YORK TIMES 1998 ALMANAC 787 (1997).

Eight years ago, the FCC began to discard its largely discredited rate regulation scheme by adopting market-based reforms. It abandoned older style, cost-plus rate-of-return regulation in favor of "price cap" regulation of "access charges,"[3] which focused on prices and created incentives for telephone companies to innovate and become more efficient. "Price caps" are a system in which regulators set a maximum cap on prices for a certain service, and the cap is reduced each year by a set amount based on estimated improvements in efficiency. Local exchange carriers support price cap regulation because it allows them to charge the cap price even if the actual cost of providing the service is substantially lower, thus potentially leading to higher profits. Regulators like the price cap regime because it consistently reduces access charges. Despite eight years of tinkering, the FCC continues to try to get these new price cap regulations "right," while controversy rages among local telephone companies, long distance carriers, customers, and regulators concerning the scope and necessity of the FCC's regulatory regime.

This article analyzes the last eight years of experience under price cap regulation and evaluates what has gone right and wrong. Although price cap regulation has produced reduced rates to long-distance carriers (though not necessarily to long-distance customers) and more efficient pricing than under rate-of-return regulation, it has ultimately fallen victim to incessant tampering and lagged far behind marketplace changes.

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[3] "Access charges" are the fees that long distance carriers pay to local telephone companies for use of their networks to complete long distance calls and comprise some 40 percent of long distance carrier costs.

Perhaps the most troubling aspect of the Commission's price cap regulatory regime is that the FCC has not allowed price caps to function free of tampering. The entire premise of the price cap regime is that by placing a cap on prices, local carriers will have an incentive to improve efficiency beyond those mandated by the caps themselves, because, unlike under rate of return regulation, carriers can keep the profits. The FCC has undermined these very advantages by reinserting vestiges of rate-of-return regulation into the new system and permitting external political factors to impact its price cap decisions. First, the Commission has repeatedly imposed retroactive adjustments to the price cap indices in order to "correct" "underestimates." Second, the Commission has repeatedly revised the productivity factor upwards and maintained a non-efficiency based add-on to determining the factor. Third, the calculation formula for the X-factor itself has been quite arbitrary, each time generating charges that the changes were politically motivated or result-driven. Using high earnings to justify a higher X-factor is, in effect, back door rate of return regulation, a result the FCC said it was trying to avoid. Finally, the FCC has never adopted a "pass through" requirement that would mandate that long distance carriers pass along price reductions generated by price caps to consumers. Absent such a requirement, the Commission has struggled to broker side deals with long distance carriers that insure consumers benefit from these reductions.

Each of these four departures from price cap principles has undermined the fundamental premise of the regulatory program; namely, to permit price cap carriers to keep higher-than-expected productivity gains as profit, as an incentive to improve efficiency, while at the same time reducing consumer prices. Instead, the Commission, as if it were still functioning under a

rate of return regime, has looked to the company's ultimate rate of return, determined that the rate was too high, and then adjusted the price caps to eliminate some of these gains, while struggling to find ways to prompt consumer rate reductions. Although these changes have all been well-intentioned, they have ultimately helped to sink the very ship they were designed to save. If the ship is to be righted and the voyage to full competition resumed, the Commission should return to its original price cap principles by adopting a series of course corrections that will enable all parties to thrive.

Until the voyage to competition is complete, the Commission should adopt the following reforms to ensure that the public realizes the full benefits of price caps:

- simplify and maintain X-factor principles over the long haul to create firm LEC incentives to become more efficient;
- refrain from political tinkering with X-factor or retroactive adjustments in the cap that deny LECs the benefit of their bargain by using a moving historical average to compute X-factor charges;
- eliminate the consumer product dividend so that the cap reflects actual achievable efficiency gains;
- adopt an explicit pass through requirement that will require long distance carriers to pass through price cap reductions to consumers;
- provide pricing flexibility to allow the caps to function more like free markets; and
- permit new services to be offered outside the caps to encourage innovation and recognize the markets that now exist for these services.

Only when a consistent and predictable price cap system is in place will the goals of creating market-based incentives for improved efficiency be achieved and the process depoliticized. As set forth below, such a price cap course is consistent with the initial stated goals of price cap

regulation and best positions the Commission for the eventual transition to a free competitive market for these services.

This article lays out the case for these reforms based on the initial price cap theory and the evolving state of the telecommunications marketplace. Section I presents different models of regulating local exchange carriers, describing the difficulties with the old rate-of-return system and the theoretical advantages of a price cap regime. Section II explains how the FCC's creation of a price cap plan in 1990 contained modifications to address the perceived shortcomings of a pure price cap system. Section III describes the many subsequent modifications the FCC made to its original 1990 plan. Section IV details the experiences of various states with price cap systems, including the progressive reforms by states like California that have been responsive to market and regulatory developments. Finally, section V evaluates the current price cap system, discussing both its advantages and shortcomings and sets forth recommendations designed to allow price caps to achieve their full regulatory potential.

I. History of Local Exchange Carrier Regulation.

To furnish long distance telephone service, providers such as AT&T need to connect to local networks, which are owned and operated by Local Exchange Carriers ("LECs"), such as US West.[4] Before the advent of the modern telecommunications revolution, it was widely believed

[4] We sometimes refer to long-distance carriers by their more technical name "interexchange carriers" or "IXCs," reflecting that such carriers must transfer a call over both local and long-distance networks in order to connect a long-distance call.

that telephone service was a natural monopoly, especially local telephone service, which required a connection to each individual customer's residence or business.

Initially, because AT&T had a monopoly in the provision of both local and long distance services, the FCC relied upon informal negotiated ratemaking it termed "continued surveillance." In the 1960s with the advent of some competition in the local market, the FCC turned to rate-of-return regulation, a widely used means of regulating industries with limited competition, in order to control the amount that could be charged by LECs for allowing a long-distance call to go over the local network. More recently, as the idea that telephony is a natural monopoly has been discarded in the face of technological advances, regulators have considered alternative means of regulating rates charged by LECs to IXCs for interconnecting long-distance calls with the local networks. Two of the more prominent and more promising means of regulation are Social Compacts and Price Caps. This section describes the FCC's historical regulation of "access charges."

A. The Agency's Early Efforts to Regulate the Telephone Industry Focused on the Rate of Return Model.

1. The Commission Attempted to Effectively Regulate AT&T's Monopoly in Long-Distance and Local Telephone Services.

Before the mid-1960s, regulation of the telephone industry was relatively straightforward. AT&T was the sole provider of interexchange services, and thus the only company that the FCC had to regulate. It was widely believed that the provision of telephone services constituted a

natural monopoly,[5] an industry where the entire market demand can be met at the least cost by a single firm,[6] because, among other things, the cost of entering the market and of laying new telephone lines was considered prohibitively expensive. Congress itself readily accepted the belief that substantial technological barriers to entry in the telephone industry rendered the Bell System such a natural monopoly.[7]

Given this widely held view that the telephone industry was a natural monopoly, the FCC's regulatory policy in this era aimed at increasing efficiency, limiting consumer costs, and ensuring universal access to telephone services. It did not give any thought to increasing competition. As one commentator observed of the FCC's approach: "Where such conditions prevail, competitive entry, at least in theory, will prove short-lived, thereby wasting scarce resources. However, to prevent an unreasonable rise in prices and reduction in quality of service,

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[5] There have been disputes between economists as to whether the structure of the telecommunications was indeed a natural monopoly. *See, e.g.*, MORTON I. HAMBURG ET AL, COMMUNICATIONS LAW AND PRACTICE, (Law Journals Seminars - Press, 1998); Howard Griboff, *New Freedom for AT&T in the Competitive Long Distance Market*, 44 FED. COM. L.J. 435, 438 n.9 (May 1992) ("In the case of the phone system, regulatory, economic, and technological barriers to competitive entry helped AT&T maintain its market dominance and 'monopoly' status.")

[6] Walter G. Bolter et al, TELECOMMUNICATIONS POLICY FOR THE 1980S: THE TRANSITION TO COMPETITION 31 (Prentice Hall, Inc. 1984).

[7] *See* Dean Burch, *Common Carrier Communications by Wire and Radio: A Retrospective*, 37 FED. COMM. L.J. 85, 88 (1985).

as is customary with unregulated monopolies, the FCC maintained 'continued surveillance' of the rates charged and the services provided through a tariffing mechanism."[8]

In developing a telecommunications regulatory model, the FCC looked to other agencies responsible for regulating industries that were deemed natural monopolies, such as the electric utilities.[9] Accordingly, the Commission used rate base regulation, the same tool historically used to regulate other public utilities.[10]

Initially, the rate-setting process between the FCC and AT&T was relatively informal. From 1934 to 1965, under a program labeled "continued surveillance," the FCC and AT&T essentially engaged in an informal process of rate-making.[11] As one scholar described the situation:

> In effect, continuing surveillance consisted of private negotiations between AT&T and the FCC concerning the level of interstate rates and aggregate revenues . . ..During the early 1960s, the FCC through continuing surveillance process, set an informal limit for the return on AT&T's investment at approximately 8%. When AT&T's rate of return approached this percentage, the FCC and AT&T would initiate negotiations that were often followed by reductions in interstate rates.[12]

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[8] Sutapa Ghosh, *The Future of FCC Dominant Carrier Rate Regulation: The Price Caps* Scheme, 41 FED. COMM. L.J., 401, 403 (1989).

[9] Like the telephone company, the electric companies provided service through a wire connection to each customer.

[10] Bolter, *supra* note 6, at 31.

[11] Bolter, *supra* note 6, at 27.

[12] *Id.*

a) The Emergence of Formal Rate-of-Return Regulation.

By the mid-1960s, however, the telecommunications industry began to change. Emerging technologies such as computers, microchips, and microwave transmission began to create for the first time a real possibility for the formation of a truly competitive telecommunications market. The traditional belief that the telephone sector was a natural monopoly began to seem doubtful in light of technological advances such as microwave technology. Given this new potential, regulators began to wonder if a monopolistic interexchange system was the best means of providing uniform and universal service.[13] Moreover, the FCC realized that negotiated informal ratemaking was no longer the best means of regulating a market which could, in some aspects, be competitive.

Despite the promise of new technology, the FCC feared that AT&T's vast resources and dominance would preclude the entry of competitors.[14] Indeed, only small parts of AT&T's monopoly were believed to be in areas where competition was viewed as possible in the near future. The main such area was the long distance market. Consequently, in 1967, the agency instituted a series of new regulations designed to prevent AT&T from cross-subsidizing competitive services with monopoly revenue to gain an unfair competitive advantage.[15] These

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[13] Ghosh, *supra* note 8, at 404.

[14] *Id.* at 402.

[15] *Id.* (the main objective being "to deter AT&T from shifting revenue from services on which it held market dominance to emerging services on which it faced competition").

new regulations served as the agency's formal implementation of the rate-of-return regulatory strategy.[16]

Rate base regulation, commonly referred to as rate of return regulation (ROR), was a ratemaking instrument of public utility commissions. Its purpose was to protect the consumer from excessive costs, while ensuring that investors received a fair return on their investments. As one commentator described the system:

> Regulators replace the market as the enforcer of economic efficiency by establishing the cost structure considered most representative of costs in a competitive market. Establishing prices involves negotiation between the regulated company and the regulators, with the final figure usually being a compromise between a competitive market and monopoly pricing. Once the cost structure has been established, the regulators must ensure the economic viability of the essential service provider by adding a pre-set rate of return on invested capital.[17]

Accordingly, public utility commissions and carriers were expected to work together to determine the rates that regulated companies would charge to American consumers. To pass constitutional muster, the determined rates had to be 1) 'just and reasonable' and 2) balance the interests of the investor and the consumer,[18] but these broad standards allowed the regulatory

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[16] Patricia Margiotta, *The Local Exchange Carrier Price Cap Order*, 63 GEO. WASH. L. REV. 723, 724 (1996).

[17] Robert B. Friedrich, *Regulatory and Antitrust Implications of Emerging Competition in Local Access Telecommunications: How Congress and the FCC Can Encourage Competition and Technological Progress in Telecommunications*, 80 CORNELL L. REV. 646, 689-90 (1995).

[18] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

commissions considerable flexibility to work with the businesses to reach a desired rate of return.[19]

Designed to foster competition in some market segments and to sustain sufficient monopoly revenues in others, rate-of-return regulation involved a complex series of calculations that carefully examined a telecommunications carrier's revenue and expense structure to determine an "optimal" rate of return. Each local exchange carrier ("LEC") was required to provide a detailed cost of service analysis covering the previous twelve months.[20] These analyses attempted to determine the total value—or cost—of the expenditures necessary to provide phone service. This information would help inform the FCC of the actual cost of providing telephone service. After ascertaining this value, the agency limited the service provider in question to a specified percentage return on its investment. To increase rates above the authorized level, carriers had to file additional documentation justifying the need for increased rates. Such documentation included "a projection of costs study, complete explanations for the studies and data, and any other relevant cost or marketing data."[21]

Under this framework, the "correct" rate of return promised to provide consumers with expanded telephone services at reasonable rates. Additionally, the rate would also satisfy the

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[19] As one commentator noted, "the process of setting a 'fair' rate of return is a difficult one. If set too low, investors could be deterred and the regulation could constitute an unconstitutional confiscation of earned revenue. On the other hand, if set too high, consumers would pay inflated prices that would not reflect the quality of the services provided." Ghosh, *supra* n. 8, at 406.

[20] Hamburg, *supra* note 5, at 4-39. *See also* 47 C.F.R. §§ 61.38 (b).

[21] Hamburg, *supra* note 5, at 4-39.

service providers by allowing them to cover their costs and achieve a reasonable return on their investment.

2. Rate of Return Regulation Is Inherently Inefficient in Mature Competitive Markets.

In the beginning of telecom regulation, the benefits of a rate-of-return policy outweighed any apparent disadvantages. Aided by declining costs, telephone service increased exponentially, and carriers received a healthy return on their investments.

Nevertheless, problems developed. The cost-plus strategy implicit in rate of return regulation, combined with difficulties of administration, eventually undermined the system's benefits. Carriers had little incentive to invest in a way that increased efficiency and regulators feared that carriers were padding their books with the assurance of full recovery plus profit. Moreover, the birth of the competitive marketplace ushered in the demise of a rate of return approach.

a) Rate of Return – Essentially a "Cost-Plus" Contract.

A rate-of-return regulatory strategy is analogous to a cost-plus contract, with all its attendant shortcomings.[22] A cost-plus contract usually begins with an estimate of actual production costs, but the estimate is not binding. Rather the buyer agrees to reimburse all costs actually incurred by the seller, and to add an appropriate profit margin.[23] The FCC itself

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[22] *Policy and Rules Concerning Rates for Dominant Carriers (Part One of Two)* (Further Notice of Proposed Rulemaking), 3 FCC Rcd 3195, 3222 (1988) *("Dominant Carriers FNPRM").*

[23] *Id.*

observed these parallels between rate of return and cost-plus contracts, stating that "rate-of-return is analogous to a cost-plus contract, since all costs that can reasonably be represented as necessary to production generally become part of the firm's revenue requirement and are collected from ratepayers."[24] Thus, unlike in a normal market, little incentive exists to reduce production costs.

As public utilities under the rate-of-return system, the amount of money that LECs spent delivering services was divided into two categories: costs and investment.[25] Traditionally, public utilities were allowed to set rates up to an amount that recovered costs on a dollar-for-dollar basis, plus a reasonable rate of return on the amount invested. The simplified basic formula is thus Rate = C + I(R), where C is costs, I is investment, and R is the rate of return.[26]

Assigning numbers to this formula shows why, under a rate-of-return system, the utility may have a disincentive to become more efficient. Imagine that Company A supplies telecommunications services, and has invested $100 in infrastructure overall to do so. In addition to its investment, the company spends $100 a year on costs, such as salaries for its employees. Here, if the set rate of return was 10%, the utility would be able to charge up to $110

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[24] *Id.*

[25] *See FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[26] *Id.*

when it first offers its service; $100 to recover actual costs (salaries), and $10 as a 10% return on its $100 investment. [27]

If Company A became more efficient by reducing salaries, it would not benefit at all. The savings would be passed directly on to the consumers, as the company is only allowed to charge for actual expenses. So in this example, if Company A's costs dropped from $100 to $80, the maximum allowable rate would drop to $90. An increase in costs would also be passed directly through to consumers, so if Company A's staffing costs grew to $150, the company could charge $60. This meant that the utility faced neither positive pressure to decrease costs nor negative pressure against cost increases.

The utility may also seek to become more efficient by decreasing the level of investment necessary to provide the same amount of service. Digital switches, for example, are much less maintenance intensive than electro-mechanical units, and their installation may thus reduce the overall amount that Company A has to spend on infrastructure. Under rate of return, the gains of that efficiency increase would have to be passed on to consumers.[28] In this example, a 10% reduction in the amount spent on infrastructure would reduce the company's overall investment to $90, but because the company is allowed to make at most a 10% return on investment, the utility would have to lower its prices to $109, or $100 in costs plus a 10% rate of return of $9.

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[27] Since investment is net of depreciation, these figures change during subsequent years. The annual depreciation expense is added to costs. For simplicity, we ignore these effects in this example.

[28] *See* Ghosh, *supra* note 8, at 411.

Thus, the utility's total profit can actually decrease, the more efficient that the company becomes.[29]

That the utility can earn more overall profits by increasing its investment also may lead to what some have called "gold plating." This is the alleged practice of using higher quality or capacity infrastructure than is necessary to provide the required service to increase the utility's amount of investment and thus its total profits.[30] A telecommunications firm, for example, might use expensive large capacity switches in an area where lower capacity, lower cost switches or remote nodes would perform just as well. While the rate of return that the company can earn does not change, the company will be earning that rate on a larger amount of invested dollars, and thus have higher total profits. Regardless of the prevalence of gold plating, the risk of such behavior pointed out the perverse incentives created by a rate of return system. In addition, oversight to prevent such potentialities was complex and expensive, imposing a large burden on both the companies and the government, and the system still failed to provide positive incentives for utilities to reduce costs.[31]

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[29] Of course, a utility's incentive to reduce investment costs will be heavily dependent on the return it could earn in alternative investments. Thus, if the return set under ROR were too high, the incentive to "gold plate", or to install higher quality or capacity infrastructure than needed, would increase. At the same time, if the return set under ROR were too low, there would be little incentive to gold plate because the utility could earn a greater return on alternative investments.

[30] *See supra* at n. 29.

[31] *Policy and Rules Concerning Rates for Dominant Carriers* (Second Report and Order), 5 FCC Rcd 6786, 6790 (1990) *("Second Report and Order").*

b) High Levels of Administrative Involvement and Oversight.

In addition to distorting natural economic incentives, rate-of-return regulation also created administrative difficulties. The actual process of calculating the appropriate rate of return detracted from the successful implementation of the policy. The divestiture of AT&T, combined with the rise of over 1300 access providers, made the rate-of-return regulatory scheme cumbersome and difficult to administer. As the agency explained, "When rate of return was applied by the Commission to interstate telephone operations in the 1960s, the regulatory environment in which it was introduced was vastly different from today. In 1965, rate of return needed to be applied only to one telephone services provider — AT&T. . . . Today, we operate in a much more complex environment. . . . For the first time, the Commission had to apply its rate of return mechanisms directly to 1400 providers of access."[32]

In this complex environment, effective cost of service analysis — to say nothing of extensive monitoring for gold-plating and cost-padding — was a difficult and time-consuming task. The Commission soon realized that the administrative maintenance of such a system exacted high costs and potentially harmed the market for telephone services. Although the agency performed such tasks, the costs both to the agency and to the public were high. The FCC ultimately concluded that its experience revealed that, while "rate of return oversight is a responsible, functional method of correcting for these [unsavory] tendencies . . . , a regulatory

[32] *Id.*

system that simply corrects for a tendency to pad investments or expenses is not a system that can also drive LECs to become more efficient and productive."[33]

The mounting concerns about rate-of-return regulation were becoming more acute with the rapid changes occurring throughout the national and international telecommunications markets. The Commission stated that it was "concerned that, particularly for the largest LECs, the system of regulation we currently employ does not serve to sharpen the competitiveness of this important segment of the industry at a time when markets for telecommunications goods and services are becoming increasingly competitive, both nationally and internationally."[34] Facing significant technological advances and potential international competition, the FCC was forced to re-examine the effectiveness and necessity of rate-of-return regulation in light of new competitive marketplace pressures.

3. The Agency Abolishes the Rate-of-Return System.

The growing concern that rate-of-return regulation was ill-suited to the new telecommunications marketplace eventually led the FCC to eliminate its rate-of-return system for the largest carriers.[35] Under examination, the persistent failure of rate-of-return to replicate the competitive market became apparent. Although some had suggested improvements to the rate-of-return system to increase market competitiveness, the FCC ultimately concluded that,

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[33] *Id.*

[34] *Id.*

[35] Other carriers, predominantly smaller rural providers, continue to be regulated under a rate of return system.

"rate of return does not provide sufficient incentives for broad innovations in the way firms do business."[36] Many feared these adverse incentives would hinder the arrival of a competitive market.

Consequently, in the late 1980s, the Commission began to search for an alternative regulatory strategy that could incorporate and mimic the incentives found in a competitive market. As the agency commented, "[i]ncentive regulation, by creating incentives for carriers to become more productive, generates powerful motives to innovate, and is a better way of regulating."[37]

B. The FCC Rejected the Social Compact Model.

One possible alternative, used by several states, was the so-called "social compact" system. A social compact was an agreement between a carrier and a regulatory agency about efficiency gains and carrier profits. As two commentators explained:

> The social contract postulates a quid pro quo by which ratepayers are assured that efficiency will be imputed in their rates and telephone companies are assured that the rates for monopoly services will increase at the rate of inflation, less a factor representing that efficiency gain. This approach could lead to deregulation which would take place through an agreement between state authorities and individual telephone companies. The companies would be required to limit local rate increases according to some external index, such as the Consumer Price Index, and to make specified capital investments during the contract period to maintain and upgrade their networks. In return, the companies would be freed from the burdens of rate-of-return regulation for all

[36] *Second Report and Order* at 6790.

[37] *Id.*

> services and would be subject to minimal regulation, at most, of particular services.[38]

Given the initial success that several states appeared to have with the social compact approach,[39] the FCC considered it as a replacement for rate-of-return regulation for the entire nation. Under a national social compact, the Commission would freeze telephone rates for interstate services. "Increases thereafter would be limited by a certain formula (such as increases in the consumer price index). In return, all other telephone company services would be deregulated or de-tarriffed."[40]

Ultimately, however, the FCC decided against the social compact system. Although consumers initially would benefit from a price freeze, the agency had doubts about the policy's long-term effectiveness.[41] The FCC was especially dubious of the program's ability to improve innovation and efficiency incentives throughout the industry.[42] As the Commission concluded, "although freezing rates would stabilize rates, over time such action would cause rates to depart

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[38] Gail Garfield Schwartz & Jeffrey H. Hoagg, *Virtual Divestiture: Structural Reform of an RHC*, 44 FED. COM. L.J. 285, 317 n.79 (1992).

[39] *See, e.g., Second Report and Order.* "The Vermont commission and New England Telephone (NET) have agreed upon a Negotiated Social Contract, effective 1988-92. Under this contract, NET's local service rates are frozen; its toll, WATS, and Centrex rates are capped." *Id.* at 6792.

[40] Department of Commerce National Telecommunications and Information Administration, *Comprehensive Review of Rate of Return Regulation of the U.S. Telecommunications Industry*, 51 F.R. 36837, 36839 (1986).

[41] *Dominant Carriers FNPRM* at 3236-40.

[42] *Id.*

from underlying costs in an unpredictable manner. This would promote neither consumers' nor carriers' interests."[43]

Social compacts also came under heavy criticism from commentators and other industry observers. One fear was that the telephone companies might possibly evade pricing limits by degrading service quality while holding prices flat.[44] Another concern was that if the cost of providing service dramatically declined, telephone companies might reap excessive profits.[45] Furthermore, the deficiencies of rate-of-return could resurface because freezing prices for only one customer class might stimulate cross-subsidization, with its resulting inefficiencies.[46] Based on these different policy concerns, the FCC rejected social compacts as a replacement for rate-of-return regulation.

C. The Commission Believed Price Cap Regulation Best Balanced the New Regulatory Demands.

With the social compact alternative discredited, the FCC next examined the potential for a price cap approach to rate regulation. A number of states, as well as foreign countries such as Great Britain, had experimented with price caps with considerable success.[47] Unlike a rate-of-

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[43] *Id.* at 3207.

[44] *Comprehensive Review of Rate of Return Regulation of the U.S. Telecommunications Industry*, 51 Fed. Reg. at 36840.

[45] *Id.*

[46] *Id.*

[47] *See Policy and Rules Concerning Rates for Dominant Carriers* (Notice of Proposed Rulemaking), 2 FCC Rcd 5208, 5212-13 (1987).

return scheme that regulates the amount of profit a company can earn, a pure price cap scheme focuses directly on regulating the end price that the utility charges its customers. This shift in emphasis from profit to price provides a number of theoretical advantages: 1) it is easier and less costly to administer; 2) it is much better at promoting efficiency on the part of the utility; 3) it allows for a smoother and less disruptive transition between monopoly and competitive service provision; and 4) it reduces access charges, which in theory should reduce consumers' long distance costs.

1. The FCC Sees Price Caps as Easier and Less Costly to Oversee than Rate-of-Return Based Systems.

A rate of return system focuses on the maximum allowable percentage return that providers can make on their total level of investment.[48] As a result, the regulatory agency must establish elaborate proceedings to verify the total amount that the utility has invested in providing service, whether this investment is reasonable, and the amount that the company is actually earning expressed as a percentage of that investment. The process is expensive and time consuming, both for the utility and the regulatory agency.

In contrast, price cap regimes have the potential to be much easier to implement. In the most basic price cap system, the governing body simply sets the maximum price that the provider can charge for its services. Since the focus is on the end price charged to the consumer, rather than the amount that the provider invests in delivering its service, whether the utility is

[48] *See supra* at Section I(A)(2)(a).

complying is readily apparent. The agency need only look at the price that the provider is charging, which means the need for unwieldy cost-of-service hearings is reduced or eliminated.[49]

Of course, the price cap system implemented by the FCC in 1990 for the largest LECs was much more complicated than a simple, "X price and no higher" regime.[50] Many of the details of the FCC plan required close monitoring. But even with the added nuances required by the complex nature of the telecommunications industry, the focus on price, which itself is generally easily observable, made price cap systems easier to administer than a rate-of-return regime.[51]

2. The Commission's Plans to Promote Efficiency and Technological Development by Allowing LECs to Reap the Benefits of Change.

In another contrast to a rate-of-return regime, a pure price cap system allows the company to keep the extra profit generated by efficiency increases in either infrastructure or expenses.[52] Under a price cap system, the regulatory body focuses on setting the maximum price that the utility can charge for its services, rather than specifying the amount of money that the utility's shareholders can earn on their investment. This means that the regulatory agency commits not to

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[49] *See* Ghosh, *supra* note 8, at 421.

[50] The specific details of the plan adopted by the FCC are discussed in Section II, *infra*.

[51] *Second Report and Order* at 6791.

[52] Compare *supra* Section I(A)(2).

intercede and force the utility to return profits that it earns in excess of the prescribed rate of return, which in turn gives the company the incentive to maximize efficiency.[53]

For example, assume that Company B's total cost outlay to provide telecommunications services is $110. Under a rate-of-return regime, the agency would have to determine which costs were investment and which were expenses, and it would only allow the company to recover the specified rate on the amount of investment.[54] A reduction in expenses would lead to no gain in profits, as these costs are recovered on a 1:1 basis, while a reduction in investment might actually lead to lower overall profits.

If Company B is operating under a pure price cap regime, however, the situation is much different. If the price per unit is set at $115 under price caps and the overall cost per unit to Company B is $110, then the company starts by making a $5 per unit profit. If the company can become more efficient and reduce costs by 10 percent (dropping the cost per unit to $99), its profit increases by more than 200 percent, to $16 per unit. Under a pure price cap system, the

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[53] In a "pure" price cap system, the utility would be allowed to retain the entire amount it gained through increases in efficiency. The FCC's ultimate system was far from pure, as discussed *infra*.

As discussed below, the FCC initially adopted a hybrid price cap scheme which required the LECs to pass some of their revenue from efficiency gains onto the consumer. This "sharing doctrine" has since been eliminated by the Commission. *See infra* sections II and III; *Second Report and Order; Price Cap Performance Review for Local Exchange Carriers* (Fourth Report and Order and Second Report and Order), 12 FCC Rcd 16642 (1997) *("Fourth Report and Order")*; *see also* James M. Fink, *The Battle Over the Rewrite of Illinois' Telecommunications Law: Is More Reform Needed?*, 11 N. ILL. U. L. REV. 189, 210 (1991).

[54] *See supra* Section I(A)(2)(a).

regulatory body does not lower the maximum rates that utilities can charge when there is a drop in production costs.[55] As this simplified example shows, even a modest gain in overall production efficiency can lead to a tremendous increase in profitability, which provides a powerful stimulus for LECs to find cheaper, more effective ways to provide service. Moreover, since the price cap model does not distinguish between expenses and investment, the LEC can explore reductions in either of these areas to produce efficiency gains.

Price caps thus address the alleged problems of "gold plating" or "cost-padding" of the traditional rate-of-return regime. By specifying the maximum amount that the provider can charge for a service, the price cap system removes the incentive to install costly and unnecessary infrastructure. If Company B can only charge $115 per unit for its services, it is unlikely to build a system that increases its costs to $114, when a system that cost $110 would do just as well. In fact, the price cap system puts just the opposite pressure on a telecommunications provider, producing positive incentives to reduce cost.

The price cap system is so effective in eliminating the urge for unnecessary investment that some worried that it would go too far and lead to a reduction in service quality.[56] To the extent that competition exists in the marketplace, this criticism is less important. Competition from other firms, which are looking for a competitive advantage, will provide a countervailing pressure on the utility to provide the highest quality service for which its consumers will pay.

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[55] Ghosh, *supra* note 8, at 408-09. This example refers to a pure price cap model that does not contain anything like the FCC's sharing formula or the X-Factor discussed *infra*.

[56] *See, e.g.,* Margiotta, *supra* note 16, at 727-28 n.47.

However, in markets where competition has yet to develop, the potential problems of service degradation can be addressed using regulatory quality-of-service reviews.[57]

3. The FCC's View of Price Caps as Transitional Regulatory Mechanism Between Monopoly and Competition.

Price caps more closely mimic a competitive market than the old rate-of-return scheme. Under rate-of-return regulation, the FCC established prices based on the LEC's costs plus a reasonable return on investment. Consequently, the FCC could only indirectly modify the prices that consumers pay by (1) changing the percentage rate-of-return on investment that the utilities may recover or (2) challenging the LEC's costs. With price caps, however, the agency has more flexibility to set the price of service directly, and thus it has a better opportunity to set prices at a level that mirrors what they would be in a competitive environment. Furthermore, the efficiency improvements that the utilities will create under price caps means that the overall price of services can be lowered without imposing confiscatory regulations.[58]

Since price caps more closely simulate the conditions of a competitive market, they allow for a transition from a regulated to a deregulated industry. A transitional step between the old regime and a competitive marketplace allows the consumer to receive the benefits of a competitive marketplace, such as increased efficiency and greater technological innovation, without having to wait for real competition to develop.[59]

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[57] *See, e.g., Second Report and Order* at 6827.

[58] *Id.* at 6799.

[59] *See infra* Section V.

Moreover, the use of an incentive-based regulatory system like price caps increases the flexibility that a company has to respond to changing market conditions.[60] Under a rate-of-return regime, a utility must file a tariff with the regulatory body to alter prices; the subsequent tariff investigation requires the company to prove that the rate increase is justified. These investigations can be time consuming and expensive and often require the production of extremely detailed cost support data. As non-regulated competitors enter the market who do not have the same obligations, this complex and exhaustive process will put the regulated company at a significant disadvantage, since it will be unable to respond quickly to its competitors' actions.[61]

In a price cap regime, however, the utilities have a measure of pricing flexibility. This allows them to adjust their prices within a specified range in response to shifts in market conditions, such as the entry of a new competitor.[62] For example, if an unregulated competitor entered the market and tried to "cherry pick" (i.e. take the best and most lucrative customers), a utility that operated under traditional rate-of-return regulation could do little to prevent the practice. On the other hand, a utility with pricing flexibility might be able to react quickly enough in changing its own prices to stave off such an attack.[63] Eventually, once competition

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[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] Of course, the proper degree of pricing flexibility that the LECs require in order to meet competitive challenges is a subject of debate. For further discussion of this point, see Section II,

(Continued...)

becomes established in the marketplace, government regulation in general can be reduced or eliminated; the free market will produce efficient prices and high quality service.[64]

4. The Commission Believed That Consumers Would Benefit from the Reductions in Access Rates Caused by the Productivity Factor.

The final motivation behind adopting price caps comes from the long-distance market. As the price cap is reduced because of productivity and other gains, the maximum access charge that LECs may assess for interconnecting long distance calls will also be reduced commensurately.[65] In a non-competitive market, the long-distance carrier that pays this access charge to the LEC might not pass along its savings to its customers, leading to a yearly windfall for that company equal to the size of the productivity factor. A truly competitive long-distance market should mitigate this concern. In theory, with any input cost in a competitive market, a lower access fee would likely be passed on to the long-distance consumer as different providers maneuver for pricing advantages. In practice, the long distance market may not act as competitively as the Commission would like. Therefore, in order to ensure consumers benefit from price cap reductions, the price cap scheme should have contained a cost savings pass-through, that requires long-distance providers to lower rates commensurate with any reduction in

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infra.

[64] *See* J. Gregory Sidak & Daniel F. Spulber, *Deregulation and Managed Competition in Network Industries*, 15 YALE J. REG. 117 (1998).

[65] James E. Norris, *Price Caps: An Alternative Regulatory Framework for Telecommunications Carriers*, PUB. UTIL. FORT., Jan. 18, 1990, at 44.

access charges.[66] As a result, the long-distance consumer would stand to gain immediately from all access rate drops.

II. The FCC's Initial Implementation of a Price Cap Regime.

After much debate and a number of proceedings, the FCC adopted a price cap system to regulate GTE and the seven largest LECs in 1990.[67] This was not, however, a pure price cap system. Although the Commission wished to achieve the policy goals previously described, it also feared the potential instability of a system previously untested on such a broad scale. As a result, the agency imposed significant restrictions on LECs, which the FCC admitted might not fully produce the efficiency incentive of a pure price cap regime.

The Commission adopted a formula to be applied annually for calculating price caps. The basic formula is New Price Cap = Last Year's Price Cap + Inflation +/ - "Exogenous Costs" – "Productivity Adjustment."[68] Inflation is measured by the Gross National Product Price

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[66] As noted below, one of the criticisms of price caps has been that long-distance providers such as AT&T have failed to pass on the savings from price caps onto consumers. *See, e.g.* COMMUNICATIONS DAILY, June 26, 1995 at 4 ("AT&T raised eye brows with [its] letter to FCC . . . that said savings as [a] result of lower LEC access charges aren't enough to trigger a reduction in AT&T's basic rates to public.")

[67] A price cap system was not imposed on the smaller LECs, though they could opt to enter a price cap system if they wished. The FCC limited the plan to the larger LECs because its collected data for the productivity offset applied to the larger carriers and it feared that the mid-sized carriers could not generate productivity gains of the same magnitude. *See Second Report and Order* at 6787.

[68] Theodore D. Frank & Mitchell Lazarus, *Developments in the Local Exchange Marketplace - 1995*, 427 PLI/PAT 7, 30 (1995). For an example of the full technical formula, see *Price Cap Performance Review for Local Exchange Carriers* (First Report and Order), 10 FCC Rcd 8961,

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Index,[69] and this section discusses each of the other components of the formula in detail. In addition to the basic formula, the FCC also instituted policies that would retrospectively keep the LEC returns within certain limits, in effect imposing both a profit ceiling and a profit floor. These policies are also discussed in detail below.

A. The Initial Productivity Factor Was Set at a Level That Reflected the LEC Industry's Historical Productivity.

A key component of the price cap formula was a "productivity factor," also known as an "X-Factor" or a "productivity adjustment." The factor is meant to reflect that the telecommunications industry as a whole was becoming more efficient faster than the rest of the economy.[70] The productivity factor attempted to quantify this difference in efficiency improvements for the price cap formula and pass the benefits on to ratepayers.[71]

The productivity factor had to be chosen carefully, however, to ensure it accurately reflected gains in efficiency that the LECs were likely to achieve. On the one hand, a productivity factor set too low would not pass efficiency gains through to consumers.[72] The LECs would essentially receive a windfall due to efficiency gains that outpaced the caps. If the

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9148-52 (1995) *("First Report and Order")*.

[69] *Second Report and Order* at 6792.

[70] *Id.* at 6796.

[71] *Id.* The FCC set the X factor based only on the efficiency gains that exceeded those of the economy as a whole, since the efficiency gains of the economy as a whole were already reflected in the inflation factor separately accounted for in the price cap formula. *Id.*