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Before the
Federal Communications Commission
Washington, D.C.

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

ORDER ON RECONSIDERATION

Adopted: December 22, 1998 **Released:** January 22, 1999

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

I. INTRODUCTION

1. On March 30, 1995, the Commission adopted the *Price Cap Performance Review First Report and Order* in the first comprehensive review of price cap regulation for local exchange carriers (LECs).[1] In that Order, the Commission reached certain tentative conclusions for modifying the long-term price cap plan and made interim revisions to its price cap rules.[2] On May 19, 1995, AT&T Corp. (AT&T), MCI Telecommunications Corporation (MCI), and the Ad Hoc Telecommunications Users Committee (Ad Hoc) (collectively referred to as petitioners) filed separate petitions for reconsideration of portions of the *Price Cap Performance Review First Report and Order*.[3] Six parties filed oppositions to the petitions for

[1] *Price Cap Performance Review for Local Exchange Carriers*, CC Docket 94-1, First Report and Order, 10 FCC Rcd 8961 (1995), *aff'd, Bell Atlantic Telephone Companies v. FCC*, 79 F.3d 1195 (D.C. Cir. 1996) (*Price Cap Performance Review First Report and Order*).

[2] *See Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9026 (finding that the record was insufficient to choose a long-term methodology for computing the X-Factor and directing the Common Carrier Bureau to draft a Further Notice of Proposed Rulemaking seeking further comment and analysis on the development and implementation of a long-term methodology for computing the X-Factor); *see also Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9049 (tentatively concluding that sharing and low-end mechanisms should eventually be eliminated).

[3] AT&T Petition for Limited Reconsideration or, in the Alternative, Clarification (AT&T Petition); MCI Petition for Reconsideration (MCI Petition); Petition for Expedited Partial Reconsideration of the Ad Hoc Telecommunications Users Committee (Ad Hoc Petition). On April 9, 1998, Ad Hoc filed a Motion to Dismiss

reconsideration[4] and each of the petitioners filed reply comments. For the reasons discussed below, we deny the petitions for reconsideration.

II. BACKGROUND

2. In 1990, the Commission replaced rate-of-return regulation for the Bell Operating Companies and GTE Operating Companies with price cap regulation, effective January 1, 1991, and made price cap regulation optional for other LECs.[5] The plan established in the *LEC Price Cap Order* created a price cap index (PCI) for each of several baskets of LEC services. Each LEC's PCIs are adjusted annually to account for inflation,[6] exogenous cost changes,[7] and LEC productivity gains as measured by the "X-Factor."[8] The original LEC price cap plan also included sharing[9] and low-end adjustment mechanisms,[10] which are

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its Petition for Expedited Partial Reconsideration on the grounds that it was moot.

[4] The parties filing oppositions were: the United States Telephone Association (USTA); New York Telephone Company and New England Telephone and Telegraph Company (NYNEX); BellSouth Telecommunications, Inc. (BellSouth); GTE Service Corporation and its affiliated domestic telephone operating companies (GTE); Rochester Telephone Corp. (Rochester); and Sprint Corporation (Sprint) on behalf of Sprint Communications Company, L.P. and the United and Central Telephone Companies.

[5] *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6785 (1990) and Erratum, 5 FCC 7664 (1990)(*LEC Price Cap Order*); *modified on recon.*, 6 FCC Rcd 2637 (1991) (*LEC Price Cap Reconsideration Order*), *further recon.*, 6 FCC Rcd 4524 (1991)(*ONA Part 69 Order*), *second further recon.*, 7 FCC Rcd 5235 (1992), *aff'd*, *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

[6] In the *LEC Price Cap Order*, the Commission used the Gross National Product Price Index (GNP-PI) as the inflation measure. *LEC Price Cap Order*, 5 FCC Rcd at 6792-93. In the *Price Cap Performance Review First Report and Order*, the Commission replaced this inflation measure with the Gross Domestic Product Price Index (GDP-PI). *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9115-16.

[7] Exogenous cost changes are certain cost changes caused by administrative, legislative, or judicial action beyond the control of the carrier, and not otherwise reflected in the price cap formula. These exogenous cost changes are listed in Section 61.45(d) of the Commission's Rules, 47 C.F.R. § 61.45(d).

[8] In the *LEC Price Cap Order*, the Commission determined that the GNP-PI does not fully reflect the fact that the LECs' higher-than-average growth in productivity had resulted in lower-than-average telephone prices, relative to inflation. The Commission therefore concluded that a productivity offset, the "X-Factor," must be included in the price cap formula to ensure that rates continued to decline in relation to inflation. *LEC Price Cap Order*, 5 FCC Rcd 6796. In the Price Cap Performance Review First Report and Order, the Commission allowed LECs to chose between three X-Factors, 5.3, 4.7, and 4.0. *Id* at 9050.

[9] At the time of the petitions, sharing was a backstop mechanism to ensure that price cap regulation fairly distributed the risks and rewards of future productivity gains between the LECs and customers. *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9035-36. Under the sharing plan, once a LEC achieved a certain rate of return it was required to return a portion of its earnings back to its customers by charging lower rates in the future. *Id.*

automatic adjustments to the PCIs that are triggered by an individual LEC's rate-of-return performance.[11]

3. The Commission initiated in 1994 the first comprehensive review of the performance of the interim LEC price cap plan, and as a result of the review issued the *Price Cap Performance Review First Report and Order*. In the *Price Cap Performance Review First Report and Order*, the Commission reaffirmed the principal policy goals of price cap regulation. The Commission did conclude, though, that its primary goal of improving consumer welfare by introducing profit incentives and price constraints that more closely replicate the results that a competitive market would produce would be served by making certain changes to the existing system.[12] In the *Price Cap Performance Review First Report and Order*, the Commission, *inter alia*, concluded that it should make changes to the method used for calculating the X-Factor. Based on the record, however, the Commission was able to decide only on the broadest features of a method.[13] The Commission established an interim plan increasing the number of X-Factor options from two to three options and revising the rules governing sharing obligations.[14] It set a base X-Factor at 4.0 percent, and set optional X-Factors at 4.7 percent and 5.3 percent.[15] The Commission adjusted the sharing requirements for the 4.0 percent and 4.7 percent X-Factors and eliminated the sharing requirements for carriers electing the 5.3 percent X-Factor.[16] The Commission retained the

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[10] At the time of the petitions, the low end adjustment was a back stop mechanism intended to prevent any price cap LEC from experiencing such low earnings over an extended period of time that its ability to provide quality service and attract capital would be seriously impaired. *Id.* at 9036. At the time of the *Price Cap Performance Review First Report and Order*, under the low end adjustment if earnings of a LEC fell below 10.25 percent in a base year, the LEC could raise its PCI, and consequently its rates, in the following year to the level required to earn 10.25 percent, using the prior period as the baseline. *Id.* at 9036.

[11] *LEC Price Cap Order*, 5 FCC Rcd at 6801.

[12] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9003.

[13] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9026-33.

[14] See *supra* notes 7 and 8. *Price Cap Performance Review First Report and Order* at 9050. *See Price Cap Performance Review First Report and Order*, 10 FCC Rcd 9054-57, for a complete discussion of the three X-Factors.

[15] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9055.

[16] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9050, 9058. Those LECs that chose a 5.3 X-Factor were not subject to sharing. *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9035-36. Those LECs that chose an X-Factor of 4.7 were required to share half of the earnings from 12.25 to 16.25 percent and, all of their earnings from 16.25 percent. *Id.* LECs that selected an X-Factor of 4.0 percent were required to share half of their earnings from 12.25 to 13.25 percent and share all earnings above 13.25 percent. *Id.*

existing low-end adjustment mechanism for the two lower X-Factors, but eliminated it for LECs electing the 5.3 percent X-Factor.[17] The Commission declined to adopt a proposal that would have required an exogenous cost decrease equal to the increase in subsidies a purchasing carrier receives from dial equipment minutes (DEM) weighting and increased Universal Service Fund (USF) payments.[18]

4. Since the issuance of the *Price Cap Performance Review First Report and Order*, the Commission has issued three Further Notices of Proposed Rulemaking seeking comment on proposed revisions to the price cap plan.[19] Based upon comments received in response to these Further Notices of Proposed Rulemaking, the Commission has issued three orders: (1) the *Price Cap Performance Review Third Report and Order*,[20] (2) the *Access Reform Order*,[21] and (3) the *Price Cap Performance Review Fourth Report and Order*.[22]

5. In the *Price Cap Performance Review Third Report and Order*, the Commission made it easier for price cap LECs to lower prices for certain services by eliminating lower service band indices.[23] In the *Access Reform Order*, the Commission reformed the current

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[17] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9050.

[18] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9106-07.

[19] *Price Cap Performance Review for Local Exchange Carriers*, CC Docket 93-124, Second Further Notice of Proposed Rulemaking, 11 FCC Rcd 858 (1995); *Price Cap Performance Review for Local Exchange Carriers*, CC Docket 94-1, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 13659 (1995); *Access Charge Reform*, CC Docket 96-262, Notice of Proposed Rulemaking (*Access Reform NPRM*) 11 FCC Rcd 21485 (1996)

[20] *See Price Cap Performance Review for Local Exchange Carriers*, CC Docket 94-1, Third Report and Order (*Price Cap Performance Review Third Report and Order*)(contained within the *Access Reform NPRM*), 11 FCC Rcd 21354, 21485 (1996).

[21] *Access Charge Reform*, CC Docket No. 96-262, First Report and Order, 12 FCC Rcd 15982 (1997) (*Access Reform Order*); *recon.*, Order on Reconsideration, 12 FCC Rcd 10119 (1997); Second Order on Reconsideration, 12 FCC Rcd 1606 (1997) *aff'd sub nom.* Southwestern Bell Telephone Co. v. FCC, 153 F. 3d 523 (8th Cir. 1998).

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

[23] *Price Cap Performance Review Third Report and Order*, 11 FCC Rcd at 21487. Price changes within service categories are limited by rate bands applied to the Service Band index (SBI), an index of rates within each of the service categories. Service categories limit a LECs ability to offset price reductions for one service with an increase in the price of another service in a different category within the same basket. *LEC Price Cap Order*, 5 FCC Rcd at 6788. Under the original price cap regulatory plan, rate changes that conformed to the limits set by a LECs PCIs and SBI bands were presumed lawful and permitted to take effect on fourteen days

rate structure to bring it more into line with cost causation principles. In general, the Commission found that non-traffic sensitive (NTS) costs incurred to serve a particular customer should be recovered though flat fees, while traffic sensitive costs should be recovered through usage-based rates.[24] Accordingly, the Commission revised its rules regarding the recovery of common line costs so that ultimately price cap incumbent LECs will recover their interstate common line revenues through a flat-rated subscriber line charge (SLC) and a presubscribed interexchange carrier charge (PICC).[25] Following the same principles that flat-rate charges should recover fixed costs and variable charges should recover variable costs, the Commission also made several modifications to the rate structure for switching and transport services.[26]

6. In the *Price Cap Performance Review Fourth Report and Order*, the Commission established final rules regarding its price cap plan, including the elimination of multiple X-Factors. Instead, the Commission instituted a single X-Factor set at 6.5 percent based on a total factor productivity (TFP) methodology (a ratio of an index of total outputs to an index of total inputs), calculated on a total company basis rather than an interstate basis.[27] The Commission also eliminated the sharing requirements. The Commission found it was inconsistent with the general competitive paradigm that was established by the Telecommunications Act of 1996. The Commission also found that sharing might make it more difficult to deregulate services that became subject to substantial competition because sharing might create an incentive for LECs to misallocate costs from deregulated common carrier services to services that remain subject to sharing requirements.[28] The Commission maintained the low-end adjustment mechanism for LECs with substantially below average earnings because it found that while some LECs have achieved high earnings, others have not always done so.[29] Finally, the Commission required rates to be adjusted to levels where they would have been had the changes in the *Price Cap Performance Review Fourth Report and*

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notice. *Id* at 6801. Rates that fell above or below the SBI indices were said to be "above service band" or "below service band" rates and carried a heavy burden of justification. *Id.* at 6801-02.

[24] *Access Reform Order*, 12 FCC Rcd at 15986.

[25] In order to provide incumbent LECs and IXCs with adequate time to adjust to this rate structure change, the Commission is phasing in this new cost recovery system. *Access Reform Order,* 12 FCC Rcd at 16007-16034.

[26] For example the Commission concluded that both entrance facilities and direct-trunked transport services should be priced on a flat-rated basis. *Access Reform Order*, 12 FCC Rcd at 16048-50.

[27] *Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16679.

[28] *Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16699-16703.

[29] *Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16691.

Order been instituted in 1996.[30]

III. ISSUES ON RECONSIDERATION

7. The petitioners raised a number of issues that have been resolved or rendered moot due to the Commission's actions in the *Price Cap Performance Review Third Report and Order*, the *Access Reform Order*, and the *Price Cap Performance Review Fourth Report and Order*. These issues include: (1) whether the X-Factors in the interim plan were set too low;[31] (2) whether carriers should have three X-Factor options in the interim plan;[32] (3) whether sharing should be eliminated and/or whether the sharing bands should be recalibrated because of lower costs of capital;[33] (4) whether the low-end adjustment mechanism should be eliminated for all price cap LECs in the interim plan;[34] (5) whether additional downward pricing flexibility should have been granted to the price cap LECs;[35] (6) whether the Commission should have adopted a per-line formula for the common line basket rather than

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[30] *Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16714.

[31] In the *Price Cap Performance Review Fourth Report and Order*, the Commission replaced the multiple X-Factors with a single X-Factor of 6.5. *See Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16693-94. As part of its petition for reconsideration of the *Price Cap Performance Review Fourth Report and Order*, AT&T argues that the each price cap LEC should be required to adjust its price cap PCIs to the levels for the 1997-1998 tariff year that would have been in effect had the Commission adopted the 6.5 percent X-Factor in time to become effective with the LECs' 1995 annual tariff filing. We will consider this issue in a separate order on reconsideration of the *Price Cap Performance Review Fourth Report and Order.*

[32] In the *Price Cap Performance Review Fourth Report and Order*, the Commission eliminated the three-tiered X-Factor. *See Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16703.

[33] In the *Price Cap Performance Review Fourth Report and Order*, the Commission permanently eliminated sharing because it found that sharing was inconsistent with the general competitive paradigm that was established during the Telecommunications Act of 1996. *Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16699-16703.

[34] In the *Price Cap Performance Review Fourth Report and Order*, the Commission maintained the low-end adjustment mechanism because it found that while some incumbent LECs have achieved high earnings under price caps, others have not always done so. *Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16691. We note that the Commission's decision regarding the low-end adjustment is currently the subject of a petition for reconsideration.

[35] Subsequent to MCI's petition for reconsideration of the *Price Cap Performance Review First Report and Order*, the Commission released the *Price Cap Performance Review Third Report and Order* in which it eliminated the lower service band limits finding that this elimination would lead to lower prices. *See Price Cap Performance Review Third Report and Order*, 11 FCC Rcd at 21485-88.

maintaining the Balanced 50-50 PCI for the formula;[36] (7) whether the Commission should require exogenous cost treatment of fully amortized equal access and network reconfiguration costs;[37] and (8) whether exogenous cost changes should be limited to those that shift revenues into or out of the interstate jurisdiction.[38]

8. Three issues raised by petitioners remain to be resolved: (1) whether carriers electing the 5.3 percent X-Factor should have been subject to sharing for the first seven months of 1995, rather than merely the first six months; (2) whether rates should be reinitialized because the price cap LECs' cost of capital declined during the first four years of price cap regulation; and (3) whether the Commission should require an exogenous cost change to reflect the increased subsidies received by certain LECs purchasing new exchanges.

A. Application of Sharing for July 1995 to Carriers Electing 5.3 Percent X-Factor.

1. Petitions

9. In the *Price Cap Performance Review First Report and Order*, the Commission increased the productivity offset in the price cap formula, found that this resulted in an increased X-Factor,[39] and made a corresponding one time reduction to the price cap LECs'

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[36] In the Balanced 50-50 formula, the Commission added a term "g/2," to the per-minute common line PCI formula, to represent half the growth in demand per line in the prior year. *Access Reform Order*, 12 FCC Rcd at 16026 *citing LEC Price Cap Order* 5 FCC Rcd at 6793, 6795. In the *Access Reform Order*, the Commission concluded that the PCI formulas for the traffic sensitive and trunking baskets should be used for the common line basket, once traffic sensitive common carrier line (CCL) charges have been eliminated, because at that point, growth in minutes per line will not affect a carrier's common line revenues. *Access Reform Order*, 12 FCC Rcd at 16027. To avoid unnecessary rate churn, however, the Commission declined to change the current Balanced 50-50 formula for the common line basket while this per-line charge is phased in. *Id.*

[37] The Commission addressed the issue of exogenous cost treatment of equal access expenses that have been fully amortized in the *Access Reform Order*. In the *Access Reform Order*, the Commission directed price cap LECs to make a downward adjustment to the traffic sensitive basket in the Annual Access Tariff filing that took effect on July 1, 1997 to account for the completed amortization of equal access expenses. *Access Reform Order*, 12 FCC Rcd at 16118.

[38] In the *Price Cap Performance Review Fourth Report and Order*, the Commission declined to limit exogenous treatment to those changes that shift revenues between interstate and intrastate jurisdictions finding that such a restriction would eliminate the Commission's discretion to consider extending exogenous cost treatment to extraordinary cost changes not listed in the rules that the Commission shall later permit or require. *Price Cap Performance Review Fourth Report and Order*, 12 FCC Rcd at 16711.

[39] *See supra* n. 7. The Commission set the original X-Factor of 3.3 percent based on the average of two historical LEC-productivity studies: the Spavins-Lande Study which examined long-term pricing trends and the Frentrup-Uretsky Study which focused on revenue and demand trends from 1984-1990. *LEC Price Cap Order*,

PCIs.[40] The Commission directed price cap LECs to make this one time adjustment to their PCIs in their 1995 annual access tariff filing so that the adjustment would be reflected in intestate access rates that took effect August 1, 1995.[41] Concomitantly, the Common Carrier Bureau (Bureau) issued the *TRP Revisions Order* establishing an August 1, 1995 effective date for the price cap LECs' 1995 annual access tariff rather than the original date of July 1, 1995 and providing guidance as to how to implement the Commission's directive.[42]

10. In its petition, AT&T requests that the Commission clarify whether carriers that elected a 5.3 percent X-Factor will be subject to a sharing obligation with respect to the first seven months of 1995, rather than for just the first six months. AT&T asserts that a seven month sharing obligation is implicit in the Bureau's actions establishing the August 1, 1995 effective date for the price cap LECs 1995 annual access tariff. AT&T notes that during the first seven months of 1995, the price caps for the LECs' access rates were computed on the basis of the 3.3 percent and optional 4.3 percent X-Factors that were found to be too low in the *Price Cap Performance Review First Report and Order*. AT&T further observes that the Commission stressed in the *LEC Price Cap Order* that the sharing mechanism's purpose was to guard against the possibility that the productivity factors had been set too low. AT&T asserts that there is no rational basis for allowing the LECs to avoid sharing for the full seven-month period. AT&T points out that some LECs acknowledged that the *Price Cap Performance Review First Report and Order* requires continuation of the LECs' sharing obligations through July 31, 1995 by applying for a waiver of their sharing obligations in return for applying the 5.3 percent X-Factor retroactively to January 1, 1995.[43]

Appendix C, 5 FCC Rcd at 6892-94 In the *Price Cap Performance Review First Report and Order*, the Commission concluded that it had erred in including the 1984 data point in the Frentrup-Uretsky Study; recalculated the X-Factor excluding the 1984 data point; and found that this resulted in an X-Factor of 4.0 percent. *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9052-54 The Commission decided that on a going forward basis the corrected minimum X-Factor of 4.0 percent should be used for the interim plan.

[40] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9069- 9070.

[41] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9069-9070.

[42] *Cost Support Material to be Filed with 1995 Annual Access Tariffs, Revisions to Tariff Review Plan for Price Cap Companies and Order*, 10 FCC Rcd 5720 (Com. Car. Bur. 1995)(*TRP Revisions Order)*

[43] AT&T Petition at 7-8.

2. Oppositions

11. USTA, Sprint, and GTE state that AT&T incorrectly suggests that a LEC's sharing obligation should be based on the seven calendar months in 1995 prior to the August 1 effective date of the LECs' 1995 annual access tariffs. They contend, instead, that the sharing obligation should be based on the first six calendar months in 1995. They assert that the *TRP Revisions Order* already adjusted PCIs to account for the one-month delay in the effective date.[44] They argue that the Bureau's adjustment ensures that LEC price cap revisions that took effect on August 1, 1995 will have the same financial result as if they had been made effective on July 1, 1995 and that therefore the sharing obligation is only required for the first half of the calendar year 1995.[45]

3. Discussion

12. In light of the Commission direction that LECs perform a one time PCI adjustment for the 1995 annual access tariff and the Bureau's guidance in the *TRP Revision Order* as to how to implement the Commission's direction, several LECs raised questions regarding how the PCI adjustment would effect their sharing obligations.[46] Specifically, the LECs sought to apply the 5.3 percent X-Factor retroactively to January 1, 1995, and to be excused from any sharing obligation with respect to their earnings during the 1995 calendar year. In reviewing these petitions, the Bureau considered whether the sharing obligation of those LECs choosing the 5.3 percent X-Factor should be based on the first six or first seven months of calendar year 1995.[47] The Bureau determined that because the price cap LECs had already been required to adjust their PCIs downward to account for the one-month delay in the effective date of the 1995 annual access tariff, the sharing obligation should be based on a six-month

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[44] USTA Comments at 15, *citing TRP Revisions Order*, 10 FCC Rcd at 5723; Sprint Comments at 5; GTE Comments at 20-22.

[45] USTA Comments 14-17; Sprint Comments at 5; GTE Comments at 20-22.

[46] The Bureau received petitions from Ameritech, Pacific Bell, Nevada Bell, Rochester Telephone Corp., Frontier Communications of Iowa, Inc., Frontier Communications of Minnesota, Inc., Lincoln Telephone and Telegraph Company, United Company, and Central Telephone Company.

[47] *Annual 1995 Access Tariff Filings, Ameritech Petition Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995*, 10 FCC Rcd 12289 (Com. Car. Bur. 1995). *See also, Annual 1995 Access Tariff Filings, Pacific Bell and Nevada Bell Petition Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995*, 10 FCC Rcd 12301 (Com. Car. Bur. 1995); *Annual 1995 Access Tariff Filings, Petitions Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995*, Rochester Telephone Corp. and Frontier Communications of Iowa, Inc. and Frontier Communications of Minnesota, Inc., Lincoln Telephone and Telegraph Company, 10 FCC Rcd 9874 (Com. Car. Bur. 1995); *Annual 1995 Access Tariff Filings, United and Central Telephone Companies Petition Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995*, 10 FCC Rcd 12643 (Com. Car. Bur. 1995).

period.[48] We agree with this determination and find that the adjustment accounting for the one-month delay obviates any need for carriers choosing the 5.3 X-Factor effective August 1, 1995 to be subject to sharing for the first seven months, rather than the first six months, of the 1995 calendar year. Accordingly, we deny AT&T's motion in this regard.

B. Reinitialization of Rates Because of Lower Cost of Capital.

1. Petitions

13. In light of its finding that the productivity factor had been initially set too low, the Commission decided to require LECs to make a one time reduction of their PCIs.[49] AT&T and MCI argue that the PCI reduction called for by the Commission was not sufficient and that the lower cost of capital during the first three years of price cap regulation (1991-93) requires that the LECs' price caps be further reduced.[50] AT&T claims that it demonstrated in its comments that a discounted cash flow analysis indicated a 132 basis point reduction in the LECs' cost of capital for 1991-93, and that half of that cost reduction had not been reflected in the GNP-PI. AT&T states that although the Commission acknowledged that the LECs' cost of capital had decreased since the adoption of the LEC price cap plan, the Commission failed to explain why it did not reduce the PCIs to reflect the impact of that change.[51] MCI argues that the carriers received an unintended windfall during four years of price caps due to the decline in the cost of capital and that the Commission must adjust LEC rates to reflect that decline.[52]

2. Oppositions

14. USTA and NYNEX argue that, after evaluating all the issues raised by the commenters, the Commission found that there were no changes in the LECs' cost of capital that would have required rate changes even if the LECs were under rate-of-return regulation.[53]

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[48] *Id.*

[49] Specifically, the Commission required LECs to multiply their PCIs for the common line basket, traffic sensitive basket, and trunking basket, by a factor equal to the following equation: 1-(0.007n) where "n" was the number of years the LEC elected to use an X-Factor of 3.3 percent. *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9070.

[50] AT&T Petition at 5-6; MCI Petition at 17-19.

[51] AT&T Petition at 5-6.

[52] MCI Petition at 18-19.

[53] USTA Comments at 7; NYNEX Comments at 17.

USTA notes, for example, the Commission's decision to retain 11.25 percent as the cost of capital for cable companies.[54] NYNEX also asserts that the Commission's findings were not limited to an evaluation of the cost of debt and that the petitioners present no arguments that the Commission has not already considered and properly rejected.[55] USTA, BellSouth, and GTE argue that, contrary to AT&T's claims, changes in interest rates are already reflected in the GNP-PI component of the price cap formula.[56]

3. Discussion

15. We reject AT&T's and MCI's request that we reinitialize the PCIs to reflect the impact of the LECs' lower cost of capital for 1991-93. The Commission's purpose in reinitializing the PCIs in the *Price Cap Performance Review First Report and Order* was solely to set them at the appropriate level on a going-forward basis. The Commission did not adjust the PCIs to return to ratepayers any amounts based on the LECs' performance during the initial period of price cap regulation.[57] Because the Commission found that the cost of capital at the time of the *Price Cap Performance Review First Report and Order* had returned to approximately the same levels that prevailed at the initiation of price caps, no reinitialization of PCIs was needed to reflect changes in the cost of capital on a prospective basis.[58] We recognize that to the extent that decreases in the cost of capital are not reflected in the GNP-PI or GDP-PI in the original and interim price cap plans, carriers may receive an unanticipated benefit.[59] Conversely, to the extent GNP-PI or GDP-PI does not reflect increases in the cost of capital, ratepayers may receive an unanticipated benefit. In any case, the magnitude of the decrease in interest rates in the early 1990s was not sufficient to merit an exogenous adjustment under our rules. For these reasons, we affirm our decision not to readjust the PCIs on account of changes in the cost of capital.

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[54] USTA Comments at 7, *citing Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service*, Report and Order and Further Notice of Proposed Rulemaking, 9 FCC Rcd 4527, 4634-35 (1994).

[55] NYNEX Comments at 17.

[56] USTA Comments at 7; BellSouth Comments at 9-10; GTE Comments at 13.

[57] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9071-72.

[58] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9073.

[59] *See supra* n. 5.

C. Exogenous cost change for LECs selling exchanges.

1. Petitions

16. In the *Price Cap Performance Review First Report and Order*, the Commission rejected MCI's proposal to require price cap LECs selling an exchange to make an exogenous cost decrease equal to any increase in subsidies received by the purchasing carrier.[60] On reconsideration, MCI argues that the Commission erred in refusing to require a price cap LEC that sells an exchange to make an exogenous cost adjustment to its PCI to reflect any increased USF support or DEM subsidy that the LEC purchasing the exchange receives. MCI asserts that the Commission did not require exogenous treatment based upon the incorrect analysis that such treatment would require the selling LEC to reflect in its rates the change in costs that the purchasing LEC experienced. MCI claims that when the purchasing LEC determines how much it will pay for the exchange, it considers the flow of income, including any subsidy payments, that it will receive. Thus, the price paid to the selling LEC reflects a premium to account for the subsidy that the purchasing LEC will receive. MCI argues that applying the principles of the United States Court of Appeals for the District of Columbia Circuit's opinion in *Democratic Central Committee*,[61] this premium must be captured for ratepayers, who, by paying for the subsidy, have borne the burden of paying for the asset that resulted in the premium paid to the LEC.[62]

2. Oppositions

17. USTA argues that MCI's proposal is fundamentally mistaken. USTA states that changes in the circumstances of a purchasing LEC have no relation to those of the price cap seller. USTA asserts that some sales and swaps of exchanges reduce the DEM subsidy effect to the purchasing carrier, because the addition of more access lines may make the purchaser eligible only for double weighting as opposed to triple weighting. USTA further argues that application of MCI's proposal would discourage LECs from entering into transactions that would promote service to high-cost areas.[63] GTE argues that the Commission has reviewed transactions involving sales and swaps of exchanges on a case-by-case basis and, where necessary, has imposed requirements on the parties as a condition for approval. It asserts that

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[60] *Price Cap Performance Review First Report and Order* at 10 FCC Rcd at 9106. MCI was concerned that the prospect of increased subsidies to the purchasing carrier might encourage the sale of high-cost exchanges by large LECs to small high cost LECs. *Id.* at 9107

[61] *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission,* 485 F.2d 786 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 935 (1974).

[62] MCI Petition at 22-23; MCI Reply at 8.

[63] USTA Comments at 23-26.

this makes it unnecessary to adopt a generic change in the price cap plan to account for sales and swaps of exchanges.[64] GTE and USTA argue that the *Democratic Central Committee* case does not entitle ratepayers to the benefit of any premium, but instead requires a balancing of the equities.[65]

3. Discussion

18. At the time of the *Price Cap Performance Review First Report and Order*, LEC study areas with greater-than-average costs per loop[66] received high-cost assistance from the USF.[67] In addition, study areas with fewer than 50,000 loops received interstate assistance to cover their local switching costs. For such LEC study areas, the interstate DEM was weighted so that a higher percentage of local switching costs was allocated to the interstate jurisdiction than for LEC study areas with more than 50,000 loops.[68] Consequently, LECs that were eligible to use the DEM weighting factor recovered a greater share of their local switching costs from interstate ratepayers than other LECs.[69] By affording different treatment to small and large study areas, the rules created an incentive for companies with large study areas to sell high-cost exchanges to companies that qualify for more USF or DEM assistance in small study areas.[70] We recognize that it was possible that these incentives might have resulted in the payment of some premium by the purchaser to the seller of such an exchange to reflect the increased subsidies the purchaser might receive as a result of the purchase. We do not believe, however, that a rule requiring an exogenous adjustment to the PCIs of the selling LEC is the best way to address the issue raised by MCI. As an initial matter, MCI's proposed approach is inconsistent with our overall definition of exogenous costs, because it does not involve a cost caused by administrative, legislative, or judicial requirements beyond the control of the carriers.[71] Further, determining whether a selling LEC received a premium due to increased subsidies that a purchaser might receive and the amount of any such

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[64] GTE Comments at 26.

[65] GTE Comments at 24-26; USTA Comments at 25-26.

[66] A loop is "[a] pair of wires, or its equivalent, between a [local telephone] customer's station and the central office from which the station is served." 47 C.F.R. Part 36, Appendix-Glossary.

[67] Subpart F of Part 36 of the Commission's Rules, 47 C.F.R. §§ 36.601 *et. seq.*

[68] 47 C.F.R. § 36.125(f)

[69] *See* Section 36.125 of the Commission's Rules, 47 C.F.R. § 36.125.

[70] *See Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, 10 FCC Rcd 12309, 12328 (1995)(*USF Notice*).

[71] *LEC Price Cap Order*, 5 FCC Rcd at 6807.

premium could be difficult to resolve and impose significant administrative burdens on all parties involved.

19. Since the adoption of the *Price Cap Performance Review First Report and Order*, the Commission has adopted rules, in its *Universal Service Order*,[72] that address the concerns underlying MCI's petition. Specifically, in the future, support for high-cost exchanges will be provided through explicit competitively neutral mechanisms, for both large and small companies. A carrier that acquires telephone exchanges from an unaffiliated carrier will receive universal service support for acquired exchanges at the same per-line support levels for which those exchanges were eligible prior to the transfer of the exchanges.[73] Thus, it will no longer be possible for a purchasing carrier to receive more universal service subsidy for a newly acquired exchange than the selling carrier was receiving for that exchange, and the seller will not receive a premium.

20. We find that *Democratic Central Committee* is not controlling here. In *Democratic Central Committee*, the court held that in the absence of an administrative rule, the allocation of capital gains on the sale of public utility assets out of regulation between investors and consumers depends in the first instance upon who bore the risk of loss associated with the assets when they were used to provide regulated service. In *Illinois Public Telecom. Ass'n. v. FCC*, the court further interpreted *Democratic Central Committee,* finding that under price cap regulation ratepayers do not bear the risk of loss and thus are not due any capital gains.[74] The principles enunciated in *Democratic Central Committee* are, however, inapposite in the case of regulated telecommunications plant transferred with traffic from one regulated LEC to another. Such transactions are governed by our accounting rules, which prescribe that any gains or losses associated with a sale of an exchange with traffic are treated as retained earnings and do not accrue to ratepayers.[75]

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[72] *See Federal-State Joint Board on Universal Service,* CC Docket 96-45, Report and Order, 12 FCC 8776 (1997) (*Universal Service Order*).

[73] 47 C.F.R. § 54.305.

[74] *Illinois Public Telecom. Ass'n. v. FCC*, 117 F.3d 555, 569 (D.C.Cir. 1997) (*Illinois Public Telecom Ass'n*).

[75] Section 32.2000(d)(5) of the Commission's Rules, 47 C.F.R. § 32.2000(d)(5). *See also* 47 C.F.R. § 32.2000(b) (acquiring company records plant purchased with traffic at original costs, with additional amounts accounted for as goodwill or telecommunications plant adjustment.)

IV. FINAL REGULATORY FLEXIBILITY ANALYSIS

21. In the *Price Cap Performance Review First Report and Order*, we conducted a Final Regulatory Flexibility Analysis, as required by section 603 of the Regulatory Flexibility Act, which has been amended subsequently by the Contract With America Advancement Act of 1996, Pub. L. No, 104-121, 110 Stat. 847 (1996).[76] Our actions in this Order do not affect this analysis.

V. ORDERING CLAUSE

22. Accordingly, IT IS ORDERED that the petitions for reconsideration filed by AT&T Corp., MCI Telecommunications Corporation, and the Ad Hoc Telecommunications Users Committee ARE DENIED.

Federal Communications Commission

Magalie Roman Salas

Magalie Roman Salas
Secretary

[76] *Price Cap Performance Review First Report and Order*, 10 FCC Rcd at 9143.

STATEMENT OF
COMMISSIONER HAROLD FURCHTGOTT-ROTH

Re: ***Price Cap Performance Review for Local Exchange Carriers, CC Docket 94-1***

I support this Order denying various petitions for reconsideration as the issues raised seem to have been resolved or rendered moot by subsequent Commission action. I write separately, however, to express my continued concern with the Commission's micromanagement of LECs in general. The Commission's authority to require sharing and to provide low-end adjustments for price cap LECs are mere vestiges of outdated rate of return regulation. In today's increasingly competitive telecommunications marketplace, the Commission should be focusing its efforts on transitioning to a more competitive environment for price cap LECs.

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.