BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

REPLY TO DIRECT CASES of the GENERAL SERVICES ADMINISTRATION

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CONTENTS

I. Introduction 1

II. The ILECs' Direct Case 2

III. A Represcription of the Rate of Return Is Necessary 4

A. Any Represcribed Rate of Return Will Be Lower Than 11.25 Percent 4

B. A Represcribed Rate of Return Is Required to Constrain the ILECs' Market Power 9

C. The Commission Must Establish a Rate of Return for Universal Service Support 11

IV. The Regulatory Books Capital Structure Is the Appropriate Basis for Compositing Debt and Equity Costs 11

V. A Reduced Rate of Return Will Not Threaten the ILECs' Ability to Raise Capital 14

VI. Access Charges Should be Adjusted for the Revised Rate of Return 16

A. All ILEC Access Charges Should Be Reinitialized at 9.5 Percent Return on Investment 16

B. In the Alternative, the Reduction in Rate of Return Should Be Treated as an Exogenous Factor in the Price Cap Formula 19

VII. Conclusion 21

SUMMARY

The five ILECs and their associations that filed comments in this proceeding argue that the Commission should refrain from represcribing a new unitary rate of return for interstate services to replace the 11.25 percent authorized in 1990. They present two contradictory arguments in support of this position, first, that increases in the risks of local exchange services since 1990 would result in a prescription higher than the currently authorized 11.25 percent, and second, that a represcription would disturb the investor community, thereby reducing the accessibility of capital and increasing its cost.

The ILECs decline, however, to calculate a revised rate of return. GSA demonstrates the apparent reason, which is that even if all of the ILECs' criticisms of the Commission's tentatively recommended methodology are incorporated into the recalculation, the resultant rate of return is still 65 basis points below the 11.25 percent authorized in 1990.

GSA submits that the ILECs assertions that growing local exchange competition has increased risks and capital costs are without foundation, as demonstrated by the ILECs' control of 96.8 percent of local exchange revenues in 1997. This control provides the ILECs with market power that requires the represcription of a rate of return. Additionally, a rate of return must be prescribed in order to calculate the going-forward costs of serving high-cost rural and insular areas, as required by Section 254 of the Communications Act.

The ILECs' one substantive recommendation is that the Commission develop its composite cost of capital using a capital structure reflective of the market, rather than the book values of debt and equity. This recommendation would employ a debt/equity mix of 20/80 rather than the 43/57 mix found in the Appendix to the Commission's Notice. The ILECs' recommended capital structure is inappropriate because it does not reflect the paid-in capital that was used to buy the plant and equipment to which the cost of capital will be applied. Rather, market equity value largely reflects discounted future earnings from

investments in unregulated activities, some of which may not yet have been made.

Finally, GSA agrees with the Comments of the New Networks Institute that the earnings of the price cap carriers have become excessive. GSA repeats its earlier recommendation that these carriers' rates be reinitialized to the revised rate of return, which GSA proposes be 9.5 percent. In the alternative, the change in rate or return should be treated as an exogenous change in cost, and the ILECs' price caps should be adjusted downward for the effect of the 175 basis point reduction in the capital return component of access costs.

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Exchange Carriers

REPLY TO DIRECT CASES
by the
GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA") submits this Reply to Direct Cases on behalf of the customer interests of all Federal Executive Agencies ("FEAs") in response to the Commission's Notice Initiating a Prescription Proceeding ("Notice") released on October 5, 1998. In the Notice, the Commission initiated a proceeding to represcribe the authorized rate of return for interstate access services provided by incumbent local exchange carriers ("ILECs") and sought comment on the methods by which it can calculate the ILECs' cost of capital.

I. INTRODUCTION

GSA has reviewed the Initial Comments and Direct Cases of

- Five Incumbent Local Exchange Carriers ("ILECs")
- A consolidated filing of five ILEC associations ("Associations")
- Two Interexchange Carriers ("IXCs"), and
- the New Networks Institute.

The IXCs' filings deal only with the treatment of the "low end adjustment" for price

cap carriers and are addressed in GSA's Reply Comments that accompany this filing. The New Networks Institute challenges the entire structure and level of access charges, and thus does not constitute a direct case in response to the Commission's Notice of October 5, 1998. Accordingly, this Reply will address primarily the filings of the ILECs and their Associations, collectively, "the ILECs."

II. THE ILECS' DIRECT CASE

None of the ILECs presents a "Direct Case" in the sense intended by the Commission. That is, no ILEC offers what it believes to be the appropriate rate of return to be applied to non-price cap carriers. All argue that there is no need to represcribe the rate of return, and most contend that the effort would do more harm than good.[1] To the extent that the ILECs address the unitary rate of return at all, they assert that increases in their risks since 1990 have more than offset the decline in capital costs, such that a proper represcription would result in an increase, not a decrease in the carriers' rate of return.[2]

In support of their position, the Associations attach Comments prepared by William E. Avera. Dr. Avera believes that the present rate of return is a "conservative" estimate of the cost of capital that would result from a full fledged review of the ILECs' capital costs, but he recommends that the present rate of return not be changed. He asserts that such an effort would require "significantly more sophistication than in the past"[3] because investors perceive that the ILECs are facing increasing risks and uncertainty in their core local exchange business. This perception causes ILECs to obtain an increasing proportion of their capital in the form of equity funds, and even the debt costs of many

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[1]Associations at Summary i; Bell Atlantic at 2; GTE at 2; SBC at 2; US WEST at 3; Virgin Islands Telephone Comany ("Vitelco") at 3.

[2]Associations at 12; Bell Atlantic at 2; SBC at 2;

[3]Avera Comments at 5.

ILECs are increasing because they have been pushed to higher-cost sources of debt financing. Dr. Avera concludes that these changes have offset any impact of the observed fall in interest rates on the ILECs' capital costs. [4]

Bell Atlantic, GTE and US WEST support their comments with the affidavit by Dr. James Vander Weide of Duke University. Most of Dr. Vander Weide's testimony addresses the Commission's practice of weighting the ILECs' mix of debt and equity according to their respective book values, rather than the market values which are much more equity-intensive. Rather than the 43/57 debt/equity mix recommended by the Commission, Dr. Vander Weide proposes a 20/80 mix representative of market values of the respective sources of capital for S&P companies and for the Regional Holding Companies and GTE. When this revised weighting of capital components is combined with a recognition of the increase in ILECs' investment risk since the last prescription, the result should be a composite cost of capital that exceeds the currently authorized 11.25 percent.[5]

Finally, US WEST offers the affidavit of Peter C. Cummings, which addresses most of the technical questions posed by the Commission's Notice. Like Dr. Vander Weide, Mr. Cummings emphasizes the claimed importance of market, rather than book weights in establishing the mix of debt and equity in the unitary rate of return.[6] Mr. Cummings supports the DCF and CAPM methodologies.[7] He recommends that quarterly dividends be compounded for purposes of establishing the dividend yield in the DCF formula, and he supports an adder to the equity return to account for flotation costs.[8] While Mr.

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[4] Id. at 3.

[5] Vander Weide Affidavit at 11.

[6] Cummings Affidavit at 12.

[7] Id. at 18-32.

[8] Id. at 20-24.

Cummings deals with most of the mechanics of rate of return calculation, he does not actually calculate a rate of return.

III. A REPRESCRIPTION OF THE RATE OF RETURN IS NECESSARY

The ILECs offer two arguments to support their position that the Commission should refrain from represcribing the rate of return. The first is that such a represcription is unnecessary because the resultant return will likely be greater than the 11.25 percent currently prescribed. The second is that a represcribed return lower than the 11.25 percent would disturb the investor community, which in turn would reduce the accessibility and increase the cost of capital by ILECs, particularly the small ILECs subject to rate of return regulation. That these two objections are self-contradictory is patently obvious.

A. Any Represcribed Rate of Return Will Be Lower Than 11.25 Percent

If, as the ILECs contend, the current rate of return is too low, then one would expect the ILECs to be pressing for a represcription. That they do not press for a represcription, and that they decline to calculate a rate of return, suggests that they do not believe their own arguments that a represcribed rate of return would be higher than the currently authorized rate. In fact, none of the modifications proposed by the ILECs to the Commission's tentatively adopted methodology for calculating rate of return would generate a composite rate of return higher than 11.25 percent. Indeed, even when all of the proposed modifications recommended by the ILECs are composited, the result is still a return below 11.25 percent.

On behalf of US WEST, Peter Cummings presents a number of criticisms of the Commission's recommended Discounted Cash Flow ("DCF") methodology. Mr. Cummings first recommends that the growth factor used in the DCF formula be the

growth forecasts of the Institutional Brokers Estimate System ("I/B/E/S") rather than the Standard and Poor's Analysts Consensus Estimates ("ACE").[9] The following comparison demonstrates that there is very little difference between these two sets of estimates, at least as for the five RBOCs:

Table 1

RBOC Earnings Per Share Forecasts

Company	ACE 3-Yr. Growth Rate	ACE 5-Yr Growth Rate	I/B/E/S 5-Yr Growth Rate
Ameritech	7.69%	9.0%	9.0%
Bell Atlantic	6.43%	8.0%	8.0%
BellSouth	9.10%	8.0%	9.0%
SBC	n.a.	11.0%	10.5%
US WEST	4.36%	6.0%	6.0%

Mr. Cummings next reprimands the Commission for failing to compound the quarterly dividends.[10] As GSA pointed out in its direct case, such compounding is inappropriate because the investor's dividends are compounded externally to the issuance of those dividends. The company issuing the dividends does not have to provide the compounded amounts.

Nevertheless, the impact of compounding can be estimated, if not measured precisely. Among the complexities to which the Commission alluded is the requirement to assume a return for the reinvested dividends. That return might be the average for the market, or it might be the return for the companies under study. In any case, there is an

[9]Affidavit of Peter C. Cummings at 19.

[10]Id. at 20-23

element of circularity to this compounding in that it requires an estimate of the average equity return in order to estimate the average equity return.

Assuming, for the sake of illustration, that the market average return from reinvestment is 12 percent, then the one-year effect of compounding for four dividends would be approximately half that amount, or six percent:. Increasing each of the forecast RBOC dividends, as reported in Table 2 (page 10) of GSA's Direct Case, by this factor has the following effect on the RBOCs' dividends:

Table 2

RBOC Dividends

Company	Dividend	Compounded Dividend
Ameritech	$1.32	1.40
Bell Atlantic	1.56	1.65
BellSouth	0.79	.84
SBC Communications	0.99	1.05
US WEST	2.20	2.33

Mr. Cummings next argues that any DCF return must be increased for flotation costs.[11] As GSA pointed out in its direct case, flotation costs are not incurred for retained earnings or for equity issued under dividend reinvestment programs. They are incurred only when new stock is issued for public sale, a rare occurrence among the ILECs. Even then, they are incurred only for the incremental stock issue, not the entire amount of equity capital.

Nevertheless, Mr. Cummings believes that the rate of return to equity should be

[11] Id. at 22-25.

increased to account for flotation costs. He does not supply a flotation cost estimate, but in his January 8, 1999 testimony in US WEST's Arizona rate case, he recommends an adder of 1.17 percent for US WEST.[12]

Mr. Cummings finds that the Commission's proposed average of recent past monthly high and low stock prices is not representative of the current stock price. He recommends averaging stock prices for a recent ten-day period.[13] The average closing RBOC stock prices for the ten trading days ending March 3, 1999 are as follows:

Table 3

RBOC Stock Prices Feb 18- Mar 3, 1999

Company	Average Closing Price
Ameritech	$64.09
Bell Atlantic	$57.19
BellSouth	$46.29
SBC Communications	$52.32
US WEST	$56.96

The foregoing adjustments to the elements of the DCF formula in accordance with Mr. Cummings' criticisms allows the following reestimation of the RBOCs' equity return:

[12]US WEST Filing, January 8, 1999 with the Arizona Corporation Commission for an increase in rates, Testimony of Peter C. Cummings, page 57.

[13]Affidavit of Peter C. Cummings at 26.

Table 4

RBOC Dividends

Company	Compound Dividend	10-day Price	Dividend Yield	I/B/E/S Growth	DCF Return	Increased for Flotation
Ameritech	1.40	64.09	2.18%	9.0%	11.18%	11.31%
Bell Atlantic	1.65	57.19	2.89%	8.0%	10.89%	11.02%
BellSouth	.84	46.29	18.81%	9.0%	10.81%	10.94%
SBC Communications	1.05	52.32	2.01%	10.5%	12.51%	12.66%
US WEST	2.33	56.96	4.96%	6.0%	10.96%	11.09%
All RBOCs						**11.40%**

The principal challenge the ILECs mount to the Commission's tentatively recommended calculation procedures relates to the capital structure used to blend the cost of debt and the cost of equity to develop a composite cost of capital. The ILECs argue that this mix should reflect market valuations of equity, not book equity amounts, so that the debt/equity mix should be on the order of 20/80, rather than the 43/57 found by the Commission in Appendix B, page 2 to the Notice. [14]

For reasons discussed subsequently in this Reply, GSA believes that the ILECs' proposed capital structure is altogether inappropriate. Nevertheless, even if one assumes the propriety of the ILECs' capital structure, the resultant composite is still well below the currently prescribed 11.25 percent:

[14]Affidavit of James Vander Weide at 11; Affidavit of Peter C. Cummings at 14.

Table 5

RBOC Overall Cost of Capital

Element	Proportion	Cost	Weighted Cost
Debt	.20	7.39%	1.48%
Equity	.80	11.40%	9.12%
Total Capital	1.00		**10.60%**

Even if every one of the ILECs' criticisms to the Commission's tentative methodology for calculating the rate of return is accepted, the indicated rate of return is still 65 basis points below the 11.25 percent rate of return authorized in 1990. GSA submits that none of the ILECs' criticisms are appropriate and, as found in GSA's direct case, the rate of return should be reset at **9.5 percent**.

B. A Represcribed Rate of Return is Required to Constrain the ILECs' Market Power.

The ILECs make much of the alleged threat of increased competition for their core local exchange business. Dr. Vander Wiede, for example, refers to the "dramatic growth of CLEC [Competitive Local Exhange Carrier] revenues and market share."[15] Dr. Avera asserts that competitors have penetrated the market for local access service, causing the ILECs to lose their natural monopolies.[16]

The "dramatic growth" of CLEC revenues and market shares arises only because of the base of zero from which they started five years ago. From 0.2 percent of local service revenues in 1993, the CLECs and Competitive Access Providers ("CAPs") had

[15]Affidavit of James Vander Weideat 13.

[16]Comments of William Avera at 13.

increased their share by 1997 to 1.6 percent. Other non-ILECs accounted for 1.5 percent, so that the ILECs retained 96.8 percent of the market.[17]

This hardly constitutes workable competition. In particular, it is not sufficient competition to exercise a controlling influence on the market power of the ILECs. Market power is defined as the ability of a dominant participant in a market to maintain rates for a sustained period above the levels that would be established by an effective competitive market. As long as the ILECs control the overwhelming majority of the local exchange network, and particularly the irreplaceable local loops, they continue to be in a position to exert market power over prices for the use of that network. Included within the reach of that market power are the prices for interstate access services. For these services, the market conditions that led to the establishment of Commission regulation continue to apply.

Section 201(b) of the Communications Act establishes the duty of the Commission to ensure that all charges, practices, classifications and regulations for the provision of interstate communications services are just and reasonable. When interstate carriers are able to exert market power to support prices significantly higher than the cost of service, including the cost of capital, then those prices are no longer just and reasonable.

GSA submits that the current prices for interstate access services qualify for that description. The original basis for the allowed rate of return is no longer valid. A revised and much lower rate of return is clearly warranted. This means that the rates of the carriers still on rate of return regulation should be reduced immediately. It also means that the already exorbitant rates of return enjoyed by the price cap carriers are even more unreasonable than previously perceived. The Commission's obligation to the ratepaying public requires that the rate of return be represcribed.

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[17]FCC, Common Carrier Bureau, Industry Analysis Division, "Local Competition," December 1998, Table 2.1.

C. The Commission Must Establish a Rate of Return for Universal Service Support.

The 1996 Telecommunications Act added Section 254 to the Communications Act for purposes of establishing mechanisms to support universal high-quality service at reasonable and affordable rates to consumers in all regions of the Nation, including low-income consumers and those in rural, insular and high-cost areas.[18] On May 8, 1997, the Commission issued its Report and Order in response to that Section. In that Order, the Commission set forth the procedures for determining the basis for support to high-cost areas. The Commission determined that such support should be based on the forward-looking costs of serving such areas. In para. 250 of the Order, the Commission described the criteria for forward-looking cost determinations. One of those criteria was that "the rate of return must be either the authorized federal rate of return, currently 11.25 percent, or the state's prescribed rate of return."[19]

As demonstrated in GSA's direct case and in this reply, the 11.25 percent is no longer an appropriate rate of return. Thus, quite regardless of all other considerations, the universal service costing program requires the Commission to prescribe a new interstate rate of return.

IV. THE REGULATORY BOOKS CAPITAL STRUCTURE IS THE APPROPRIATE BASIS FOR COMPOSITING DEBT AND EQUITY COSTS

About the only truly substantive suggestion offered by the ILECs in response to the Commission's Notice is their recommendation that the proportions of debt and equity in the overall return be weighted by the market value of the respective components of capital, not by their book value. The ILECs and their experts argue that market prices are

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[18]Communications Act of 1934 as amended by The Telecommunications Act of 1996, §254(b).

[19]Report and Order, CC Docket No. 98.-45, May 8, 1997, ¶250(4).

the only relevant basis for the valuation of any investment; while book values are merely historical records of funds invested, not true measures of value in any economic, going-forward basis.[20] Both Dr. Vander Weide and Mr. Cummings therefore recommend that the debt/equity mix for the ILECs be set at 20/80,[21] rather than the Commissions proposed 43/57.[22] Since equity capital costs more than debt capital, the effect of this change in weighting is to increase the composite rate of return.

There are in fact four different capital structures that could be used to develop a composite cost of capital. The first is the capital structure shown in the companies' financial reports to the SEC and their shareholders. This capital structure is inappropriate because it incorporates equity writeoffs in the mid-1980s that were never recognized by the Commission for regulatory purposes. In large measure, these equity writeoffs reflected the deregulation of depreciable plant that the carriers assumed they would never recover. Financial book ratios therefore tend to be too leveraged, that is, too debt-heavy for use in setting a return to regulated investment.

The second capital structure is that maintained on the regulatory books in accordance with the Commission's Uniform System of Accounts. Unlike the capital shown in the financial books, the capital reported in the Commission's regulated books represents all of the funds invested in the carriers' existing plant and equipment, no more and no less. There are no writedowns of undepreciated plant, nor is there intangible capital in the form of discounted future earnings, as is the case with the ILECs' favored market capital.

This regulatory capital structure is the appropriate basis for a composite return on

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[20]US WEST at 5; SBC at 5; GTE at 4; Bell Atlantic at 10.

[21]Affidavit of James Vander Weide at 12; Affidavit of Peter C. Cummings at 14.

[22]Notice, Appendix B, page 2.

rate base for carriers still subject to cost based regulation. The reason is that this capital structure matches the valuation of that rate base. That is, it records the sources of the funds that were raised to buy the plant and equipment on which the carrier is allowed to earn a return. It is admittedly a historical record, but then, so is the rate base.

The third capital structure is that advocated by the ILECs. It reflects the market value of the company's debt -- usually equivalent to the book value -- and the market value of the company's equity, which for the RBOCs is on the order of five times the financial book value and three times the regulatory book value. As the ILECs correctly point out, this value does not reflect the historical contributions to the purchase of plant and equipment. Rather, it reflects the discounted future value of the earnings and dividends that investors expect they will receive in the future from the entire enterprise, inclusive of unregulated investments, some of which have not even been made.

This capital structure is inappropriate to apply to a historical rate base because it tends to understate the proportion of debt that was actually used to buy the plant and equipment subject to regulation. The existing regulated plant and equipment was not bought with equity inflated by future earnings expectations. Rather, it was acquired with paid-in capital. That paid-in capital took the form of cash derived from depreciation expense, retained earnings, corporate bonds, or new stock issuances -- in other words, the record of book investment.

The fourth capital structure is only obliquely mentioned in the ILECs' filings. It is the true going-forward mix of debt and equity that the company will use to fund future investments. Looking ahead, say, five years, what is the mix of debt and equity from which the company will raise the funds to expand its capital base? This mix is emphatically <u>not</u> the market value mix advocated by the ILECs. Indeed, the very fact that these market value mixes are now so equity rich suggests that future capital resources could be weighted fairly heavily toward debt. The inflation in the value of the ILECs' equity provides ample headroom for adding more low-cost debt financing.

Conceptually, this prospective debt/equity mix is the appropriate capital structure for use in estimating the "going-forward" costs required for universal service support and for the pricing of unbundled network elements. The difficulty with this capital structure is that it is unknowable. It is largely determined by the company's Chief Financial Officer. It is subject to a host of influences totally within management discretion: dividend payout policy, the rate of capital expansion, internal rates of return, prospective mergers and acquisitions, and line of business changes. None of these factors is capable of objective analysis, with the result that a true going-forward capital structure can never be ascertained. The second-best alternative is the one adopted by the Commissions, which is to look to the past mix of sources of funds for construction. The implicit assumption is that historic mix is a reasonable surrogate for the future mix.

V. A REDUCED RATE OF RETURN WILL NOT THREATEN THE ILECS' ABILITY TO RAISE CAPITAL.

Much of the ILECs' direct case is devoted to expostulation over the threat that a revised rate of return will have on their ability to serve the public.[23] The ILECs assert that the investor community is greatly concerned with the growing threat of competition, and that a reduction in the rate of return would be interpreted as a failure to recognize the new level of risk to which the ILECs are currently exposed. In the words of Dr. Avera, "An announcement by the Commission lowering access returns will make it even more difficult for ILECs and their potential competitors to raise capital."[24]

The ILECs provide no evidence whatever that they are having difficulty raising capital. Indeed, none of the major ILECs reports any need to raise capital externally in order to cover construction expenditures. In every case, the cash flow from operations

[23]Associations at Summary i; Bell Atlantic at 3

[24]Comments by William Avera at 10.

substantially exceeds all construction requirements. Even if there were investor concerns about risk and competition, the ILEC community has little need to access the capital markets to raise new funds for their operations.

To illustrate, Ameritech reported net capital expenditures in 1997 of $2.64 billion. It also made additional investments, including acquisitions, of $1.07 billion. In that year, the Company's earnings were $2.30 billion and its depreciation charges another $2.52 billion. Cash flow from operations exceeded cash for investing activities by 36 percent. [25] Similarly, BellSouth reported net cash from operating activities in 1997 of $7.03 billion and net cash used for investing activities of $4.50 billion.[26] SBC's cash flows were not as unbalanced. The Company reported cash from operations of $6.97 billion as against cash flow for investing activities of $6.22 billion, inclusive of $1.12 billion in acquisitions.[27]

Dr. Avera refers to a "credit squeeze" brought on by "unfavorable industry and capital market conditions" that presumably affects adversely small to medium-sized ILECs.[28] Yet Dr Avera offers no objective evidence of this condition. He notes that these carriers have continuing needs for capital, which no one denies. He acknowledges the contributions of the Rural Utilities Service for high cost service to rural communities, although he implies that this support is drying up.[29] He does not mention, however, the continued support of this Commission for rural telephone service and the new programs that the Commission is developing in response to the Telecommunications Act of 1992.

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[25]Ameritech, 1997 Annual Report to Stockholders, Consolidated Statements of Cash Flows, page 39.

[26]BellSouth Form 10K for 1997, page 40.

[27]SBC Communications, Inc. 1997 Annual Report to Stockholders, "Consolidated Statements of Cash Flows."

[28]Comments of William E. Avera at 31, 32.

[29]Id. at 32, 33.

There is no objective evidence whatever that the setting of a new rate of return would disturb the capital markets. Allowed rates of return in the electric and gas industry are subject to continuous readjustment. There is no indication that these industries have been adversely impacted by the "upheaval" of rate of return represcriptions.

VI. ACCESS CHARGES SHOULD BE ADJUSTED FOR THE REVISED RATE OF RETURN.

The Comments of the New Networks Institute ("NNI") do not address the specific rate of return that the ILECs should be allowed, but rather the current very high level of access charges and excessive returns that the larger carriers are earning. NNI notes these excessive earnings and concludes that "local telephone services are some of the most profitable business [sic] in America."[30]

GSA agrees with NNI that there is little benefit to the consuming public if the Commission represcribes the ILECs' rate of return but then does nothing to flow the effect of that represcription into the access charges for interstate services. As matters now stand, the only direct impact will be a reduction in the access charges of the small carriers that are still on rate of return regulation. The Associations indicate that these carriers account for only seven percent of all access lines.[31]

A. All ILEC Access Charges Should Be Reinitialized at 9.5 Percent Return on Investment.

At the end of 1990, when the Commission prescribed the current 11.25 percent

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[30]NNI at 5.

[31]Associations at 2.

interstate rate of return, all ILEC access rates were initialized to achieve that level of earnings.[32] At the same time, the Commission initiated "incentive regulation" in the form of a price cap plan. That plan allowed carriers to retain all earnings between the authorized rate of return and 12.25 percent. ILECs electing a 3.3 percent productivity offset could keep half of all earnings up to 16.25 percent. Those electing a 4.3 percent productivity offset could retain 50 percent of all earnings up to 17.25 percent.[33]

In 1991, the first year of the price cap plan, the carriers' returns generally conformed to the newly authorized rate of return. While individual carriers enjoyed rates of return well above 11.25 percent, others fell short, so that the overall average was only about a half percent higher, 11.78 percent.[34] In subsequent years, however, the average rate of return of the price cap carriers increased, sharing notwithstanding. In 1992 it averaged 12.42 percent, in 1993 13.12 percent, and in 1994 13.58 percent.[35]

On April 7, 1995, the Commission found that its productivity offsets had been too low. This time it adopted three alternative offset factors, 4.0, 4.7 and 5.3 percent. Carriers opting for the lower two factors were required to share half their earnings between 12.25 percent and 13.25 percent and alternatively 16.25 percent.[36] ILECs choosing the highest offset factor did not have to share earnings at all.

The higher productivity offsets did not slow the upward trend in carrier earnings, however. In 1995, the price cap carriers earned, on average, 14.02 percent. In 1996, the

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[32]Order, CC Docket No. 89-624, December 7, 1990, ¶1.

[33]Second Report and Order, CC Docket No. 87-313, October 4, 1990, ¶163.

[34]"Trends in Telephone Service," FCC, Common Carrier Bureau, Industry Analysis Division, February 1999, Table 14.1.

[35]Id.

[36]First Report and Order, CC Docket No. 94-1, April 1, 1995, ¶200.

average soared to 15.15 percent.

On June 6, 1997, the Commission again increased the productivity offset, this time to a single 6.5 percent, and it eliminated sharing altogether.[37] Still, the average return increased, reaching 15.64 percent for the full year 1997.[38]

This average, however, conceals extraordinary variation. Obviously, most carriers are earning well above the authorized 11.25 percent, but some are enjoying earnings in excess of 25 percent. Indeed, the highest return in the nation in 1997 was 48.86 percent, earned by GTE Southwest - Contel of New Mexico. On the other hand, some carriers have not fared nearly so well. Among the largest carriers, Southwestern Bell reported only a 10.32 percent return for 1997.[39]

It is obvious that the passage of years since the initiation of the price cap formula has allowed access charges to drift away from the anchor of cost. This drift could never occur in a truly competitive market. In any other industry, an average return of 15.64 percent would have generated a flood of new entrants, depressing prices and forcing earnings back to a more competitive level. Meanwhile, the carriers with inadequate earnings would have increased their prices to levels that approach the cost of capital. The overall return, as well as the specific returns of the individual firms, would have gravitated to the cost of capital, which GSA has calculated to be 9.5 percent.

Possibly one of the worst outcomes is that the very high ILEC returns are in fact encouraging new entrants. If so, then this economically rational response is creating economically inefficient participants in the market. When eventually these new entrants

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[37]Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, May 21, 1997, ¶8.

[38]"Trends in Telephone Service," Table 14-1.

[39]Id.

are confronted with ILEC prices that actually reflect underlying costs, they will find their investments insupportable, in many cases worthless. Investors will have suffered needless losses, and the economy will have wasted its resources.

GSA suggests that it is time to rationalize access charges by reinitializing them back to the rate of return. Not only would this action restore balance among the different carriers' charges, but it would yield a $2 billion benefit to the consuming public, as quantified in Attachment 1 to GSA's Reply Comments on the NPRM that accompany this Reply.

B. In the Alternative, the Reduction in Rate of Return Should Be Treated as an Exogenous Factor in the Price Cap Formula.

In its most recent price cap review, the Commission considered the possibility of reinitializing access charges based on Total Service Long Run Incremental Costs ("TSLRIC") or on a revised rate of return.[40] GSA supported this proposal in its Comments and Reply Comments,[41] but the Commission declined to undertake such a drastic revision of access charges on the grounds that it would undermine the incentives for efficiency. Indeed, the Commission suggested that the carriers' high earnings justified the price cap regime as having induced efficiency and productivity gains.

If the Commission still holds this view, then it might consider the alternative of treating the change in rate of return as an exogenous variable in the price cap formula. When the Commission established the price cap plan, it allowed for independent adjustments to the price cap index to account for cost changes triggered by

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[40]Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262, et.al., December 24, 1996, ¶¶223-230.

[41]See Comments of GSA and the Department of Defense, January 29, 1997 and Reply Comments, February 14,1997.

administrative, legislative or judicial action beyond the control of the carriers. Such adjustments are designed to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates.[42]

A change in the cost of capital is a truly exogenous cost factor brought about by forces totally beyond the control or influence of the carriers. Capital costs have declined quite independently of the actions of any ILEC. That being the case, then it is appropriate to adjust the ILECs' price caps to reflect the revision in the rate of return. As estimated by GSA, that revision is 175 basis points in the return component of the cost of access. The Commission could choose to calculate this exogenous effect on the basis of each carrier's individual costs, or it could prescribe a common percentage downward adjustment in all the ILECs' price cap indices. In either case, it would flow through to consumers the effect of an exogenous cost reduction that bears no relation to the carriers' internal efficiency or productivity performance.

[42]Second Report and Order, CC Docket 87-313, October 4, 1990, ¶166

VII. CONCLUSION

As a major user of telecommunications services, GSA respectfully urges the Commission to prescribe a 9.5 percent return for the interstate services of the ILECs and to reinitialize the price caps to that level of earnings, or in the alternative, make an exogenous adjustment for the effect of the 175 basis point reduction.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, MICHAEL J. ETTNER, do hereby certify that copies of the foregoing "Reply to Direct Cases of the General Services Administration" were served this 16th day of March, 1999, by hand delivery or postage paid to the following parties:

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