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March 16, 1999

Margalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, SW
Room TW - A325
Washington, DC 20554

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MAR 16 1999

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Dear Ms. Salas:

Re: **CC Docket No. 98-166**

Responsive Filing of the United States Telephone Association, National Telephone Cooperative Association, National Rural Telecom Association, Organization for the Promotion and Advancement of Small Telecommunications Companies, Independent Telephone and Telecommunications Alliance, and National Exchange Carrier Association

Attached is the Joint Responsive Case filing of the above-referenced ILEC trade associations and reply to the NPRM.

Should you have any questions regarding this filing, please contact the undersigned counsel.

Sincerely,

A handwritten signature in black ink that reads "Keith Townsend".

Keith Townsend
Director Legal & Regulatory Affairs
& Senior Counsel

cc: Hon. William E. Kennard
Hon. Susan Ness
Hon. Michael K. Powell
Hon. Harold Furchtgott-Roth
Hon. Gloria Tristani
Lawrence Strickling
Lisa Zaina

Yog Varma
Timothy Peterson
Joann Lucanik

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Before the
Federal Communications Commission
Washington, D.C. 20554

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MAR 16 1999

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

**JOINT RESPONSIVE CASE AND REPLY COMMENTS
OF LOCAL EXCHANGE CARRIER ASSOCIATIONS**

FILING ASSOCIATIONS:

United States Telephone Association

National Telephone Cooperative Association

National Rural Telecom Association

Organization for the Promotion and
Advancement of Small Telecommunications
Companies

Independent Telephone and Telecommunications
Alliance

National Exchange Carrier Association

March 16, 1999

SUMMARY

The record compiled to date in this docket shows that, rather than seeking to represcribe the authorized rate of return, the Commission should devote its resources to other matters, such as universal service, interconnection, and access issues, that are more important to telecommunications users and providers. Resolving those proceedings would reduce regulatory uncertainty for the incumbent LECs and their customers. Developments since the last represcription in 1990, especially passage of the Telecommunications Act of 1996, have increased the risks of all LECs, including rate-of-return LECs. The current authorized rate of return of 11.25% is, therefore, a conservative estimate of incumbent LECs' prospective capital costs based on current data.

The positions of those parties that seek to decrease the authorized rate of return are fundamentally flawed. GSA's analysis relies on an incorrect capital structure for the LECs, and wrongly assumes that the Regional Bell Holding Companies are comparable in risk to the incumbent LECs generally. GSA significantly understates LECs' costs of debt and equity, and GSA's discounted cash flow ("DCF") model incorrectly adjusts the expected growth rate of earnings and ignores quarterly dividends and flotation costs. The studies cited by MCI are outdated and share many of the flaws of GSA's analysis.

Lowering the authorized rate of return would be against the public interest. Doing so would only increase the risks and uncertainties faced by rate-of-return and price-cap LECs. GSA's proposal to ignore infrastructure needs in a represcription would undermine an important objective of the Communications Act, particularly since incumbent LECs have carrier-of-last-resort obligations in all areas of the country.

Because of the increased risks for all LECs since the last reprscription, the present authorized interstate rate of return substantially understates incumbent LECs' capital costs. Indeed, the incumbent LECs' current cost of capital is in the range of 13.95% to 14.15%, calculated using market valuations.

To address these high capital costs, a full-scale reprscription proceeding should increase the authorized interstate rate of return from the current 11.25%. However, because of the numerous other, more critical Commission proceedings that directly affect the incumbent LECs and their customers, there is no need to pursue this proceeding at this time.

As a separate issue, the low-end formula adjustment mechanism for price cap LECs should be maintained or increased.

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Prescribing the Authorized)	CC Docket No. 98-166
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)	

**JOINT RESPONSIVE CASE AND REPLY COMMENTS
OF LOCAL EXCHANGE CARRIER ASSOCIATIONS**

I. INTRODUCTION

The Local Exchange Carrier Associations (the "Associations")^{1/} hereby submit their joint responsive case and reply comments in the above-captioned prescription proceeding, pursuant to sections 65.103 through 65.105 of the Commission's Rules.^{2/}

The direct cases and comments filed in this proceeding demonstrate that, rather than seeking to re prescribe the authorized rate of return, the Commission should devote its resources to other matters, such as universal service, interconnection, and access issues, of

^{1/} The Associations are the United States Telephone Association ("USTA"), the National Telephone Cooperative Association ("NTCA"), the National Rural Telecom Association ("NRTA"), the Organization for the Promotion and Advancement of Small Telecommunications Companies ("OPASTCO"), the Independent Telephone and Telecommunications Alliance ("ITTA"), and the National Exchange Carrier Association ("NECA").

^{2/} See 47 C.F.R. §§ 65.103-105. This filing responds to direct cases filed on January 19, 1999, with respect to paragraphs 1 through 50 of the above-captioned Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking, FCC 98-222 (rel. Oct. 5, 1998) (the "Notice"), and also replies to initial comments filed on January 19, 1999, on the rulemaking proposals in paragraphs 51 through 55 of the Notice.

greater importance to telecommunications users and providers.^{3/} Resolution of those proceedings would reduce regulatory uncertainty for the incumbent LECs and their customers. Developments since the last re prescription, especially passage of the Telecommunications Act of 1996 (the "1996 Act"), have increased the risks of all LECs, including rate-of-return LECs. Thus, the currently authorized rate of return of 11.25% is a conservative estimate of all LECs' prospective capital costs.

The positions of those parties that seek to decrease the authorized rate of return are fundamentally flawed.^{4/} The attached submissions of Dr. William E. Avera and Dr. Randall S. Billingsley show that GSA's analysis relies on an incorrect capital structure for the LECs, and wrongly assumes that the Regional Bell Holding Companies ("RBHCs") are comparable in risk to the incumbent LECs generally.^{5/} Dr. Billingsley demonstrates that GSA significantly understates LECs' costs of debt and equity, and that GSA's discounted cash flow ("DCF") model incorrectly adjusts the expected growth rate of earnings and ignores quarterly dividends and flotation costs. The studies cited by MCI are outdated and share many of the flaws of GSA's analysis.

^{3/} See direct case of Associations at 4; SBC Communications Inc. ("SBC") at 3; Virgin Islands Telephone Company ("Vitelco") at 2-3; see also comments of Bell Atlantic at 2-4; GTE at 2-4; US West, Inc. ("U S West") at 3. All references in this response to the "direct case" of a party refer to direct cases filed on or about January 19, 1999 in CC Docket No. 98-166. All references to "comments" of a party refer to initial comments filed on or about January 19, 1999 in this docket.

^{4/} See especially direct case of the General Services Administration ("GSA") at 23; see also comments of MCI WorldCom, Inc. ("MCI WorldCom") at 3-4.

^{5/} See Attachment A hereto ("Avera responsive testimony") at 3-7; Attachment B ("Billingsley testimony") at 6-8, 34-40.

As Dr. Avera states, reducing the prescribed interstate rate of return for incumbent LECs would:

- send a chilling signal to investors in incumbent LECs and their potential competitors.
- divert the Commission's attention from implementing competition and advancing public policy objectives such as universal service and infrastructure development.^{6/}

Contrary to the public interest, lowering the authorized rate of return would only increase the risks and uncertainties faced by both the rate-of-return LECs and the price-cap LECs. As Dr. Avera notes, GSA's proposal to ignore infrastructure needs in a represetion would undermine an important objective of the Communications Act, particularly since incumbent LECs have carrier-of-last-resort obligations in all areas of the country.^{7/}

In light of the increased risks for all LECs since the last represetion, the currently authorized interstate rate of return substantially understates incumbent LECs' capital costs. The Billingsley testimony demonstrates in detail that the incumbent LECs' current cost of capital is in the range of 13.95% to 14.15%, calculated using market valuations.^{8/}

Because of these high capital costs, a full-scale represetion proceeding properly would increase the authorized interstate rate of return from the current 11.25%. However, because of the numerous other, more critical Commission proceedings that directly affect the

^{6/} See Avera responsive testimony at 1.

^{7/} See *id.* at 2, 5.

^{8/} See Billingsley testimony at 3, 21-34.

incumbent LECs and their customers, there is no current need to pursue this proceeding.^{9/}

As a separate issue discussed below in section III, the low-end formula adjustment mechanism for price cap LECs should be maintained or increased.

II. IF THE COMMISSION TAKES ANY ACTION IN THIS DOCKET, IT SHOULD INCREASE THE AUTHORIZED RATE OF RETURN

Contrary to GSA's claims,^{10/} all LECs are subject to substantially larger risks than in 1990, the time of the last represcription. The Associations showed in their direct case that, in recognition of these risks, a represcription is unnecessary. However, if the Commission chooses to pursue this proceeding, the authorized rate of return should be increased substantially.

As the record shows, such a represcription is fully justified by the increased risks of incumbent LECs since even before passage of the 1996 Act. Competitive risks for rate-of-return LECs have grown significantly, as evidenced by the Commission's own studies regarding the marketplace.^{11/} The numerous mergers and strategic alliances involving competitors of the incumbent LECs provide further evidence of such risks. AT&T's just-completed merger with TCI is one such competitive development, as is AT&T's recently

^{9/} To the extent that a prescribed rate of return would be necessary for determining universal service support, *see* Notice ¶ 8 and direct case of GSA at 2-3, no rate of return less than the current authorized rate should be used. Under no circumstances should the Commission attempt to prescribe different rates of return for LECs' interstate access and interexchange services. *See id.* Any such attempts would be arbitrary and would constitute harmful micromanagement of LEC operations.

^{10/} *See* direct case of GSA at 3-5 (claiming that business risks faced by BOCs are greater than those faced by other LECs).

^{11/} *See* Billingsley testimony at 8-11, *citing Local Competition* (Indus. An. Div., Com. Carr. Bur., Dec. 1998).

announced strategic relationship with Time Warner. Similarly, MCI WorldCom, itself the product of a recent merger, has entered into an alliance with AOL's Compuserve unit to integrate long distance and Internet offerings.

Competitive risks have increased due to the emergence of fiber optic networks and satellite and wireless providers that offer alternatives to LECs' private line and access services.^{12/} Satellite and terrestrial wireless providers are placing major competitive pressures on rural LECs.^{13/}

At the same time, the Commission's ongoing proceedings, particularly those addressing interconnection,^{14/} universal service,^{15/} and access charges,^{16/} increase the regulatory risks of the incumbent LECs.^{17/} As the Associations have explained, incumbent LECs are now subject to extensive regulatory obligations under the 1996 Act, often without any assurance that they will be able to recover the costs they are required to incur. This is

^{12/} See, e.g., Billingsley testimony at 9-18; Avera responsive testimony at 3, 4-5; Affidavit of James H. Vander Weide, Ph.D., attached to comments of Bell Atlantic ("Vander Weide Affidavit") ¶¶ 25-31.

^{13/} See Billingsley testimony at 11.

^{14/} See, e.g., *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499 (1996), *aff'd in part, remanded in part, AT&T Corporation v. Iowa Utilities Board*, 1999 U.S. Lexis 903 (Nos. 97-286, et al. Jan. 25, 1999).

^{15/} See, e.g., *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776 (1997), *appeal pending sub nom. Texas Office of Public Utility Counsel v. FCC*, No. 97-60421 (5th Cir. argued Dec. 1, 1998); *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Second Recommended Decision, FCC 98J-7 (rel. Nov. 25, 1998).

^{16/} See, e.g., *Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982 (1997); Order on Reconsideration, 12 FCC Rcd 10119 (1997); *aff'd sub nom. Southwestern Bell Telephone Co. v. FCC*, 153 F.2d 523 (8th Cir. 1998); Second Order on Reconsideration, 12 FCC Rcd 16606 (1997).

^{17/} See Billingsley testimony at 18-21.

the case for new programs such as local number portability, customer proprietary network information requirements, and new law enforcement requirements imposed under the Communications Assistance for Law Enforcement Act.^{18/} Moreover, technological changes, highlighted by the development of satellite, cable television, terrestrial wireless, and Internet-based technologies, have heightened risks for incumbent LECs, many of which continue to rely on traditional wireline infrastructure.^{19/} Taken together, these growing risks result in an increased cost of capital for the incumbent LECs.

A. The Incumbent LECs' Cost Of Capital Is At Least 13.95%

The Billingsley testimony quantifies the effect on the capital costs of incumbent LECs of the increased competitive, regulatory, and technological risks described above.^{20/} In concluding that the cost of capital for incumbent LECs is in the range of 13.95% to 14.15%, Dr. Billingsley analyzes empirically derived market values, rather than book values, to determine the LECs' average capital structure, cost of equity, and cost of debt.^{21/} As the Billingsley testimony notes, the use of market values, rather than book values, in calculating capital structures is standard practice for cost of capital and capital budgeting analyses.^{22/}

^{18/} See direct case of Associations at 8.

^{19/} See Avera responsive testimony at 5 and Vander Weide Affidavit ¶¶ 32-33. At the same time, LECs' operating leverage -- the ratio of their fixed costs to variable costs -- has grown, which increases the sensitivity of LECs' returns to fluctuations in revenue. See *id.* ¶ 24.

^{20/} See Billingsley testimony at 23 and Exhibit RSB-4.

^{21/} See also direct case of the Associations at 12; Avera responsive testimony at 6-7.

^{22/} See Billingsley testimony at 33-34, citing S.A. Ross, R.W. Westerfield, and B.D. Jordan, *Essentials of Corporate Finance* (1996) at 316-317 and R.A. Brealey and S.C. Myers, *Principles of Corporate Finance* (5th ed. 1996) at 214, 517.

Dr. Billingsley finds that the average market value-based capital structure of the incumbent LECs consists of 12.17% debt and 87.83% equity.^{23/} Dr. Billingsley also estimates the average cost of debt for the incumbent LECs to be 6.35%.^{24/}

Dr. Billingsley estimates the current average cost of equity for incumbent LECs to be in the range of 15.00% to 15.21%, based on (i) a DCF model for a group of publicly traded firms comparable in risk to the average incumbent LEC, with adjustments for the payment of quarterly dividends as well as flotation costs, (ii) a capital asset pricing model ("CAPM") analysis for that comparable group of firms, and (iii) corroboration through a risk premium analysis using data on capital market expectations.^{25/} The cost of capital for incumbent LECs is derived by combining the average costs of equity and debt, weighted according to the capital structure described above.

These calculations demonstrate that the authorized interstate rate of return should be increased if the Commission proceeds with a re prescription. As the Billingsley testimony explains, the current overall capital cost range of 13.95% to 14.15% is well above the current prescription of 11.25%. Indeed, the current average cost of equity of 15.00% to 15.21% exceeds the range of 12.5% to 13.5% that the Commission found to be reasonable in the 1990 re prescription.^{26/} The substantially increased risks faced by incumbent LECs

^{23/} See Billingsley testimony at 5. This is consistent with Dr. Avera's finding, noted in the Associations' direct case, that the LECs' capital structure is approximately 80% or more equity and 20% or less debt. See direct case of the Associations at 12; Billingsley testimony at 32-33.

^{24/} See *id.* at 31-32. This is conservative, since the average yield on A-rated public utility bonds was 6.97% in January, 1999.

^{25/} The Billingsley testimony at 21-31, and its attached exhibits, describe these analyses in detail.

^{26/} See *id.* at 5.

compared to the environment of 1990 call for a higher authorized rate of return for the rate-of-return LECs.

B. The Proposals Of GSA And MCI WorldCom To Decrease The Authorized Rate of Return Are Fundamentally Flawed

Among parties filing direct cases or initial comments in this proceeding, only GSA and MCI WorldCom specifically advocate a decrease in the authorized rate of return. In doing so, each incorrectly relies on assumptions and methodologies that tend to underestimate the LECs' capital costs. Because GSA presents the more detailed direct case, we first refute GSA's claims.

1. The GSA Direct Case Contains Multiple Errors

Capital Structure: As the Billingsley testimony shows, GSA wrongly relies on a capital structure based on book values, rather than market values.^{27/} Dr. Billingsley notes that no investor would pay the book values of the incumbent LECs' debt and equity while they are traded in open capital markets.^{28/} The effect of this erroneous basis for the incumbent LECs' capital structure is to produce a historical capital structure that is "clearly biased downward."^{29/}

^{27/} See Billingsley testimony at 37-38, *citing* direct case of GSA at 22; *see also* Vander Weide Affidavit ¶ 22; comments of U S West at 4-5.

^{28/} See Billingsley testimony at 38.

^{29/} See *id.*

Cost of Equity: In estimating the cost of equity using a version of the DCF model, GSA makes multiple errors.^{30/} Most notably, GSA incorrectly bases its DCF analysis on an assumption that the RBHCs are comparable in risk to the incumbent LECs generally.^{31/}

In contrast, the Billingsley testimony makes no assumptions concerning the relative riskiness of the RBHCs and the incumbent LECs. Indeed, it conducts an objective empirical analysis that demonstrates that the RBHCs are not, as a group, comparable in risk to the incumbent LECs.^{32/} In short, GSA applies its DCF analysis to the wrong group of companies and thereby derives cost of equity estimates that are irrelevant to analyzing the incumbent LECs' capital costs.

The DCF model used by GSA also wrongly adjusts the expected growth rate in earnings, which, as the Billingsley testimony explains, systematically underestimates the resulting cost of equity by implicitly assuming that dividends have no time value -- an invalid assumption.^{33/} GSA's DCF model improperly fails to adjust for flotation costs.^{34/} These errors cause GSA's DCF model to underestimate the incumbent LECs' cost of capital. The Billingsley testimony shows that GSA's DCF model does not accurately portray the

^{30/} See direct case of GSA at 8-17.

^{31/} See *id.* at 3-4, 5-7.

^{32/} See Billingsley testimony at 34-35.

^{33/} See *id.* at 35, 36-37. See also Notice ¶ 24; comments of U S West at 12.

^{34/} See *id.* at 36. See also Notice ¶ 25; comments of U S West at 12-13.

investor's perspective, and therefore significantly underestimates the incumbent LECs' capital costs.^{35/}

GSA wrongly calls for the Commission to accord CAPM analysis "very little weight."^{36/} CAPM should not be ignored if the Commission proceeds with a represcription. As U S West explains, CAPM is the dominant model for estimating cost of equity capital.^{37/} The Billingsley testimony describes in detail the CAPM model it uses to estimate the incumbent LECs' cost of capital, which uses prospective beta coefficients and other expectational data consistent with the theoretical basis of CAPM analysis.^{38/}

Cost of Debt and Preferred Stock: Any analysis of the cost of debt and the cost of preferred stock should be based on the costs of new debt and new issues of preferred stock, rather than the historical costs of previously issued securities, as GSA incorrectly does.^{39/} For example, yield spreads between recent debt issues of LECs and U.S. Treasury securities of comparable maturity should be used to estimate the cost of debt.^{40/}

^{35/} See Billingsley testimony at 37-38. In general, stock prices used in the DCF model should be averaged over a relatively short period. See Notice ¶ 27; comments of U S West at 13.

^{36/} See direct case of GSA at 21.

^{37/} See comments of U S West at 14.

^{38/} See Billingsley testimony at 24-27.

^{39/} See Notice ¶¶ 12-14, 15-16; comments of U S West at 10.

^{40/} See *id.*

2. MCI WorldCom's Studies Are Outdated And Contain Errors
Similar To Those Of GSA

MCI WorldCom's comments share many of the foregoing weaknesses of GSA's direct case. MCI WorldCom incorrectly and illogically refers to studies filed in earlier proceedings to claim that the authorized rate of return should be decreased.^{41/} As the Billingsley testimony shows, MCI WorldCom presents no current evidence regarding the capital costs of the incumbent LECs. Because MCI WorldCom's studies rely on dated, historical inputs rather than prospective estimates based on current data, the Commission cannot rely on the outdated studies of MCI WorldCom for determining incumbent LECs' capital costs.^{42/}

MCI WorldCom's obsolete studies also make many of the same errors that GSA does.^{43/} Thus, for purposes of applying a DCF model, these studies improperly assume that the RBHCs are comparable in risk to the incumbent LEC industry as a whole. They also wrongly adjust the estimated growth rate in the DCF model. The MCI WorldCom studies fail to adjust for flotation costs, and incorrectly use the annual form of the DCF model even though the publicly-traded incumbent LECs commonly pay quarterly dividends. As a result, the Commission cannot rely on the studies to which MCI WorldCom refers as a basis for determining the capital costs -- or the authorized interstate rate of return -- for the incumbent LECs.

^{41/} See comments of MCI WorldCom at 3-4.

^{42/} See Billingsley testimony at 39-40.

^{43/} See *id.*

III. THE THRESHOLD FOR THE LOW-END FORMULA ADJUSTMENT MECHANISM SHOULD BE MAINTAINED OR INCREASED

Both AT&T and MCI recommend that the LFAM be eliminated in this proceeding.^{44/} However, as long as the Commission continues to require a price cap formula adjustment that incorporates an unrealistic and excessive productivity gain each year, and as long as price cap rate structures and price levels are micro-managed by regulation and not by the marketplace, the incumbent LECs' downside risks continue to be significantly out of balance with potential rewards. Elimination of the LFAM in the context of a rescription proceeding for rate-of-return LECS ignores the interdependence of the LFAM with the components and objectives of price cap regulation.

AT&T advances several misconceptions regarding the LFAM. First, AT&T's statement that smaller LECs may "opt out" of price cap regulation^{45/} is incorrect. The Commission's rules do not permit a carrier to simply "opt out" of price cap regulation. Second, contrary to AT&T's claims, LECs have not abused the LFAM, which, indeed, has rarely been utilized. Third, AT&T incorrectly claims that the current LFAM allows incumbent LECs to recover past earnings deficiencies. LFAM adjusts the price cap six months after the calendar year for which earnings are measured. The price cap formula can then be adjusted only to a level 100 basis points below the prescribed rate of return. Even the reduced level of rate of return would not be recovered, for a full twelve months of applying the adjusted access rates -- eighteen months beyond the year in question.

^{44/} See comments of AT&T at 2, 5, MCI at 4.

^{45/} See comments of AT&T at 2.

MCI's proposed formula to calculate the earned rate of return necessary to trigger the LFAM must be rejected, since it would result in the recapture of all earnings above the prescribed rate of return.^{46/} Such a ridiculous result would only serve as a potential punishment to LECs that are unable to achieve average industry productivity, contrary to the purpose of the LFAM, which provides protection to LECs with productivity growth below the industry average. In addition, MCI's proposal could well increase the cost of capital for LECs. At the current 11.25% authorized rate of return, the LFAM trigger under MCI's proposal would be only 3.12%. Such a preposterously low threshold would increase the perceived risk of the LEC industry, which in turn could bid up investors' required return on LEC capital. MCI's proposal is absurd and must be rejected.

The best course for the Commission would be to (i) reduce the productivity factor, consistent with the updated results of the Commission's price cap methodology^{47/} and (ii) implement a framework whereby competitive services could be removed from price cap regulation. These steps are consistent with the purpose and incentives of price cap regulation.

IV. CONCLUSION

The evidence presented in the direct cases and initial comments in this proceeding demonstrates that the best course is to resolve other pressing matters while retaining the existing authorized rate of return. However, if a represetion takes place, the Commission

^{46/} See comments of MCI at 6.

^{47/} See F.M. Gollop, *Technical Report: Replication and Update of the X-Factor Constructed Under FCC Rules*, in comments of USTA in CC Docket No. 96-262 (Oct. 26, 1998) at Attachment D.

should increase the authorized rate of return substantially. The Commission should increase or maintain, but not otherwise modify, the low-end formula adjustment mechanism for price cap LECs.

Respectfully submitted,

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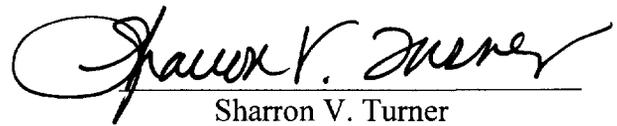
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CERTIFICATE OF SERVICE

I, Sharron V. Turner, do certify that on March 16, 1999 copies of the foregoing Joint Responsive Case of the Local Exchange Carrier Associations were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.


Sharron V. Turner

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CC DOCKET NO. 98-166

COMMENTS OF DR. WILLIAM E. AVERA, CFA

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NATIONAL TELEPHONE COOPERATIVE
ASSOCIATION, NATIONAL RURAL TELECOM
ASSOCIATION, ORGANIZATION FOR THE PROMOTION
AND ADVANCEMENT OF SMALL
TELECOMMUNICATIONS COMPANIES, INDEPENDENT
TELEPHONE AND TELECOMMUNICATIONS
ALLIANCE, AND NATIONAL EXCHANGE CARRIER
ASSOCIATION**

CC DOCKET NO. 98-166

**COMMENTS OF DR. WILLIAM E. AVERA, CFA
FILED ON BEHALF OF
THE UNITED STATES TELEPHONE ASSOCIATION, NATIONAL
TELEPHONE COOPERATIVE ASSOCIATION, NATIONAL RURAL
TELECOM ASSOCIATION, ORGANIZATION FOR THE PROMOTION
AND ADVANCEMENT OF SMALL TELECOMMUNICATIONS COMPA-
NIES, INDEPENDENT TELEPHONE AND TELECOMMUNICATIONS
ALLIANCE, AND NATIONAL EXCHANGE CARRIER ASSOCIATION**

Q. Please state your name and business address.

A. My name is William E. Avera. My address is 3907 Red River, Austin, Texas.

Q. Are you the same William E. Avera who filed comments in this docket on behalf of the telephone associations?

A. Yes, I am.

Q. What is the purpose of your reply comments?

A. I am responding to the comments filed in this proceeding by General Services Administration ("GSA"), AT&T, and MCI WorldCom.

Q. What are your conclusions?

A. In their comments, all three parties claim to embrace pro-competitive policies. Yet their proposals would forestall the development of viable competition in the market for access services for several reasons:

- Reducing the prescribed rate of return for incumbent local exchange carriers (ILECs) interstate access service would send a chilling signal to investors in ILECs and their potential competitors.
- Diverting the Commission's attention from the thorny policy issues that need to be resolved to clear the path for competition while protecting public policy objectives such as universal service and infrastructure improvement.

GSA and MCI WorldCom assert that rising stock prices and falling interest rates since 1990 imply that the cost of capital has decreased. This simplistic and incorrect

assertion ignores the increasing risks of providing access services as a result of competition, technological advances, and regulatory uncertainty. Moreover, the increases in stock prices have been driven largely by prospects of higher growth. For the ILECs, the shift in capital structure toward significantly higher equity ratios (as properly measured by market values) implies that the overall cost of capital for ILECs has risen, not fallen.

GSA, AT&T, and MCI WorldCom miss the main policy imperative—the ILECs are the service providers of last resort and must be able to raise capital to maintain and upgrade the vital telecommunications infrastructure in all areas of the country. GSA’s proposal to ignore infrastructure needs in determining cost of capital would undermine an important and continuing policy objective of the Telecommunications Act. AT&T’s and MCI WorldCom’s proposals to alter or abandon the low end adjustment could well put at risk the ability of some ILECs to raise capital when confronted with adverse circumstances.

Q. Do the three parties properly describe the role of regulators in fostering the development of competition in formerly regulated industries?

A. No. Although claiming to support the Commission’s efforts to bring the benefits of competitive markets to consumers, they set up a false dichotomy between regulation and competition. For example, GSA seems to suggest that regulators should stay on the path of traditional regulation until competition is fully developed.¹ As I discussed in my direct comments, this country’s experience with other deregulated industries suggests that regulation requires considerable finesse during periods of transition. Policies such as signaling lower returns, however, would undermine the development of competition and ultimately harm consumers. The regulatory framework must be adjusted to accommodate both the entry of competition and legislatively mandated policy goals such as universal service and infrastructure development.

¹GSA Direct Case at 2.

Q. Don't the three parties claim to support efforts to increase competition in the telecommunications industry?

A. Even participants who support competition may unwittingly advocate policies that would impair the continued development of competitive telecommunications markets. For example, GSA contends that the current market share held by ILECs somehow implies that they hold "dominant market power over access" that requires a high level of regulation in general and rate-of-return regulation in particular.² GSA urges the Commission to reduce the prescribed rate of return for ILECs.

GSA ignores the fact that the potential entry by new firms is the most powerful check on market power in any industry. As I pointed out in my initial comments, low returns from interstate access services will discourage entry into the market for interstate access services by reducing incentives of interexchange carriers and others to invest in access networks and technologies. It is axiomatic that competition cannot grow in a market in which returns are held below competitive levels.

Q. How do the three parties misjudge the implications of increased competition and changes in the capital markets since the ILEC rate of return was last prescribed in 1990?

A. In the first place, it is too simplistic to suggest that the capital markets "indicate" that the cost of capital for ILECs has dropped.³ Even the most astute financial economists (*e.g.*, Alan Greenspan) sometimes find the capital markets inscrutable. Capital market movements are driven by many factors that must be carefully analyzed before well-founded inference may be drawn. Viewed broadly, the evidence from the capital markets implies that the cost of capital for ILECs has very likely risen. The higher risk faced by telecommunications firms have raised the cost of equity for the ILECs at the same time it has forced them to shift their capital structures toward much higher equity levels.

²GSA Direct Case at 2.

³GSA Direct Case at 2.

The higher stock market can be a very misleading indicator of the cost of capital, since high prices may reflect a change in growth rates. No one would seriously suggest, for example, that the recent extraordinary rise in the prices for stocks of Internet-related companies indicates that the risk and cost of capital is lower for these companies. The level of the stock market alone does not determine the cost of capital.

Q. Does the observation that the ILECs face different risks than do industrial companies in competitive markets imply that the ILECs' risks are less?

A. No. Investors realize that in today's markets, telecommunications service providers can no longer assume that they have captive customers in protected service territories. As GSA acknowledges, the restructuring of the telecommunications market began in the 1970s. Sophisticated customers, especially large telecommunications users, realize they have a choice.

Because of their high proportion of fixed costs, when telephone companies lose customers, it is much more damaging to the bottom line than it is for most other industries. Moreover, investment in telecommunications tends to be much less mobile than it is for other industries. Large retailers can sell off locations in declining markets and redeploy the inventory elsewhere. Manufacturing firms can retool their factories to produce different products. But telecommunications facilities can be used only to provide telecommunications services and are usually tied to a particular service territory. GSA may believe that because ILECs have established service territories, they face lower risks, but the facts suggest otherwise.

The competitive inroads in metropolitan areas have been widely reported, but telephone companies in smaller communities face the same challenges. In working with small and rural telephone companies across the country, I have observed that competition is an increasing risk. Many smaller ILECs obtain a significant portion of their revenue from a handful of large customers, such as colleges, industrial facilities, prisons, national parks, and resorts. If one or more of these customers leave a smaller ILEC's system, the

loss of revenue has a profound impact on the company's profit because costs would decrease little, if any. In addition, breakthroughs in cable TV, satellite, and wireless technology raise the specter of significant customer loss for smaller ILECs because the basic infrastructure is already deployed in rural areas and these technologies may be especially well-suited to serve less densely populated areas.

Q. Can infrastructure development be ignored, as GSA apparently urges?⁴

A. No. The Telecommunications Act recognizes the importance of continued infrastructure development. As I noted in my direct comments, a community's telecommunications network has become a vital element in maintaining the residents' quality of life and attracting new businesses. Clearly, the Commission should consider the financial challenges faced by many ILECs in deciding to adjust the prescribed rate of return. For the reasons discussed in my direct comments, a change in the prescribed rate of return at this point might impair the ability of some ILECs to raise sufficient capital to invest in maintaining their local infrastructures.

I am particularly surprised that GSA, the agency representing the interests of all federal executive agencies, would apparently ignore the importance of developing the telecommunications infrastructure. Federal facilities across the country depend on the infrastructure maintained and upgraded by rate-of-return ILECs. Not only is infrastructure development essential to the goal of economic growth and opportunity for all communities, it is essential to the operation of the many federal facilities outside metropolitan areas. Almost 50 years ago, President Eisenhower proposed the interstate highway system to support national defense. His vision has linked the nation's communities for both government and private purposes. Similarly, ensuring that the telecommunications infrastructure will support federal facilities across the country also advances the broader national policy of rural community development.

⁴GSA Direct Case at 24.

Q. How do the proposals of AT&T and MCI WorldCom to alter the low-end adjustment mechanism also run counter to the policy of fostering infrastructure development?

A. ILECs will not be able to attract sufficient capital to maintain and upgrade their systems if the Commission recognizes the need to adjust a company's rate of return only when it is in "dire financial circumstances," as AT&T seems to suggest. A company's financial resiliency and its ability to attract capital for investing in upgrading infrastructure disappear long before it is in "dire financial circumstances."

MCI WorldCom's formula approach, on the other hand, assumes that high earnings by a company in the past enable it to continue to access capital markets despite disappointing current results. Investors who provide capital today are interested only in tomorrow's financial performance. The past is relevant only to the extent that it may predict the future. All too often, the financial circumstances that cause disappointing returns persist through time. Hence, an ILEC facing "dire financial circumstances" cannot mollify investors with the glories of past performance. The attitude of investors toward any company is not "what have you done for me lately?"; rather, their attitude is "what will you do for me tomorrow?" The customers and communities served by financially troubled ILECs are concerned about the ability of their carrier of last resort to raise capital. They will not take solace in MCI WorldCom's assurance that "[a]ny one year of low earnings will be quickly offset by higher earnings in succeeding years."⁵ Unfortunately, a troubled ILEC could not take MCI's observation "to the bank."

Q. Do you have any final observations?

A. GSA commented that the special charges booked by the RBOCs in recent years are one cause of the companies' extraordinarily erratic earnings over the same period.⁶ The same write-offs have distorted book-value capital structures, and thus provide one of the

⁵MCI WorldCom Comments at 5.

⁶GSA Direct Case at 15.

reasons that market-value capital structures should be used to measure the cost of capital for ILECs. As I noted in my initial comments, market-value capital structures have moved toward higher equity levels to be consistent with the increasing business risk caused by growing competition. The shift in capital structures since the re prescription in 1990 more than offsets any decrease in ILEC debt costs over the same period.

Q. Does that complete your reply comments?

A. Yes.

**BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
IN THE MATTER OF:
PRESCRIBING THE AUTHORIZED RATE OF RETURN
FOR INTERSTATE SERVICES OF LOCAL EXCHANGE
CARRIERS
CC DOCKET NO. 98-166**

**COMMENTS OF DR. RANDALL S. BILLINGSLEY, CFA
MARCH 16, 1999**

**FILED ON BEHALF OF:
THE UNITED STATES TELEPHONE ASSOCIATION,
NATIONAL TELEPHONE COOPERATIVE
ASSOCIATION, NATIONAL RURAL TELECOM
ASSOCIATION, ORGANIZATION FOR THE PROMOTION
AND ADVANCEMENT OF SMALL
TELECOMMUNICATIONS COMPANIES, INDEPENDENT
TELEPHONE AND TELECOMMUNICATIONS
ALLIANCE, AND NATIONAL EXCHANGE CARRIER
ASSOCIATION**

1 capital-related testimony to numerous state regulatory commissions and to the Federal
2 Communications Commission (FCC or “Commission”). My business address is:
3 Department of Finance, Pamplin College of Business, Virginia Polytechnic Institute and
4 State University, Blacksburg, Virginia 24061-0221. More details on my qualifications
5 may be found in Billingsley Exhibit No. RSB-11.

6
7 These comments are my independent professional opinions and are not presented by me
8 as a representative of Virginia Polytechnic Institute and State University.

9
10 **Q. Have you prepared exhibits to accompany these comments?**

11
12 **A.** Yes, my comments and eleven exhibits were prepared by me or under my direction and
13 supervision.

14 15 **II. PURPOSE OF COMMENTS AND SUMMARY OF CONCLUSIONS**

16 **A. PURPOSE OF COMMENTS**

17
18 **Q. What is the purpose of your comments in this proceeding?**

19
20 **A.** My purpose is to provide capital market evidence that is useful in evaluating the
21 Commission’s proposal to represcribe the authorized rate of return for interstate access
22 services provided by incumbent local exchange companies (ILECs) not subject to price cap
23 regulation. Specifically, I provide evidence on whether there has been a significant change

1 in the ILECs' cost of equity, cost of debt, and overall cost of capital since the
2 Commission's last represcription in 1990 of an overall cost of capital of 11.25%. I
3 consequently evaluate the reasonableness of the continued use of an overall cost of capital
4 of 11.25% in regulating the ILECs not subject to price cap regulation by estimating the
5 ILECs' current cost of capital. My estimates of the ILECs' current overall cost of capital
6 range from 13.95% to 14.15%. I also comment on the cost of capital implications of the
7 consistently increasing investment risk of the ILECs. Finally, I rebut the incorrect cost of
8 capital estimates filed by the General Services Administration (GSA) and rebut the
9 empirically unsupported and dated cost of capital recommendations filed by MCI
10 WorldCom, Inc. (MCI WorldCom) in this proceeding.

11

12 **B. SUMMARY OF COST OF CAPITAL ANALYSIS**

13

14 **Q. Please describe the approaches that you use to determine the ILECs' cost of capital**
15 **and summarize your conclusions.**

16

17 A. My analysis uses objective market data to determine the cost of capital for the ILECs by
18 estimating the average cost of capital for the local telephone operating companies for which
19 there is available financial data. The telephone operating companies are, as a group, the
20 broadest, most economically meaningful representatives of the ILEC industry as a whole.
21 Because most of the large local telephone operating companies are subsidiaries of parent
22 holding companies, few have equity trading in the market. Thus, there is little direct market

1 evidence on the firms' cost of capital. It is consequently necessary to infer the costs of
2 capital for the companies using capital market data.

3
4 The average cost of equity for the ILECs is determined from two distinct but
5 complementary approaches. In the first approach I apply the discounted cash flow (DCF)
6 model to a group of firms identified as comparable in risk to the average ILEC. An average
7 cost of equity capital is calculated by applying the DCF model to each of the comparable
8 firms in order to provide an objective, market-determined cost of equity capital for the
9 ILECs. In the second approach, I use the capital asset pricing model (CAPM) to estimate
10 the cost of equity capital for the group of publicly traded firms that are comparable in risk
11 to the ILECs. Finally, I conduct a risk premium analysis that uses data on capital market
12 expectations to evaluate the reasonableness of the ILECs' estimated cost of capital.

13
14 The cost of equity for the ILECs is in the range of 15.02% to 15.23% using the comparable
15 firm group DCF model approach. The CAPM approach indicates that the ILECs' cost of
16 equity capital is in the range of 15.00% to 15.21%. The risk premium approach indicates
17 that the expected return on the overall equity market, as measured by the S&P 500, is
18 currently between 13.69% and 14.69%. Billingsley Exhibit No. RSB-1 explains how my
19 analytical approaches are consistent with well-accepted regulatory and economic standards
20 in cost of capital analysis. From these analyses, I conclude that the current cost of equity
21 capital for the ILECs is within the range of 15.00% to 15.23%.

22

1 My analysis determines the average cost of debt for the ILECs to be 6.35% and the average
2 market value-based capital structure to consist of 12.17% debt and 87.83% equity.
3 Combining these capital structure weights and the average cost of the debt with the above
4 average cost of equity estimates produces an overall average cost of capital for the ILECs
5 in the range of 13.95% to 14.15%.

6
7 **Q. Please discuss the significance of your cost of capital findings relative to the**
8 **Commission's recent proposal to represcribe the authorized rate of return for**
9 **interstate access services provided by ILECs not subject to price cap regulation.**

10
11 A. The ILECs' current prospective cost of equity range of 15.00% to 15.23% is in excess of
12 the Commission's range of 12.50% to 13.50% found to be reasonable in 1990. I also find
13 that the ILECs' overall cost of capital is in the range of 13.95% to 14.15%, which is well in
14 excess of the Commission's current authorized overall rate of return of 11.25%. Thus, my
15 cost of capital findings indicate that if the Commission should decide to represcribe the
16 authorized rate of return for the ILECs that are subject to rate of return regulation for their
17 earnings on interstate access services at this time, the overall cost of capital should be
18 increased above the current level of 11.25%. This recommendation would apply to the
19 threshold rate of return for the low-end formula adjustment mechanism (LFAM) and the
20 Commission should allow ILECs whose calendar year earnings fall below the new
21 threshold to adjust their basket indices appropriately.

22
23 The increase in ILEC capital costs results largely from the higher perceived risk of

1 investing in companies that provide local exchange and access services. Investors have
2 consequently increased their return requirements to compensate for placing their funds at
3 higher risk in this more competitive industry. The ILECs have been forced to accommodate
4 this greater business risk by relying more heavily on equity than debt financing, which has
5 put additional upward pressure on overall capital costs. While interest rates have generally
6 fallen since the Commission last prescribed authorized rates of return in 1990, the
7 downward pressure of lower interest rates on capital costs has been more than offset by the
8 upward pressure exerted on capital costs by the increasing business risks of the ILEC
9 industry. These joint factors explain my finding that the ILECs' overall capital cost
10 significantly exceeds the Commission's current authorized rate of 11.25%.

11
12 **C. SUMMARY OF REBUTTAL OF THE GENERAL SERVICES**
13 **ADMINISTRATION'S COST OF CAPITAL ESTIMATES FOR THE**
14 **ILECS**

15
16 **Q. What issues does your rebuttal focus on in the GSA's comments concerning capital**
17 **costs of the ILECs?**

18
19 **A.** My rebuttal discusses the GSA's failure to rely on appropriate market value-based capital
20 structures in estimating the ILECs' overall cost of capital and explains the errors in the
21 GSA's application of the DCF model to estimate the ILECs' cost of equity capital. The
22 GSA's incorrect reliance on book value-based capital structures significantly
23 underestimates the amount of equity in the ILECs' average capital structure. As discussed

1 below, the use of market values is theoretically appropriate and consistent with common
2 practice in both cost of capital and capital budgeting analysis. The GSA's errors in
3 estimating the ILECs' cost of equity using the DCF approach include: 1) inappropriate and
4 unsupported reliance on the RBOCs as comparable in risk to the ILECs; 2) inappropriate
5 application of the estimated expected growth rate; 3) failure to adjust for flotation costs,
6 and 4) failure to use the appropriate form of the DCF model that recognizes the quarterly
7 payment of dividends. These errors explain why the GSA underestimates the ILECs' cost
8 of equity as only 10.75% and overall cost of capital as only 9.50%.

9
10 **D. SUMMARY OF REBUTTAL OF MCI WORLDCOM'S COST OF CAPITAL**
11 **OBSERVATIONS ON THE ILECS**

12
13 **Q. What issues does your rebuttal emphasize concerning MCI WorldCom's comments**
14 **on the ILECs' capital costs?**

15
16 **A.** My rebuttal explains that MCI WorldCom merely assumes that the ILECs' current overall
17 cost of capital is below the Commission's current authorized rate of 11.25%. MCI
18 WorldCom only cites several proceedings since 1994 in which it has filed ILEC-related
19 cost of capital studies. Yet the approaches used in MCI WorldCom's previously filed
20 studies make many of the same errors made by the GSA (e.g., see Statement of Matthew I.
21 Kahal on Behalf of MCI Communications, CC Docket No. 94-1, filed May 1994), which
22 are elaborated on below. MCI WorldCom's most recent cost of capital evidence is based on

1 data no more recent than September of 1998 and in the case of the RBOC data, is based on
2 even older data (see Rate of Return for Local Exchange Telephone Companies, Prepared
3 for MCI WorldCom, Inc. by Matthew I. Kahal, October 1998, included in MCI WorldCom,
4 Inc. Comments, CC Docket No. 96-262, CC Docket No. 94-1, RM-9210, filed October 26,
5 1998). The Commission deserves to have more up-to-date market evidence on the ILECs'
6 capital costs. Thus, MCI WorldCom's failure to present any current evidence concerning
7 the ILECs' capital costs in the current proceeding leaves their position unsupported and
8 therefore unreliable as a basis for making a recommendation to the Commission concerning
9 the appropriateness of the current authorized overall cost of capital of 11.25%.

10
11 **III. CURRENT STATUS OF COMPETITION IN THE TELECOMMUNICATIONS**
12 **INDUSTRY**

13
14 **Q. What is the current status of competition in the telecommunications industry?**

15
16 **A.** Competition in the telecommunications industry has increased dramatically in recent years.
17 The sources of that increased competition include a greater threat of new entrants in the
18 industry, a significant increase in the number and strength of existing competitors, a greater
19 threat of substitute telecommunications products and services, more intense rivalry among
20 existing competitors in the industry, and enhanced regulatory risk at both the state and the
21 federal levels. Thus, both actual and potential competition have increased and the business
22 risk of the industry has consequently increased. Indeed, a recent study by the Commission
23 documents the significant and growing trend toward greater competition in the local

1 telephone exchange market by observing (see *Local Competition*, Industry Analysis
2 Division, Common Carrier Bureau, Federal Communications Commission, December
3 1998):

- 4 • The revenues of competitors in the local exchange market continue to increase
5 rapidly, starting from a very small base. In 1997, the revenues of local service
6 competitors doubled ... (p. 1).
- 7 • Local service competitors are deploying fiber in their networks at a faster rate than
8 are ILECs. Local competitors tripled their amount of fiber in place from the end of
9 1995 to the end of 1997. Local competitors now have at least 11% of the total fiber
10 optic system capacity potentially available to carry calls within local markets (p. 2).

11
12 What investors believe about the future competition that the ILECs will face is critical to
13 cost of capital analysis. Investors' expectations of competition and its impact on risk are
14 what are reflected in the capital costs faced by the ILECs.

15
16 **Q. Specifically how has competition increased in recent years?**

17
18 A. The intraLATA and local exchange markets have become much more competitive in recent
19 years. Large businesses have been able to bypass the ILECs' private line and access
20 services using fiber optic networks, microwave transmission and very small aperture
21 terminals (VSAT). The growth of competitive access providers (CAPs) such as
22 Metropolitan Fiber Systems (MFS) and the Teleport Communications Group (TCG) has

1 allowed large business customers to connect with long distance carriers (interexchange
2 carriers or IXC) without paying access charges to the ILECs.

3
4 It is clear that investors believe that major CAPs, IXCs, and cable television (CATV)
5 companies are positioning themselves to compete vigorously for customers in the local
6 exchange market. The ILECs face heightened potential competition that poses additional
7 risk to their operations and their ability to recoup extensive infrastructure investments.
8 Investors see such competition coming from wired, wireless, and Internet sources. Consider
9 the representative recent observations on competition in **Business Week** (“Zooming Down
10 The I-Way,” Andy Reinhardt, Peter Elstrom, and Paul Judge, April 7, 1997, pp. 76-87):

11 [O]utside the boardrooms of telecom’s giants, innovation is sweeping the wired and
12 wireless world-bubbling up from the bottom. Hundreds of alternative carriers and
13 nimble startups are leaping head-first into the newly deregulated environment (p. 76).

14
15 The Internet is also giving rise to new products that could undermine traditional
16 phone services. The one that sends shivers down the spines of telecom execs:
17 software that lets you place phone calls over the net (p. 77).

18
19 The Internet is not the only threat to the telephone companies. A slew of startups are
20 finding ways to eat into traditional telephone usage ... PCs are becoming telephone
21 command centers for video conferencing and unified messaging that combines e-mail,
22 fax, and voicemail (p. 78).

1 The provision of wireless services such as personal communication systems by CAPs,
2 CATV operators, and electric utilities also enhances the ability of customers to completely
3 bypass local exchange services. Wireless services are becoming a viable consumer
4 alternative to ILEC services. Further, there is a major push to develop worldwide wireless
5 service through satellite networks offered by organizations that include Iridium World
6 Communications (Motorola), GlobalStar (Loral), ICO Global (Inmarsat), and Odyssey
7 (TRW). "Traditional" wireless services and worldwide satellite networks will increasingly
8 put competitive pressure on the providers of rural wireline telephone services. Thus, these
9 alternatives will only increase the competitiveness of that environment and thus magnify
10 the business risk of all ILEC operations. This growing risk is increasing the ILECs' cost of
11 raising capital.

12
13 **Q. Has the business risk of the telecommunications industry increased in recent years**
14 **and is it expected to continue increasing in the future, especially due to the passage of**
15 **and uncertainties in implementing the Telecommunications Act of 1996?**

16
17 **A.** Yes. The passage of the Telecommunications Act and responses to its passage dramatically
18 indicate that business risk has been increasing and will increase even more in the future.
19 The Act, which was signed into law by President Clinton on February 8, 1996, essentially
20 allows local, long-distance, and cable companies to get into one another's businesses. Thus,
21 the traditional barriers that separated these industry sectors are now officially being
22 dropped. While market pressures have been eroding these limits in recent years, the various

1 competitors are now moving forward rapidly. However, open competition brings a
2 significant increase in risk.

3

4 The passage of the Telecommunications Act is apparently viewed as risky by investors,
5 competing telecommunications firms, and by the Commission. Indeed, the Commission has
6 observed:

7 ... [I]ncumbent LECs face potential competition as a result of the Act that they did not
8 face previously. This potential competition could increase the risks facing the
9 incumbent LECs, and thus increase their cost of capital, thus mitigating, to some
10 extent, the factors suggesting that incumbent LECs' cost of capital has decreased
11 since 1990 (Notice of Proposed Rule Making, Third Report and Order, and Notice of
12 Inquiry, FCC 96-488, December 24, 1996, p. 101, paragraph 228).

13 The implication is that investors are requiring higher rates of return to compensate for the
14 higher investment risk resulting from the new competitive environment fostered by the
15 implementation of the Telecommunications Act.

16

17 **Q. How have recent mergers and acquisitions changed the nature of competition in the**
18 **telecommunications industry?**

19

20 A. Numerous dramatic recent mergers and acquisitions have significantly increased the degree
21 of competition among telecommunications firms and in so doing have increased the risks
22 faced by industry investors. This implies that investors must increase their return
23 requirements in order to be adequately compensated for the increased riskiness of holding

1 telecommunications stocks.

2

3 Consider the following key mergers and acquisitions, consummated or pending, in the
4 industry over the last few years: AT&T / Tele-Communications (TCI), Bell Atlantic / GTE,
5 WorldCom / MCI Communications, WorldCom / MFS Communications, SBC
6 Communications / Southern New England Telephone (SNET), SBC Communications /
7 Ameritech, Alltel / 360° Communications, SBC Communications / Pacific Telesis, MCI
8 Communications / Brooks Fiber Properties, WorldCom / UUnet Technologies, AT&T /
9 McCaw Cellular, and AT&T / Teleport Communications. Further, these explicit mergers
10 and acquisitions do not reflect the numerous strategic alliances within the
11 telecommunications industry that have altered the competitive landscape. For example,
12 MCI WorldCom recently (February 4, 1999) announced an agreement with America
13 Online's CompuServe to provide MCI WorldCom's subscribers with local Internet access.
14 Thus, such subscribers will be able to get Internet access and long-distance services on one
15 bill.

16

17 A particularly important competitive development is AT&T's recently announced a
18 strategic relationship with Time Warner to offer cable telephony. AT&T Chairman and
19 Chief Executive Officer C. Michael Armstrong describes it as follows ("AT&T and Time
20 Warner Form Strategic Relationship to Offer Cable Telephony," AT&T News Release,
21 February 1, 1999):

22

Together with our merger with Tele-communication, Inc. (TCI) and agreements with

1 five TCI affiliates, the Time Warner joint venture will enable AT&T to reach more
2 than 40 percent of U.S. households over the next four to five years. In addition, we
3 look forward to working with Time Warner in the delivery of next-generation
4 broadband communications services.

5 This joint venture gives AT&T the exclusive right to offer residential and small business
6 telephony services over Time Warner's cable systems for the next twenty years. The **Wall**
7 **Street Journal** reports that "[t]he Time Warner pact is aimed at helping AT&T sidestep the
8 regional phone companies ..." ("AT&T, Time Warner in Cable-TV Accord," Leslie Cauley
9 and Rebecca Blumenstein, February 2, 1999, p. A3). Thus, this strategic alliance is an
10 important example of how the ILECs' competitive position within the telecommunications
11 industry is being eroded, thereby increasing its business risk and attendant capital costs.

12
13 The planned acquisition of TCI by AT&T is another significant recent source of greater
14 investment risk. The following comments support the enormous perceived significance of
15 the deal, as reported in **Business Week** ("At Last, Telecom Unbound," Peter Elstrom,
16 Catherine Arnst, and Roger Crockett, July 6, 1998, pp. 24-27):

17 ... [I]n an ironic twist, AT&T, the company that has perhaps missed the most
18 opportunities in the new world of digital communications, has come up with the deal
19 that, if it works, will take advantage of all these trends – and could be the catalyst for
20 other deals and business plans that break the bottleneck and finally deliver on the
21 promise of digital convergence. "This is the deal that's going to get competition
22 going," says former FCC Commissioner Reed Hundt. "This is exactly what regulators
23 envisioned – consumers having choice." (p. 24).