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

In the Matter of	)	
	)	
Improved Regulation of Interstate Services Of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers	)	RM No. 10011

EXHIBIT 2

AFFIDAVIT OF JAMES H. VANDER WEIDE

PLAN FOR IMPROVED REGULATION
OF
NON-PRICE CAP INCUMBENT
LOCAL EXCHANGE CARRIERS
AND INTEREXCHANGE CARRIERS

October 20, 2000

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Qualifications and Purpose

Q. What is your name and business address?

A. My name is James H. Vander Weide. I am Research Professor of Finance and Economics at the Fuqua School of Business, Duke University. I am also President of Financial Strategy Associates, a firm that provides strategic and financial consulting services to clients in the electric, gas, insurance, telecommunications, and water industries. My business address is 3606 Stoneybrook Drive, Durham, North Carolina.

As a Professor at Duke University, I have taught courses in corporate finance, investment management, management of financial institutions, statistics, economics, and operations research, as well as a Ph.D. seminar on the theory of public utility pricing. I have also been active in executive education at Duke, directing and teaching in executive programs both stateside and abroad for leading international firms. In addition to my teaching, I have written a book entitled, *Managing Corporate Liquidity: An Introduction to Working Capital Management*, and numerous articles and research papers on such topics as portfolio management, the cost of capital, capital budgeting, the effect of

1 regulation on the performance of public utilities, and cash management. I hold a Ph.D. in
2 finance from Northwestern University and a B.A. in economics from Cornell University.
3 Q. What is the purpose of your affidavit?
4 A. The Multi-Association Group has asked me to: (1) review their proposal for regulatory
5 reform; (2) evaluate its consistency with sound economic policy in telecommunications;
6 and (3) make a recommendation to the Commission on whether this proposal should be
7 accepted. From my review of the Multi-Association Group Plan ("the Plan"), I conclude
8 that the Plan furthers the goals of economic policy in telecommunications, and I
9 recommend that the plan be accepted by the Commission.
10 Economic Policy in Telecommunications
11 Q. What is the primary objective of economic policy in telecommunications?
12 A. The primary objective of economic policy in telecommunications is to promote the
13 widespread availability of high quality, reliable telecommunications services at
14 affordable rates.
15 Q. What policies has the Commission pursued to achieve this objective?
16 A. The Commission has pursued its economic policy objective in telecommunications by:
17 (1) regulating rates; (2) encouraging competition; (3) providing incentives for efficiency
18 and cost reduction; (4) rebalancing rates; and (5) providing both implicit and explicit
19 support for universal service.
20 Q. What particular forms of rate regulation has the Commission exercised?
21 A. The Commission has exercised both rate of return regulation and incentive regulation.
22 **Rate of Return Regulation**
23 Q. What is rate of return regulation?

1 A. Rate of return regulation is a system of regulation that controls rates by requiring that a
2 company's return on investment be no greater than the return its investors could earn on
3 other investments of similar risk. The first step in rate of return regulation is to measure
4 the company's operating expenses, its investment in plant and equipment, called its rate
5 base, and its fair rate of return on investment. The next step is to determine the
6 company's revenue requirement through the formula:

7 *Revenue Requirement = Operating Expenses + Fair Rate of Return x Rate Base.*
8 Finally, the Commission sets rates for telecommunications services that produce.
9 sufficient revenues to allow the company to earn its revenue requirement. The set of
10 rates for specific regulated services that allow the company to earn its revenue
11 requirement is called the rate structure. Under rate of return regulation, the rate structure
12 for regulated services frequently involves pricing some services above cost so as to
13 provide cross subsidies to other regulated services that are priced below cost. These
14 cross subsidies have contributed to the goal of universal service in rural areas as
15 evidenced by the 94 percent penetration of telephone service nationwide.

16 Q. How does rate of return regulation encourage telecommunications companies to reduce
17 costs, expand services, and invest in new telecommunications technologies?

18 A. Rate of return regulation encourages efficient behavior primarily through the
19 administration of regulatory oversight. If a company acts efficiently in the production
20 and sale of regulated telecommunications services, it will be able to set rates that are
21 sufficient to recover all operating expenses plus a fair rate of return on the company's
22 investment. If a company acts inefficiently, a portion of its operating expenses or its
23 investment may be disallowed.

1 **Incentive Regulation**

2 Q. What is incentive regulation?

3 A. Incentive regulation is a form of regulation that further breaks the link between a
4 company's rates and its expenses. Rather than basing rate changes on increases or
5 decreases in a company's own expenses, regulators base rate adjustments on increases or
6 decreases in an external cost standard such as the GDP-PI. By basing rate changes on
7 changes in an external cost standard, incentive regulation shifts the focus from rate of
8 return to increasing efficiency.

9 Q. What are the major benefits of incentive regulation?

10 A. Incentive regulation provides enhanced incentives for a company to reduce costs, expand
11 service, and invest in new telecommunications technologies. If the company's efforts to
12 reduce costs, expand service, and invest in new technologies are successful, the company
13 is permitted to earn a higher rate of return. On the other hand, if the company's efforts
14 are unsuccessful, the company's rate of return will be lower. In addition, incentive
15 regulation frequently provides flexibility for the company to price individual services in
16 line with sound business and economic principles, and it reduces the costs of regulation.

17 Q. What types of "efficiency" does incentive regulation seek to encourage?

18 A. Incentive regulation seeks to encourage technical efficiency, allocative efficiency and
19 dynamic efficiency. Technical efficiency refers to the ability of a company to use the
20 least amount of inputs, such as labor and capital, for a given level of output. Allocative
21 efficiency refers to the company's ability to set prices for different telecommunications
22 services that reflect the true economic costs of producing those services. Dynamic

1 efficiency refers to the company's ability to choose the correct level of investment in new
2 technologies and services.
3 Q. How does incentive regulation encourage technical efficiency?
4 A. Incentive regulation encourages technical efficiency by breaking the link between the
5 company's revenues and the amount it spends on labor and capital inputs. Under
6 incentive regulation, the company's profits increase whenever it can produce and sell the
7 same level and quality of services with fewer labor and capital inputs. Likewise, its
8 profits decrease whenever the company uses too many labor and capital inputs to produce
9 telecommunications services.
10 Q. How does incentive regulation encourage allocative efficiency?
11 A. Incentive regulation encourages allocative efficiency by giving companies the flexibility
12 to more closely align rates with the manner in which costs are incurred. Thus, incentive
13 regulation generally produces rates that provide stronger economic signals to customers
14 about the level of society's resources they are consuming. Economic theory suggests that
15 stronger price signals lead to a more efficient allocation of society's resources.
16 Q. How does incentive regulation encourage dynamic efficiency?
17 A. As noted above, dynamic efficiency refers to the company's ability to choose the correct
18 level of investment in new technologies and services. Companies have an incentive to
19 invest in new technologies and services whenever the expected rate of return from such
20 investments exceeds the cost of capital. Since incentive regulation focuses on efficiency
21 rather than rate of return, it places no limits on the return companies can achieve by
22 investing in new technologies and services. Thus, incentive regulation provides greater
23 incentive for these investments.

1 Q. Is incentive regulation appropriate for all telecommunications companies?

2 A. Incentive regulation is inappropriate for those rural carriers serving areas with limited
3 growth, or even negative growth, due to out-migration of population. In situations of low
4 or negative growth, carriers have limited opportunities to reduce costs and increase
5 revenues. Nonetheless, these carriers are obligated to serve as carriers of last resort: they
6 must maintain the network and the capability to serve all consumers in face of negative
7 growth. Given the unfavorable demographics of these rural companies' service
8 territories, these companies will have limited incentive to introduce new technologies and
9 services unless they receive some assurance that they will have the opportunity to recover
10 the costs of their investments in rates. Rate of return regulation provides this necessary
11 assurance.

12 **The Telecommunications Act of 1996**

13 Q. Are you familiar with the Telecommunications Act of 1996 ("the Act")?

14 A. Yes, I am.

15 Q. What was the purpose of the Act?

16 A. Congress passed the Act to provide for a deregulatory and competitive structure for
17 telecommunications markets and to assure the availability of basic and advanced
18 telecommunications services to all regions of the country at comparable and affordable
19 rates.

20 Q. How does the Act encourage competition in telecommunications markets?

21 A. The Act specifically removes all regulatory barriers to entry in telecommunications
22 markets and requires incumbent carriers to: (1) interconnect their facilities with other
23 telecommunications carriers; (2) provide non-discriminatory access to network elements

on an unbundled basis; (3) offer for re-sale at wholesale rates any service the carrier provides at retail; (4) provide number portability; (5) provide dialing parity to competing providers of local exchange and toll service; and (6) provide physical collocation of the equipment necessary for interconnection or access to unbundled network elements.

Q. Does the Act provide any exemptions to the above requirements for rural telephone companies?

A. Yes. Section 251(f) (1) provides an exemption from these requirements for rural telephone companies until such companies have received a bona fide request for interconnection and network elements, and the state has determined that the request is not economically burdensome, is technically feasible, and is consistent with the Act's universal service provisions. In addition, Section 251 (f) (2) allows states to suspend or modify the interconnection requirements for those companies with fewer than two percent of the nation's subscriber lines installed, in the aggregate, nationwide.

Q. Are there any other ways in which the Act treats rural telephone companies differently from other telephone companies?

A. Yes. Concerning universal service requirements, the Act treats rural telephone companies differently with respect to: (1) the number of providers eligible for universal services support [Section 214 (e) (2)]; (2) the definition of "service area" for the purpose of determining universal service support obligations and mechanisms [Section 214 (e) (5)]; and (3) the requirements imposed on competitive carriers as a condition of entry in rural markets [Section 253 (f)].

Q. How does the Act provide for the availability of basic and advanced telecommunications services to all regions of the country at affordable rates?

1 A. The Act relies primarily on deregulation and competition to achieve this policy goal. In
2 addition, the Act establishes certain universal service principles that the Commission is
3 required to implement. These universal service principles include: (1) quality services
4 should be available at just, reasonable, and affordable rates; (2) basic and advanced
5 telecommunications services should be provided in rural, insular, and high cost areas at
6 rates that are reasonably comparable to rates charged in urban areas; (3) basic and
7 advanced telecommunications services should be available at discounted rates to rural
8 schools, libraries, and hospitals; (4) all providers of telecommunications services should
9 contribute to the preservation and enhancement of universal service; and (5) universal
10 service support should be explicit and sufficient to achieve these universal service goals.
11 Q. Why is universal service a desirable policy goal?
12 A. Universal service is desirable for two reasons. First, the benefit of telecommunications
13 service to any one customer increases exponentially with the number of other customers
14 that are connected to the network. Thus, it is beneficial to society for as many people to
15 have telecommunications service as possible. Second, access to telecommunications
16 service is a significant component of economic welfare. Those who do not have access to
17 telecommunications service are significantly disadvantaged with respect both to their
18 ability to consume and to their ability to advance in society.
19 **The Commission's Regulatory Reform Program**
20 Q. Has the Commission taken any steps to implement the Act's goals?
21 A. Yes. The Commission has taken numerous steps to: (1) develop pricing policies and
22 regulations regarding interconnection, collocation, the purchase of unbundled network
23 elements, and the resale of services provided at retail; (2) set standards for number

portability and dialing parity; (3) reform the system of interstate access charges; (4) establish a system of explicit and sufficient support for universal service; and (5) assure that rates for and availability of basic and advanced services in rural areas are reasonably comparable to rates and availability of basic and advanced services in urban areas. I limit my discussion to access reform, universal service support, and provision of high quality services in rural areas at comparable rates, because these issues are the major focus of the Plan.

Access Reform

Q. How are access charges currently determined for non-price cap LECs?

A. Access charges for the non-price cap LECs are currently determined in four steps. First, the non-price cap LECs must record all revenues, expenses, and investment in accordance with the Commission's Uniform System of Accounts. The non-price cap LECs must then divide their revenues, expenses, and investment into accounts associated with regulated and non-regulated services. Next, they determine the fraction of regulated expenses and investments that should be allocated to the interstate jurisdiction via the separations process (Part 36 of the Commission's Rules and Procedures). Finally, the Commission determines a set of interstate access rates that allows the non-price cap LECs to recover their interstate expenses and earn a fair rate of return on their interstate investment.

Q. How are the non-price cap LECs' regulated expenses and investment allocated to the interstate jurisdiction via the separations process?

A. The separations process recognizes that some facilities, such as private lines, are used exclusively for interstate services. The cost of these facilities are assigned entirely to the interstate jurisdiction. The process further recognizes that most of the non-price cap

1 LECs' telecommunications facilities are used to provide both interstate and intrastate
2 services, and that the cost of these facilities can be classified as either traffic sensitive or
3 non-traffic sensitive. As their names imply, traffic sensitive costs are those that depend
4 on the amount of usage of telecommunications facilities, while non-traffic sensitive costs
5 are those that must be incurred, even if the company's telecommunications facilities are
6 not used. Traffic sensitive costs are allocated via the separations process on the basis of
7 the relative percentage of intrastate and interstate minutes of use. Non-traffic sensitive
8 costs are allocated 75 percent to intrastate, 25 percent to interstate.
9 Q. Have economists recognized any basic principles that should govern the pricing of
10 interstate access services?
11 A. Yes. Economists have long recognized that the pricing of interstate access services
12 should reflect the manner in which interstate access costs are incurred. Thus, traffic
13 sensitive costs should be recovered through usage-sensitive rates, and non-traffic-
14 sensitive costs should be recovered through flat rates. Economists have also recognized
15 that there must be a margin above cost to cover overhead expenses.
16 Q. Does the Commission recognize the basic economic principle that access costs should be
17 recovered in the same manner in which access costs are incurred?
18 A. Yes. The Commission recognized the basic economic principle that access costs should
19 be recovered in the same manner in which they are incurred as early as 1983, when it
20 issued its Order in MTS and WATS Market Structure, CC Docket No. 78-72, Third
21 Report and order, Phase 1, 93 FCC 2d 241, *recon.*, 97 FCC 2d 682 (1983), *second recon.*,
22 97 FCC 2d 834 (1984). In that Order, the Commission stated its goal of gradually
23 increasing end user access charges to the point where they fully recovered the non-traffic

sensitive costs of providing end user access. Subsequent political considerations caused the Commission to abandon this goal well short of the point where non-traffic sensitive costs were fully recovered through end user access charges. However, the Commission made further steps in the direction of recovering access costs more economically in its 1997 Access Reform Order. Finally, the Commission recognized this economic principle in the *Sixth Report And Order In CC Docket Nos. 96-262 And 94-1, Report and Order In CC Docket No. 99-249, Eleventh Report and Order In CC Docket No. 96-45,* issued May 31, 2000, when it stated at paragraph 12:

> In promulgating its access charge rules, the Commission has recognized that, to the extent possible, costs of interstate access should be recovered in the same way that they are incurred. This approach is consistent with principles of cost-causation and promotes economic efficiency. Thus, non-traffic-sensitive costs should be recovered through fixed, flat-rated fees. Similarly, traffic-sensitive costs should be recovered through corresponding per-minute access rates. The Commission's rules, however, are not fully consistent with this goal. In particular, because the Commission has taken a cautious approach in addressing affordability concerns, it has taken measured steps toward this goal by limiting the amount of the allocated interstate cost of a local loop that is assessed directly on residential and business customers as a flat monthly charge.

Universal Service

Q. What steps has the Commission taken to implement the universal service provisions of the Act?

A. The Commission has taken at least two steps to implement the universal service provisions of the Act. First, the Commission has established an explicit funding mechanism to fulfill the Act's requirement that advanced telecommunications services be made available at discounted rates to schools, libraries, and hospitals in rural areas. Second, the Commission has investigated a variety of models for determining the cost of providing telecommunications services in some rural areas. The Commission has

1 referred this issue to the Joint Board. Third, the Commission has established explicit
2 funding mechanisms for Long Term Support and Local Switching Support. Previously,
3 these support dollars were implicit subsidies built into interstate access rates. Fourth, the
4 Commission has approved a plan put forth by the Coalition for Affordable Local and
5 Long Distance Service ("CALLS") to reduce implicit subsidies in access rates and
6 provide an explicit and sufficient means of supporting universal service.

7 **The CALLS Plan**

8 Q. Are you familiar with the CALLS Plan?

9 A. Yes, I am.

10 Q. What are the major features of the CALLS Plan?

11 A. The CALLS plan has the following features:

12 • Increases the primary residential and single line business subscriber line charge
13 ("SLC") caps to $4.35 on July 1, 2000, and gradually increases the SLC caps
14 thereafter to $6.50 on July 1, 2003;
15 • Removes $650 million in implicit universal service support from carrier access
16 charges;
17 • Creates an explicit portable interstate access universal service support mechanism;
18 • Eliminates the residential PICC;
19 • Requires IXCs to flow through reductions in access rates to residential and business
20 customers;
21 • Temporarily eliminates minimum usage rates for low-usage customers by long
22 distance carriers; and
23 • Provides additional lifeline assistance to low income customers to protect them from
24 increases in the residential SLC.

25 Q. How does the CALLS plan address the Commission's economic policy goals in the areas
26 of access reform and universal service?

27 A. The CALLS plan directly achieves the Commission's goals of recovering access costs in
28 the same manner in which they are incurred, removing implicit subsidies embedded in
29 carrier access rates, and assuring explicit and sufficient support for universal service.

1 Q. Does the CALLS plan apply to rate of return regulated companies?

2 A. No. The CALLS plan does not apply to rate of return regulated companies. However,
3 the CALLS plan affects the rate of return regulated companies because it increases the
4 disparity in the access rates charged by the rate of return and price cap LECs, and
5 increases the pressure on interexchange carriers to de-average interstate toll rates,
6 contrary to Section 254 (g) of the Act.

7 The Plan

8 Q. Are you familiar with the Plan?

9 A. Yes, I am.

10 Q. What is the purpose of the Plan?

11 A. The Plan seeks to provide a comprehensive and integrated solution to outstanding
12 regulatory issues in the areas of interstate access, universal service support, separations,
13 and rate of return.

14 Q. What are the major features of the Plan?

15 A. The Plan has the following features:

16 • Allows participating companies to choose between incentive regulation (Path A), and
17 rate of return regulation (Path B), over a reasonable transition period.[1]
18 • Reduces Path A carrier access rates to a prescribed $0.016 composite average level.
19 • Increases the SLC for Path A and Path B companies to the prevailing CALLS'
20 companies cap under the CALLS plan.
21 • Removes current ceilings on universal service support.

[1] Companies that initially choose Path B also have an opportunity to shift to incentive regulation during the first five years of the Plan. At the end of the five-year transition period, however, Path B companies must apply for a waiver from the Commission to move to incentive regulation. Plan participants expect that companies with the majority of access lines will choose the incentive regulation option by the end of the transition period.

- Creates an explicit and sufficient system of universal service support to replace implicit subsidies in current access rates.
- Requires long distance carriers to flow-through reductions in access rates to residential and business customers.
- Adjusts lifeline assistance support to shield low-income customers from increases in residential SLCs.
- Retains the current 25 percent non-traffic sensitive interstate allocation factor and 11.25 percent interstate allowed rate of return on investment.
- Includes a low-end adjustment feature that is similar to the current low-end adjustment feature for the price cap LECs.

Q. What are the primary economic benefits of the Plan?

A. The Plan has numerous economic benefits. First, the Plan reduces, and in some cases eliminates, the implicit subsidies in the current access charge system for non-price cap LECs. Second, the Plan provides explicit and sufficient support for universal service, as required by the Act. Third, as also required by the Act, the Plan assures that rural telecom customers will have access to high quality telecommunications services at rates that are reasonably comparable to those charged in urban areas. Fourth, the Plan provides incentives for the Path A non-price cap LECs to reduce costs, expand services, and increase investments in new telecommunications technologies in rural areas through a form of incentive regulation that, although different from price caps, is compatible with the pooling environment. Fifth, the Plan eliminates the time and expense of litigating the complex, outstanding regulatory issues in the areas of access charges, universal service, separations, and rate of return. Finally, the Plan encourages telecommunications competition in rural areas.

Reduction of Implicit Subsidies

Q. How does the Plan reduce the implicit subsidies in the current access charge system for non-price cap LECs?

1 A. By gradually increasing the subscriber line charge to the caps stated in the CALLS Plan,
2 the Plan allows a significantly higher percentage of non-traffic sensitive costs to be
3 recovered through flat end user fees. Since the shortfall in recovery of non-traffic
4 sensitive costs has previously been covered by usage sensitive carrier common line
5 charges, the Plan allows for a significant reduction in carrier access rates over the life of
6 the plan. Thus, the Plan moves towards recovering traffic sensitive costs with usage
7 based rates, and non-traffic sensitive costs with flat rates.
8 Q. Does the Plan address the Commission's concerns regarding implicit subsidies?
9 A. Yes. As the Commission recognized in Paragraphs 26—28 of the CALLS Order,
10 however, the task of determining the cost of providing service in every area of the
11 country is both difficult and time consuming, and the methods that should be used to
12 determine the cost of providing access are highly controversial. Yet, there is common
13 agreement that carrier access rates are currently above the traffic sensitive cost of
14 providing access, and subscriber line charges are currently below the non-traffic sensitive
15 cost of providing access. Furthermore, subscriber line charges in high cost rural areas
16 simply cannot increase to the point of recovering non-traffic sensitive costs without
17 impairing the affordability of telecommunications service in high cost rural areas, and
18 violating the Act's principle of comparability. In this environment, it is preferable to
19 accept a comprehensive consensual approach that moves in the right direction, rather
20 than to endlessly debate the complex issues involved in implementing access and

universal service reform.[2] The Plan offers such a comprehensive approach to access and universal service reform that takes reasonable steps in the right direction.

Q. Are the Plan's reductions in per-minute carrier access rates and increases in SLCs similar to those the Commission has previously approved in the CALLS Order?

A. Yes. The reductions in per-minute carrier access rates in the Plan are proportional to the reductions in carrier access rates already approved by the Commission. In addition, the Plan requires non-price cap LECs to increase their SLCs up to the capped levels allowed in the CALLS Plan. Thus, the Plan's reductions in carrier access rates and increases in SLCs are very similar to access changes the Commission has already approved.

Explicit and Sufficient Support for Universal Service

Q. How does the Plan provide explicit and sufficient support for universal service?

A. The Plan provides explicit and sufficient support for universal service through the removal of the cap on high cost support and the creation of a Rate Averaging Support ("RAS") mechanism that is designed to recover the shortfall between the Path A non-price cap pooling LECs' total interstate revenue requirement and the amounts they collect in carrier access rates, subscriber line charges, and existing universal service support mechanisms. Universal service support under the RAS mechanism will be collected in the same manner as universal support under the Commission's current universal service support programs.

Q. Are the universal service support payments provided by the RAS portable?

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[2] As the Commission states in Paragraph 28 of the CALLS Order, "It is this comprehensive solution of historically contentious issues that allows us to take these actions while ensuring that consumers in high-cost areas will continue to have affordable service." *Sixth Report And Order In CC Docket Nos. 96-262 and 94-1, Report and Order*

1 A. Yes. The RAS support payments are portable to all eligible telecommunications carriers.

2 **Assurance of Comparable Rates**

3 Q. How does the Plan assure that rates for telecommunications services in rural areas will be
4 reasonably comparable to those in urban areas?

5 A. The Plan assures that rates for telecommunications services in rural areas will be
6 reasonably comparable to those in urban areas in several ways. First, the Plan reduces
7 the non-price cap LECs' carrier access rates in proportion to the reductions in carrier
8 access rates identified in the CALLS Plan. Second, the Plan requires interexchange
9 carriers to pass through reductions in carrier access rates to toll customers in the non-
10 price cap LECs' primarily rural areas, and to provide all of their rate plans ubiquitously to
11 both urban and rural customers. Third, the Plan requires interexchange carriers to
12 abandon their plans to geographically de-average toll rates and to adhere to the Act's
13 requirement that: (1) rates for interexchange services in rural and high cost areas be no
14 higher than rates for such services in urban areas; (2) customers in rural, insular, and high
15 cost areas have access to interexchange services that are reasonably comparable to
16 interexchange services provided in urban areas; and (3) rates for interexchange services
17 must be reasonable comparable to rates for similar services in urban areas. Fourth, the
18 Plan requires increases in the subscriber line charges up to the capped levels of those
19 specified in the CALLS plan. Since a majority of the urban access lines are served by
20 CALLS Plan participants, SLC charges in rural areas as proposed in the Plan will be
21 reasonably comparable to those in urban areas.

In CC Docket No. 99-249, Eleventh Report And Order In CC Docket No. 96-45, issued May 31, 2000.

Enhanced Incentives for Efficiency and Investment in New Technologies

Q. How does the Plan provide enhanced incentives for efficiency and investment in new technologies?

A. The Plan offers three sources of enhanced incentives for efficiency and investment in new technologies. First, the Plan requires the non-price cap LECs who choose Path A to move to incentive regulation by the end of a five-year transition period. Prior to the end of the five-year transition period, Path A companies can move to incentive regulation on an individual study area basis. As noted above, incentive regulation provides enhanced incentives for cost reduction and investment in new technologies by breaking the link between a company's costs and its revenues. If a company is able to reduce its costs through increased efficiency or investment in new technologies, its profits will increase.

Second, the Plan removes the current cap on high cost loop support. Rural telephone companies are a very diverse group. Many are very small companies that serve areas with declining population. These companies simply do not have the financial resources to maintain and upgrade their plant under the current limits on high cost loop support. Removing these limits will allow the rural telephone companies to invest in the new technologies required to bring high quality telecommunications service to rural areas.

Third, the Plan offers an opportunity to settle many complex regulatory issues in the areas of interstate access, universal service support, separations, and rate of return. By settling these issues, the Plan will produce a more stable environment for telecommunications investment by the non-price cap LECs. The risk caused by massive

upcoming regulatory changes has encouraged companies in rural study areas to postpone investment. Adoption of the Plan will reduce the uncertainty about these changes.

Q. How will the incentive regulation feature of the Plan work?

A. Under the Plan, all companies choosing incentive regulation will eventually settle with the NECA pool on the basis of a fixed Revenue Per Line ("RPL"). The initial RPL will be based on the most recent cost study or average schedule revenue requirement data prior to conversion to incentive regulation, adjusted for inflation. In all subsequent years, the RPL would be adjusted annually to reflect changes in inflation. Thus, the revenue requirements of these companies will be targeted to inflation rather than to changes in company-specific expenses and investments.

Q. Is it reasonable to adjust the RPL to reflect inflation?

A. Yes. An inflation adjustment is a common feature of incentive regulation plans in the telecommunications industry. For example, the FCC has included an inflation adjustment in its price cap plan for the price cap LECs, and the Rural Task Force has included an inflation adjustment in its final recommendations for universal service support (see Section IV, B, 1, *Rural Task Force Recommendation to the Federal-State Joint Board on Universal Service*, adopted September 22, 2000). The Rural Task Force recognized that universal service funding must be adjusted for both line growth and inflation if rural carriers are to have an incentive to make the infrastructure investments required to provide access to advanced services:

> The federal universal service support fund should be sized so that it presents no barriers to investment in plant needed to provide access to advanced services. Specifically, to remain "sufficient" under the 1996 Act, the fund should be sized so that investment in rural infrastructure will be permitted to grow. [Section IV, A, 1, c.]

Q. Please describe the Low End Adjustment ("LEA") feature of the Plan.

1 A. The LEA feature allows all non-price cap LECs with study areas earning a return on
2 equity of less than 10.25 percent in any rate period to receive payments from the NECA
3 pool in twelve equal installments over the following period that are sufficient to bring the
4 prior year's earned rate of return in that study area up to 10.25 percent. For those carriers
5 with five or fewer study areas, the LEA feature allows payments from the NECA pool
6 sufficient to bring the prior year's rate of return up to 10.75 percent if the LEC can
7 demonstrate that the rate of return for a study area during the previous year was less than
8 10.75 percent.
9 Q. How does the LEA feature assure that Path A non-price cap carriers have an incentive to
10 reduce costs and invest in new telecommunications technologies and services?
11 A. Most non-price cap carriers operate in high cost low-density rural areas that are both
12 costly and difficult to serve. Non-price cap LECs are unlikely to make investments in
13 new telecommunications services and technologies in these areas without some backstop
14 rate of return on their investment. By supplying this backstop, the LEA feature provides
15 an incentive for the Path A non-price cap LECs to take the risk of investing in their high
16 cost service territories. In this regard, the LEA feature of the Plan is similar to the
17 protections already enjoyed by the price cap LECs.
18 Q. The Plan calls for continuation of the current 11.25 percent rate of return on investment.
19 How does this feature affect the Plan participants?
20 A. The Plan signatories anticipate that the majority of non-price cap access lines will move
21 to incentive regulation within the five-year transition period of the plan. For the
22 companies choosing incentive regulation, the 11.25 percent rate of return primarily
23 affects the level of the LEA. For those carriers who choose to continue under rate of

1 return regulation, the 11.25 percent rate of return will also affect the revenues they are
2 allowed to achieve over the life of the plan.
3 Q. Why is the continuation of the current 11.25 percent rate of return an important feature of
4 the Plan?
5 A. Investments in telecommunications facilities are long-term investments that cannot be
6 reversed. The non-price cap LECs will be more likely to invest in new
7 telecommunications facilities if they can be reasonably assured that they will have an
8 opportunity to earn an adequate return on their investment over the life of the facilities.
9 By continuing the current 11.25 percent authorized rate of return, the Commission can
10 reduce the uncertainty about the prospective returns the non-price cap LECs are likely to
11 achieve on investments in new telecommunications technologies and services. Thus, the
12 non-price cap LECs will be more likely to invest in new telecommunications
13 technologies and services if the Commission affirms the current 11.25 percent allowed
14 rate of return on investment.
15 Q. Do you have any evidence that 11.25 percent is a reasonable rate of return for the non-
16 price cap LECs?
17 A. Yes. I provided evidence in CC Docket 98-166, filed on January 19, March 16, and
18 April 8, 1999, that the non-price cap LECs cost of capital exceeds the Commission's
19 currently authorized 11.25 percent allowed rate of return on investment.
20 **Encouraging Competition in Rural Areas**
21 Q. What is the economically preferable avenue of competition in areas served by rural
22 telecommunications companies?

1 A. Facilities-based competition is undoubtedly the economically preferable avenue of
2 competition in areas served by rural telecommunications companies. Under facilities-
3 based competition, competitors compete on the cost and quality of the entire set of
4 telecommunications services offered to customers. However, facilities-based competition
5 for telecommunications services in rural areas is difficult to achieve.
6 Q. Why is facilities-based competition for rural telecommunications services difficult to
7 achieve?
8 A. Facilities-based competition for rural telecommunications services is difficult to achieve
9 because the subscriber line charge is currently significantly below the non-traffic
10 sensitive cost of providing telecommunications service in high cost rural areas. In
11 addition, some of the remaining implicit support in the pricing of access has not been
12 made explicit. Thus, potential competitors are unlikely to find it to be profitable to invest
13 in alternative telecommunications facilities in high cost areas.
14 Q. How does the Plan improve the prospects for facilities-based competition?
15 A. The Plan has two features which significantly improve the prospects of facilities-based
16 competition in the mostly rural non-price cap LECs' service territories. First, by
17 significantly increasing the level of the SLCs, the Plan allows the SLCs to more closely
18 approximate the non-traffic sensitive cost of providing telecommunications service in
19 these high cost areas. Second, by providing additional portable subsidies for eligible
20 telecommunications carriers, the Plan provides the prospect that competitors can receive
21 revenues sufficient to cover the costs of building their own facilities.
22 Recommendation
23 Q. What is your recommendation with regard to the Plan?

A. I recommend that the Commission adopt the Plan in its entirety. The Plan offers significant incentives for the non-price cap LECs to reduce costs and invest in new telecommunications services and technologies. By bringing prices more in line with costs, the Plan also provides clearer price signals to customers and encourages competition in the non-price cap LECs' service territories. Finally, the Plan provides an explicit, portable, and sufficient universal support mechanism for telecommunications services in rural, insular, and high cost areas. Thus, the Plan assures that customers in these areas will have access to advanced telecommunications services at rates that are reasonably comparable to those charged in urban areas.

I declare under penalty of perjury that the foregoing is true and correct. Executed on October 17, 2000.

/signed/
James H. Vander Weide