provision of telecommunications services in rural America by ultimately relying on markets to discipline prices and service quality and, whenever possible, to reduce regulatory oversight. Finally, we seek comment on merging the Long Term Support mechanism into Interstate Common Line Support as of July 1, 2003, when the CCL charge will be eliminated.

A. Alternative Regulation

1. Background

213. Price cap carriers' access charges are limited by price indexes that are adjusted annually pursuant to formulas set forth in our Part 61 rules. One element of the formulas is the X-factor, which reduces the price cap indexes to reflect price cap carrier productivity gains above those reflected in the GDP-PI. In this way, price cap carrier customers receive some of the benefits of the increased efficiencies through lower rates. Price cap carriers are permitted to earn returns higher, or potentially lower, than the prescribed rate of return that incumbent carriers are allowed to earn under rate-of-return rules. Price cap regulation encourages price cap carriers to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings, while setting price ceilings at reasonable levels.[559] Individual price cap companies have incentives to cut costs and to produce efficiently, because in the short run their behavior has no effect on the prices they are permitted to charge, and they are able to keep any additional profits resulting from reduced costs.

214. Although price cap regulation eliminates the direct link between changes in allocated accounting costs and changes in prices, it does not sever the connection between accounting costs and prices entirely. The overall interstate revenue levels still generally reflect the accounting and cost allocation rules used to develop access rates to which the price cap formulas were originally applied. Price cap indexes are adjusted upwards if a price cap carrier earns returns below a specified level in a given year. A price cap carrier that is eligible to, and elects to, price access services using the Commission's pricing flexibility rules forgoes its right to an automatic low-end adjustment. Moreover, a price cap carrier may petition the Commission to set its rates above the levels permitted by the price cap indexes based on a showing that the authorized rate levels will produce earnings that are so low as to be confiscatory. In the past, all

[559] The price cap regulations also give price cap carriers greater flexibility in determining the amount of revenues that may be recovered from a given access service. The price cap rules group services together into different baskets, service categories, and service subcategories. The rules then identify the total permitted revenues for each basket or category of services. Within these baskets or categories, price cap carriers are given some discretion to determine the portion of revenue that may be recovered from specific services. Subject to certain restrictions, this flexibility allows price cap carriers to alter the access charge rate level associated with a given service. For example, within the category of switching services, a price cap carrier may choose to recover a greater portion of its switching revenues through access charges assessed to one kind of switching service rather than through charges assessed to another switching service. Although the LEC must still observe the switched-access rate structure that is set forth in Part 69 of our rules (which determines what services may be offered and whether charges may be imposed on a per-minute or flat-rated basis), the rate level of the access charge will vary depending on the amount of revenues that the LEC chooses to recover from a given service.

or some price cap carriers were required to "share," or return to ratepayers, earnings above specified levels. This sharing requirement was eliminated in 1997.[560]

215. Under the MAG incentive plan, rate-of-return carriers that participate in the NECA pooling system and that elect Path A would have a transition period of five years within which they could move on a study-area basis from rate-of-return regulation to incentive regulation. At the end of the five year period, all study areas of all Path A carriers would be subject to incentive regulation. Once a Path A carrier elects incentive regulation for any study area in the pool, it cannot later choose to recover that study area's cost based on traditional rate-of-return regulation. Path A incentive regulation provides that a study area recovers all of its common line and traffic sensitive switched settlements on a revenue per line (RPL) basis for the pool. The RPL of each Path A study area would be set at the per-line revenue level based on the most recent cost study data or average schedule revenue requirement data available prior to the study area converting to incentive regulation. This initial RPL for each study area would be adjusted for inflation using the GDP-PI and adjusted annually thereafter for inflation. To increase earnings, Path A carriers would have incentives to lower their unit cost per line and to increase their lines. Interstate access revenue would not be fixed but would depend on growth in the number of lines if it is to increase in real terms. A component of the NECA pool revenue requirement for Path A carriers would be provided through RAS, an explicit and portable form of universal service support. The RAS would recover Path A pool members residual revenue requirements that are not recovered through SLCs, other access rate elements, and other forms of explicit universal service support. Rate-of-return carriers also would have a low-end adjustment factor below which earnings would not be allowed to go: 10.25 percent for carriers with more than five study areas, and 10.75 percent for those carriers with five or fewer study areas.

2. Discussion

216. In this section, we critique the MAG proposal for introducing incentive regulation for rate-of-return carriers. This evaluation will form a foundation on which to discuss the development of an appropriate alternative regulation plan for rate-of-return carriers. We then explore several options for alternative regulation and seek input to assist in setting the parameters of any plan to be adopted. Properly designed, an alternative regulatory approach will, over time, drive rates toward forward-looking costs and prepare regulated companies for competing in a deregulated market. In addition, an alternative regulatory mechanism may offer rate-of-return carriers a degree of pricing flexibility and the opportunity to share in the profits from the cost reductions they will make to prepare for competitive entry, while sharing some of those savings with consumers.

a. Critique of MAG's Incentive Regulation Proposal

217. Based on the present record, we are unable to conclude that the MAG's incentive regulation plan should be adopted. As we explain below, the MAG's incentive regulation plan does not properly balance carrier and customer interests given the current regulatory

[560] Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Report and Order, CC Docket No. 96-262, Second Report and Order, 12 FCC Rcd 16642, 16700 (1997) (*1997 Price Cap Review Order*), *aff'd in part, rev'd in part, USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

environment for those carriers. In addition to the broad concerns we identify in this section with the plan as proposed, other issues will be raised in the discussion addressing the development of an alternative regulatory structure for rate-of-return carriers.

218. Initially, we agree with those parties asserting that the inflation-adjusted RPL component of the MAG's incentive plan would allow carriers to increase their revenues without any recognition of the productivity gains that historically have been realized by the telephone industry.[561] Thus, it is not clear that rates under the MAG incentive plan would be just and reasonable, as required by section 201(b) of the Act.[562] Under the MAG plan, all the benefits of productivity or efficiency improvements would accrue to the carrier in the form of higher returns and none of the benefits accrue to access customers. Overlaying the MAG incentive regulation plan on rate-of-return industry revenues from 1995-1999, AT&T has estimated that rate-of-return carriers would have realized $424 million more in traffic sensitive revenues in 1999 alone under the MAG incentive regulation plan than they realized under rate-of-return regulation, due primarily to productivity gains in local switching and transport.[563]

219. One possible solution would be to establish one or more X-factors. The record, however, is not adequate to determine an X-factor or factors that would be appropriate for all rate-of-return carriers that might elect incentive regulation. This task is particularly difficult because of the diversity of rate-of-return carriers. Therefore, an optional alternative regulation plan might be appropriate for rate-of-return carriers, as urged by a number of commenters.[564] An X-factor could be needed to keep rate-of-return carriers' rates reasonable because competitive conditions in most rate-of-return carrier markets cannot be relied upon to act as a check on rate-of-return carriers' ability to implement anti-competitive prices.

220. We also find that the plan as structured does not insure that adequate investment or service quality levels will necessarily be maintained. Several parties have alleged that any incentive plan must contain controls to ensure that consumers are not harmed in this regard. Rate-of-return carriers electing incentive regulation, as proposed, might have the incentive to reduce costs by reducing investment (and therefore depreciation) and maintenance levels in order to achieve greater profits that it may then retain, without there being any benefit to consumers in the form of assurances of continued investment and maintenance of rate-of-return carrier facilities, or of the sharing of any efficiency gains with customers.

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[561] *See, e.g.*, AT&T Comments at 16, California Commission Comments at 16, GCI Comments at 5, NASUCA Comments at 20, WorldCom Comments at 3-7.

[562] 47 U.S.C. § 201(b).

[563] AT&T Comments at 16 and Appendix A; *but see* MAG Reply at 21-23 (questioning assumptions and time period selected by AT&T).

[564] *See, e.g.*, Interstate Telcom Group Comments at 8-11, Western Alliance Comments at 6-10, GVNW Consulting Reply at 6, Innovative Telephone Reply at 3-5, John Staurulakis Reply at 2.

b. Principles

221. An alternative regulation plan initially must ensure that rates remain just and reasonable, as required by section 201(b).[565] This is the fundamental underpinning of all regulatory models. To ensure that rates remain just and reasonable and that a carrier not receive a windfall from the elimination of any existing inefficiencies, the benefits to be realized from the adoption of an alternative regulation plan should be shared equitably between the carrier and its customers. Under price cap regulation, the Commission initialized rates after reviewing the cost of capital and employed an X-factor productivity adjustment to ensure that price cap carrier rates reflected industry average productivity improvements, while permitting price cap carriers that could be more efficient to keep some or all of any increased earnings. We invite parties to comment on how this goal might be realized most effectively with regard to rate-of-return carriers, and whether something akin to the price cap methods should be used, or whether some other effective alternative exists.

222. We seek comment on whether the rewards a rate-of-return carrier electing an alternative regulation plan might realize should be related to the risk the carrier assumes. Under such an approach, the less stringent the X-factor offset, the smaller the increased profits the carrier would be permitted to retain. We also ask parties to comment on whether a range of options should be offered to rate-of-return carriers, and whether the same set of options should be offered to all rate-of-return carriers. If only a limited set of options is to be offered to some rate-of-return carriers, what characteristics of a carrier or its environment should determine the set of options to be offered? We invite parties to comment on these considerations generally and on how the correct relationships might be determined to ensure that rates remain just and reasonable.

223. The design of an alternative regulation plan must also address the incentives an alternative regulation plan gives rate-of-return carriers to reduce investment in plant and equipment, or to reduce expenditures on maintaining service quality, in order to increase profits at the expense of maintaining adequate investment or service quality. Section 254(b) identifies the availability of comparable services in rural areas as a criteria in assessing universal service.[566] The achievement of these goals clearly requires investment in rural areas, which must therefore be supported by any alternative regulation plan we adopt.

224. Rate-of-return regulation has worked well in extending service to rural America, along with our universal service program and the work of state commissions to support service in these areas. We seek comment on how to maintain quality assurance and expansion of new and advanced services in rural and non-rural areas served by rate-of-return carriers under any alternative regulatory plan we might adopt. As we develop an alternative regulation plan for rate-of-return carriers, are there state programs we can rely on as means to ensure that adequate investment and service quality will be maintained? Such programs could include various types of state programs that oversee small company activities and focus on investment and service quality. In addition, certain indicia of competition, such as the designation of an eligible

[565] 47 U.S.C. § 201(b).

[566] 47 U.S.C. § 254.

telecommunications carrier in the rate-of-return carrier's service area, might also permit us to conclude that the incentives to invest and maintain service quality are present. We invite parties to comment on the extent to which regulatory and competitive conditions could be effective tools in developing a workable alternative regulatory mechanism. Parties should address how the different possible components of an alternative regulatory plan discussed below might be modified as regulatory or competitive conditions change.

225. Finally, we believe that an alternative regulatory plan must minimize the administrative burdens on small carriers and regulatory intervention in their operations, while achieving the other principles noted above. In this regard, an alternative regulation plan should consider the size of the carriers that will be subject to the plan and be no more restrictive than necessary to achieve the necessary public interest objectives. We therefore invite parties to address the impact any alternative regulation plan might have on small incumbent local telephone companies, as required by the Regulatory Flexibility Act.[567]

226. As we proceed, it will be with a focus on these objectives. We invite parties to comment on the validity of these objectives and how they apply to the different measures of any alternative regulation plan proposed. We also ask parties to identify additional principles that should be applied to the development of an alternative regulatory mechanism. In the following section we address several specific considerations associated with developing an alternative regulatory plan.

c. Issues in Developing an Alternative Regulatory Plan

227. *Optionality*. The scope of an alternative regulation plan affects in significant ways the design of that plan. Several rate-of-return carrier interests assert that any alternative regulation plan must be optional because of the diversity among rate-of-return carriers in their operating conditions. On the other hand, AT&T urges us to make an alternative regulation plan applicable to the largest rate-of-return carriers on a mandatory basis.[568] Given the wide variations among rate-of-return carrier operating conditions, we believe it would be extremely difficult to establish a mandatory alternative regulatory plan for all rate-of-return carriers. We invite parties to comment on the extent to which an alternative regulation plan should be completely optional, or whether it should be mandatory for a subset of larger rate-of-return carriers. Parties should address what criteria should be used to determine which carriers would be subject to alternative regulation on a mandatory basis. We also seek comment on whether any optional alternative regulation plan should be one-way, so that, once made, a carrier could not return to rate-of-return regulation. Alternatively, are there certain conditions, such as when earnings are sufficiently low for a sufficiently long period of time, or simply after a specified period of time, or after each review period, when a carrier could be permitted to return to rate-of-return regulation? Parties are invited to address what those conditions might be and how rates should be determined upon return to rate-of-return regulation.

[567] *See* 5 U.S.C. § 603.

[568] *See, e.g.*, AT&T Comments at 14; *accord*, WorldCom Reply at 3.

228. *Alternative regulation in a pooling context.* The MAG's incentive regulation plan was designed to work within the NECA pooling structure. Today, nearly all rate-of-return carriers participate in the NECA common line pool, and more than sixty percent of the minutes of rate-of-return carriers are charged at NECA rates. This offers many administrative benefits to carriers and to the Commission, particularly in the form of tariff administration. It may, however, blunt some of the benefits that may be realized from an alternative regulatory plan.[569] If cost savings that a carrier realizes are included in the pool settlements process, rather than being retained by the carrier achieving the efficiency gains or reflected in lower rates to the customers, the carrier will have little incentive to pursue cost efficiencies. We invite parties to comment on whether an alternative regulation plan can and should be designed to work within the NECA pooling structure, whether there are ways for NECA to revise its pooling procedures to facilitate meaningful incentive regulation, or whether rate-of-return carriers should be required to leave the pool to avail themselves of any alternative regulatory plan. Parties should also address how an alternative regulatory plan would apply to those rate-of-return carriers outside the NECA pools, including any problems created if a rate-of-return carrier was, for example, in the common line pool but not the traffic sensitive pool.

229. *Use of revenue per line (RPL).* The MAG proposes to use a RPL amount as the basis for establishing its incentive plan, adjusting the RPL amount annually for inflation.[570] Thus, a rate-of-return carrier electing incentive regulation would settle with the NECA pool on the basis of its inflation-adjusted RPL amount. A rate-of-return carrier's costs and its settlement amount from NECA would therefore no longer be linked. The rate-of-return carrier would thus have the incentive to reduce its operating costs since it could retain the difference between the RPL amount and its actual costs, if lower. On the other hand, if its costs were higher than the RPL amount, it would not receive additional settlements. Several commenters oppose the use of a revenue cap, alleging that a rate-of-return carrier would have every incentive to reduce its investment and expenses since these no longer affect their settlements with the NECA pool.[571]

230. In response, the MAG argues that Path A incentive regulation under its plan differs from both price cap regulation and revenue cap regulation. It asserts that Path A incentive regulation breaks the link between prices and unit costs of interstate access, thereby encouraging Path A carriers to reduce their unit costs per line to increase earnings. It asserts that a Path A carrier's total revenues depend on increases in the number of lines. It notes that unlike price cap regulation, RPL does not ensure that growth in usage for access services priced on a per-minute basis will result in greater revenues for the Path A carrier. Further, the MAG argues that increased minutes of use would reduce the size of the MAG's proposed RAS.[572]

[569] *Price Cap Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961, 9045-46 paras. 187-89 (1995), *aff'd sub. nom.*, Bell Atlantic Telephone Companies v. FCC, 79 F.3d 1195 (D.C. Cir. 1995).

[570] Unlike price cap regulation, under which a LEC may benefit from the sale of additional vertical services, the RPL approach would not increase permitted revenues from the sale of additional vertical services.

[571] *See, e.g.*, NASUCA Comments at 22, Texas Commission Comments at 3.

[572] *See* Letter from William F. Maher, Jr., Esq., to Dorothy Attwood, Chief, Common Carrier Bureau, Federal Communications Commission (May 24, 2001).

231. We invite parties to comment on the use of an RPL amount as a starting point for an alternative regulatory plan. We specifically invite comment on whether the MAG's contention that RPL is different from a revenue cap is correct. On its face, it appears that in some cases, as when competition exists, a carrier could lose lines and thus revenues, while under a pure revenue cap structure, it could increase prices to recover any shortfall. Furthermore, if an external check existed, such as a state-imposed investment plan, future investment and service quality might not be adversely affected. On the other hand, without a competitive or regulatory check, the RPL approach might work much like a pure revenue cap. Binding revenue cap regulation has been criticized as being damaging to market efficiency since it provides firms with incentives to lower total costs rather than per-unit costs and increase prices at or above monopoly levels by restricting output more than it would if it were an unregulated monopolist. We ask parties to comment on the extent to which the presence of competition or an external check would affect a carrier's incentives in an RPL system, and how such factors could be included in an alternative regulatory system for rate-of-return carriers. Parties should also address how to respond to the concern expressed in the record that rate-of-return carriers would have every incentive in the year they choose to enter an alternative regulation program to maximize their costs and plant investment, in order to maximize their initial rates.[573]

232. We also ask parties to address whether there are other approaches to establishing an alternative regulatory mechanism that would work better than RPL over a broader range of competitive and regulatory landscapes. For example, would it be possible and preferable to use baskets of traffic-sensitive and non-traffic-sensitive service revenues or prices as the baseline against which to measure rate-of-return carrier productivity? Parties proposing alternatives should be specific in laying out their plan and should address how their plan is consistent with the principles enumerated above. Parties should also address what an appropriate alternative regulatory plan should be if we were to conclude that a rate-of-return carrier must leave the NECA pool to participate in such a plan.

233. In addition, we invite parties to address whether, rather than developing a new alternative regulatory plan for rate-of-return carriers, we should establish a method by which rate-of-return carriers would be eligible to adopt the CALLS plan. Parties should particularly address what modifications if any, would be necessary in the indexing and universal service aspects of the CALLS plan to make it appropriate for rate-of-return carriers, without jeopardizing the position of any party currently subject to the CALLS plan.

234. *Productivity and sharing considerations.* The MAG incentive plan does not contemplate any initial rate reduction, or a recurring productivity offset (X-factor). Under the MAG plan, rates initially would be based on a rate-of-return carrier's settlements from the NECA pools at the time the carrier elected incentive regulation, and increased by inflation in future years. Several parties assert that any plan must have a productivity factor in order to keep rates just and reasonable, contending that the telephone industry traditionally has achieved greater productivity than that reflected in the GDP-PI.[574] Several parties also contend that an

[573] *See, e.g.*, California Commission Comments at 2-3, GCI Comments at 4-5, Wisconsin Commission Comments at 9.

[574] *See, e.g.*, California Commission Comments at 22, GCI Comments at 5, NASUCA Comments at 19, Qwest Comments at 4-5, Wisconsin Commission Comments at 10.

incentive plan for rate-of-return carriers must include a sharing mechanism, as the original price cap plan did.[575]

235. We invite parties to comment on the extent to which a productivity offset or initial rate reduction should be part of any alternative regulatory plan for rate-of-return carriers. This is a difficult issue for rate-of-return carriers due to the variations in their operating conditions. Many smaller rate-of-return carriers' investment patterns are lumpy, with only occasional significant new investments, as when they replace a switch or a major trunking facility. Some rate-of-return carriers may not realize sufficient demand growth to realize any scale economies. These smaller carriers might not be interested in an alternative regulation plan that included a productivity offset. It would be helpful if parties addressed the means by which we should establish any productivity offset and the level at which it should be set. These comments should take into account the possibility that the alternative plan would, for some or all rate-of-return carriers, be optional. Thus, only those rate-of-return carriers that thought they could exceed the productivity threshold might elect the alternative regulatory plan.

236. Several uncertainties exist in initiating an alternative regulatory plan if it is optional. It will be unclear how many rate-of-return carriers may elect any plan until such time as they are required to exercise that option. Furthermore, calculation of a productivity offset will be imprecise due to lack of knowledge of which carriers would be participating. We therefore invite parties to comment on whether an alternative regulatory plan for rate-of-return carriers should include a sharing mechanism to account for the difficulty in the calculation of an appropriate X-factor. Parties should also address the level at which, and the extent to which, any sharing should be required, whether sharing requirements should be linked to service quality levels, and the relationship between the levels of any X-factor and sharing obligations.

237. As the Commission has noted previously, sharing mechanisms have significant incentive-blunting characteristics caused by the reduced incentive to increase efficiency if the carrier can only retain a portion of the savings. We therefore seek comment on whether a system of regulation with a lag might be appropriate for rate-of-return carriers. Under such a plan, a productivity offset would be established based on an appropriate industry grouping. Rate-of-return carriers electing the alternative regulation plan would be permitted to keep any increased profits realized from increased efficiency or line growth. After some period of time, such as three years, the Commission would reexamine the productivity offset and adjust it prospectively, reflecting the realized experience of the previous three years. We invite parties to comment on the use of regulation with a lag. They should address the setting of the productivity offset in this context, as well as the length of time between reviews. We invite parties to comment on whether RPL is the appropriate baseline against which to apply the productivity offset under this scenario and whether the RPL level should be based on an individual carrier's revenues or on some grouping of carriers. Parties should also address whether a sharing or a lag plan introduces the fewest efficiency disincentives and is most likely to create proper incentives.

238. *Low-end adjustment.* As with price cap regulation, the MAG proposes a low-end-adjustment factor. Unlike the low-end adjustment for price cap carriers, however, the low-

[575] *See, e.g.*, AT&T Comments at 17, California Commission Comments at 23-24.

end adjustment proposed by the MAG would ensure that rate-of-return carriers electing incentive regulation would not earn below the low-end adjustment. It would do this by providing for a prospective revenue payment from the NECA pool that would give it the difference between what it actually earned and the low-end adjustment over a twelve-month period. Price cap carriers, on the other hand, are only permitted to adjust their price cap indexes to allow them to set prospective rates at a level that would allow them to earn at the level of the low-end adjustment. We invite parties to comment on the need for a low-end adjustment and on how to establish the proper level. We specifically ask parties to address whether a low-end adjustment in an alternative regulatory plan should protect against earnings below that level during a particular tariff period, or whether it should be used to retarget rates so that the carrier will have an opportunity to earn that level in the future tariffing period, as is done in the price cap context. We also invite parties to comment on whether there is any need for a higher low-end adjustment for smaller rate-of-return carriers, and if a higher low-end adjustment is necessary, how the higher low-end adjustment should be determined, which carriers should be covered, and the extent to which the low-end adjustment should be higher. Finally, we ask whether, if rate-of-return carriers are granted pricing flexibility, they should be required to forego the automatic low-end adjustment just as price cap carriers do.

239. *Monitoring*. The adoption of an alternative regulatory plan would alter the incentives of carriers, and establish new parameters regulating those carriers electing the alternative plan. We invite parties to comment on whether there is any need to establish reporting requirements to monitor service quality and carrier investment in an alternative regulatory regime, or whether it will be possible to rely on competitive conditions or state investment and service quality standards to control any adverse effects of the new incentives. Finally, we ask parties to comment on how often we should review an alternative regulatory plan. Because conditions change over time, it may periodically be necessary to modify some of the parameters based on the new circumstances, or a better understanding on our part of how they are working with respect to the rate-of-return LECs electing the alternative plan. Parties are also invited to suggest precise methodologies for modifying the relevant parameters.

240. *Other issues*. Finally, we invite parties to comment on other concerns they may have with the Commission's possible adoption of an alternative regulatory plan for rate-of-return carriers. In particular, parties are encouraged to address issues relating to the timing of the election to be governed by the alternative regulatory plan. For example, should the election be available only on one fixed date, or should carriers have the option to elect at a time of their own choosing?

B. Pricing Flexibility

1. Background

241. When it adopted the access charge structure in 1983, the Commission required all incumbent LECs to offer all interstate special and switched access services at geographically averaged rates for each study area.[576] Since that time, the Commission has increased incumbent

[576] *See* 47 C.F.R. § 69.3(e)(7); *see also 1983 Access Charge Reform Order*, 93 FCC 2d at 314-15. The Commission has not prescribed a special access rate structure.

LECs' pricing flexibility and ability to respond to the advent of competition in the exchange access market. In the *Special Access* and *Switched Transport Expanded Interconnection Orders*, the Commission permitted incumbent LECs to introduce density zone pricing for high capacity special access and switched transport services in a study area, provided that they could demonstrate the presence of "operational" special access and switched transport expanded interconnection arrangements and at least one competitor in the study area.[577] The Commission also permitted incumbent LECs to offer volume and term discounts for switched transport services upon specific competitive showings.[578]

242. In 1999, the Commission recognized that the variety of access services available on a competitive basis had increased significantly since the adoption of the price cap rules. The Commission therefore granted price cap carriers immediate flexibility to deaverage services in the trunking basket[579] and to introduce new services on a streamlined basis.[580]

243. The Commission also adopted a framework for granting further regulatory relief upon satisfaction of certain competitive showings. The Commission determined that relief generally would be granted in two phases and on a Metropolitan Statistical Area (MSA) basis. To obtain Phase I relief, the Commission required price cap carriers to demonstrate that

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[577] *Expanded Interconnection with Local Telephone Company Facilities, Amendment of the Part 69 Allocation of General Support Facility Costs*, CC Docket Nos. 91-141 and 92-333, Report and Order, 7 FCC Rcd 7369, 7454 n.411 (1992) (*Special Access Expanded Interconnection Order*), *vacated in part and remanded, Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994); *Expanded Interconnection with Local Telephone Company Facilities*, 9 FCC Rcd 5154, 5196 (1994) (*Virtual Collocation Order*); *Switched Transport Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141, Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7425-32 (1993) (*Switched Transport Expanded Interconnection Order*), *aff'd, Virtual Collocation Order*, 9 FCC Rcd 5196 (1994). "Expanded interconnection" refers to the interconnection of one carrier's circuits with those of a LEC at one of the LEC's wire centers so that the carrier can provide certain facilities-based access services. *See Virtual Collocation Order*, 9 FCC Rcd at 5158. An expanded interconnection offering is deemed "operational" when at least one interconnector has taken a switched cross-connect element. *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7426-27.

[578] *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7463; *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7435. The Commission allowed LECs to offer volume and term discounts for switched transport services in a study area upon demonstration of one of the following conditions: (1) 100 DS1-equivalent switched cross-connects (*i.e.*, the cabling inside the LEC central office that connects the LEC network to the collocated equipment dedicated to a competitive access provider using expanded interconnection) are operational in the Zone 1 offices in the study area; or (2) an average of 25 DS1-equivalent switched cross-connects per Zone 1 office are operational. In study areas with no Zone 1 offices, volume and term discounts may be implemented once five DS1-equivalent switched cross-connects are operational in the study area. *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7435.

[579] The Commission allowed price cap carriers to define the scope and number of zones within a study area, provided that each zone, except the highest-cost zone, accounts for at least 15 percent of the incumbent LEC's trunking basket revenues in the study area and that annual price increases within a zone do not exceed 15 percent. The Commission also eliminated the requirement that LECs file their zone plans prior to filing a tariff.

[580] *See supra*, § IV.E.2; *Access Charge Reform*, CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, *Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers*, CCB/CPD File No. 98-63, *Petition of U S West Communications, Inc., for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona, MSA*, CC Docket No. 98-157, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221, 14238-43 paras. 34-44, 14252-57 paras. 59-66 (1999) (*Pricing Flexibility Order*).

competitors have made irreversible, sunk investments in the facilities needed to provide the services at issue. For dedicated transport and special access services, price cap carriers were required to demonstrate that unaffiliated competitors have collocated in at least 15 percent of the carrier's wire centers within an MSA or collocated in wire centers accounting for 30 percent of the carrier's revenues from these services within an MSA.[581] Higher thresholds were applied, however, for channel terminations between a LEC end office and an end user customer. In that case, the carrier was required to demonstrate that unaffiliated competitors have collocated in 50 percent of the price cap carrier's wire centers within an MSA or collocated in wire centers accounting for 65 percent of the price cap carrier's revenues from this service within an MSA. For traffic sensitive, common line, and the traffic sensitive components of tandem-switched transport services, the Commission required carriers to show that competitors offer service over their own facilities to 15 percent of the carrier's customer locations within an MSA. Phase I relief permits price cap carriers to offer, on one day's notice, volume and term discounts and contract tariffs for these services, so long as the services provided pursuant to contract are removed from price caps. To protect those customers that may lack competitive alternatives, carriers receiving Phase I flexibility are required to maintain their generally available, price cap constrained tariffed rates for these services.[582]

244. To obtain Phase II relief, the Commission required price cap carriers to demonstrate that competitors have established a significant market presence (*i.e.*, that competition for a particular service within the MSA is sufficient to preclude the incumbent from exploiting any individual market power over a sustained period) for provision of the services at issue. The Commission found that Phase II relief for dedicated transport and special access services would be warranted when a price cap carrier demonstrates that unaffiliated competitors have collocated in at least 50 percent of the carrier's wire centers within an MSA or collocated in wire centers accounting for 65 percent of the carrier's revenues from these services within an MSA. The Commission imposed a higher threshold to channel terminations between a LEC end office and an end user customer. In that case, a price cap carrier is required to show that unaffiliated competitors have collocated in 65 percent of the carrier's wire centers within an MSA or collocated in wire centers accounting for 85 percent of the carrier's revenues from this service within an MSA. Phase II relief permits price cap carriers to file tariffs for these services on one day's notice, free from both the Part 61 rate level and the Part 69 rate structure rules.[583]

245. The Commission sought comment in a companion Further Notice on additional pricing flexibility for common line and traffic sensitive services. First, the Commission sought comment on permitting price cap carriers to deaverage rates for services in the common line and traffic sensitive baskets in conjunction with identification and removal of implicit universal service support in interstate access charges and implementation of an explicit high cost support

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[581] To satisfy the collocation triggers we adopt herein, an incumbent LEC must demonstrate, with respect to each wire center with collocation, that at least one of the competitors therein uses transport services provided by a transport provider other than the incumbent LEC.

[582] *Pricing Flexibility Order,* 14 FCC Rcd at 14261-96 paras. 77-140.

[583] *Pricing Flexibility Order,* 14 FCC Rcd at 14296-302 paras. 141-157. The Commission eliminated the low-end adjustment mechanism for those price cap carriers qualifying for and electing to exercise either Phase I or Phase II pricing flexibility.

mechanism. The Commission also sought comment on how to define zones for purposes of deaveraging. In addition, the Commission sought comment on which rate elements may be deaveraged and whether deaveraging should be subject to SLC and PICC caps or any other constraint. The Commission also sought comment on the appropriate Phase II triggers for granting greater pricing flexibility for traffic sensitive, common line, and the traffic-sensitive components of tandem-switched transport services.[584] The Commission in the *Interstate Access Support Order* allowed price cap carriers to deaverage their SLCs.[585]

2. Discussion

246. With this Further Notice, we extend our consideration of pricing flexibility to rate-of-return carriers, as we indicated we would do in the *1998 Notice*.[586] In this section we seek comment on methods of extending pricing flexibility to rate-of-return carriers in addition to those already available to them under current rules or under the rules adopted in the accompanying Order. As noted above, rate-of-return carriers may deaverage their transport and special access rates if there is a single cross-connect in the study area and may offer volume and term discounts on transport services if a minimum threshold of DS1s are provided in their central offices in the study area. Under the rules adopted today, rate-of-return carriers may deaverage their SLC charges if certain criteria are met[587] and are permitted to disaggregate the universal service support they receive.[588] We also streamlined the requirements for rate-of-return carriers to introduce new services.[589]

247. As competition develops in the service areas of rate-of-return carriers, it is important that they have pricing flexibility, just as it was important for price cap carriers. Given that rate-of-return carriers are generally smaller than even the smallest price cap carrier, it is likely that the same combinations of pricing flexibility and triggers will not produce the same results for rate-of-return carriers. In fact, smaller rate-of-return carriers may be especially reliant on a few large users for significant portions of their revenues. Furthermore, these smaller carriers may not be able to realize the volumes that make certain types of pricing flexibility practical. Below, we consider different types of pricing flexibility for rate-of-return carriers and the circumstances under which a rate-of-return carrier should be eligible for pricing flexibility.

a. Types of Pricing Flexibility

248. In this Notice, we focus on three types of pricing flexibility for rate-of-return carriers: geographic deaveraging within a study area; volume and term discounts; and contract pricing. These are the types of pricing flexibility mentioned most often by rate-of-return carriers

[584] *Id.* at 14320-49 paras. 190-257.

[585] *See Interstate Access Support Order*, 15 FCC Rcd at 13007 para. 113.

[586] *1998 Notice*, 13 FCC Rcd at 14240 para. 5.

[587] *See supra*, § IV.A.2.c.

[588] *See id.* at § IV.D.2.a.

[589] *See id.* at § IV.E.2.

in the comments in response to the *1998 Notice*.[590] These are also the three types of pricing flexibility provided to price cap carriers. Accordingly, it is appropriate for us to start with these types of pricing flexibility.

249. These three pricing flexibility options offer incumbent LECs significant ability to price their services closer to cost and to respond to competitive entry. Geographic deaveraging within a study area would permit rate-of-return carriers to price in a manner that reflects cost differences from one geographic location to another. Volume and term discounts would permit rate-of-return carriers to reflect economies related to capacity differences and to the certainties offered by term contracts. Finally, contract pricing would permit rate-of-return carriers to respond to requests for proposals and to address more complex communications needs of customers. These pricing alternatives would, once available, make rate-of-return carriers' pricing structures more efficient and permit them to respond to competition

250. While there are clear benefits from pricing flexibility, there are also competitive concerns raised by their introduction. Thus, if introduced too soon, pricing flexibility might be used to erect a barrier to competitive entry. For example, a rate-of-return carrier could deaverage its rates so that the attractive customers received very low rates, or it could lock up customers before entry began through the use of lengthy term contracts. In addition, in offering deaveraged rates or volume and term discounts, a carrier could, absent some restriction, increase rates excessively for remote customers or for low-volume customers to offset reductions resulting from the introduction of deaveraged rates or volume discounts for higher-volume customers.[591] Such practices could inhibit competitive entry and deny customers in rate-of-return carrier service areas the benefits of competition.

251. We invite parties to comment on our proposal to extend pricing flexibility to rate-of-return carriers in the forms noted above. In doing so, parties should address how the unique characteristics of rate-of-return carriers may affect the benefits and risks associated with pricing flexibility. They should identify any differences in the benefits and risks that may exist in relation to common line, local switching, and transport and special access services separately. Parties should also address whether any special rules for pricing flexibility are needed to prevent anti-competitive behavior from inhibiting the development of competition in these markets. For example, should the number of zones rate-of-return carriers are permitted to establish be fewer than price cap carriers are permitted, or should the degree of deaveraging or volume and term discounts be limited due to the rate-of-return carriers' smaller size? In a recent waiver order, we conditioned the grant of volume and term pricing flexibility for transport and the TIC on the carrier calculating a rate using the requirements of sections 69.106(b) and 69.124(b) and (c) of the Commission's rules to establish a ceiling rate for the associated non-discounted access service offering.[592] We invite parties to comment on whether such a restriction should be

[590] *See, e.g.*, ALLTEL Reply in CC Docket No. 98-77 at 2-4, NRTA and NTCA Reply in CC Docket No. 98-77 at 14, OPASTCO Reply in CC Docket No. 98-77 at 13-14, TDS Reply in CC Docket No. 98-77 at 22-24, USTA Reply in CC Docket No. 98-77 at 23-26.

[591] *See ATU Telecommunications Request for Waiver of Sections 69.106(b) and 69.124(b)(1) of the Commission's Rules*, Order, 15 FCC Rcd 20655, 20662 para. 22 (2001).

[592] *Id.*

imposed on the introduction of pricing flexibility on rate-of-return carriers to preclude anti-competitive behavior.

252. Parties should also address the impact that permitting pricing flexibility would have on the NECA pooling process. Would NECA need to establish exception rates for those rate-of-return LECs qualifying for pricing flexibility, and, if so, how burdensome would this be on NECA? Are there other ways of handling pricing flexibility within the pooling process that would be less burdensome? Parties also should address whether permitting pricing flexibility within the pooling process would be so burdensome on NECA, or offer anti-competitive opportunities to rate-of-return carriers, that rate-of-return carriers should be required to leave the NECA pool as a condition of obtaining pricing flexibility.

253. We also invite parties to identify other forms of pricing flexibility that may be appropriate for the development of an efficient, competitive exchange access marketplace. Parties suggesting other forms of pricing flexibility should evaluate the benefits and risks of those forms of pricing flexibility, as well as the conditions under which such pricing flexibility might be appropriately granted to rate-of-return carriers.

b. Timing of Pricing Flexibility

254. The determination of when pricing flexibility should be granted to rate-of-return carriers is a more difficult question than which types of pricing flexibility to consider granting. It is the opportunity to exercise pricing flexibility prematurely that presents the greatest anti-competitive risk to the development of competition. To address these concerns for price cap carriers, we granted some pricing flexibility immediately and designed a two-phased approach for determining when further pricing flexibility could be obtained by price cap carriers. Each phase had its own trigger to determine when a price cap carrier qualified for the pricing flexibility offered under each phase. We invite parties to comment on the extent to which pricing flexibility should be granted to rate-of-return carriers immediately, and which types of pricing flexibility should be deferred until some appropriate level of competition in a rate-of-return carrier service area has been established. Parties should comment on whether a two-phased approach for rate-of-return carriers should be used given their small size.

255. The decision to immediately permit geographic deaveraging of transport and special access services within a study area was premised in part on the fact that price cap carriers were facing some degree of competition in their service areas. This is not necessarily the case for all rate-of-return carriers. We therefore ask parties to comment on whether immediate geographic deaveraging of transport and special access services within a study area is warranted, or whether some degree of competition should be required before such pricing flexibility is permitted. We are particularly concerned about an incumbent LEC's ability to use pricing flexibility to preclude competitive entry. Parties should also address what the standard should be for determining when deaveraging should be permitted, if it is not permitted immediately.

256. For pricing flexibility other than geographic deaveraging of transport and special access services, the Commission established competitive criteria for determining when a price cap carrier could qualify for such pricing flexibility. The criteria required price cap carriers to demonstrate that competitors have made irreversible, sunk investments in the facilities needed to provide the services at issue, or that competitors have established a significant market presence

(*i.e.*, that competition for a particular service within the MSA is sufficient to preclude the incumbent from exploiting any individual market power over a sustained period) for provision of the services at issue, for Phases 1 and 2, respectively. We believe it is necessary to adopt criteria to determine when rate-of-return carriers may offer services using pricing flexibility plans. To that end, we invite parties to address whether a standard similar to that used for price cap carriers should be used for rate-of-return carriers. To assist us in evaluating different criteria, it would be especially useful if parties would address how they anticipate competition developing in rate-of-return carrier service areas, given their generally small customer base.

257. Parties are invited to address the appropriate competitive criteria that should determine when any particular pricing flexibility should be permitted. We recognize that the competitive levels used for price cap carriers may be overly restrictive for the smaller rate-of-return carriers. We ask parties to suggest appropriate levels. Parties should also address other proposals that have been made in various contexts, including the existence of a carrier in the service area with eligible telecommunications status, the issuance of a request for proposals by a customer in the rate-of-return carrier's service area, the filing by a rate-of-return carrier of a tariff offering UNEs, and the receipt by a rate-of-return carrier of a request for UNEs.

258. For price cap carriers, the Commission used the MSA as the geographic scope within which to measure competition to determine if pricing flexibility should be permitted. For most rate-of-return carriers, MSAs are not relevant and thus could not be the measurement base. Given the generally smaller size of rate-of-return carriers, it seems appropriate to use the study area as the basis on which to measure competitiveness in determining whether pricing flexibility is warranted for rate-of-return carriers. We seek comment on the use of study areas as the measurement base. We also solicit suggestions of other, more appropriate measures.

259. We also invite parties to comment on whether any rate-of-return carrier services should be permitted to be filed on one day's notice and whether any services should be treated as non-dominant services. For price cap carriers, we required that services be removed from price cap baskets when the services were offered under contract to preclude cross-subsidization. A similar mechanism does not exist for rate-of-return carriers. If we were to permit contract pricing, what measures would be necessary to ensure that rate-of-return carriers did not cross-subsidize the non-dominant services with revenues from their other access services?

C. All-or-Nothing Rule

1. Background

260. Section 61.41 of the Commission's rules provides that if an individual rate-of-return carrier or study area converts to price cap regulation, all of its affiliates or study areas must also do so, except for those using average schedules.[593] This is commonly referred to as the "all-or-nothing" rule. Also, this section provides that if a price cap carrier is in a merger, acquisition, or similar transaction, it must continue to operate under price cap regulation after the

[593] 47 C.F.R. §§ 61.41(b), 69.605 ("[a] telephone company that was participating in average schedule settlements on December 1, 1982, shall be deemed to be an average schedule company except that any company that does not join association tariffs for all access elements shall not be deemed to be an average schedule company.").

transaction.[594] In addition, when rate-of-return and price cap carriers merge or acquire one another, the rate-of-return carrier must convert to price cap regulation within one year.[595] Furthermore, LECs that become subject to price cap regulation are not permitted to withdraw from such regulation[596] or participate in NECA tariffs.[597]

261. These rules address two concerns the Commission had regarding mergers and acquisitions involving price cap companies.[598] First, in the absence of the rule, a LEC might attempt to shift costs from its price cap affiliate to its non-price cap affiliate.[599] This would allow the non-price cap affiliate to charge higher rates than otherwise possible to recover its higher revenue requirement (because of the increased costs), while at the same time, increasing profits of the price cap affiliate as a result of its cost savings.[600] The second concern was that a LEC might attempt to "game the system" by switching back and forth between rate-of-return regulation and price cap regulation.[601] A price cap carrier could increase earnings by opting out of price cap regulation, building a larger rate base under rate-of-return regulation in order to raise rates, and then after returning to price cap regulation, cutting costs back to an efficient level. The Commission reasoned it would not serve the public interest to allow a carrier to "fatten up" under rate-of-return regulation and "slim down" under price cap regulation, because rates would not decrease in the manner intended under price cap regulation.[602] The Commission, however, has permitted a waiver of the "all-or-nothing" rule where it has found that petitioners have established good cause and that the waiver will serve the public interest.[603]

[594] 47 C.F.R. § 61.41(c)(1).

[595] 47 C.F.R. § 61.41(c)(2); *see Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, 6821 (1990), *Erratum*, 5 FCC Rcd 7664 (Com. Car. Bur. 1990) (*LEC Price Cap Order), modified on recon.*, Order on Reconsideration, 6 FCC Rcd 2637, 2704 (1991) (*LEC Price Cap Reconsideration Order), aff'd sub nom. National Rural Telecom Association v. FCC*, 988 F.2d 174 (D.C. Cir. 1993), *petitions for further recon. dismissed*, 6 FCC Rcd 7482 (1991), *further modification on recon., Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Order on Further Reconsideration and Supplemental Notice of Proposed Rulemaking*, 6 FCC Rcd 4524 (1991) (*ONA Part 69 Order*), *further recon., Memorandum Opinion and Order on Second Further Reconsideration*, 7 FCC Rcd 5235 (1992).

[596] 47 C.F.R. § 61.41(d).

[597] 47 C.F.R. 61.41(a)(3).

[598] *See LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2706 para. 148; *see also ALLTEL Corp. Petition for Waiver of Section 61.41 of the Commission's Rules and Applications for Transfer of Control*, CCB/CPD 99-1, Memorandum Opinion and Order, 14 FCC Rcd 14191, 14199 (1999) (*ALLTEL Order*).

[599] *See LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2706.

[600] *Id.*

[601] *Id.*

[602] *Id.*

[603] Under section 1.3 of the Commission's rules, "any provision of the Commission's rules may be waived by the Commission . . . or on petition if good cause therefor is shown." 47 C.F.R. § 1.3. Courts have interpreted this to require that a petitioner demonstrate "special circumstances warrant a deviation from the general rule and that such deviation will serve the public interest." *Northeast Cellular Telephone Co. v. FCC*, 897 F.2d 164 (D.C. Cir. 1990) (citing *Wait Radio v. FCC*, 418 F.2d 1153, 1158 (D.C. Cir. 1969), *cert. denied*, 409 U.S. 1027 (1972)). For

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262. Section 69.3(e)(9) of the Commission's rules, known as the affiliate withdrawal rule or the pooling "all-or-nothing" rule, also addresses concerns of cost-shifting between affiliates.[604] It requires that if a LEC chooses to withdraw one of its study areas from the NECA pool to file its own carrier common line rates, all of its study areas must also do so, and a holding company withdrawing one of its affiliates must withdraw them all.[605] Otherwise, LECs could remove only their low-cost study areas while leaving high-cost areas in the pool, which could create incentives to shift common line costs from carriers that leave the pool to those that remain.[606] Also addressing gaming concerns, section 69.3(i)(4) provides that once a carrier elects to withdraw from the NECA tariff and become subject to price cap regulation, neither it nor its affiliates may participate in the NECA tariff again.[607] The Commission has refused to allow a price cap carrier to participate in the NECA tariffs and pool because this structure involves significant sharing of financial risks that would diminish a carrier's incentive to operate more efficiently and achieve the lower rates desired under price cap regulation.[608]

263. The MAG proposal provides that when a carrier under incentive regulation (Path A carrier) or under rate-of-return regulation (Path B carrier) "(A) acquires lines, exchanges or study areas from a telephone company subject to price cap regulation, or (B) acquires, is acquired by, merges with, or otherwise becomes affiliated with a telephone company subject to price cap regulation, the Path A LEC or Path B LEC may retain its status as a Path A LEC or

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example, the Commission has granted waivers in cases where rate-of-return carriers have acquired price cap exchanges and a price cap company, thus permitting them to continue operating under rate-of-return regulation rather than requiring them to convert to price caps. In these instances, the Commission concluded that concerns about cost shifting and gaming were not at issue. *See, e.g., ATEAC, Inc., Alaska Tel. Co., Arctic Slope Tel. Assoc. Coop., Inc., Interior Tel. Co., Inc., Mukluk Tel. Co., Inc., and United-KUK, Inc. Petitions for Waiver of Sections 61.41(c) and (d) of the Commission's Rules*, CCB/CPD No. 00-03, Memorandum Opinion and Order, 15 FCC Rcd 23511, 23518 para. 14 (2000); *Minburn Telecom., Inc. Petition for Waiver of Sections 61.41(c) and (d) of the Commission's Rules*, CCB/CPD No. 99-16, Memorandum Opinion and Order, 14 FCC Rcd 14184, 14188, para. 8 (1999); *ALLTEL Corp. Petition for Waiver of Section 61.41 of the Commission's Rules and Applications for Transfer of Control*, CCB/CPD 99-1, Memorandum and Order, 14 FCC Rcd 14191, 14201-02 para. 27-28 (1999) (*ALLTEL Order*) (finding of special circumstances based on service to diverse areas in 22 states with varied market conditions, thus making the application of a single productivity factor under price cap regulation not suitable for ALLTEL's entire operation).

[604] 47 C.F.R. § 69.3(e)(9).

[605] *See MTS and WATS Market Structure*, CC Docket Nos. 78-72, Report and Order, 2 FCC Rcd 2953, 2956 para. 25 (1987), *Erratum*, 2 FCC Rcd 4208 (1987) (*MTS and WATS Order*).

[606] *Id.*

[607] 47 C.F.R. § 69.3(i)(4).

[608] *See LEC Price Cap Order*, 5 FCC Rcd at 6819 ("The relationship between pooling and price cap regulation is fundamental to the rules defining LEC eligibility for price cap regulation. We have repeatedly emphasized in this proceeding that price cap regulation will increase carriers' incentives to achieve heightened efficiency, which in turn will lead to lower rates. Participation in pools, by its nature, entails risk-sharing, and thus a weakening of incentives to operate efficiently. We believe that the reasoning presented in the *Second Further Notice* against extending price cap regulation to NECA pool members remains valid."); *see also Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989)(*Second Further Notice*).

Path B LEC or become subject to price cap regulation[.]" This proposal effectively would repeal the "all-or-nothing" rules.

264. Proponents of repealing the "all-or-nothing" rules generally argue that: (1) they are inefficient and unduly restrictive because they force carriers to choose a form of regulation that may not suit either their high-cost or low-cost affiliates; (2) there is insufficient evidence of cost-shifting to justify the rules; and (3) the Commission could rely on accounting safeguards and other non-structural mechanisms to prevent cost-shifting, as it does in other contexts.[609] These arguments are discussed in more detail below.

265. We believe that to the extent any changes to these rules would promote greater operating efficiency or pricing flexibility, they should be addressed in the overall context of incentive regulation. Therefore, we take no action presently on the MAG proposal regarding the "all-or-nothing" rules, but rather incorporate this proposal into this Further Notice dealing with incentive regulation and pricing flexibility. We also recognize that there are some issues related to the "all-or-nothing" rule that are creating uncertainty that may be inhibiting carriers from choosing price cap regulation. As a result, it would be beneficial to resolve the future status of the "all-or-nothing" rule as expeditiously as possible, regardless of the timing of implementing other incentive regulation or pricing flexibility issues in this Further Notice.

2. Issues for Comment

266. The "all-or-nothing" rules were created a little more than ten years ago,[610] and the rationale for the rules has withstood the scrutiny of the United States Court of Appeals for the D.C. Circuit.[611] We would like to explore more precisely whether our regulatory policy—generally not to permit affiliated carriers to operate under different systems of regulation—is still serving the public interest; what, if any, circumstances and conditions that prompted these rules in the past have changed; and whether, or why, the MAG's proposed rule changes would be the correct and necessary solution to address any problems with the rules. We encourage interested parties from all industry segments to expand the discussion of why these rules should be retained, repealed or modified.

267. As discussed further below, we invite comment on whether the "all-or-nothing" restrictions unreasonably and unfairly limit affiliated companies from selecting regulatory options that would enable them to operate more efficiently, especially in light of the highly diverse service areas of some carriers. In the course of this analysis, some general questions to consider include the following. What, if anything, is different today than when the Commission previously considered this issue?[612] Would customers be better off and would competition be

[609] *See, e.g.*, TDS Reply at 2-8.

[610] *See LEC Price Cap Order*, 5 FCC Rcd 6786 at 6821 para. 5 (creating section 61.41(c) of the Commission's rules in 1990); *MTS and WATS Order*, 2 FCC Rcd at 2959 para. 46 (creating affiliate withdrawal rule in 1987).

[611] *See National Rural Telecom Assoc. v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

[612] *See LEC Price Cap Order*, 5 FCC Rcd at 6820 ("Price cap regulation may be more attractive to one affiliate than another, but our requirement that both or neither join price cap regulation is not unfair in light of the strong need for this rule.").

better served with or without the rules? Are the rules working effectively since the waiver process allows the Commission to grant carriers exceptions to the "all-or-nothing" restrictions as a means of "fine tuning" our regulation here?[613] What impact does an increasingly competitive environment have on whether these rules should be retained or eliminated?

268. Some commenters argue that the "all-or-nothing" rules in mergers and acquisitions limit a carrier's ability to choose the most appropriate and efficient form of regulation, to the detriment of both the carrier and its customers.[614] For example, when ALLTEL, a rate-of-return carrier, merged with Aliant, a price cap carrier, the Commission agreed with ALLTEL's reasons for desiring to remain a rate-of-return carrier.[615] But ALLTEL, "not seeking to maintain separate affiliates under different systems of regulation," also was required to revert Aliant, which had elected price cap regulation, to rate-of-return regulation.[616] Aliant, however, subsequently sought a waiver, contending price cap regulation benefited its customers, and was granted permission to continue operating temporarily as a price cap carrier.[617] Does this example suggest that the "all-or-nothing" regulatory requirements are overly restrictive, or out of step with marketplace realities? Does it suggest that the purpose served by the rules may be overshadowed by any regulatory inefficiency that may result?

269. Some rate-of-return carriers contend the affiliate withdrawal rule also works against selecting the most appropriate and efficient form of regulation for diverse study areas because they must all elect the same common line pool status as a group and move to price cap regulation together.[618] Some affiliates may be ready to accept the risk and potential reward of incentive regulation, while other affiliates might not be in a position to leave rate-of-return regulation.[619] These incumbent LECs also advocate repeal of this rule in combination with

[613] *See National Rural Telecom. Assoc. v. FCC,* 988 F.2d at 181 ("[W]aiver processes are a permissible device for fine tuning regulations, particularly where . . . the Commission must enact policies based on 'informed prediction.'") (citing *Telocator Network v. FCC,* 691 F.2d 525, 550 n.191 (D.C. Cir. 1982)).

[614] *See, e.g.,* TDS Reply at 10.

[615] *See ALLTEL Order,* 14 FCC Rcd at 14199-14200 para. 19, 14202 para. 28. Under the "all-or-nothing" rules, ALLTEL's merger with Aliant Communications obligated ALLTEL to convert from rate-of-return to price cap regulation and Aliant to remain subject to price cap regulation. The Commission, however, agreed with ALLTEL that it lacked "the economies of scope and scale of the largest LECs for whom the price cap system was designed" and permitted ALLTEL to remain under rate-of-return regulation. As a result, Aliant was also required to convert to rate-of-return regulation and leave price cap regulation which has pricing efficiencies." *Id.*

[616] *Id.* at 14202, para. 27.

[617] *See ALLTEL Corp. Petition for Waiver of Section 61.41 of the Commission's Rules,* CCB/CPD No. 99-01, Order, DA 01-1408 (Com.Car.Bur. rel. June 12, 2001). Aliant's waiver allows it to continue operating as a price cap carrier until July 1, 2002.

[618] *See, e.g.,* TDS Reply at 5-6 ("For example, TDS Telecom's 106 ILECs serve from 509 access lines to 66,250 access lines, spread through 28 states, with an average of 5,700 lines. The TDS Telecom ILECs' service territories range from 31.8 square miles to 4,617 square miles. Their density ranges from less than 1 access line per square mile to 600 access lines per square mile, with an average density of less than 17 for the 106 ILECs, well below the non-rural carrier average of 128 lines per square mile and below the rural telephone company average of 19 lines per square mile. The TDS Telecom ILECs' costs per line range from $2,910 to $450.").

[619] *See, e.g.,* ITTA Comments at 2, TDS Reply at 2 (arguing the all-or-nothing rule "(1) dooms some affiliates – such as TDS Telecom's 66,000-line Tennessee Telephone Company – to a form of regulation that is less efficient

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geographic deaveraging as a pricing flexibility measure to enable them to respond to competition from competitive carriers for high-volume business customers.[620] In this way, incumbent LECs would have flexibility to depool and deaverage rates within study areas by filing their own common line tariffs based on their own costs where competition was a threat, and also make decisions for other study areas based on their particular market and service conditions.[621] Opposing parties, however, contend that such pricing flexibility would be premature until local markets become sufficiently competitive to prevent incumbent LECs from engaging in cross-subsidization and predatory pricing.[622] Furthermore, they object to repealing this rule because it would result in parent companies removing their low-cost companies from the pool and leaving their high-cost areas in, thus driving NECA pool rates higher.[623] Are there any other considerations to note in assessing whether the affiliate withdrawal rule is promoting the public interest? What would be the impact and consequences of higher NECA pool rates resulting from the exit of low-cost carriers?

270. We also seek comment on whether the "all-or-nothing" restrictions are currently necessary to prevent cost shifting and gaming. Commenters disagreed on this issue and on whether our present accounting and allocation rules provide existing and sufficient safeguards against cost shifting.[624] Some parties contend these rules have outlived their usefulness, and are not needed to address cost shifting and gaming concerns because they are more speculative than real.[625] Others argue that cost shifting and gaming concerns are still valid,[626] and that their

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for them or (2) dooms other affiliates – such as TDS Telecom's very small companies serving an Indian reservation at the bottom of the Grand Canyon and four islands off the coast of Maine – to move to incentive regulation before their study area conditions warrant the change. Both results prejudice the ILECs' customers, who are deprived of greater efficiency incentives in the first case and of necessary revenues in the second case, and the ILECs, which are hampered in competing and deprived of the stability needed for infrastructure investments.").

620 *See* TDS Comments in CC Docket No. 98-77 at 22 ("When a relatively low cost member of the NECA pool charges the rates in NECA's tariff, set to recover the costs of all pool members including those with higher service costs, the resulting averaged rate is set above that lower cost carrier's cost of service. In contrast, a CLEC is able to provide interexchange access at rates which reflect only its own costs. This, in turn, gives it a competitive advantage in providing alternative access service."); *see also* ITTA Comments at 2.

621 *See, e.g.*, TDS Reply at 7-8 (Commission should provide same flexibility to withdraw from and rejoin NECA common line pool as is applicable to participation in traffic sensitive pool), ALLTEL Comments in CC Docket No. 98-77 at 8 (arguing that ALLTEL's "disparity in density underscores ALLTEL's need to be able to depool individual study areas to respond to competition" and that allowing companies to exit the NECA CCL pool on a study area basis would be consistent with Commission rules that allow companies to exit the NECA traffic sensitive pool on a study area basis), USTA Comments in CC Docket No. 98-77 at 24-25; *but see MTS and WATS Order,* 3 FCC Rcd at 4561 paras. 114 (stating that since non-traffic sensitive costs vary among companies more than traffic sensitive costs, companies might have a greater incentive to shift non-traffic sensitive costs among study areas).

622 *See, e.g.*, AT&T Reply in CC Docket No. 98-77 at 9-12.

623 *Id.*

624 MAG Comments at 28 ("The Commission's current accounting safeguards and reporting requirements are more than adequate to guard against any such cost-shifting."), TDS Reply at 8-9 ("The Commission's old concerns about cost shifting are now addressed successfully by its accounting and allocation rules."); *but see* WorldCom Comments at 5 ("The detection of non-price cap carrier cost-shifting would be extremely difficult, given that these carriers are subject to relaxed oversight of their accounting practices.").

625 *See, e.g.*, MAG Comments at 28-29, TDS Reply at 2, 4-9.

elimination would be anti-competitive and could result in cost manipulation.[627] TDS asserts that the rules have begun to erode with no evidence of cost shifting or gaming,[628] citing exceptions adopted by the Commission to the pooling "all-or-nothing" rules in mergers and acquisitions,[629] common ownership of cost-based and average schedule companies,[630] the ability of average schedule companies to remain in the pool if their depooling affiliate changes from rate-of-return regulation to price caps,[631] waivers allowing price cap exchanges to revert to rate-of-return regulation following mergers and acquisitions, and common ownership of incumbent and competitive carriers. We invite further comment on whether these examples warrant greater relaxation, or elimination, of the "all-or-nothing" requirements. Specifically, is the risk of cost-shifting and gaming outweighed by regulatory efficiency gains that could result from eliminating the "all-or-nothing" requirements? Is the Commission's policy behind the rule—to avoid creating cost-shifting incentives as opposed to correcting actual abuses—serving the public interest?[632] Has the competitive environment made cost shifting or gaming concerns less or more relevant? Are there alternative accounting and reporting rules that could substantially

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[626] WorldCom Comments at 6 ("[e]limination of the 'all or nothing' rule would open the door to precisely the type of cost-shifting that this rule was designed to prevent (particularly if the acquired ILEC were a Path B rate of return carrier or a Path A carrier that had yet to shift to incentive regulation).").

[627] Assoc. of Comm'ns Enterprises Comments at 6, Global Crossing Comments at 13, WorldCom Comments at 5, AT&T Reply at 17.

[628] TDS Reply at 6-8.

[629] *See* 47 C.F.R. § 69.3(g)(1) (carrier which participates in the NECA common line pool may continue to do so even after a merger with a carrier that does not participate in the pool); *but see LEC Price Cap Order,* 5 FCC Rcd at 6821 para. 284 (reasoning that a carrier with both pooled and non-pooled affiliates is different from a carrier with both price cap and non-price cap affiliates because pooled and non-pooled affiliates are all subject to rate-of-return regulation and "have little incentive to shift costs between pooled and non-pooled affiliates, since all such companies' earnings are limited to a unitary cost of capital that we impose. By contrast a company with both price cap and non-price cap affiliates has a significant incentive to shift costs from its price cap to its non-price cap affiliates, since the total dollars these latter companies will earn will be increased as their rate bases increase.").

[630] *See* TDS Reply at 6-8 ("There is no evidence that the exception has caused any cost shifting or other abuses. Yet...the Commission has held that average schedule settlements provide the same kind of incentives as price caps because they 'depend upon the demand for the services that [the carrier] provides rather than upon its costs of providing those services.") (citing *LEC Price Cap Order*, 5 FCC Rcd at 6820, para. 277); *but see National Rural Telecom Assoc. v. FCC,* 988 F.2d at 181 ("Because these companies are compensated on the basis of standardized rather than individualized cost estimates, they do not have a conventional rate-of-return firm's temptations for cost shifting or gold-plating.").

[631] *See* 47 C.F.R. § 61.41(c)(3) (not requiring a company that converts to price cap regulation to make all its average schedule affiliates also convert to price cap status); TDS Reply at 7 ("The incentives the Commission found in average schedule regulation led it to permit common ownership of price caps and average schedule study areas, and even to justify continued pool participation by average schedule affiliates of price cap carriers. Since this amounts to allowing continuing affiliations among incentive-regulated and ROR carriers, the absence of resulting problems compellingly supports further relaxation of all-or-nothing requirements.").

[632] *See MTS and WATS Market Structure,* CC Docket No. 78-72, Memorandum Opinion and Order on Reconsideration and Order Inviting Comments, 3 FCC Rcd 4543, 4561 n.115 (1988) ("We note that our concern with improper cost allocations among study areas is based on our desire not to provide an unnecessary incentive for such cost-shifting in the common line context, and not on recorded evidence of past abuses.").

reduce cost shifting concerns? Would it be reasonable to impose more stringent reporting requirements on carriers that seek waivers of the "all-or-nothing" requirements?

271. We also seek comment to resolve a related issue: how rate-of-return carriers that are required to convert to price cap regulation in a merger or acquisition, or choose to convert to price cap regulation, will receive universal service support. Under the current rules, a rate-of-return carrier upon converting to price cap regulation is required to withdraw from the NECA common line pool and is no longer eligible for LTS.[633] Interstate access universal service support for price cap carriers is funded by a capped, interstate access support mechanism created in the *Interstate Access Support Order*,[634] but the Commission in that order "did not explicitly address how entry of new carriers into price caps affects distribution of interstate access universal service support."[635] This question is particularly significant for potential price cap companies like Puerto Rico Telephone Company (PRTC) that could be a large recipient of the support.[636] We invite commenters to address how entry of new carriers into price cap regulation would affect distribution of interstate access universal service support for price cap carriers. As a transitional measure for rate-of-return carriers that convert to price cap regulation, should we allow retention of LTS or Interstate Common Line Support? Instead of receiving the same amount of support that the carrier received under rate-of-return regulation, should the previous support amount be added to the total interstate access universal service support available under the *Interstate Access Support Order* and then divided among all price cap carriers pursuant to the formula established in that order? We seek input on any other related considerations or ideas to resolve this question of universal service support for new price cap carriers on a going forward basis.

D. Consolidation of Long Term Support and Interstate Common Line Support

272. We tentatively conclude that LTS will be merged with Interstate Common Line Support as of July 1, 2003, after which participation in the NECA common line pool will not be required for receipt of universal service support. As discussed below, LTS no longer will serve an independent purpose after the CCL charge is phased out, and its restriction to pooling carriers hampers the competitiveness of incumbent LECs. Although the Commission previously maintained this restriction in part due to the risk-sharing benefits of pooling, we believe that the need for this risk-sharing function will be reduced or eliminated by conversion of the CCL charge to explicit universal service support. We seek comment on these conclusions.

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[633] *See* 47 C.F.R. §§ 61.41, 54.303(a).

[634] *See Interstate Access Support Order*, 15 FCC Rcd at 13046 para. 201.

[635] *Puerto Rico Tel. Co. Petition for Waiver of Section 61.41 or Section 54.303(a) of the Commission's Rules*, CCB/CPD No. 99-36, Order, DA 01-1353 at 4 (Com.Car.Bur. rel. June 12, 2001).

[636] PRTC currently is operating as a rate-of-return carrier pursuant to a temporary waiver of sections 61.41 and 54.303 of the Commission's rules until July 1, 2002. *Id.* at 4 para. 7.

1. Background

273. The historical purpose of LTS was to prevent the CCL rates of pooling carriers from rising significantly above the national average CCL rate.[637] In 1997, the Commission concluded that LTS should be continued, but that modifications were necessary to make it explicit, portable, and competitively neutral.[638] The Commission reasoned that LTS, as modified, continued to serve the public interest "by reducing the amount of loop cost that high cost LECs must recover from IXCs through CCL charges and thereby facilitating interexchange service in high cost areas, consistent with the express goals of section 254."[639] In the *Universal Service Fourth Order on Reconsideration*, the Commission declined to eliminate the requirement that carriers participate in the NECA common line pool in order to be eligible for LTS.[640] The Commission wished to avoid disruption for rate-of-return carriers by maintaining the existing LTS program until it undertook comprehensive access charge and universal service reform for such carriers.[641] The Commission also cited its desire not to "undermine the pool's usefulness in permitting participants to share the risk of substantial cost increases related to the CCL charge by pooling their costs and, thereby, charging an averaged CCL rate close to that charged by other carriers. This operation of the pool, like LTS payments, serves section 254's goal of facilitating interexchange service in high cost areas."[642] As discussed above, the Commission largely has phased out the CCL charge for price cap carriers, and it will be removed from the rate structure of rate-of-return carriers as of July 1, 2003.[643]

2. Discussion

274. We tentatively conclude that LTS will be merged with Interstate Common Line Support as of July 1, 2003, after which participation in the NECA common line pool will not be required for receipt of universal service support. We believe that merging LTS with Interstate Common Line Support is warranted in the interest of administrative simplicity, because LTS no longer will serve an independent purpose after the CCL charge is phased out. Because the CCL charge will be eliminated, LTS will not be required to reduce the costs recovered through CCL charges.[644] Moreover, carriers now receiving LTS will be eligible for Interstate Common Line Support to meet their common line revenue requirements not recovered through SLC charges. Most carriers will receive Interstate Common Line Support in an amount equal to or greater than the amount of LTS support they now receive. If retained, LTS's practical effect would be merely to reduce the Interstate Common Line Support received by each pooling carrier. Although we conclude above that retention of LTS as a separate support mechanism is warranted during the

[637] *See supra*, § III.B.

[638] *Universal Service First Report and Order*, 12 FCC Rcd at 9164-65 para. 299.

[639] *Id.*; *see Universal Service Fourth Order on Reconsideration*, 13 FCC Rcd at 5361-63 paras. 74, 76.

[640] *Universal Service Fourth Order on Reconsideration*, 13 FCC Rcd at 5361-63 paras. 74-76.

[641] *Id.*

[642] *Id.*

[643] *See supra*, § IV.A.2.d.

[644] *See Universal Service First Report and Order*, 12 FCC Rcd at 9164-65 para. 299.

transition to a more efficient common line rate structure, we do not believe that LTS should be retained once the CCL charge is eliminated.[645] In this regard, we note that the Commission's prior concern that LTS modifications might cause unnecessary disruption no longer appears to be a valid basis for maintaining the status quo with regard to LTS, because we now have undertaken comprehensive access charge and universal service reform for such carriers.[646]

275. We also believe that merging LTS with Interstate Common Line Support is warranted in the interest of promoting competition. As discussed above, restricting eligibility for universal service support to pooling carriers hampers the competitiveness of incumbent LECs by forcing them to choose between universal service support and the freedom to set rates outside the NECA common line pool.[647] The Commission previously maintained this restriction in part due to the risk-sharing benefits of pooling, but we believe that this risk-sharing function will be diminished substantially by conversion of the CCL charge to explicit universal service support.[648] The pool's averaged CCL rates spread across pooling companies the risks related to recovery of residual common line costs through a per-minute charge. Unlike a per-minute charge, however, per-line universal service support is not subject to unpredictability and variation.

276. We seek comment on these tentative conclusions. We recognize that the proposed elimination of LTS as a separate, pooling-restricted support mechanism may impact membership in the NECA common line pool.[649] Nevertheless, we anticipate that the pool will continue to perform important administrative functions, such as tariff filings for many small carriers for whom such burdens would be excessive in the absence of the ability to pool, as well as risk-sharing functions related to the recovery of traffic sensitive costs.[650] We invite interested parties to comment on these issues.

[645] *See supra*, § IV.D.2.a.

[646] *See Universal Service Fourth Order on Reconsideration*, 13 FCC Rcd at 5361-63 paras. 74, 76.

[647] *See supra*, § IV.D.2.a; *see also* California Commission Comments at 3 (MAG proposal to restrict support to pooling carriers "would stifle competition in rural areas"), ICORE Comments at 18 ("Any rural access reform policy that is not 'pooling neutral' is terrible public policy that caters to the NECA status quo.").

[648] *See Universal Service Fourth Order on Reconsideration*, 13 FCC Rcd at 5363 para. 76.

[649] *See id.* at 5362 para. 75 ("we note that a number of companies that have chosen to leave the NECA common line pool in the past generally have done so because their costs have decreased such that they can charge a lower CCL interstate access rate than the NECA CCL rate and recover their costs without LTS support. . . . Although we recognize that other considerations may influence a carrier's decision to exit the pool, we can only presume that any carrier that has left did so after balancing all factors and determining that it could forego the receipt of LTS.").

[650] *See Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation*, CC Docket No. 92-135, Notice of Proposed Rulemaking, 7 FCC Rcd 5023, 5030 (1992); *MTS and WATS Market Structure*, CC Docket No. 78-72, *Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, CC Docket No. 80-286, Memorandum Opinion and Order on Reconsideration, 3 FCC Rcd 4543, 4560 n.108 and accompanying text (1988).