STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

September 27, 2004

Ms. Marlene K. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20024

Re: Ex Parte Comments – To be filed in the proceeding captioned "In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers," CC Docket Nos. 00-256, 96-45

Dear Ms. Dortch:

In accordance with Section 1.l206(b)(1) of the Federal Communications Commission's ("FCC" or "Commission") Rules, President Michael Peevey of the Public Utilities Commission of the State of California ("California" or "CPUC") hereby submits for filing two copies of a letter to Chairman Powell of the Federal Communications Commission for inclusion in the public record in the above-referenced docket. This letter involves California's comments on the above-entitled matter and the upcoming decision of the FCC in this matter. Copies of the letter were also sent to Commissioner Abernathy, Commissioner Martin, Commissioner Copps, and Commissioner Adelstein.

Sincerely,

/s/ JONADY HOM SUN

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Attorney
California Public Utilities Commission

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PUBLIC UTILITIES COMMISSION
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Mr. Michael K. Powell
Chairman
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20024

Re: Ex Parte Comments – To be filed in the proceeding captioned "In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers," CC Docket Nos. 00-256, 96-45

Dear Mr. Powell:

I appreciate the Commission's willingness to work with the states as the Commission considers CenturyTel's proposal that would modify the Commission's price cap rules to permit ROR carriers to elect a modified form of price cap regulation on a study area basis. More specifically, CenturyTel proposes to 1) eliminate the all-or-nothing rules contained in section 61.41(c)(2) and (3) so that ROR carriers that acquire price cap exchanges need not convert to price caps at the holding company level, and 2) eliminate section 61.41(b) so that ROR carriers can elect price cap regulation on a study area basis.

For the reasons discussed below, the CPUC continues to support the "all-or-nothing" rule. However, if the Commission chooses to adopt CenturyTel's proposal, then at a minimum, the Commission should 1) reduce the low-end adjustment of 10.25 percent and 2) implement limitations in the study areas to safeguard against cost shifting. In addition, the CPUC offers the Commission information on our own price cap regulation and how we implement the sharing mechanism and set the productivity factor. Silence on the other issues connotes neither agreement nor disagreement with these proposals.

A. The "All-or-Nothing" Rule Should be Maintained.

The CPUC believes the Commission should maintain the "all-or-nothing" rule. While California has not seen carriers attempt to go back and forth between regulatory frameworks, such rules provide a deterrent to potential regulatory abuses. Consistent with the CPUC's comments filed in 2001[1], we oppose the elimination of the merger and acquisition safeguards currently in place.

B. Low end adjustment is too high.

If CenturyTel's plan is adopted, the CPUC recommends the Commission adopt a low-end adjustment that is more within the range of the CPUC's ROR earnings floor. The CPUC has a mechanism in its price cap form of regulation that provides a protection to the LECs that is similar to the low-end adjustment element of CenturyTel's plan, with one significant difference – a substantially lower rate. The CPUC's trigger mechanism allows a LEC to come before the Commission to adjust elements of its regulatory framework and/or adjust prices of service when earnings fall below a specified level for 2-consecutive years. CenturyTel's plan contained a low-end adjustment set at 10.25 percent to ensure reasonable earnings opportunities. The CPUC agrees with AT&T that the low-end adjustment is overly generous. As noted by AT&T, the LEC's cost of capital in 1999 was only in the 8 to 9 percent range.[2] It would be unreasonable to adopt a low-end adjustment rate greater than the cost of capital. Furthermore, the CPUC's Citizens and SureWest ROR earnings floor is 6.5 percent and 6.75 percent, respectively. In addition, the CPUC's Verizon Telephone Company and SBC earnings floor is set at 7.75 percent and 6.75 percent, respectively. CenturyTel's proposed low-end adjustment is about 30 to 40 percent higher than the CPUC's earnings floor set for California companies. Permitting an artificially high low-end adjustment of 10.25 percent would provide incentives for carriers to overspend, make risky investments and even gold-plate their networks, since now they are guaranteed a high return regardless of inefficiencies or poor management decisions. Ultimately, the burden of this mistake will fall on the ratepayers.

C. Limitation on Study Areas.

The CPUC agrees with both AT&T and MCI that limitations should be implemented if the Commission does permit study area-by-study area election. We support AT&T's proposal of requiring ROR carriers to elect incentive regulation for all contiguous study areas,[3] and MCI's proposal of placing strict limits on the types of study areas that may be left under ROR regulation.[4] We believe that implementing limitations at the study area level would provide a safeguard against cost shifting.

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[1] See CPUC Comments, CC Docket No.00-256, February 26, 2001.

[2] See AT&T Comments at 22.

[3] See AT&T Comments at 21.

[4] See MCI Comments at 4.

However, if the Commission decides to allow ROR carriers to elect price cap regulation on a study area basis, this could potentially affect the intrastate revenue of the rural ILECs because it could affect NECA support for the rural ILECs. NECA support affects the *intrastate* revenues of the rural ILECs. Therefore, before allowing ROR carriers to elect price cap regulation on a study area basis, it should be contingent on the states having explicit authority to approve such an election.

D. CPUC Sharing Mechanism

The CPUC originally adopted the earnings sharing mechanism to four price cap companies to provide protection to ratepayers from an improperly functioning indexing mechanism. The mechanism employs several ROR thresholds, including a ROR cap that provides a protection to ratepayers from unreasonably excessive profits for the utility[5]. However, under the current CPUC price cap model, only two of the remaining four companies are still required to share their earnings. Per CPUC D.98-10-026, earnings sharing has been suspended for SBC California and Verizon California, Inc. The CPUC found that sharing distorts incentives for utilities to invest and be efficient, as well as results in asymmetric treatment between firms. On the other hand, SureWest Telephone Co. (SureWest) and Citizens Telecommunications Company (Citizens) are still required to share their earnings over 11.5 percent and 11.25 percent, respectively. SureWest is required to share with ratepayers 50 percent of its earnings between the benchmark and cap RORs (cap is at 15 percent), and refunds to ratepayers 100 percent of its earnings above the cap ROR. Citizens is required to share with ratepayers 50 percent of its earnings between the benchmark and cap RORs (cap is at 14.75 percent), and refunds to ratepayers 100 percent of its earnings above the cap ROR.

E. CPUC Productivity Factor

Pursuant to CPUC D.89-10-031, the CPUC developed a price cap model with an index mechanism that included a formula I-X that updates the revenues yearly for inflation and expected productivity improvements for the telecommunications industry. The "I" is inflation as measured by the gross national product price index (GNP-PI) and "X" is productivity. The original decision adopted a productivity factor of 4.5%, which was set higher than historical levels to ensure that ratepayers receive significant benefits expected due to adoption of an incentive-based regulatory framework. However by 1995, the CPUC had suspended the application of the I-X formula. Per D.95-12-052, the CPUC found that the productivity factor was inappropriate because the underlying assumptions and data on which the productivity rate was based on were obsolete. On the other hand, the CPUC also found that setting productivity factors lower than the prevailing rate of inflation would lead to rate increases and were also inappropriate. Therefore, the CPUC decided to suspend the application of I-X formula and set the productivity factor equal to the inflation factor.

[5] See CPUC D.89-10-031.

In general, the CPUC believes the Commission should not eliminate the "all-or-nothing" rule. If the Commission chooses to adopt CenturyTel's proposal, then the CPUC recommends the Commission implement limitations at the study area level to constrain cost shifting. In addition, the CPUC believes that the low-end adjustment proposed by CenturyTel is too high, and that the low-end adjustment should be reduced to set the adjustment at a more reasonable rate. The CPUC also provides information to the Commission on how the CPUC implements the sharing mechanism and set the productivity factor under our current price cap regulation.

Sincerely,

/s/ MICHAEL PEEVEY

MICHAEL PEEVEY
President

cc: Kathleen Q. Abernathy, FCC Commissioner
Michael J. Copps, FCC Commissioner
Kevin J. Martin, FCC Commissioner
Jonathan S. Adelstein, FCC Commissioner