TED STATES CO
DISTRICT OF C
FILED
AUG - 5 1998
CLERK

ORAL ARGUMENT SCHEDULED
JANUARY 20, 1999

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 97-1469
and Consolidated Cases

UNITED STATES TELEPHONE ASSOCIATION, *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION and
the UNITED STATES OF AMERICA,
Respondents.

On Petitions for Review of an Order of the
Federal Communications Commission

FINAL JOINT BRIEF OF PETITIONERS MCI TELECOMMUNICATIONS CORPORATION AND AD HOC TELECOMMUNICATIONS USERS COMMITTEE

Thomas F. O'Neil III
Maria L. Woodbridge
MCI Telecommunications Corporation
1133 19th Street, N.W.
Washington, D.C. 20036

Carl S. Nadler
Donald B. Verrilli, Jr.
Anthony C. Epstein
Jon M. Shepard
Jenner & Block
601 13th Street, N.W.
Washington, D.C. 20005

Counsel for MCI Telecommunications Corporation

James S. Blaszak
Kevin S. DiLallo
Mark G. Johnston
Levine, Blaszak, Block &
Boothby, LLP
2001 L Street, N.W., Suite 900
Washington, D.C. 20036

April 30, 1998

Counsel for Ad Hoc Telecommunications Users Committee

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 97-1469
and Consolidated Cases

UNITED STATES TELEPHONE ASSOCIATION, *et al.*,

Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION and
the UNITED STATES OF AMERICA,

Respondents.

On Petitions for Review of an Order of the
Federal Communications Commission

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to Circuit Rule 28(a)(1), Petitioners MCI Telecommunications Corporation and Ad Hoc Telecommunications Users Committee certify as follows:

A. Parties and Amici

The parties that participated in the FCC proceedings below are listed in Appendix A of the order under review. They are as follows:

Ad Hoc Telecommunications Users Committee
American Petroleum Institute
The Ameritech Operating Companies
AT&T Corporation

The Bell Atlantic Telephone Companies
The BellSouth Telephone Companies
California Cable Television Association**
Cincinnati Bell Telephone Company
Frontier Corporation
General Services Administration
GTE Service Corporation
International Communications Association*
LDDS WorldCom**
Lincoln Telephone and Telegraph Company (now known as
Aliant Communications Co.)
MCI Telecommunications Corporation
MFS Communications Company**
National Cable Television Association**
NYNEX Telephone Companies
Pacific Bell and Nevada Bell
Southwestern Bell Telephone Company
Southern New England Telephone Company*
Sprint Corporation
Time Warner Communications Holdings, Inc.*
Telecommunications Resellers Association
United States Telephone Association
US West Communications, Inc.

*Filed comments only.
**Filed reply comments only.

The following parties have filed petitions for review or motions to intervene in these consolidated review proceedings.

Petitioners:
United States Telephone Association (Case No. 97-1469)
GTE Service Corporation (Case No. 97-1471)
Bell Atlantic Telephone Companies (Case No. 97-1475)
NYNEX Telephone Companies (Case No. 97-1479)
US West, Inc. (Case No. 97-1494)
MCI Telecommunications Corporation (Case Nos. 97-1495, 97-1497)
Southwestern Bell Telephone Company (Case No. 97-1496)
GTE Midwest, Inc. (Case No. 97-1498)
Ad Hoc Telecommunications Users Committee (Case No. 97-1500)
Bell Atlantic - Virginia, Inc. (Case No. 97-1501)
BellSouth Corporation and BellSouth Telecommunications, Inc.
(Case No. 97-1645).

Intervenors: Airtouch Communications, Inc.
Allied Associated Partners, LP
America's Carriers Telecommunication Association
Ameritech Corporation
Association for Local Telecommunications Services
AT&T Corporation
Bell Atlantic Telephone Companies
BellSouth Corporation
BellSouth Telecommunications, Inc.
Cable & Wireless, Inc.
Citizens Utilities Company
Competition Policy Institute
Competitive Telecommunications Association
Frontier Corporation
GELD Information Systems
Independent Telephone & Telecommunications Alliance
Nevada Bell
Pacific Bell
The Southern New England Telephone Company
Southwestern Bell Telephone Company
Telecommunications Resellers Association
US West, Inc.
WorldCom, Inc.

Rule 26.1 Disclosure Statement

Pursuant to Federal Rule of Appellate Procedure 26.1 and Circuit Rule 26.1, Petitioners submit these disclosures of interest.

Petitioner MCI Telecommunications Corporation ("MCIT") is a wholly-owned subsidiary of MCI Communications Corporation ("MCIC"), which is a publicly held corporation. MCIC and MCIT provide a wide variety of telecommunications services, including but not limited to national and international voice and data services and information services. Other than MCIC, MCIT does not have any non-wholly-owned parent company, subsidiary, or affiliate (as defined in Circuit Rule 26.1) that is publicly traded. MCIC has announced plans to merge with WorldCom, Inc., which is also a publicly held corporation.

Ad Hoc Telecommunications Users Committee ("Ad Hoc") is an unincorporated, nonprofit association whose members include some of the nation's largest business users of telecommunications services and products. The organization represents its members' interests in telecommunications matters before the Federal Communications Commission and in the federal courts. Ad Hoc has no parent company, subsidiary or affiliate, and therefore, no associated entity has issued shares to the public.

B. Ruling Under Review

The ruling under review is the FCC's *In re Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, Fourth Report and Order, CC Docket No. 94-1 and Second Report and Order, CC Docket No. 96-262, 12 F.C.C.R. 16,642 (1997). A synopsis of the order was published in the Federal Register on June 11, 1997, at 62 Fed. Reg. 31,939.

C. Related Cases

To Petitioners' knowledge, there are no related cases (within the meaning of Circuit Rule 28(a)(1)(C)) pending in this or any other court.

STATEMENT REGARDING DEFERRED APPENDIX

Pursuant to Federal Rule of Appellate Procedure 30(c), the parties have used a deferred appendix.

TABLE OF CONTENTS

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES i

A. Parties and Amici i

Rule 26.1 Disclosure Statement iii

B. Ruling Under Review iv

C. Related Cases iv

STATEMENT REGARDING DEFERRED APPENDIX iv

TABLE OF AUTHORITIES vii

GLOSSARY x

JURISDICTION 1

STATEMENT OF ISSUES 1

STATUTES AND REGULATIONS 2

STATEMENT OF THE CASE 2

I. Interstate Exchange Access and FCC Regulation 3

II. The Fundamentals of Price Caps 4

III. The 1990 LEC Price Cap Order and the First X-Factor 5

IV. The 1995 Performance Review 7

V. The Order Under Review 8

SUMMARY OF ARGUMENT 10

STANDARD OF REVIEW 11

ARGUMENT 12

I. THE COMMISSION ACTED ARBITRARILY AND CAPRICIOUSLY IN FAILING FULLY TO CORRECT THE INACCURACIES IT ACKNOWLEDGED IN THE LEC PRICE CAP INDICES. 12

A. The Commission's Stated Policy of Complete Corrections for Inaccurate X-Factor Calculations. 13

B. The Commission Failed to Order a Complete Correction Here. 13

C. The Commission Provided No Reasonable Explanation for Failing to Correct the Price Cap Indices Completely. 16

II. THE COMMISSION EXCEEDED ITS AUTHORITY AND ACTED ARBITRARILY AND CAPRICIOUSLY WHEN IT ELIMINATED THE SHARING MECHANISM. 17

A. The Commission Exceeded its Authority and Ignored its Statutory Obligation to Ensure That Carriers' Charges Are Just and Reasonable by Implementing a Ratemaking System That Allows the LECs to Earn Returns Outside the Zone of Reasonableness. 18

B. The Commission's Elimination of Sharing Was Arbitrary and Capricious. 21

C. The Commission's Decision to Retain the Low-end Adjustment While Eliminating Sharing Was Arbitrary and Capricious. 27

III. THE COMMISSION ARBITRARILY AND CAPRICIOUSLY FAILED TO ADDRESS THE DEMONSTRATED BIAS CREATED BY USING TOTAL COMPANY PRODUCTIVITY, RATHER THAN INTERSTATE-ONLY PRODUCTIVITY, TO CALCULATE THE BASELINE PRODUCTIVITY OFFSET OF THE X-FACTOR. 29

CONCLUSION 33

TABLE OF AUTHORITIES

FEDERAL CASES

American Telephone and Telegraph Co. v. FCC, 572 F.2d 17
(D.C. Cir. 1987) 18

American Telephone and Telegraph Co. v. FCC, 836 F.2d 1386
(D.C. Cir. 1988) 19, 20

Competitive Telecommunications Association v. FCC, 87 F.3d 522
(D.C. Cir.1996) 11

**Democratic Central Committee of D.C. v. WMATA*, 485 F.2d 786
(D.C. Cir. 1973) 28

FPC v. Hope Natural Gas Co., 320 U.S. 591, 64 S. Ct. 281 (1944) 19, 28-29

**Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486
(D.C. Cir. 1984) . . . . *passim*

Greater Boston Television Corp. v. FCC, 444 F.2d 841 (D.C. Cir. 1970) . . . 12, 32

Illinois Public Telecom. Association v. FCC, 117 F.3d 555 (D.C. Cir. 1997),
cert. denied, 118 S. Ct. 1361 (1998) 4

MCI Telecommunications Corp. v. FCC, 10 F.3d 842 (D.C. Cir. 1993) 12

MCI Telecommunications Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985) 18

Mobil Oil Corp. v. FPC, 417 U.S. 283, 94 S. Ct. 2328 (1974) 25

**Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Auto Ins.*,
463 U.S. 29, 103 S. Ct. 2856 (1983) 11, 12, 32

National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993) 22

In re Permian Basin Area Rate Cases, 390 U.S. 747, 88 S. Ct. 1344 (1968) 19

United States v. FCC, 707 F.2d 610 (D.C. Cir. 1983) 19-20, 21

Note: Cases upon which we chiefly rely are marked with asterisks.

FEDERAL STATUTES

5 U.S.C. § 706(2) 11

28 U.S.C. § 2342 1

28 U.S.C. § 2344 1

47 U.S.C. § 151 3

47 U.S.C. § 160(a) 18

47 U.S.C. § 201(b) 3, 18

47 U.S.C. § 204(a)(3) 23

47 U.S.C. § 402(a) 1

47 C.F.R. § 1.773(a) 23

47 C.F.R. § 61.42 4

47 C.F.R. § 61.45 . . . . 4, 5

62 Fed. Reg. 31,939 1

ADMINISTRATIVE DECISIONS

Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services, Further Notice of Proposed Rulemaking, CC Docket No. 95-20, FCC 98-8 (rel. Jan. 30, 1998) 26

In re Implementation of Section 402(b)(1)(A) of the Telecommunications Act of 1996, 12 F.C.C.R. 2170 (1997) 22, 23

In re Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, 10 F.C.C.R. 13,659 (1995) 29

In re Price Cap Review for Local Exchange Carriers, First Report and Order, 10 F.C.C.R. 8961 (1995), *aff'd sub nom. Bell Atlantic Telephone v. FCC*, 79 F.3d 1195 (D.C. Cir. 1996) . . . . *passim*

In re Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform, Fourth Report and Order, Second Report and Order, 12 F.C.C.R. 16,642 (1997) . . . . *passim*

In re Policy and Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking, 3 F.C.C.R. 3195 App. D (1988) 4

In re Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 F.C.C.R. 2873 (1989) 3

In re Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 F.C.C.R. 6786 (rel. Oct. 4, 1990), *erratum*, 5 F.C.C.R. 7664 (1990), *modified on recon.*, 6 F.C.C.R. 2637 (1991) . . . . *passim*

GLOSSARY

APA	Administrative Procedure Act
BOC	Bell Operating Company
CPD	Consumer Productivity Dividend
FCC	Federal Communications Commission
GDP-PI	Gross Domestic Product Price Index
LEC	Local Exchange Carrier
IXC	Interexchange Carrier
PCI	Price Cap Index
TFP	Total Factor Productivity

JURISDICTION

The final agency action under review here was released on May 21, 1997, and summarized in the Federal Register on June 11, 1997, at 62 Fed. Reg. 31,939. Petitions for review were timely filed within 60 days of publication in the Federal Register. MCI's petitions were filed with this Court on June 11, 1997 (No. 97-1391) and June 18, 1997 (No. 97-1403); Ad Hoc's petition was filed with the Second Circuit on June 20, 1997 (No. 97-4191). Jurisdiction is proper under 47 U.S.C. § 402(a) and 28 U.S.C. §§ 2342 and 2344. On June 26, 1997, the Judicial Panel on Multidistrict Litigation consolidated petitions relating to the order under review in the Tenth Circuit. On July 28, 1997, the Tenth Circuit transferred the consolidated petitions to this Court.

STATEMENT OF ISSUES

1. Whether the Federal Communications Commission ("FCC" or "Commission") acted arbitrarily and capriciously by failing, contrary to its established policy, to correct completely acknowledged errors in the price cap indices and thus allowed the inaccuracies to become "permanently ingrained" in the Commission's regulation of interstate access charges?

2. Whether the Commission exceeded its statutory authority and acted arbitrarily and capriciously by abandoning its enforcement of the just-and-reasonable standard to curb Local Exchange Carriers' ("LECs'") excessive profits from interstate access charges and by eliminating its safeguards against excessive carrier profits while continuing to protect LECs against inadequate earnings?

3. Whether the Commission acted arbitrarily and capriciously when it chose to ignore the bias in the price cap indices created by measuring LEC productivity in the *interstate* access market with data from the LECs' activities in both the *interstate* access and *intrastate* markets?

STATUTES AND REGULATIONS

The text of relevant statutes and regulations is set forth in the Addendum to this Brief.

STATEMENT OF THE CASE

In the order challenged here,[1] the FCC revised its "price cap" regulations for interstate access charges. Although MCI and Ad Hoc generally support the FCC's price cap approach, this particular order was flawed in three key respects. *First*, the Commission failed to correct the price cap indices completely after concluding that they understated LEC productivity. *Second*, the Commission acted arbitrarily, capriciously, and outside its statutory authority in eliminating the ceiling on LEC profitability and exposing consumers to excessive rates while protecting carriers from deficient earnings. *Third*, the Commission inexplicably ignored evidence of a systematic bias in its methodology for determining future price caps. This Court should direct the FCC to correct these errors.

[1] *In re Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, First Report and Order, Second Report and Order, 12 F.C.C.R. 16,642 (1997) ("1997 Price Cap Order") (JA 19).

I. Interstate Exchange Access and FCC Regulation

Pursuant to the Communications Act of 1934, the FCC is obligated to ensure that the charges of common carriers for regulated interstate telecommunications services are "just and reasonable." 47 U.S.C. §§ 151, 201(b). This mandate includes regulation of interstate access charges, *i.e.,* the charges imposed by local exchange carriers ("LECs") for their part in originating and terminating long-distance calls.

For many years, the FCC regulated these charges through a rate-of-return or "cost-plus" system that allowed local carriers to charge rates that would recover their cost of providing service plus a reasonable rate of return. *See In re Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 F.C.C.R. 2873, ¶¶ 16-35 (1989) ("AT&T Price Cap Order"). The principal goal of the rate-of-return system was to provide adequate earnings for dominant carriers (like AT&T was in the long distance market and the Bell Operating Companies ("BOCs") and GTE are today in the local and interstate access markets), while preventing them from extracting excessive profits from customers. *Id.* ¶ 76.

In the AT&T Price Cap Order, the Commission concluded that rate-of-return regulation was flawed, principally because by setting prices on a "cost-plus" basis, the system gave telephone companies the incentive to incur unnecessary costs. *Id.* ¶¶ 29-35, 75-86. Accordingly, the FCC adopted a "price cap" system for regulating interstate charges. The Commission first used the price cap system to regulate AT&T's charges for long-distance services. It later required large LECs, including the BOCs and GTE, to set their interstate rates pursuant to the price cap system.[2]

II. The Fundamentals of Price Caps

"Under a price cap system, 'the regulator sets a maximum price, and the firm selects rates at or below the cap.'" *Illinois Public Telecom. Ass'n v. FCC*, 117 F.3d 555, 570 (D.C. Cir. 1997), *cert. denied*, 118 S. Ct. 1361 (1998) (citation omitted). The Commission divided interstate access services into "baskets," assigned each basket a Price Cap Index ("PCI") of 100 based on the charges in place at the time, and provided a method for adjusting these PCIs annually. 47 C.F.R. §§ 61.42, 61.45. A Price Cap LEC is entitled to streamlined tariff review if it can show that the rate of change of its actual prices has been less than or equal to the FCC's mandated rate of change in prices, *i.e.*, the PCIs. *See* LEC Price Cap Order ¶¶ 227-229; *see also In re Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, 3 F.C.C.R. 3195 App. D (1988) ("Calculating the Price Cap Indices: Some Examples").

The Commission's formula for setting and annually modifying the PCIs consists of three components: (1) a measure of inflation, represented now by the Gross Domestic Product Price Index ("GDP-PI"); from which is subtracted (2) an "X-Factor," consisting of (a) a baseline productivity offset and (b) a Consumer Productivity Dividend ("CPD"); plus or

[2] Certain other local carriers could elect to use price caps. *See generally In re Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 F.C.C.R. 6786 (1990) ("LEC Price Cap Order"), *erratum*, 5 F.C.C.R. 7664 (1990), *modified on recon.*, 6 F.C.C.R. 2637 (1991), *aff'd sub nom. National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

minus (3) certain exogenous cost changes. 47 C.F.R. § 61.45. Each year, the existing PCI is adjusted by the result of this formula.

Each of these components has a specific rationale. The inflation measure represents economy-wide productivity gains and price changes and allows the FCC to regulate interstate access prices in real, rather than inflated, terms. LEC Price Cap Order ¶ 2. The productivity offset sub-element of the X-Factor is necessary because the telecommunications industry has historically enjoyed greater productivity than the economy as a whole, and the offset represents this difference. *Id.* ¶¶ 47-54, 74-95. The Commission added the CPD sub-element to encourage productivity increases and to ensure that at least a portion of carriers' increased productivity under price caps is passed on to access consumers as reduced rates. *Id.* ¶ 76. Finally, the exogenous cost adjustments generally include cost changes caused by administrative, legislative, or judicial action, which are outside the control of the carriers. *Id.* ¶¶ 48, 166-190.

III. The 1990 LEC Price Cap Order and the First X-Factor

In 1990, the Commission established the basic framework for LEC price cap regulation and set the X-Factor that would be used for the subsequent four years. The Commission averaged the results from two in-house studies of historical productivity[3] and

[3] *See* J. Christopher Frentrup and Mark I. Uretsky, "A Study of Local Exchange Carrier Post-Divestiture Switched Access Productivity," in LEC Price Cap Order App. C ("Frentrup-Uretsky Study") and Thomas C. Spavins, "The Long Term View of the Appropriate Productivity Factor For Interstate Exchange Access," in LEC Price Cap Order App. D ("Revised Spavins-Lande Study").

directed that the X-Factor (including a CPD of 0.5 percent) be set at either 3.3 percent with a stringent "sharing" requirement or 4.3 percent with a reduced sharing requirement. LEC Price Cap Order ¶¶ 77, 100. The "sharing" requirement was one component of a "backstop" plan to make adjustments if the price caps allowed LEC earnings to become too high or too low. The Commission adopted twin mechanisms in this regard: a sharing mechanism and a low-end adjustment. LEC Price Cap Order ¶¶ 120-122, 127-128. The first required the LECs to "share" with consumers a portion of their earnings over certain threshold levels.[4] The low-end adjustment, for its part, ensured that LEC earnings would not fall below a defined level. *Id.* ¶ 127.[5]

The Commission stated that its backstop plan represented a balancing of competing goals -- the need to provide profit incentives to the Price Cap LECs while ensuring that their rates were just and reasonable: "A backstop mechanism can help ensure that the [price cap] plan fairly shares the risks and rewards of future productivity gains between the

[4] Sharing is accomplished by adjusting the price cap -- and hence rates -- downward in the period following the period of high earnings. The sharing mechanism established three categories for the Price Cap LECs: the "no sharing zone," the "50-50 sharing zone," and the "100% sharing zone." As originally adopted, carriers choosing the 3.3% X-Factor were allowed to retain 100% of their earnings up to 12.25%, but were required to share 50% of their earnings between 12.25% and 16.25%, and to share 100% of their earnings above 16.25%. In contrast, carriers electing the 4.3% X-Factor were permitted to retain 100% of their earnings up to 13.25%, but were required to share 50% of their earnings between 13.25% and 17.25%, and to share 100% of their earnings above 17.25%. LEC Price Cap Order ¶¶ 123-126.

[5] The low-end adjustment permits a Price Cap LEC whose earnings fall below a pre-established level to adjust its rates upward in the next year to achieve earnings above the threshold. LEC Price Cap Order ¶ 127.

LECs and customers, even in the unpredictable and varying circumstances of future years." *Id.* ¶ 121.

IV. The 1995 Performance Review

In 1995, the FCC reviewed how price caps were working. The FCC generally reaffirmed its commitment to price caps and reviewed several proposed new methodologies for computing the X-Factor. *In re Price Cap Review for Local Exchange Carriers*, First Report and Order, 10 F.C.C.R. 8961, ¶¶ 99-165 (1995) ("1995 Price Cap Order"), *aff'd sub nom. Bell Atlantic Tel. Cos. v. FCC,* 79 F.3d 1195 (D.C. Cir. 1996). The Commission tentatively committed to a model submitted by United States Telephone Association ("USTA"), a LEC trade association, in which the baseline productivity offset for the X-Factor would be determined according to an industry-wide total factor productivity ("TFP") measurement of all Price Cap LECs. *Id.* ¶ 106. TFP is the ratio of Price Cap LEC outputs to Price Cap LEC inputs, and the rate of growth in TFP equals the rate of growth of the output index minus the rate of growth of the input index. *Id.* As the Commission explained:

> In its simplest form, total factor productivity is the ratio of a firm's (or industry's or nation's) total output to its total input. A firm can become more productive by producing greater output from the current level of inputs, by producing the same level of output from fewer inputs, or through a combination of both.

Id. ¶ 9 (footnotes omitted). In USTA's proposal, the outputs would include both intrastate and interstate services, and the input figure would be the weighted average of indices calculated for total company capital, labor, and materials. *Id.* ¶¶ 106-107.

The Commission was unable to resolve all the issues regarding computation of TFP in 1995. Nevertheless, the Commission determined that it had previously underestimated Price Cap LEC productivity and the X-Factor. *Id.* ¶¶ 144, 201-209. Relying on revised versions of its in-house productivity studies, the Commission allowed Price Cap LECs to select from among three X-Factors, 4.0, 4.7 or 5.3 percent. LECs that selected the higher X-Factors (and thus a greater productivity target) were permitted to retain more of the earnings they could achieve over certain levels.[6] The Commission directed the LECs to recalculate their PCIs on a prospective basis as if the newly-identified 4.0 percent X-Factor had been in effect from the beginning of price cap regulation in 1991. *Id.* ¶ 248.

V. The Order Under Review

In the order under review, the FCC used TFP methodology to select a new X-Factor of 6.5 percent. 1997 Price Cap Order ¶ 141 (JA 75). To arrive at this factor, the Commission measured Price Cap LEC productivity by looking at data concerning total company performance, including both *inter*state and *intra*state activities. *Id.* ¶¶ 110-111 (JA 64-65).

Several commenters observed that because the X-Factor regulates LEC pricing for *interstate* access only, it should be based solely on evidence of Price Cap LEC *interstate*

[6] LECs that chose the lowest X-Factor were allowed to retain all earnings up to 12.25%. These carriers were required to share 50% of their earnings from 12.25% to 13.25% and to return through sharing all earnings over 13.25%. LECs that opted to operate under the 4.7% X-Factor could retain one half of their earnings between 12.25% and 16.25%, and were compelled to return all earnings over 16.25%. LECs that picked the 5.3% X-Factor were allowed to retain all earnings, *i.e.*, they were not required to share. 1995 Price Cap Order ¶¶ 220-222.

productivity. *Id.* ¶¶ 107, 111 (JA 63, 65). These commenters also adduced evidence showing that the LECs' "interstate productivity growth was greater than total productivity growth" and, as a result, "reliance on total company data in measuring TFP tends to understate the LECs' interstate access productivity growth." *Id.* ¶ 107 (JA 63). Although the FCC had earlier agreed that total company performance data would distort the X-Factor, and despite the evidence of bias in the record, the Commission failed to address the problem. *Id.*

The Commission concluded that its new X-Factor was "a more accurate method of measuring productivity performance than we have previously used and demonstrates that the interim X-Factor [the Commission had] adopted in 1995 understates LEC industry productivity growth." *Id.* ¶ 178 (JA 91-92). Under price cap regulation, each new year's PCI is the product of applying the adjustment factors described above to the existing PCI. *See supra* pages 4-5, above. If the existing PCI is inaccurate or distorted (as the Commission found it to be), fixing the adjustment factors alone will not cure the fact that they are being applied to the existing, flawed, PCI. Accordingly, the Commission acknowledged that, unless the PCIs were recalculated as if the more accurate 6.5 percent X-Factor had been used in past years, the inaccuracies would become "permanently ingrained" in the PCIs. *Id.* ¶ 179 (JA 92).

Re-adjustment to purge the impact of prior X-Factor inaccuracy was especially appropriate, the Commission noted, because "our repeated emphasis that the X-Factor adopted [in 1995] was 'interim' should reasonably have put carriers on notice that another adjustment of the type we had adopted in that order would be possible -- perhaps beginning with the 1995 tariff year, the first year under the interim X-Factor." *Id.*

Surprisingly, however, the Commission did not require the Price Cap LECs to re-calculate their price cap indices to remove fully the impact of the earlier, inaccurate X-Factor estimates. Instead, the FCC only required re-calculation as if the more accurate X-Factor had "become effective with the LECs' *1996* annual tariff filings." *Id.* (emphasis in original).

The 1997 Order also eliminated the sharing mechanism, thus removing any effective constraint on carrier over-earnings. *Id.* ¶ 148 (JA 78). The Commission attempted to justify the elimination of sharing by claiming its new X-Factor was more accurate than in the past. *Id.* ¶ 154 (JA 80-81). In addition, the Commission stated that sharing was inconsistent with its ultimate goal of deregulation when Price Cap LECs' markets become competitive. *Id.* ¶¶ 150-151 (JA 79). Finally, the Commission stated that sharing blunted carrier incentives to operate efficiently and encouraged carriers to misallocate costs to subsidize unregulated services with revenue from regulated services. *Id.* ¶¶ 151, 153 (JA 79, 80). The Commission did not, however, eliminate the low-end adjustment, the companion "backstop" mechanism to sharing that protects carriers from deficient earnings. *Id.* ¶ 11 (JA 27).

SUMMARY OF ARGUMENT

The 1997 Price Cap Order, though generally sound, was arbitrary and capricious in three respects. *First*, the Commission acknowledged that its PCIs were tainted by the use of inaccurate data in earlier years' calculations. In a break with established policy, however, the Commission chose not to make a complete correction to the PCIs. The

Commission thus allowed acknowledged errors to become "permanently ingrained" in the price cap methodology used to regulate interstate access charges.

Second, the Commission removed controls it had created to guard against excessive Price Cap LEC earnings on interstate access charges without adequately justifying its actions or reconciling this action with its statutory obligation to regulate interstate rates. Inconsistently, the FCC retained its safeguards designed to guard against the corollary danger of inadequate earnings on the same charges. In taking these actions, the Commission exceeded its authority and abdicated its statutory obligation to ensure that common carrier rates are "just and reasonable."

Third, the Commission arbitrarily ignored the inaccurate and distorting effect of measuring LEC *interstate* productivity based upon data from their overall operations, including *both interstate and intrastate* activities.

STANDARD OF REVIEW

This case is governed by the Administrative Procedure Act ("APA"), which requires the Court to set aside agency actions that are arbitrary and capricious, unsupported by substantial evidence, in excess of the agency's statutory authority, or otherwise not in accordance with law. 5 U.S.C. § 706(2)(A), (C), (E). While the APA contemplates due deference to agency decision making, it also demands that the agency have "'examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choice made.'" *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522, 529 (D.C. Cir. 1996) (*quoting Motor Vehicle Mfrs. Ass'n v. State*

Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43, 103 S. Ct. 2856, 2866 (1983)); *MCI Telecommunications Corp. v. FCC*, 10 F.3d 842, 846 (D.C. Cir. 1993).

Moreover, an agency may not depart from settled policy without providing a well-reasoned explanation for the departure. *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 41-43, 103 S. Ct. 2866-67; *Greater Boston Television Corp. v FCC*, 444 F.2d 841, 851 (D.C. Cir. 1970). When an agency changes course, it is "obligated to supply a reasoned analysis for the change." *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 42, 103 S. Ct. at 2866. There is a presumption "against changes in current policy that are not justified by the rulemaking record." *Id.* (emphasis omitted).

ARGUMENT

I. THE COMMISSION ACTED ARBITRARILY AND CAPRICIOUSLY IN FAILING FULLY TO CORRECT THE INACCURACIES IT ACKNOWLEDGED IN THE LEC PRICE CAP INDICES.

The Commission determined that it had previously underestimated the X-Factor and adopted a new 6.5 percent X-Factor. 1997 Price Cap Order ¶ 141 (JA 75). As it had in 1995, the Commission recognized the necessity of recalculating the price cap indices to remove the ingrained effect of the earlier inaccurate offset. *Id.* ¶ 179 (JA 92). Nevertheless, the Commission adjusted the indices for only one year (1996) of the six that had been impacted by earlier years' inaccurate X-Factors. *Id.*

A. The Commission's Stated Policy of Complete Corrections for Inaccurate X-Factor Calculations.

In its 1995 recalculation of an "interim" X-Factor, the Commission addressed the question of whether to re-initialize affected PCIs after modifying the X-Factor. Rather than permitting errors to persist indefinitely, the Commission announced a policy of recomputing the indices to purge completely the impact of prior errors:

> If, as we now conclude, the productivity factor we selected was lower than the actual difference between LEC productivity and that of the economy as a whole, then the price cap formula was less favorable to ratepayers, and more favorable to shareholders, than we intended. . . . LEC PCIs are at a level that will allow future rates to be significantly higher than they would have been had we made a more accurate estimate of LEC productivity. . . . We find that this difference between the rate levels we intended to produce and the rate levels that actually exist will, if perpetuated, unreasonably shift the balance of ratepayer and shareholder interests in favor of LEC shareholders.

1995 Price Cap Order ¶¶ 246-247. Accordingly, the Commission ordered the LECs to recalculate their future price cap indices as if the interim X-Factor adopted in 1995 had been in effect since the beginning of price cap regulation in 1991. *Id.* ¶ 248.

B. The Commission Failed to Order a Complete Correction Here.

In the 1997 Price Cap Order, the Commission found that its new method of calculating the X-Factor was "a more accurate method of measuring productivity performance than we have previously used and demonstrates that the interim X-Factor that we adopted in 1995 understates LEC industry productivity growth." 1997 Price Cap Order ¶ 178 (JA 91-92). Accordingly, the Commission ordered the X-Factor increased from a minimum of 4.0 percent to 6.5 percent. Moreover, the Commission observed that it had given carriers clear notice that another recalculation of the sort ordered in 1995 would be possible when a more accurate X-Factor was identified, "perhaps beginning with the 1995 tariff year, the first year under the interim X-Factor." *Id.* ¶ 179 (JA 92).

Despite its policy in favor of recalculation and its acknowledgment that recalculation would be particularly fair in this instance, the Commission chose only to correct the price cap indices for 1996. Thus, it "explained:"

> [W]e wish to limit harm to LEC productivity incentives that could result from the perception that our regulatory policies unnecessarily lack constancy. . . . [W]e anticipated the interim period to be of shorter duration. The longer period of reliance on the interim price cap plan has prompted a longer period of relative uncertainty than [we] intended. We conclude that an adjustment to the incumbent LECs' PCIs would reasonably balance ratepayer interests with our incentive-based regulatory policies in these instances. Accordingly, we require each price cap LEC to adjust its PCIs, effective July 1, 1997, to the levels for the 1997-98 tariff year that would have been in effect had we adopted the 6.5 percent X-Factor in time to become effective with the LECs' 1996 annual tariff filings.

Id. (emphasis in original and footnotes omitted). In other words, the Commission chose *not* to require LECs to correct the impact of the admittedly inaccurate X-Factor on the price cap indices for the years 1991-1996.[7] The Commission did not even order a recalibration of the

[7] In 1995, the Commission found the X-Factor that had been in effect from the beginning of price cap regulation was distorted and inaccurate. However, the Commission also found that it did not have sufficient data to adopt a permanent X-Factor, so it adopted only an "interim" one. 1995 Price Cap Order ¶¶ 7, 14, 198-199. The X-Factor adopted in the 1997 Price Cap Order, which the Commission did find to be accurate, thus represents a more accurate measure of LEC productivity than any of those used in the years 1991 through 1996. 1997 Price Cap Order ¶ 178 (JA 91-92).

indices back to 1995, despite its recognition that the industry expected such a recalculation dating back at least that far.

The Commission's decision to order only a limited correction to the PCIs is especially surprising because the magnitude of distortion now is substantially greater than it was when the Commission ordered a complete correction in 1995. In 1995, the Commission found that the indices were off by 2.8 percent.[8] Assuming that the X-Factor has been incorrect since 1991, the indices are today incorrectly inflated by some 11.2 percent.[9] In a $23 billion market, that translates into more than $2.5 billion in excessive rates for the Price Cap LECs next year alone, and the distortion will persist. From this point forward, the PCIs will always allow Price Cap LECs to charge rates substantially higher than their legitimate productivity gains should allow.

[8] The degree of distortion is determined by multiplying the percentage by which the X-Factor was underestimated by the number of years in which that factor was used. Thus, in 1995, the Commission was moving from an X-Factor of 3.3 percent to a minimum factor of 4.0 percent. Since the inaccuracy of 0.7 percent had been working in the LECs' favor for the previous four years, the Commission found that the price cap indices were artificially inflated by approximately 2.8 percent (4 x [4.0%-3.3%]). 1995 Price Cap Order ¶ 247.

[9] This is a two step calculation. First, from 1991 to 1994, the minimum X-Factor was 3.3 percent. But the Commission recalibrated the PCIs in 1995 to correct for this error, making the effective X-Factor 4.0 percent. Multiplying the 2.5 percent underestimation (6.5%-4.0%) by four years yields a 10 percent distortion. Second, although the minimum X-Factor for the past two years has been 4.0 percent, most LECs have opted for the 5.3 percent optional offset. Since the Commission ordered the 1996 indices recalibrated, the remaining distortion is the 1.2 percent (6.5%-5.3%) from 1995. Thus, all told, the indices are inflated by 10 percent plus 1.2 percent or 11.2 percent.

C. The Commission Provided No Reasonable Explanation for Failing to Correct the Price Cap Indices Completely.

The Commission's "explanation" for perpetuating the error was confused and misguided. The Commission purported to be concerned about the appearance that its X-Factor policies might "unnecessarily lack constancy." 1997 Price Cap Order ¶ 179 (JA 92). As the Commission recognized, however, the X-Factor adopted in 1995 was very clearly "interim" in nature. *Id.* Indeed, the Commission acknowledged in its 1997 Order that it had put the entire industry on notice -- in its initial LEC Price Cap Order and again in its 1995 Price Cap Order -- that the X-Factor was subject to revision until the Commission could establish a reliable methodology for determining future LEC productivity. *See, e.g.*, *id.* ¶¶ 4, 179 (JA 24-25, 92); 1995 Price Cap Order ¶ 7 ("In this Report and Order, we adopt *interim* LEC price cap rules . . . .") (emphasis added). The industry was plainly aware that, until the Commission established a more accurate and permanent X-Factor, any change in the X-Factor would require recomputation of the PCIs.

Regulatory "constancy" would have been served by ordering a full recalculation. It was by failing to order full recalculation -- and thus allowing inaccurate calculations to become permanently ingrained in the price cap indices -- that the Commission broke with its announced policies and created an "unnecessary lack of constancy."

The Commission's only other "explanation" for not completely correcting the impact of the flawed X-Factors is a purported "uncertainty" caused by the Commission's taking approximately one year longer than anticipated to replace the flawed interim X-Factor with a permanent and accurate X-Factor. 1997 Price Cap Order ¶ 179 & n.288 (JA 92). But this explanation is equally unconvincing.

Since an adjustment of the price cap indices is prospective only, it could in no way jeopardize the LECs' past earnings. No matter how long the interim X-Factor remained in place, therefore, the LECs had "certainty" as to their permissible prices and earnings in any given year. Indeed, the only impact of the delay was that LECs enjoyed an artificially low X-Factor -- and thus the ability to raise prices more than was appropriate -- until the Commission was able to define the current 6.5 percent X-Factor. *Id.* ¶¶ 177-179 (JA 90-92). The Commission has failed to offer any rational explanation why its claimed uncertainty justifies its decision to only partially correct the impact of the flawed X-Factor once an accurate one had been defined.

The Commission's failure to order full recalculation broke with established policy and forever embedded inaccuracy and distortion in the price cap indices. Especially given the Commission's explicit recognition that such recalculation would be fair and was expected by the Price Cap LECs, its order in this regard simply did not amount to reasoned agency decisionmaking. This Court should instruct the Commission on remand to correct the acknowledged errors in the price cap indices fully and completely.

II. THE COMMISSION EXCEEDED ITS AUTHORITY AND ACTED ARBITRARILY AND CAPRICIOUSLY WHEN IT ELIMINATED THE SHARING MECHANISM.

By implementing a ratemaking system that enables Price Cap LECs to earn excessive profits on interstate access services, the Commission acted arbitrarily and capriciously and abdicated its responsibility to limit the LECs to just and reasonable charges. In so doing, the Commission exceeded its authority under the Communications Act.

A. The Commission Exceeded its Authority and Ignored its Statutory Obligation to Ensure That Carriers' Charges Are Just and Reasonable by Implementing a Ratemaking System That Allows the LECs to Earn Returns Outside the Zone of Reasonableness.

This Court has recognized that the Commission must "execute and enforce" the provisions of the Communications Act and that the Commission may not abdicate its duty to ensure that statutory standards are met. As part of this obligation, the Commission must ensure that the Price Cap LECs' charges are "just and reasonable." 47 U.S.C. § 201(b); *see MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186, 1192 (D.C. Cir. 1985). As the Second Circuit recognized in *American Telephone & Telegraph Co. v. FCC*:

> [t]he Communications Act requires . . . that rates . . . be *just*, fair, *reasonable* and nondiscriminatory. . . . We are aware of no authority for the proposition that the FCC may abdicate its responsibility to perform [this duty] and ensure that these statutory standards are met.

572 F.2d 17, 25 (2d Cir. 1978) (citations omitted, emphasis in original). *See also* Section 10(a)(1) of the Communications Act of 1934, 47 U.S.C. § 160(a)(1) (FCC may forbear from regulation only where such regulation is "not necessary to ensure" that charges are "just and reasonable").

When Congress requires an agency to set or oversee regulated companies' rates, the agency must ensure that those rates fall within a "zone of reasonableness." *See, e.g.*, *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 88 S. Ct. 1344, 1360 (1968); *United States v. FCC*, 707 F.2d 610, 612 (D.C. Cir. 1983). The "zone of reasonableness" encompasses both the minimum and maximum rate levels that an agency may authorize a regulated company to charge:

> When the inquiry is on whether the rate is reasonable to a producer, the underlying focus of concern is on the question of whether it is high enough to both maintain the producer's credit and attract capital. . . . [W]hen the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is low enough so that exploitation by the [regulated business] is prevented.

Farmers Union Central Exchange v. FERC, 734 F.2d 1486, 1502 (D.C. Cir. 1984) ("*Farmers Union*").

One measure of reasonableness that federal courts have consistently recognized is how the regulated companies' rates stand in relation to their earnings. *See, e.g., FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S. Ct. 281, 288 (1944); *American Tel. and Tel. Co. v. FCC*, 836 F.2d 1386, 1390 (D.C. Cir. 1988). In *Hope Natural Gas*, the Supreme Court held that, at a minimum, a regulated entity's rates must produce sufficient revenues to cover operating expenses and capital costs and yield a return "commensurate with returns on investments in other enterprises having corresponding risks." 320 U.S. at 603, 64 S. Ct. at 288.

The just-and-reasonable standard does not permit regulated entities to earn excessive profits. As this Court explained in *United States v. FCC,* regulated utilities are entitled to earn enough revenue to cover operating expenses and capital costs, but "[t]he return should not be higher than necessary for this purpose . . . because otherwise ratepayers would pay the excessive prices that regulation is intended to prevent." 707 F.2d at 612 (citations omitted). *See also American Tel. and Tel.*, 836 F.2d at 1390 (excessive rates improperly tip balance between investor and consumer interests).

Prior to its 1995 Price Cap Order and 1997 Price Cap Order, the Commission recognized the necessary connection between the Price Cap LECs' earnings and Section 201(b)'s prescription of just and reasonable rates. *See* LEC Price Cap Order ¶ 121. The Commission therefore circumscribed LECs' earnings by requiring them to "share" with their customers a portion of their earnings above an established rate of return. *Id.* ¶¶ 120-126. At the same time, the Commission adopted a low-end adjustment mechanism to protect carriers from under-earning. *Id.* ¶ 127.

In its 1997 Price Cap Order, the Commission acknowledged that it had required sharing to ensure that its rules "did not lead to unreasonably high rates" and that "LEC reductions in unit costs were passed through to their customers." 1997 Price Cap Order ¶ 147 (JA 77-78). In that same order, however, the Commission eliminated the sharing requirement. As a consequence, the Price Cap LECs may now charge rates that allow them to earn excessive returns. The Commission's decision to allow the LECs these excessive returns under the price cap rules is inconsistent with the Commission's obligation to ensure that carriers' charges are just and reasonable under Section 201(b) of the Act.

Although the Commission has broad discretion to craft a regulatory scheme to ensure that carriers' charges are just and reasonable, that discretion must be exercised in a manner that produces rates within the zone of reasonableness. *United States v. FCC*, 707 F.2d at 612, 615, 618. In this case, the Commission exceeded its authority by removing the only effective limit on Price Cap LEC earnings. Further, the FCC has not acted in accordance with law. Under the just and reasonable standard, the Commission cannot adopt a regulatory scheme that exposes customers to unreasonably high charges with no opportunity for refund or reparation. Yet that is precisely the regulatory scheme that the Commission has implemented through the 1997 Price Cap Order.

B. The Commission's Elimination of Sharing Was Arbitrary and Capricious.

The Commission concluded that the sharing mechanism is no longer needed to protect Price Cap LECs' customers from unreasonably high rates because the X-Factor it adopted in the 1997 Price Cap Order "[is] a much more reliable measure of incumbent LEC potential productivity gains" than the Commission's previous estimates. 1997 Price Cap Order ¶ 154 (JA 80). The Commission was "substantially more" confident that the X-Factor it adopted would "flow through a reasonable portion of LEC productivity gains to consumers," obviating the need for a sharing mechanism to correct for over-earnings. *Id.*

The Commission's reliance on its refinement of the X-Factor to guarantee just and reasonable rates is misplaced. Improving the X-Factor does not ensure that the LECs' rates will be reasonable. Whether those charges are unreasonably high turns on whether they yield carrier earnings that are outside the "zone of reasonableness." *United States v. FCC*, 707 F.2d at 612; *Farmers Union*, 734 F.2d at 1501-02. Although the level of the X- Factor affects carriers' earnings and may bring rates within the zone of reasonableness, it does not guarantee that the carriers' earnings will remain within that zone. If the X-Factor is matched to the actual course of carrier productivity, the carriers' earnings will not fall outside the zone of reasonableness. However, if the X-Factor is understated relative to carriers' rate of productivity, the carriers' earnings will climb above the zone of reasonableness and the carriers' charges will be unreasonably high. As this Court recognized in *National Rural Telecom Association v. FCC,*

> price cap regulation cannot quite live up to its promise . . . . The Commission must select a formula for the cap . . . . Obviously, no such formula can be perfect, so ultimately the Commission must check to see whether the cap has gotten out of line with reality.

988 F.2d 174, 178 (D.C. Cir. 1993) (citations omitted).

The Commission acted arbitrarily and capriciously in eliminating the sharing mechanism in the face of the real possibility that the X-Factor could be understated. Sharing has protected carriers' customers from the unreasonably high rates that can occur when the X-Factor is understated. The sharing mechanism has consistently been triggered by carrier earnings above the levels predicted by the Commission. So long as the Commission included a sharing mechanism as part of the price cap rules, any understatement of the X-Factor could not work irreparable harm on access customers. The 1997 Price Cap Order eliminated sharing as a protective backstop. Consequently, carriers' access customers are left with no protection from the unreasonably high charges that will result from an understated X-Factor.

This problem is exacerbated by a recent order by the Commission streamlining regulation of LEC tariff filings. *In re Implementation of Section 402(b)(1)(A) of the Telecommunications Act of 1996,* 12 F.C.C.R. 2170 (1997) ("*Implementation of Section 402(b)(1)(A)*"). Section 402, among other things, amended Section 204 of the Communications Act to streamline review of LEC tariff filings and to provide that LEC filings increasing rates "shall be deemed lawful" unless the Commission investigates the lawfulness of the increases within 15 days of filing. 47 U.S.C. § 204(a)(3). The Commission interpreted the words "deemed lawful" in Section 204(a)(3) to mean that the LECs' tariffed rates are lawful, not just legally effective, from the moment they take effect. *Implementation of Section 402(b)(1)(A)* ¶¶ 18-19.

As a consequence, once rates take effect and produce unreasonably high earnings, consumers' opportunity to complain and obtain damages is already foreclosed. *Id.* ¶¶ 8, 20-21. Customers may seek suspension of Price Cap LEC tariff filings prior to their effectiveness (pursuant to 47 C.F.R. § 1.773(a)(iv)). But customers will not be able to meet the standard for suspension -- that "there is a high probability the tariff would be found unlawful after investigation" -- if they argue that the rates will produce unreasonably high returns, because the Commission concluded in the 1997 Price Cap Order that the public interest is served by removing any limit on the Price Cap LECs' earnings. Therefore, the Commission has made it much more difficult to challenge LEC rates, and has correspondingly increased the danger of unreasonably high earnings in the absence of a sharing safeguard, the last effective customer shield against unreasonably high rates.

The Commission justified eliminating the sharing mechanism by asserting that doing so would maximize carrier incentives to operate efficiently. 1997 Price Cap Order ¶ 153 (JA 80). The Commission concluded that "the need for the beneficial functions served by sharing are outweighed by the benefits of eliminating sharing." *Id.* ¶ 154 (JA 80). In other words, the benefits *to consumers* of sharing are outweighed by the benefits *to the LECs* of eliminating it.

The Commission's balancing of carrier and consumer interests in the 1997 Price Cap Order was arbitrary and capricious in the same way that the Federal Energy Regulatory Commission's ("FERC's") balancing of pipeline companies' and consumers' interests in *Farmers Union* was found by this Court to be arbitrary and capricious. In *Farmers Union*, FERC had found "the consumer's interest in low pipeline rates [to be] 'submicroscopic' while the real threat to the public is underinvestment in needed oil pipelines." 734 F.2d at 1494-95 (*quoting Williams Pipe Line Co.,* 21 FERC (CCH) ¶ 61,260, 61,613-14 (Nov. 30, 1982)). Implicit in this reasoning was FERC's belief that pipeline companies' rates should be high enough to encourage investment. Thus, as the Commission did in the 1997 Price Cap Order, FERC balanced consumers' interests in reasonable rates against pipeline carriers' interests in rates high enough to promote investment, and decided that it was "'best to err on the side of liberality,'" *i.e.,* in the carriers' favor. 734 F.2d at 1495.

This Court found FERC's balancing of interests to be arbitrary and capricious and rejected FERC's reliance on the perceived incentives that would result from the rates FERC approved: "FERC failed to specify in any detail how 'non-cost' factors, such as the need to stimulate additional pipeline capacity, might justify its decision to set maximum rates at such high levels." *Id.* at 1501. The Court explained that, if an agency considers non-cost factors -- such as carriers' investment incentives -- in regulating rates, the agency's consideration of those factors must be reasonable and consistent with the agency's statutory responsibility to ensure that rates remain within the zone of reasonableness:

> "If the Commission contemplates increasing rates for the purpose of encouraging exploration and development . . . it must see to it that the increase is in fact needed, and is no more than is needed,

> for the purpose. Further than this we think the Commission cannot go without additional authority from Congress."

Id. at 1502-03 (*quoting City of Detroit v. FPC*, 230 F.2d 810, 817 (D.C. Cir. 1955)); *see also Mobil Oil Corp. v. FPC*, 417 US. 283, 308, 94 S. Ct. 2328, 2345 (1974). Because FERC had failed to demonstrate how the need to stimulate additional oil pipeline capacity justified the rate ceilings it set, this Court stated that it could not "countenance FERC's approval of oil pipeline rates which, by FERC's own admission, ensure 'creamy returns' to the carriers, and are 'far more generous than those [rates] that [FERC] or other regulators give elsewhere.'" *Farmers Union,* 734 F.2d at 1503.

In this case, the FCC allowed its emphasis on non-cost factors to obscure its ultimate obligation to ensure that consumers are not required to pay rates that exceed the boundaries of what is just and reasonable.[10] Therefore, as in *Farmers Union*, the Commission's action was arbitrary and capricious and inconsistent with statutory requirements.

The Commission also contended that sharing should be eliminated because (1) retaining sharing would make deregulation of competitive services more difficult; and (2) sharing encourages the misallocation of costs and cross-subsidization of competitive services. 1997 Price Cap Order ¶¶ 150-151 (JA 79). Neither of these rationales supports elimination of sharing at this time.

[10] The Commission found that the new X-Factor "adequately ensures that access customers benefit from the efficiencies resulting from price cap regulation." 1997 Price Cap Order ¶ 153 (JA 80). But the Commission also found that eliminating sharing would give a more efficient Price Cap LEC the option of not lowering its rates and reaping higher profit margins than its competitors. *Id.* If Price Cap LECs are able to retain their excess earnings, instead of being required to pass them along to their customers, then consumers will realize no benefit from the elimination of sharing, and carriers will reap the entire benefit of increased efficiency.

Deregulation and the elimination of sharing are related in one sense -- both might be justifiable if the Commission had found that the interstate access services market is effectively competitive and that market forces are sufficient to assure that the LECs' rates are just and reasonable without regulation or sharing. But the Commission made no such finding. Indeed, in recent proceedings, the Commission has found that Price Cap LECs are still dominant in the relevant market.[11] If and when the relevant market becomes sufficiently competitive to justify deregulation, the Commission might be justified in eliminating sharing because effective marketplace competition will check excessive rates. The Commission erred however, erred in concluding that the prospect of deregulation at an unspecified future time justifies subjecting the LECs' customers to unreasonably high charges now.

Equally unconvincing is the Commission's contention that sharing provides incentives for carriers to misallocate costs among services, resulting in undesirable cross-subsidization. 1997 Price Cap Order ¶ 151 (JA 79). Remarkably, the Commission seemed oblivious to the potential for carriers to cross-subsidize competitive services with the excess profits they realize from regulated services that are not subject to sharing. Moreover, the Commission's claims regarding cost misallocation incentives are inconsistent with its decision to retain the low-end adjustment mechanism. *Id.* ¶ 127 (JA 69). By retaining the low-end adjustment but not sharing, the rules create an incentive for carriers to misallocate costs to

[11] The Commission has recognized that the "BOCs remain the dominant providers of local exchange and exchange access services in their in-region states, and thus continue to have the ability and incentive to engage in anticompetitive behavior against competing ISPs." *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services,* Further Notice of Proposed Rulemaking, CC Docket No. 95-20, FCC 98-8, ¶ 51 (rel. Jan. 30, 1998) (footnote omitted).

regulated services in order to cross-subsidize unregulated services because the carriers can seek PCI and rate increases to recover the misallocated costs if their annual returns fall below the low-end adjustment level, *i.e.*, 10.25 percent. The Commission is not relieved of its obligation to protect carriers' customers from excessive charges merely because it may be difficult to formulate and enforce regulatory safeguards against cross-subsidization. Thus, the Commission's decision to eliminate sharing because of concerns over cross-subsidization made possible by misallocation of costs was arbitrary and capricious.

C. The Commission's Decision to Retain the Low-end Adjustment While Eliminating Sharing Was Arbitrary and Capricious.

In the 1997 Price Cap Order, the Commission jettisoned the sharing mechanism but retained the low-end adjustment, thus eliminating any risk that the LECs' earnings would drop below the lower bound of the zone of reasonableness but effectively eradicating protection from rates above the upper bound. The rationales the Commission offered to support the elimination of sharing would, if valid, also warrant elimination of the low-end adjustment mechanism; but the Commission has *retained* that mechanism without explaining why those same rationales do not compel its elimination.

First, the Commission eliminated sharing because it was confident that its new methodology for setting the X-Factor is more reliable than earlier methods. 1997 Price Cap Order ¶ 154 (JA 80-81). But the Commission failed to explain why the new method is not sufficiently precise to ensure that the LECs do not under-earn. In other words, the order fails to explain why, despite the alleged accuracy of the new X-Factor, carriers' investors need the protection against under-earnings provided by the low-end adjustment mechanism, while ratepayers deserve no effective protection from excessive carrier rates.

Second, the Commission has stated that the elimination of sharing replicates the operation of competitive markets. *Id.* ¶ 153 (JA 80). But firms operating in competitive markets are not protected from under-earning by a low-end adjustment mechanism. Hence, if the Commission is seeking to replicate competitive conditions by eliminating sharing, it should also eliminate the low-end adjustment.

Third, the Commission's action is directly contrary to the longstanding rule articulated in *Democratic Central Committee v. WMATA*, that "he who bears the financial burden of particular utility activity should also reap the benefit resulting therefrom." 485 F.2d 786, 806 (D.C. Cir. 1973). Under the price cap regime, particularly with the retention of the low-end adjustment mechanism, the LECs' customers (not their shareholders) bear the financial risk of the carriers' regulated activities. If the carriers under-earn, they are entitled to raise their rates to bring their earnings into a reasonable range. The elimination of sharing, however, means that the upside financial benefit of over-earnings will accrue to the LECs' shareholders, not the customers. This imbalance between the bearers of potential burdens and the beneficiaries of potential rewards is patently unfair.

Finally, the Commission has ignored the basic tenet that "[t]he ratemaking process involves fundamentally 'a balancing of the investor and the consumer interests,'" with the consumer's interest being "protection against unreasonable charges for the monopolistic service to which he subscribes." *Democratic Central Committee*, 485 F.2d at 806; *Hope Natural Gas*, 320 U.S. at 603, 64 S. Ct. at 288. Even if the Commission had actually balanced the interests of consumers and Price Cap LEC shareholders, the end result of this process was a home run for the shareholders and a strikeout for consumers: the LECs have no effective limit on profits and are protected from deficient earnings; consumers have no realistic protection from unreasonably high rates and effectively insure the LECs' earnings.

In short, the Commission failed to provide a reasonable explanation for eliminating sharing while retaining the low-end adjustment. The Court should remand the order to the Commission with the direction that the Commission either re-establish the sharing mechanism or provide an adequate explanation for refusing to do so.

III. THE COMMISSION ARBITRARILY AND CAPRICIOUSLY FAILED TO ADDRESS THE DEMONSTRATED BIAS CREATED BY USING TOTAL COMPANY PRODUCTIVITY, RATHER THAN INTERSTATE-ONLY PRODUCTIVITY, TO CALCULATE THE BASELINE PRODUCTIVITY OFFSET OF THE X-FACTOR.

In the order under review, the Commission failed to provide a reasonable explanation for abandoning its prior view that the use of total company data in calculating the X-Factor creates a systematic downward bias on the baseline productivity estimate. From the outset of the price cap system, the FCC has recognized that the use of total company performance data would distort the price cap system if LEC productivity were to differ between intrastate and interstate access services. LEC Price Cap Order ¶ 92; 1995 Price Cap Order ¶ 159; *In re Price Cap Performance Review for Local Exchange Carriers*, Further Notice of Proposed Rulemaking, 10 F.C.C.R. 13,659 ¶¶ 62-63 (1995). In the 1997 Price Cap Order, however, the Commission determined that this would not be a problem because there was no evidence that intrastate and interstate productivity differ. 1997 Price Cap Order ¶¶ 109-112 (JA 64-65). The Commission stated in relevant part:

> We find that the record before us does not allow us to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth. . . . [W]e find no basis in the record for making an adjustment to the X-Factor to account for any differences between interstate and total company productivity. . . . [T]he record does not demonstrate any systematic bias in using total company productivity growth . . . .

Id. ¶¶ 110, 112 (JA 64-65).

The Commission's explanation that there was no evidence of a systematic bias is wholly inadequate. In its LEC Price Cap Order, the Commission found that the *productivity* growth rate was greater for interstate access services than for intrastate services because the *demand or output* growth rate was greater for interstate access service: "the more rapid growth in interstate usage results in higher apparent interstate productivity growth." LEC Price Cap Order ¶ 92. The Commission based this conclusion on a revised in-house study of LEC productivity in the interstate access market.[12] *See id.* App. D ("Revised Spavins-Lande Study").

In that study, the FCC's experts explained that, because of the way in which the LECs are permitted to recover the costs of providing the common line or loop element of

[12] It is worth noting that the Commission ordered the original Spavins-Lande Study reworked precisely because the original version used total company data. The Commission explained that the problem with the earlier work was that it "applied to all telephone services, not to the interstate . . . services that will be subject to price caps." LEC Price Cap Order ¶¶ 91-92. In order to solve the problem, the Commission directed its experts to revise the study based on interstate productivity only. *Id.*

interstate access service, LEC earnings increase at a faster rate than their costs whenever demand or output for interstate access service increases. This is so because although the cost of providing access over the common lines is fixed and does not increase with usage, the FCC rules permit the LECs to recover their costs in part based on usage. *See id.* App. D ¶¶ 3-4, 8. Thus, when usage (*i.e.*, demand or outputs) increases, LEC revenues increase, but LEC common-line costs (*i.e.*, inputs) do not. This is the definition of productivity: an increase in outputs, resulting in increased revenues, without a corresponding increase in input costs.

In the proceedings leading to the 1997 Price Cap Order, AT&T and Ad Hoc presented undisputed evidence that the demand or output growth rates are greater in interstate access markets than in intrastate markets. Using data produced by the BOCs, AT&T showed that during the post-divestiture period from 1985-1994, the demand for interstate access services increased at an annual rate of 6.83 percent while demand for the LECs' intrastate services (local and intraLATA toll combined) grew 4.22 percent. AT&T Comments, CC Docket No. 94-1, App. A at 24-26 (Jan. 16, 1996) (Statement of Dr. John R. Norsworthy) (JA 420-22). Ad Hoc introduced additional data indicating the difference in demand growth in these markets and pointed out that total company minutes had been growing by about 3.7 percent while interstate switched access minutes alone were enjoying growth rates of approximately 10 percent. Ad Hoc Comments, CC Docket 94-1, App. at 46 (Dec. 19, 1995) (Report of ETI Economics and Technology, Inc.) (JA 304).

The demand growth evidence was not refuted, but the Commission inexplicably refused to accept it as evidence of a productivity bias.[13] The Commission did not explain or even discuss what changes led it to conclude that evidence of greater interstate demand growth rates was no longer sufficient to prove greater interstate productivity growth rates. Thus, the Commission's contention that there was "no basis in the record" for finding a systematic bias was not accurate. If anything, there was no basis in the record for refusing to credit the evidence of higher interstate demand growth as evidence of a systematic bias.

The Commission's decision to rely on intrastate data is particularly worrisome in this context because such data is irrelevant on its face. The FCC's price cap plan is supposed to ensure just and reasonable *interstate* access rates, not the rates for all LEC telecommunication services generally. Thus, only LEC productivity in interstate access services has any relevance or applicability in the price cap proceedings. The use of *intrastate* data serves only to contaminate the relevant data and skew the calculations.

Because the Commission changed its position on the risk of distortion created by using intrastate data to regulate interstate pricing without providing "a reasoned analysis for the change," its decision can only be considered arbitrary and capricious. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 42-43, 103 S. Ct. 2856, 2866-67 (1983); *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970). The Court should remand this aspect of the Commission's order, with direction that the

[13] USTA opined that interstate inputs might equal interstate outputs, but, as the Commission noted, USTA provided no evidence in support of that opinion. 1997 Price Cap Order ¶ 110 (JA 64-65).

Commission either limit itself to using interstate access data or present an adequate explanation for refusing to do so.

CONCLUSION

The Court should grant these Petitions for Review. Because the 1997 Price Cap Order established more accurate PCIs, the Court should not vacate that order. It should, however, remand to allow the Commission to address the three respects in which, as described above, the order represented arbitrary agency decisionmaking and exceeded the Commission's statutory authority.

Respectfully submitted,

Carl S. Nadler
Donald B. Verrilli, Jr.
Anthony C. Epstein
Jon M. Shepard
Jenner & Block
Washington, D.C. 20005
(202) 639-6000

Thomas F. O'Neil III
Maria L. Woodbridge
MCI Telecommunications Corporation
1133 19th Street, N.W.
Washington, D.C. 20036

Counsel for MCI Telecommunications Corporation

Kevin S DiLallo

James S. Blaszak
Kevin S. DiLallo
Mark G. Johnston
Levine, Blaszak, Block & Boothby, LLP
2001 L Street, N.W., Suite 900
Washington, D.C. 20036
(202) 857-2550

Counsel for Ad Hoc Telecommunications Users Committee

April 30, 1998

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of August, 1998, two copies of the foregoing Final Joint Brief of Petitioners MCI Telecommunications Corporation and Ad Hoc Telecommunications Users Committee were served by U.S. Mail, first class postage prepaid, on counsel for each party separately represented, as indicated on the attached service list, in accordance with Fed. R. App. P. 25 and 31(b).

Jon M. Shepard

CERTIFICATE OF LENGTH OF BRIEF

I certify pursuant to Circuit Rule 28(d)(1) that the foregoing Final Joint Brief of Petitioners MCI Telecommunications Corporation and Ad Hoc Telecommunications Users Committee contains no more than the number of words allowed by Rule 28(d)(1) and this Court's order dated January 29, 1998. In this regard, I rely on a word count reported by WordPerfect 6.1, a word processing system that includes footnotes and citations in word counts.

Jon M. Shepard

SERVICE LIST

Richardo Guzman
Counsel for Texas Office of Public Utility Counsel
Suite 9-180
1701 N. Congress
Austin, TX 78701

Richard J. Metzger
Counsel for Association for Local Telecommunications Services
1200 19th Street, NW
Suite 560
Washington, DC 20036

Frederic L. Wood
Counsel for National Emergency Number Association
Donelan, Cleary, Wood & Maser, PC
1100 New York Ave., NW
Suite 750
Washington, DC 20005-3934

Gene C. Schaerr
James P. Young
Counsel for AT&T Corp.
Sidley & Austin
1722 I Street, N.W., Suite 600
Washington, D.C. 20006

Michael J. Shortley, III
Counsel for Frontier Corporation
180 South Clinton Avenue
Rochester, NY 14646

Neal Morse Goldberg
Counsel for National Cable Television Association, Inc.
National Cable Television Association
1724 Massachusetts Avenue, NW
Washington, DC 20036

Charles C. Hunter
Catherine M. Hannan
Counsel for Telecommunications Resellers Association
Hunter & Mow
Suite 701
1620 I Street, NW
Washington, DC 20006

Jules M. Perlberg
David W. Carpenter
Counsel for AT&T Corp.
Sidley & Austin
One First National Plaza
Chicago, IL 60603

Douglas Lloyd Parker
Counsel for Edgemont Neighborhood Coalition; Alliance for Community Media; Benton Foundation; Center for Media Education; Consumer Action; Migrant Legal Action Program; National Association for Migrant Education; United States Catholic Conference; and Washington Legal Clinic for the Homeless
Institute for Public Representation
600 New Jersey Avenue, NW
Washington, DC 20001

Frederick Mark Joyce
Christine McLaughlin
Counsel for Celpage, Inc.
Joyce & Jacobs
1019 19th Street, NW
Washington, DC 20036

Wayne Kenneth Ferree
Counsel for Panamsat Corporation
Goldberg, Godles, Wiener & Wright
1229 19th Street, NW
Washington, DC 20036

J.G. Harrington
Counsel for Vanguard Cellular Systems, Inc.
Dow, Lohnes & Albertson, PLLC
1200 New Hampshire Avenue, NW
Washington, DC 20036

James R. Young
Edward D. Young III
Michael E. Glover
Betsy Roe
Edward Shakin
Bell Atlantic Telephone Companies
1320 North Court House Road, 8th Floor
Arlington, VA 22201

Linda Lee Kent
United States Telephone Association
1401 H Street, N.W., Suite 600
Washington, DC 20005

Walter H. Alford
William B. Barfield
M. Robert Sutherland
BellSouth Corporation
1155 Peachtree Street, N.E.
Suite 1800
Atlanta, GA 30367

John Windhausen, Jr.
Counsel for Competition Policy Institute
1156 15th Street, NW, Suite 310
Washington, DC 20005

Laura H. Phillips
Counsel for Concast Cellular
Communications, Inc.
Dow, Lohnes & Albertson, PLLC
1200 New Hampshire Ave., NW
Washington, DC 20036

Mark L. Evans
Michael K. Kellogg
Henk J. Brands
Counsel for Bell Atlantic Telephone Companies,
Southwestern Bell Telephone Co., U S West, Inc.,
and United States Telephone Association
Kellogg, Huber, Hansen, Todd & Evans, PLLC
1301 K Street, N.W., Suite 1000 West
Washington, DC 20005

Philip V. Permut
Counsel for COMSAT
Kelley Drye & Warren LLP
Suite 500
1200 19th Street, NW
Washington, DC 20036

Richard M. Tettelbaum
Associate General Counsel
Citizens Utilities Company
1400 16th Street, N.W.
Suite 500
Washington, D.C. 20036

Genevieve Morelli
Counsel for CompTel
Competitive Telecommunications Association
1900 M Street, N.W., Suite 800
Washington, DC 20036-3508

David A. Gross
Counsel for AirTouch Communications, Inc.
1818 N Street, N.W., 8th Floor
Washington, D.C. 20036

Kenneth S. Geller
Donald M. Falk
Counsel for Ameritech Corporation
Mayer, Brown & Platt
Suite 6500
2000 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Thomas P. Hester
Mayer, Brown & Platt
190 South LaSalle Street
Chicago, IL 60603

Kelly R. Welsh
Michael S. Pabian
Ameritech Corporation
2000 West Ameritech Center Drive
Room 4H82
Hoffman Estates, IL 60196

Diane Munns
Counsel for Iowa Utilities Board
Iowa Utilities Board
Lucas State Office Building
Des Moines, IA 50319

James D. Ellis
Liam S. Coonan
Patricia Diaz Dennis
Robert M. Lynch
Martin E. Grambow
SBC Communications, Inc.
175 E. Houston, Room 1254
San Antonio, TX 78205

Durward D. Dupre
Thomas A. Padja
Southwestern Bell Telephone Company
One Bell Center, Room 3520
St. Louis, MO 63101

Sue D. Blumenfeld
Thomas Jones
Counsel for Sprint Corporation
Willkie, Farr & Gallagher
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20036

James Blaszak
Kevin Dilallo
Mark Johnston
Counsel for the Ad Hoc Telecommunications Users Committee
Levine, Blaszak, Block & Boothby, L.L.P.
2001 L Street, N.W., Suite 900
Washington, DC 20036

William E. Kennard, Esq.
Christopher J. Wright, Esq.
John E. Ingle, Esq.
Laurence N. Bourne, Esq.
Federal Communications Commission
1919 M Street, N.W., Room 614
Washington, DC 20554

Catherine G. O'Sullivan, Esq.
Robert B. Nicholson, Esq.
Robert J. Wiggers, Esq.
Department of Justice
Antitrust Division
Appellate Section, RM 10535
601 D Street, N.W.
Washington, DC 20530

Madelyn M. DeMatteo
Counsel for Southern New England Telephone Company
The Southern New England Telephone Company
227 Church Street
New Haven, CT 06510

L. Marie Guillory
Counsel for Rural Telephone Coalition
National Telephone Cooperative Association
2626 Pennsylvania Ave., NW
Washington, DC 20037-1695

Sue D. Blumenfeld
Counsel for Sprint Corporation
Willkie Farr & Gallagher
1155 21st Street, NW
Washington, DC 20036

James Andrew Meyers
Counsel for Puerto Rico Telephone Company
Drinker, Biddler & Reath
901 15th Street, NW
Suite 900
Washington, DC 20005-2503

Patricia L.C. Mahoney
Counsel for Pacific Bell and Nevada Bell
Pacific Telesis Legal Group
Suite 1525
140 New Montgomery Street
San Francisco, CA 94105

Daniel Evan Smith
Counsel for Pronet, Inc.
Gurman, Blask & Freedman, Chartered
Suite 500
1400 16th Street, NW
Washington DC 20036

Richard S. Whitt
Counsel for WorldCom, Inc.
WorldCom, Inc.
1220 Connecticut Avenue, NW
Suite 400
Washington, DC 20036

Blossom A. Peretz
Counsel for New Jersey Division of the Ratepayer Advocate
31 Clinton Street
11th Floor
Newark, NJ 07102

Charles H. Helein
Counsel for America's Carriers Telecommunications Association
Helein & Associates, PC
8180 Greensboro Drive
Suite 700
McLean, VA 22102

Maureen A. Scott
Pennsylvania Public Utility Commission
Commonwealth & North Streets
G-28 North Office Building
Harrisburg, PA 17120

Steven A. Augustino
Counsel for Cable & Wireless, Inc.
Kelley Drye & Warren LLP
1200 19th Street, N.W., Suite 500
Washington, D.C. 20036

Curtis T. White, Managing Partner
Allied Associate Partners, LP
GELD Information Systems
4201 Connecticut Avenue, N.W.
Suite 402
Washington, D.C. 20008-1158

William T. Lake
John H. Harwood II
David Sohn
Counsel for US West, Inc.
Wilmer, Cutler & Pickering
2445 M Street, N.W.
Washington, D.C. 20037-1420

Ellen S. LeVine
Counsel for People of the State of California and Public Utilities Commission Of the State of California
505 Van Ness Avenue
San Francisco, CA 94102

Joseph DiBella
NYNEX Telephone Companies
Suite 400 West
1300 I Street, N.W.
Washington, D.C. 20005

David W. Zesiger
Independent Telephone and Telecommunications Alliance
1300 Connecticut Avenue, N.W.
Suite 600
Washington, D.C. 20036

Mark D. Roelig
Dan Poole
Robert B. McKenna
U S West, Inc.
1801 California Street, 51st Floor
Denver, CO 80202

Ward W. Wueste, Jr.
M. Edward Whelan
GTE Service Corporation
1850 M Street, N.W., Suite 1200
Washington, DC 20036

R. Michael Senkowski
Robert J. Butler
Daniel E. Troy
Counsel for GTE Entities
Wiley, Rein & Fielding
1776 K Street, N.W.
Washington, D.C. 20006

Thomas K. Crowe
Counsel for Commonwealth of the
Northern Mariana Islands
2300 M Street, NW
Suite 800
Washington, DC 20037

Paul Thomas Cappuccio
Counsel for GTE Service Corporation; GTE Alaska,
Inc.; GTE Arkansas, Inc.; GTE California Inc.; GTE Florida,, Inc.;
GTE South, Inc.; GTE Southwest, Inc.; GTE North , Inc.
GTE Northwest, Inc.; GTE Hawaiian Telephone Company;
GTE West Coast, Inc.; Contel of California; Conte of Minnesota;
Conte of the South, Inc.
Kirkland & Ellis
655 Fifteenth Street, NW, Suite 1200
Washington, DC 20005

ADDENDUM

TABLE OF CONTENTS

STATUTES

47 U.S.C. § 151 1

47 U.S.C. § 201 1

47 U.S.C. § 202 1

47 U.S.C. § 204 1

REGULATIONS

47 C.F.R. § 1.773 2

47 C.F.R. § 61.44 3

47 C.F.R. § 61.45 4

47 C.F.R. § 61.46 5

47 C.F.R. § 61.47 5

STATUTES
(47 U.S.C.)

§ 151. Purposes of chapter; Federal Communications Commission created

For the purpose of regulating interstate and foreign commerce in communication by wire and radio so as to make available, so far as possible, to all the people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex, a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges, for the purpose of the national defense, for the purpose of promoting safety of life and property through the use of wire and radio communication, and for the purpose of securing a more effective execution of this policy by centralizing authority heretofore granted by law to several agencies and by granting additional authority with respect to interstate and foreign commerce in wire and radio communication, there is created a commission to be known as the "Federal Communications Commission", which shall be constituted as hereinafter provided, and which shall execute and enforce the provisions of this chapter.

§ 201. Service and charges

. . . .

(b) All charges, practices, classifications, and regulations for and in connection with such communication service, shall be just and reasonable, and any such charge, practice, classification, or regulation that is unjust or unreasonable is declared to be unlawful . . . . The Commission may prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this chapter.

§ 202. Discriminations and preferences

(a) Charges, services, etc.

It shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges, practices, classifications, regulations, facilities, or services for or in connection with like communication service, directly or indirectly, by any means or device, or to make or give any undue or unreasonable preference or advantage to any particular person, class of persons, or locality, or to subject any particular person, class of persons, or locality to any undue or unreasonable prejudice or disadvantage.

§ 204. Hearings on new charges; suspension pending hearing; refunds; duration of hearing; appeal of order concluding hearing

. . . .

. . . .

(a)(3) A local exchange carrier may file with the Commission a new or revised charge, classification, regulation, or practice on a streamlined basis. Any such charge, classification, regulation, or practice shall be deemed lawful and shall be effective 7 days (in the case of a reduction in rates) or 15 days (in the case of an increase in rates) after the date on which it is filed with the Commission unless the Commission takes action under paragraph (1) before the end of that 7-day or 15-day period, as is appropriate.

REGULATIONS
(47 C.F.R.)

§ 1.773 Petitions for suspension or rejection of new tariff filings.

(a) Petition—(1) Content. Petitions seeking investigation, suspension, or rejection of a new or revised tariff filing or any provision thereof shall specify the filing's Federal Communications Commission tariff number and carrier transmittal number, the items against which protest is made, and the specific reasons why the protested tariff filing warrants investigation, suspension, or rejection under the Communications Act. No petition shall include a prayer that it also be considered a formal complaint. Any formal complaint shall be filed as a separate pleading as provided in § 1.721.

(i) Petitions seeking investigation, suspension, or rejection of a new or revised tariff filing or any provision of such a publication, must specify the pertinent Federal Communications Commission tariff number and carrier transmittal number; the matters protested; and the specific reasons why the tariff warrants investigation, suspension, or rejection. When a single petition asks for more than one form of relief, it must separately and distinctly plead and support each form of relief. However, no petition may ask that it also be considered a formal complaint. Formal complaints must be separately lodged, as provided in § 1.721.

(ii) For purposes of this section, tariff filings by nondominant carriers will be considered *prima facie* lawful, and will not be suspended by the Commission unless the petition requesting suspension shows:

(A) That there is a high probability the tariff would be found unlawful after investigation;

(B) That the harm alleged to competition would be more substantial than the injury to the public arising from the availability of the service pursuant to the rates and conditions proposed in the tariff filing;

(C) That irreparable injury will result if the tariff filing is not suspended; and

(D) That the suspension would not otherwise be contrary to the public interest.

(iii) For the purpose of this section, any tariff filing by a local exchange carrier filed pursuant to the requirements of § 61.39 will be considered prima facie lawful and will not be suspended by the Commission unless the petition requesting suspension shows that the cost and demand studies or average schedule information was not provided upon reasonable request. If such a showing is not made, then the filing will be considered prima facie lawful and will not be suspended by the Commission unless the petition requesting suspension shows each of the following:

(A) That there is a high probability the tariff would be found unlawful after investigation;

(B) That any unreasonable rate would not be corrected in a subsequent filing;

(C) That irreparable injury will result if the tariff filing is not suspended; and

(D) That the suspension would not otherwise be contrary to the public interest.

(iv) For the purposes of this section, tariff filings made pursuant to § 61.49(b) by carriers subject to price cap regulation will be considered *prima facie* lawful, and will not be suspended by the Commission unless the petition shows that the support information required in § 61.49(b) was not provided, or unless the petition requesting suspension shows each of the following:

(A) That there is a high probability the tariff would be found unlawful after investigation;

(B) That the suspension would not substantially harm other interested parties;

(C) That irreparable injury will result if the tariff filing is not suspended; and

(D) That the suspension would not otherwise be contrary to the public interest.

(2) *When filed.* All petitions seeking investigation, suspension, or rejection of a new or revised tariff filing shall meet the filing requirements of this paragraph. In case of emergency and within the time limits provided, a telegraphic request for such relief may be sent to the Commission setting forth succinctly the substance of the matters required by paragraph (a)(1) of this section. A copy of any such telegraphic request shall be sent simultaneously to the Chief, Common Carrier Bureau, the Chief, Tariff Division, and the publishing carrier. Thereafter, the request shall be confirmed by petition filed and served in accordance with § 1.773(a)(4).

(i) Petitions seeking investigation, suspension, or rejection of a new or revised tariff filed pursuant to section 204(a)(3) of the Communications Act made on 7 days notice shall be filed and served within 3 calendar days after the date of the tariff filing.

(ii) Petitions seeking investigation, suspension, or rejection of a new or revised tariff filing made on less than 15 days notice shall be filed and served within 6 days after the date of the tariff filing.

(iii) Petitions seeking investigation, suspension, or rejection of a new or revised tariff filing made on at least 15 but less than 30 days notice shall be filed and served within 7 days after the date of the tariff filing.

(iv) Petitions seeking investigation, suspension, or rejection of a new or revised tariff filing made on at least 30 but less than 90 days notice shall be filed and served within 15 days after the date of the tariff filing.

(v) Petitions seeking investigation, suspension, or rejection of a new or revised tariff filing mode on 90 or more days notice shall be filed and served within 25 days after the date of the tariff filing.

§ 61.44 Adjustments to the PCI for Dominant Interexchange Carriers.

(a) Dominant interexchange carriers subject to price cap regulation shall file adjustments to the PCI for each basket as part of the annual price cap tariff filing, and shall maintain updated PCIs to reflect the effect of mid-year access and exogenous cost changes.

(b) Subject to paragraph (d) of this section, adjustments to each PCI of dominant interexchange carriers subject to price cap regulation shall be made pursuant to the following formula:

$$PCI_t = PCI_{t-1} [1 + w(GNP\text{-}PI\text{-}X) + \Delta Y/R + \Delta Z/R]$$

where

GNP - PI = the percentage change in the GNP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 3.0%,

Δ Y = (new access rate—access rate at the time the PCI was updated to PCI_{t-1}) x (base period demand),

Δ Z = the dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

R = base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},

w = R - (access rate in effect at the time the PCI was updated to PCI_{t-1} x base period demand) = Δ Z, all divided by R,

PCI_t = the new PCI value, and

PCI_{t-1} = the immediately preceding PCI value.

§ 61.45 Adjustments to the PCI for Local Exchange Carriers.

(a) Local exchange carriers subject to price cap regulation shall file adjustments to the PCI for each basket as part of the annual price cap tariff filing, and shall maintain updated PCIs to reflect the effect of mid-year exogenous cost changes.

(b) Adjustments to local exchange carrier PCIs for the baskets designated in § 61.42(d)(2), (3), (4), (5), and (6) shall be made pursuant to the formula set forth in § 61.44(b), and as further explained in § 61.44(e), (f), (g), and (h).

(1) Notwithstanding the value of X defined in § 61.44(b), the X value applicable to the baskets specified in § 61.42(d)(2), (3), and (6) shall be 6.5%.

(2) For the basket specified in § 61.42(d)(4), the value of X, for all local exchange carriers subject to price cap regulation, shall be 3.0%.

(3) Notwithstanding the value of X defined in § 61.44(b), the value of X applicable to the basket specified in § 61.42(d)(5) shall be 0%.

(c)(1) Subject to paragraphs (c)(2) and (e) of this section, adjustments to local exchange carrier PCIs for the basket designated in § 61.42(d)(1) shall be made pursuant to the following formula:

$$PCI_1 = PCI_{t-1} [1 + w(GDP\text{-}PI\text{-}X)\text{-}(g/2))/(1+(g/2))] + \Delta Z/R]$$

where

GDP - PI = the percentage change in the GDP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 6.5%,

g = the ratio of minutes of use per access line during the base period, to minutes of use per access line during the previous base period, minus 1,

Δ Z = the dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

R = base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},
w = R + Δ Z, all divided by R,
PCI_t = the new PCI value, and
PCI_{t-1} = the immediately preceding PCI value.

(2) The formula set forth in paragraph (c)(1) of this section shall be used by a local exchange carrier subject to price cap regulation only if that carrier is imposing a carrier common line charge pursuant to § 69.154 of this chapter. Otherwise, adjustments to local exchange carrier PCIs for the basket designated in § 61.42(d)(1) shall be made pursuant to the formula set forth in § 61.44(b), and paragraphs (i) and (j) of this section, and as further explained in § 7thnsp;61.44(e), (f), (g), and (h). For the purposes of this paragraph, and notwithstanding the value of X defined in § 61.44(b), the X value applicable to the basket specified in § 7thnsp;61.42(d)(1), shall be 6.5%.

§ 61.46 Adjustments to the API.

(a) Except as provided in paragraphs (d) and (e) of this section, in connection with any price cap tariff filing proposing rate changes, the carrier must calculate an API for each affected basket pursuant to the following methodology:

$API_t = API_{t-1}\ [\Sigma i\ v_1\ (P\surd P_{t-1})]$
where
API_t = the proposed API value,
API_{t-1} = the existing API value,
P_t = the proposed price for rate element "i,"
P_{t-1} = the existing price for rate element "i," and
v_i = the current estimated revenue weight for rate element "i," calculated as the ratio of the base period demand for the rate element "i" priced at the existing rate, to the base period demand for the entire basket of services priced at existing rates.

§ 61.47 Adjustments to the SBI; pricing bands.

(a) In connection with any price cap tariff filing proposing changes in the rates of service categories or subcategories, the carrier must calculate an SBI value for each affected service category or subcategory pursuant to the following methodology:

$SFI_t = SBI_{t-1}\ [\Sigma i\ v_1(P\surd P_{t-1})_i]$
where
SBI_t = the proposed SBI value,
SBI_{t-1} = the existing SBI value,
P_t = the proposed price for rate element "i,"
P_{t-1} = the existing price for rate element "i," and
v_i = the current estimated revenue weight for rate element "i," calculated as the ratio of the base period demand for the rate element "i" period at the existing rate, to the base

period demand for the entire group of rate elements comprising the service category priced at existing rates.