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

CC Docket No. 92-135

In the Matter of

Regulatory Reform for
Local Exchange Carriers
Subject to Rate of Return
Regulation

REPORT AND ORDER

Adopted: May 13, 1993; Released: June 11, 1993

By the Commission: Commissioner Duggan concurring and issuing a separate statement.

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I. INTRODUCTION

1. In this Order, we take significant steps to improve the way we regulate rates for approximately 1,300 small and mid-size local exchange carriers (LECs). This group of smaller carriers represent the approximately 6 percent of LECs whose rates are not regulated pursuant to price cap regulation, *i.e.*, that remain subject to traditional rate of return regulation. While these carriers vary widely in size, ownership patterns, and capital investment, in comparison to price cap LECs, they represent only 7.6 of the total access lines, 5.3 percent of the total access minutes, and 6.3 percent of the total industry revenue requirement.

2. These smaller carriers face increased challenges on a number of fronts. Neighboring Bell Operating Companies compete for customers with new services and repackaged existing services. Changing regulatory requirements, such as the Commission implementation of Open Network Architecture and requirements for expanded interconnection, create new expectations from customers and increase the demand for quality service and responsiveness. Finally, new technologies, in particular those offered by neighboring exchanges, increase the LECs' need for regulatory flexibility and the ability to respond to competitive service offerings.

3. In the wake of the Commission decision to adopt price cap regulation for the largest LECs, these small and mid-size carriers asked for regulatory methods more attuned to their diverse needs than the price cap system. This Order provides a package of three regulatory alternatives that small and mid-size companies can use to succeed in an evolving telecommunications marketplace, and that at the same time provide incentives to offer high quality service efficiently, and at reasonable cost to ratepayers.

4. In our small and mid-size LECs Notice of Proposed Rulemaking[1] we discussed the diversity of small and mid-size LECs and the challenges to designing improved regulatory mechanisms for these carriers. We tentatively concluded that the preferred approach to regulatory reform for this segment of the LEC industry is a continuum of increasingly incentive-based approaches which permits a company to select a plan best fitting its circumstances. At each point along this continuum, we proposed regulatory reforms to foster efficient investment decisions, and to provide companies with more flexibility to meet changing market conditions than they now have under existing rate of return regulation. At each step along the

[1] Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, 7 FCC Rcd 5023 (1992)(hereinafter NPRM); 7 FCC Rcd 5501 (1992)(Erratum).

continuum of regulatory approaches, business risk would increase, as would the possibility for increased rewards in the form of potential earnings growth and reduced administrative burdens. In addition, under each approach ratepayers would be protected because efficiency gains would be passed along to ratepayers periodically in subsequent tariff review periods.

5. The record in this proceeding supports this approach. The rules we adopt here are largely as proposed in the NPRM with changes as supported by the record. These rules shall become effective 30 days after publication in the Federal Register.[2]

6. In this Order, we adopt new tariff rules to implement regulatory reform for small and mid-size LECs that remain subject to rate of return regulation. First, a new, optional, incentive-based plan is adopted which permits carriers to establish rates based on their historical costs. During the new two-year period before rates are revised, incentive plan carriers will be permitted to retain higher earnings than those that utilize prospective cost estimates in their ratemaking processes. The incentive plan also permits limited pricing flexibility and streamlined treatment for the introduction of new services in some situations. Second, we adopt rules that expand the scope of our existing small company rules by allowing LECs serving 50,000 or fewer access lines to file annual common line rates based on historical cost. Third, we amend our rules to permit carriers that do not elect to participate in the incentive plan or the small company rules to file tariffs every two years. Otherwise, we have left this baseline regulatory treatment of rate of return regulated carriers unchanged.

II. BACKGROUND

7. The *LEC Price Cap Order*[3] mandated that seven Regional Bell Operating Companies and the General Telephone Operating Companies file interstate access rates based on price cap regulation. All other carriers could choose to file rates based on price caps, but once they chose price cap regulation they could not return to rate of return regulation. Price cap regulation took effect for the largest LECs on January 1, 1991.[4] Six other large LECs have elected to become subject to price caps.[5] As a result, a substantial majority of interstate access customers are now served by companies regulated under a price cap regime.[6] With the largest LECs subject to price caps regulation, the remaining companies, subject to rate of return regulation, are fairly characterized as small and mid-size carriers.[7]

8. Of the LECs that remain subject to rate of return regulation, almost all participate in the traffic sensitive, carrier common line and end user common line pools administered by NECA. In a pooling environment, rates are based upon the total costs and total demand of all participating companies. Each company receives its actual costs, plus its share of the pool's earnings. The major reason companies want to participate in pools is to share risks, by providing a high degree of assurance that the company will recover its costs. The rates for these pools and other small and mid-size company tariffs under Section 61.38 of the Rules are based on projections of the LECs' costs and demand.[8]

9. Smaller LECs do not want to become subject to price cap regulation for numerous reasons. Many believe that they cannot abandon the risk sharing provided by the NECA pools and Long Term Support protection, which maintains a common line rate equivalent to a national average common line rate, without substantial risk to their continued financial viability. Others believe that, because of their small size, their business cycles are too long to comply with price cap's annual adjustments and that the financial effect of facility upgrades is too great to be reconciled with in the Commission's price cap framework.

10. The *LEC Price Cap Order* stated that the Commission would "initiate further proceedings dealing specifically with regulatory issues of concern to small and mid-size LECs."[9] The Order committed to examining regulatory options that "recognize the unique circumstances" facing smaller LECs.[10] Finally, the Order resolved to continue to examine small company issues "to ensure that desirable regulatory reforms are applied to small telephone companies as far as possible and applied with sensitivity to their special circumstances."[11] This docket is one of the vehicles that responds to the directives of the *LEC Price Cap Order*.[12]

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[2] *See* 5 U.S.C. § 553(b)(B).

[3] *See* Second Report and Order, 5 FCC Rcd 6786, 6827 (1990) and Erratum, 5 FCC Rcd 7664 (1990) (Com. Car. Bur.) (*LEC Price Cap Order), modified on recon.* 6 FCC Rcd 2637 (1991), *petitions for further recon. dismissed*, 6 FCC Rcd 7482 (1991), *upheld on appeal, National Rural Telecom Association v. FCC*, Nos. 91-1300, 91-1303, 91-1304 and 91-1326, slip op. (D.C. Cir. Mar. 26, 1993), *further modified on recon.* 6 FCC Rcd 4524 (1991) (*ONA Part 69 Order), petitions for recon. of ONA Part 69 Order pending, appeal docketed, D.C. PSC v. FCC*, No. 91-1279 (D.C. Cir. June 14, 1991).

[4] *Id.*

[5] All LECs with more than 1 million access lines and fourteen of the sixteen LECs with more than 500,000 access lines are subject to price cap regulation, two of which elected price cap regulation this year.

[6] Companies under price caps regulation represent 92.4 percent of the total access lines. Approximately 94.7 percent of the access minutes are provided by price caps companies. Price caps companies generate 93.7 percent of the total LEC industry revenue requirement. (1990 NECA data filed with the Commission).

[7] Most small companies, those with fewer than 50,000 access lines who are also part of NECA Subset 3, are locally owned and operated LECs, organized as closely held corporations, cooperatives or mutuals. The "mid-size" companies, with between 50,000 and approximately 1 million access lines, generally have multiple telephone company subsidiaries. The stock of larger mid-size companies is often publicly traded. For the most part, these companies operate in more than one state.

[8] Of the 1308 local exchange study areas that are not subject to price cap regulation, 1184 are included in the NECA traffic sensitive pool; and 1253 are included in the NECA common line pool. Thirty-nine small companies maintain traffic sensitive tariffs under Section 61.39 rules, outside of the NECA pool. 650 study areas are served by average schedule companies. 243 of these companies are cooperatives. (National Exchange Carrier Association Description and Justification, Annual 1993 Access Tariff Filing, Transmittal No. 546, filed april 2, 1993, at 2 and 11).

[9] *LEC Price Cap Order*, 5 FCC Rcd 6786, 6827 (1990).

[10] *Id.*

[11] *Id.*

[12] *See also* Amendment of Part 65 and 69 of the Commission's

11. In the *LEC Price Cap Order,* the Commission adopted an annual productivity growth standard of at least 3.3 percent, after inflation, as the basis for setting maximum rates for all price cap LECs. In exchange, the plan grants those carriers the opportunity to earn significantly higher profits as an incentive for even greater productivity gains, as well as greater rate flexibility and lower regulatory requirements than under rate of return regulation. Price caps was made mandatory for the large LECs: the Bell Operating Companies and the General Telephone Operating Companies. Recognizing the varied conditions and characteristics of small and mid-size LECs, the Commission permitted those companies the option of remaining under rate of return regulation or enrolling voluntarily in price caps. We also indicated that we would explore ways to adapt the efficiency incentives of price caps to the needs of small and mid-size LECS.[13]

12. We presented an optional incentive regulation plan in the NPRM that initiated this docket. Essentially the incentive plan is a form of lagged rate of return regulation which allows LECs the opportunity to earn higher profits if they can improve efficiency above their historical performance during a two-year rate period. At the end of that period, rate levels are retargeted to the rate of return prescribed by the Commission. The plan sets no specific productivity target, as price caps does, but the carrier is rewarded if it can improve its productivity, because it is allowed to retain higher levels of profit than is allowed under rate of return regulation. Ratepayers benefit from the efficiency gains achieved by the carrier, because these are flowed through into lower rates in the next rate period by the retargeting.

13. As set out in the NPRM, the optional incentive plan offers small and mid-size LECs lower potential rewards than full price caps, commensurate with the lower risks incentive plan LECs would assume. For example, price cap LECs are permitted to earn up to 12.25 percent before sharing half of returns, and up to 16.25 percent before 100 percent sharing occurs.[14] The NPRM proposed the incentive plan LECs be permitted to earn up to 1 percent above the prescribed rate of return, which is currently 11.25 percent. By comparison, carriers subject to rate of return regulation are permitted to earn only 1/4 of one percent above the prescribed rate of return, on a total interstate basis. We also proposed giving incentive plan LECs greater flexibility in setting rates, based on service baskets and bands similar to those in price caps.

14. For LECs choosing to remain under baseline rate of return regulation, we proposed to reduce regulatory burdens by moving from annual to biennial tariff filing schedules and to simpler methods of projecting costs and demand. In addition, we proposed to expand the simplified filing options for small LECs contained in Section 61.39 of our Rules,[15] currently applied only to traffic sensitive rates, by adapting them to carrier common line rates as well.

15. Taken together, this range of regulatory approaches was intended to assure reasonable rates while reducing regulatory burdens and introducing or expanding incentives for efficiency and innovation. Overall, the record developed in this docket strongly supports all of these initiatives. In the remaining sections of this Order, we discuss the revision we are making to various details of the proposals set out in the NPRM as they were presented in comments or by our own ongoing review of our small and mid-size LEC regulations.

III. OPTIONAL INCENTIVE REGULATION PLAN

16. Our price cap system was designed for the largest carriers with the benefit of a long history of carrier-by-carrier oversight and experience. This detailed knowledge of each subject carrier's costs and pricing history enabled the design of an incentive program linked directly to each carrier's prices. Because the vast majority of smaller carriers have participated in the NECA pools, we do not have for them the same company-specific experience. Therefore, in designing an incentive-based regulatory system for the smaller carriers, we have designed a system linked to each company's historical costs rather than price. In a rate of return context, the incentives are established by reliance on historical costs and an extended tariff period. Such reliance is traditionally referred to as "regulatory lag." Because rates are reestablished every two years, this system encompasses less risk than price caps. Accordingly, we have designed a system with less potential reward than price caps.

17. The optional incentive plan we adopt today will be available to any non-price cap LEC for either its traffic sensitive rates only, or for both its traffic sensitive and common line rates. In comparison to current rate of return regulation methodology, the optional incentive plan incorporates longer tariff periods, greater reliance on historical costs, broader earnings bands and greater pricing flexibility. Every two years, rates are to be recalculated based upon costs and demand established during an historical period. During the two years, carriers operating pursuant to this plan would have the incentive to reduce their costs because cost increases will lessen their earnings while cost decreases will permit greater earnings.

A. Tariff Filings: Frequency and Mid-Term Revisions

18. *Notice.* The NPRM proposed that carriers participating in the optional incentive regulation plan file tariffs every two years. The NPRM tentatively concludes that two year filings would substantially reduce regulatory burdens, simplify the tariff review process, while permitting the Commission to scrutinize rates to meet our statutory obligations under the Communications Act to ensure rates are reasonable. More significantly, the NPRM tentatively found that an extended tariff period provides sufficient regulatory lag to create incentives for companies to

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Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, 7 FCC Rcd 4688 (1992) (exploring streamlining and improvement of the method by which an authorized rate of return is selected).

[13] *LEC Price Cap Order* at 6827.

[14] If the price cap regulated LEC accepts a higher productivity factor of 4.3, the carrier is permitted to earn up to 13.25 percent before sharing half of the returns, and up to 17.25 percent before 100 percent sharing occurs.

[15] 47 C.F.R. § 61.39.

manage their costs.[16] The NPRM asked whether companies electing to participate in the optional incentive plan should be permitted to file mid-term revisions. The NPRM proposed that carriers making such mid-term filings only if rates fall 100 basis points, or 1 percent, below the authorized rate of return, which is currently 11.25 percent. We also requested comments on permitting adjustments for cost changes that would render rates unreasonable, suggesting that incentive plan LECs might be required to bear a heavy burden of proving that cost changes had rendered their rates unreasonable.[17]

19. *Comments.* Several parties[18] generally agree with the tentative conclusion that the optional incentive plan reduces regulatory burdens for smaller LECs.[19] The ICC further asserts that increasing regulatory lag by one year provides additional incentives for innovation and efficiency.[20] No party opposed the two-year tariff period, or suggested a different period.

20. With regard to mid-term tariff revisions, the ICC argues that, since the regulatory lag is increased by one year under the proposal, it is appropriate to impose a higher burden of proof to justify mid-term changes. According to the ICC, the efficiency gains are maximized when prices are held constant.[21] USTA argues that, for mid-term filings within the two-year tariff period, the LEC should not be required to meet a heavy burden of proving that its existing rates are unreasonable. USTA asserts that imposing a high standard on mid-term filings would make the optional incentive plan more risky than price cap regulation, which provides for yearly automatic rate increases if carriers earn below 10.25 percent.[22] USTA suggests that we permit companies to use a rate adjustment factor to retarget their rates to allowed earnings limits within the two-year period.[23] ITAG contends that the burden of proof in a mid-term filing should recognize the difficulties small and mid-size carriers have in managing costs and reacting to demand changes.[24] Centel argues that limiting tariff revisions to a biennial filing may be unlawful under the Communications Act, which establishes a system of carrier-initiated rates.[25]

21. *Discussion.* We agree with the commenters that requiring tariff filings every two years under the incentive plan will substantially reduce regulatory burdens and will enhance the incentives carriers have to manage costs and stimulate demand to maintain or improve earnings.[26] Under current rate of return practice, all rate of return carriers file annual tariffs, updating their rates to be effective each July 1.[27] By requiring these filings only once every two years, the administrative burdens on the carriers will be substantially reduced.

22. A more significant issue is how difficult it should be for LECs to change rates in the middle of the two-year period. If carriers electing this plan are free to increase rates during the two-year period, their incentives to improve efficiency are severely reduced. Allowing carriers under the incentive plan to increase rates freely also undercuts the rationale for permitting LECS to retain higher earnings. The incentive plan is a voluntary plan under which the LEC accepts greater risks than under cost-plus, baseline rate of return regulation in order to be permitted to achieve greater rewards, but only if it improves its productivity.

23. Nevertheless, in unusual cases, unexpected events may cause unusually low returns that justify rate increases. To address those cases, we believe a mechanism similar to the lower formula adjustment in price caps should be applied. As adapted to the incentive plan, if after one year the LEC makes an adequate tariff showing that the optional plan limits have caused rates to fall below a zone of reasonableness, and this trend is likely to continue through the two-year rate period, we will permit the LEC to adjust rates upward. In order to preserve the plan's incentives, we will consider requests for upward mid-course rate revisions only if the LEC has fallen more than 0.75 percent below the prescribed rate of return and will permit rate increases only to the extent necessary to bring earnings to that same level during the second year of the rate period. Finally, we will continue to permit LECs subject to the incentive plan to request rate adjustments targeted to the authorized rate of return if the LEC can show that rates are otherwise confiscatory. We will expect the LEC to bear the burden of demonstrating that the optional incentive plan, including the lower rate adjustment, will not permit it to set reasonable rates. Any such filings will be subject to special scrutiny and a high probability of suspension and investigation. LECs will be required to submit detailed cost support, in accordance with the most recent Tariff Review Plan, to support any

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16 NPRM, 7 FCC Rcd at 5025.

17 *Id.* The NPRM reasoned that, if mid-term filings are permitted without also demanding that the carriers bear a heavier burden of proof than in routine tariff filings, the incentives for efficiency created by reliance on historical costs and a two-year regulatory lag are substantially reduced.

18 The full names of commenting parties and abbreviations used in this Order are listed at Appendix A.

19 ALLTEL Comments at 4; *see also,* Lincoln Telephone and Telegraph Company (Lincoln) Comments at 3, GVNW, Inc./Management (GVNW) Comments at 2.

20 ICC Reply at 3; *accord* SBA Comments at 11.

21 ICC Reply at 4; *accord* Taconic Comments at 7.

22 USTA Comments at 21, citing *LEC Price Cap Order,* 5 FCC Rcd at 6802; *see also* Centel Comments at 4; PRTC Comments at 7-8; Lincoln Comments at 3-4 (arguing for 14 days' notice); JSI Comments at 3-4; SBA Comments at 12; ITAG Comments at 3-4.

23 USTA Comments at note 50; *see also* Centel Comments at 3.

24 ITAG Comments at 4-6 (arguing that costs associated with 800 database and SS7 demand levels, largely governed by interexchange carrier competition, and increased competition for exchange services contribute to the difficulty in predicting rates for a two-year period).

25 Centel Comments at 3, citing *AT&T v. FCC,* 487 F.2d 865 (CA 2d 1973); *MCI v. FCC,* 765 F.2d 1186 (D.C. Cir. 1985). Concluding that the effect of such rules would be to freeze rates, the court in *ATT v. FCC* held that this is the same as prescribing rates, which the Commission can do only after hearings have been held and the prescribed rates found to be just and reasonable. *AT&T v. MCI* at 874-875.

26 *But see* MCI Reply at 6-8 (arguing that the Commission should undertake an in-depth analysis in an attempt to ascertain the small LECs' long term productivity and place certain categories of LECs in specific risk/reward incentive regulation plans). We affirm the conclusion of the NPRM not to take a price cap approach to introducing incentives to rate of return carriers.

27 47 C.F.R. § 69.3.

mid-term filing. They should also provide a detailed explanation of why existing rates, based on adjusted historical costs, are likely to be unreasonable.

24. We do not find this plan, as USTA argues, to be more onerous than price cap regulation. Unlike the price cap rules, incentive plan LECs are not required to lower rates relative to inflation by at least 3.3 percent annually. In addition, incentive plan LECs will have their rates aligned to revenue requirements every two years. Therefore, the incentive plan places far less risk on LECs than does the price cap system. Moreover, for those carriers that are unwilling to accept the more moderate risks established by the incentive plan, more traditional rate of return tariff filing requirements remain available to them.

25. Biennial filings will also permit us a better opportunity to review rates for reasonableness, in compliance with the Communications Act. As previously established in Section 61.39, two year filing periods are sufficient to ensure interstate rates remain reasonable. We find that biennial filings, punctuated by cost-based review of revenue requirements and rates, and supplemented by our authority to investigate rates on our own motion or pursuant to complaint, are a lawful exercise of our statutory discretion to tailor our regulatory systems. Since we are not precluding mid-term revisions, the optional incentive plan does not contradict the statutory system of carrier-initiated rates.

B. Earnings Band

26. *Notice.* The NPRM proposed to establish an earnings band for carriers that elect the optional incentive plan. This band is set to recognize that there is less risk associated with the incentive plan than is inherent in price caps, yet greater risk than involved in traditional rate of return regulation. Therefore the incentive plan should permit lower earnings than price caps, yet a broader band than is currently used for rate of return regulated carriers.[28] Specifically, the NPRM proposed a band that extends 100 basis points, or 1 percent, above and below the authorized rate of return, currently set at 11.25 percent. Unlike the price cap band, this band would adjust with any rate of return represcription.[29]

27. *Comments.* The ICC argues that a band of allowable earnings is preferable to a single-point rate of return because it creates incentives for the LEC to be more efficient and innovative in order to achieve greater earnings.[30] AT&T generally supports the proposed earnings band.[31] AT&T argues that the plan limits LEC risks because "access rates would be retargeted biennially to the LECs' authorized rate of return, mid-term adjustments to the lower earnings band would be permitted, and LECs would retain the option to revert to traditional rate of return regulation."[32] MCI asserts that no LEC has provided any showing that the level of risk inherent in the incentive plan justifies increasing the level of reward. Therefore, MCI contends, the Commission should not blindly expand earnings zones.[33]

28. USTA argues that the proposed upper limit on earnings for the incentive plan is far lower than that of price caps and fails to consider the inherent risk of the proposed incentive plan.[34] USTA states that, when the LEC retargets its rates to the authorized return level at the end of the two-year period, based on historical data, there is a significant chance that the LEC will not reach its authorized rate of return if its costs increase faster in the subsequent period than does demand. USTA also asserts that the likelihood of such a risk occurring increases as the LEC participates in the plan for multiple two-year periods.[35] Finally, USTA contends that the rewards of the plan are limited because all benefits of efficiency gains, other cost savings and demand stimulation, ultimately flow to the customer due to readjusting rates every two years.[36] Therefore, USTA proposes that carriers under the optional incentive regulation plan be permitted to earn "up to 200 basis points above the authorized level before being required to retarget to the authorized return at the end of each two-year period."[37] SBA suggests a reduction in the lower level to 50 basis points below the prescribed rate of return to give LECs greater assurance that their financial structure will be protected.[38]

29. USTA asserts that AT&T fails to recognize the substantial risks to LECs under the incentive plan. USTA asserts that the requirement that LECs retarget to the authorized return at the end of two years merely limits the carriers incentive potential because all the benefits of efficiency gains ultimately flow back to the access customer.[39] Further, USTA argues, the opportunity to make mid-term revisions will do little to limit a LEC's risks because such adjustments would increase rates only up to the lower earnings band and the LEC must meet a "heavy burden" to justify any rate increase at midterm.[40] Additionally, USTA continues, while a LEC will have the option to return to baseline regulation, this feature does not mitigate the risk that a LEC might not reach its authorized rate-of-return if its costs increase during the plan period faster than demand grows for its services.[41]

30. *Discussion.* In the NPRM, we tentatively concluded that an approach similar to the price cap earnings band was appropriate for the incentive plan. The price cap plan sought to balance risk with potential reward. We also concluded that, because the risks of the incentive plan are less than those associated with price caps, the rewards of the incentive plan should be less. This rationale is sound and is consistent with our design to establish a regulatory

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[28] NPRM, 7 FCC Rcd at 5025.
[29] *Id.* at ¶ 12.
[30] ICC Reply at 4.
[31] AT&T Comments at 3.
[32] AT&T Comments at 4; *see also* SBA Comments at 15, stating that it "generally backs the encasement of incentive regulation within the integument of rate-of-return regulation for smaller LECs."
[33] MCI Reply at 5.
[34] USTA Comments at 11-12; *see also* ALLTEL Comments at 4-5; Lincoln Comments at 4-5; PRTC Comments at 6-7; Centel Comments at 4-5; GVNW Comments at 2.
[35] USTA Comments at 12-13.
[36] *Id.* at 13-14.
[37] *Id.* at 16; *see* ALLTEL Comments at 5; JSI Comments at 5; ITAG Comments at 6; PRTC Reply at 3 (supporting USTA).
[38] USTA Comments at 16.
[39] USTA Reply at 8.
[40] *Id.*
[41] *Id.* at 8-9.

continuum which balances risk and reward. The level of permissible earnings represents a substantial part of the reward equation and deserves careful consideration.

31. We believe that the plan proposed in our NPRM represented a rational balance of risk and reward. This Order makes some adjustments to the plan proposed in the NPRM. As discussed below, we are somewhat strengthening the plan's reliance upon historical costs by disallowing "known and measurable" showings and, as discussed above, by imposing a burden of proof that rates are unreasonable for mid-term corrections. Therefore, it is reasonable to increase the earnings potential of the plan over the 100 basis points proposed in the NPRM, and to raise the lower bound of the band above the 100 basis points proposed. Price cap carriers are permitted to retain earnings of up to 200 basis points above the initially prescribed level without triggering the sharing mechanism. We believe that matching this level for the incentive plan would be unreasonable; however, we also believe that, in light of other changes made in this Order, 100 basis points may be too restrictive. We also recognize that, unlike for price cap carriers, changes in the prescribed rate of return would affect the earnings zone ceiling, and the lower end, for carriers participating in the optional incentive plan. Accordingly, to better balance the risks and rewards of the incentive plan, we increase the permissible earnings zone for incentive plan carriers from a 100 to a 150 basis point maximum for LECs that elect the plan for their traffic sensitive rates only. Because there is less earnings potential under the incentive plan than under price caps, it is reasonable that there be less of a down-side risk. Therefore, we also raise the lower end from 100 basis points below the authorized rate of return to 75 basis points below the authorized rate of return.[42] Finally, we believe this increase is warranted because, to the extent the carriers increase their earnings, the benefit of those earnings is passed to ratepayers in the next tariff filing.

C. Pricing Flexibility

32. *Notice*. Consistent with the proposal to give optional incentive plan carriers flexibility in pricing new service offerings, the NPRM also proposed some additional pricing flexibility for existing services. The NPRM proposed a basket and service category system defined on the same basis as in the price cap rules. Within each two-year period, aggregate rates for each basket would remain unchanged; however, carriers could adjust rates within each service category by 10 percent up or down over the two-year period, subject to the same reduced notice and support requirements as within-band price cap filings.[43] The NPRM asked whether the rules should establish some lower bound for pricing flexibility beyond 10 percent.[44]

33. *Comments*. The LECs commenting on the pricing flexibility support the NPRM proposal.[45] USTA argues, however, that the proposal should be clarified to state that, to the extent a LEC operating under this plan has "flexed" its rates, the existing rate relationships should be preserved at the next biennial filing. As under price caps, flexibility in rate setting should be cumulative, *i.e.*, include a mechanism to smooth the transition from rates "flexed" during the prior tariff period to new rates developed during the retargeting to the authorized rate of return for the next tariff period, according to USTA.[46]

34. MCI contends that it currently takes a price cap LEC a minimum of one year to change the overall rates of a service by 10 percent. Under the Commission's incentive plan proposal, MCI states, a participating LEC could make a 10 percent change in the price of a service all at once. Therefore, MCI urges limiting the incentive regulation LECs' pricing flexibility to 5 percent per year with a cumulative impact up to a maximum of 10 percent over the two year filing period.[47] MCI also opposes USTA's proposal to make the maximum amount of price changes cumulative, arguing that the small LECs are monopolists and have not shown that they face even the very limited competitive pressures that some large LECs face.[48]

35. *Discussion*. We adopt the proposal to create a limited system of pricing flexibility for carriers operating under the optional incentive plan. Drawing on our experience with price caps, flexibility shall be recognized in the form of a no-suspension zone, within which LECs remain relatively free to adjust prices. These filings would be permitted on 14 days' notice. Should rates move outside the zone, LECs must file the same cost support showings required of price cap carriers for above-band and below-band filings.[49]

36. The differences between price cap regulation and the optional incentive plan, however, require that we modify the no-suspension zone for use here. While we will adopt the same price cap baskets and service categories used in price cap regulation,[50] we will not mandate use of an index to track carrier prices.[51] Instead, aggregate

[42] The NPRM asks whether it is appropriate to require sharing of earnings over the permissible levels for LECs participating in the optional incentive regulation plan. For the present we will not apply a sharing mechanism to the optional incentive plan. One of our goals in this proceeding is to maintain regulatory simplicity to the extent possible. While comments express some degree of interest in a sharing mechanism, there is no compelling argument made which demands that such a mechanism be a part of this regulatory plan. In general, issues pertaining to earnings in excess of the described band should be addressed in CC Docket No. 92-133 exploring streamlining and improving the method by which an authorized rate of return is selected and related enforcement issues.

[43] NPRM, 7 FCC Rcd at 5026.

[44] *Id.* at ¶ 19.

[45] ALLTEL Comments at 6; Centel Comments at 9; Lincoln Comments at 7; USTA Comments at 17.

[46] USTA Comments at 17.

[47] MCI Comments at 3-4.

[48] *Id.* at 9.

[49] *See* 47 C.F.R. § 61.49(c) and (d). Above-band filings must be accompanied by supporting materials establishing substantial cause for the proposed rates. Below-band filings must be accompanied by supporting materials establishing that the rates cover the service category's cost.

[50] 47 C.F.R. § 61.42(d)-(g).

[51] *See* 47 C.F.R. § 61.42(d) - (g). The LEC baskets include common line, traffic sensitive switched, and special access. An interexchange service basket would also be created if the LEC provides such services. The traffic sensitive basket includes the following service categories: 800 services; local switching; information; and transport. The special access basket includes: voice grade, WATS, metallic, and telegraph services; audio and video services; high capacity and DDS services; and wideband data and wideband analog services.

rates in a basket are based on aggregate revenues at the beginning of each tariff period. Aggregate prices in a service category, however, can decrease or increase by a maximum of 10 percent during the two years between rate filings.[52] The method of tracking prices will be determined in the tariff process.

37. This limited pricing flexibility responds to a variety of concerns that stimulated our re-evaluation of regulation of small and mid-size carrier pricing. First, since price cap LECs have similar rate flexibility, granting limited rate flexibility to carriers under the optional incentive plan helps ensure that small and mid-size companies can respond to pricing actions on the part of their price cap neighbors. Second, carriers regulated under this incentive plan absorb more risk than those regulated under more traditional rate of return. Our decision to employ historical costs, adjusted only by exogenous costs listed in the rules, as well as the creation of a two-year rate period, forces these carriers to manage their costs efficiently. That risk requires that we grant more freedom to manage their business operations. Without some pricing latitude, we will not succeed in creating a workable incentive-based system.

38. We do not believe there are significant advantages to MCI's proposal to limit flexibility to 5 percent per year, over our own proposal to allow 10 percent flexibility for the entire two-year period. MCI's' proposal would add a layer of administrative complexity that would undercut some of the incentive plan's goals without apparent benefit. The concerns underlying MCI's proposal, moreover, can be addressed in the tariff review process. We decline to adopt this changes in the plan.

39. We also find that pricing flexibility should be cumulative, *i.e.*, that the rate relationships of "flexed" rates in effect at the end of a tariff period should be used to set rates at the beginning of the new tariff period. Absent this ability, carriers would not have the opportunity to address changing market conditions and moving to more efficient pricing.

D. Cost Support for Incentive Plan Tariffs

1. Basis of initial and subsequent filing

40. *Notice*. The NPRM proposes basing the first optional incentive plan filing on a cost of service study for the most recent 12 month period together with related demand data for the same period. Subsequent filings would be based on similar cost and demand information for all elements for the period since the time of the carrier's last filing.[53]

41. *Comments*. ALLTEL supports the proposal to base the first incentive plan tariff filing on the company's costs for the most recent 12 month period.[54] Lincoln proposes that rates in subsequent biennial filings should be adjusted using a cost and demand rate adjustment factor. This factor would prevent possible rate jumps between rates changed through pricing flexibility and those established at the beginning of subsequent tariff periods.[55] AT&T proposes that any LEC selecting the plan must file on the public record a tariff review plan which contains historical cost and demand data underlying proposed rate levels. AT&T notes that these data are routinely generated by the LECs and are essential to verifying the reasonableness of the proposed rates.[56]

42. Centel argues that we should not adopt the proposal to base costs on historical cost and demand. First, it asserts that such methodology is only appropriate for LECs "whose past resembles their future", not for companies like Centel that have operated efficiently in the past but face increasing costs in the future.[57] Centel also contends that the incentive plan's lack of an inflation adjustment requires LECs to absorb all inflation costs which results in a greater risk that a carrier will underearn.[58] Ronan urges that we permit carriers to use the average schedules prepared by NECA as a basis for rate development under the incentive plan.[59]

43. *Discussion*. We adopt the proposal in our NPRM to base the first incentive plan filings on cost of service studies and demand studies for the most recent 12-month period. Subsequent filings will also be based on the most recent 12-month period instead of on the period since the time of the carriers last filing. We believe that basing all filings on carriers' most recent 12-month period provides the most accurate data and provides consistency among data submission by LECs, facilitating analysis, review and monitoring. Reliance on historical costs serves two objectives: (1) historical costs reduce administrative burdens by creating cost showings grounded in historical, actual data that are straight forward to produce and explain: and (2) historical costs enhance the optional incentive plan's efficiency incentives by minimizing opportunities for padding costs by over estimating future expenditures or investments. Experience with the price cap plan and the Section 61.39 rules for small companies, both of which rely on historical costs, supports our conclusion here that historical cost showings are preferable to evaluating pro-

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52 We borrow subindexes from price caps, as well as any category pricing limits differing from the plus or minus 5 percent rule.

53 NPRM, 7 FCC Rcd at 5025.

54 ALLTEL Comments at 5. *See also* Lincoln Comments at 5.

55 Lincoln Comments at 5.

56 AT&T Comments at n.5 (also arguing that tariff review plan material will be essential in establishing compliance with the optional incentive plan's provisions for pricing flexibility and new services). *But see* Lincoln Comments at 2-3 (arguing that it is no longer appropriate to define regulatory requirements based upon a Tier I and Tier II distinction, noting that the Tier I carriers still under rate of return regulation represent a small portion of the remaining 7 percent of total industry access lines. Therefore, Lincoln argues, the Commission should no longer apply filing and reporting requirements designed for the large carriers, now under price caps, to small and mid-size LECs (*i.e.*, ARMIS, TRP, etc.). Lincoln concludes that the distinction should be merely price cap and non-price cap.

57 Centel Comments at 6.

58 *Id.* at n.8; *accord* NARUC Comments at 4.

59 Ronan Comments at 2-6. Ronan also asks the Commission to provide long term and transitional support payment to small independent LECS that exit the NECA pools and to exempt such carriers from the obligation to pay such support. Finally, Ronan ask that the Commission establish that average schedule companies that leave the NECA pools be permitted subsequently to return to the pools and retain their average schedule status.

spective, projected cost and demand data. For example, rates filed by carriers under Section 61.39 of our rules have been consistently lower than comparable rates filed by NECA.

44. With respect to AT&T's suggestion that we require a tariff review plan to be submitted with each biennial filing, we agree that tariff review plans associated with annual access filings have been a useful and informative means of standardizing the presentation of LEC cost support data. We have, however, considered and rejected codifying the tariff review plan (TRP). Detailed specification of a tariff review plan in Commission rules is unworkable, given the pace of regulatory, technological and competitive changes. The Common Carrier Bureau adjusts the review plan annually to accommodate new or modified requirements, such as the advent of price cap regulation, the implementation of the price cap sharing provisions, and the implementation of Open Network Architecture and database 800 services. While we expect that the Bureau will continue to rely on a standardized review plan, tailored to the various regulatory systems in use, and that the plan will be filed on the public record, we decline to establish formal rules governing the details of the review plan.

45. We also decline to adopt a productivity factor or an inflation factor. Because of the substantial diversity among smaller carriers, it is not possible to establish a workable productivity factor. In addition, providing for inflation alone does not yield a full accounting of external pressures. The incentives of this optional plan are based on regulatory lag and reliance upon historical costs. LECs choosing the plan assume the risks and reward of national and local economic factors on their operations during the two-year rate period. If carriers, such as Centel, believe that their business profile demands such factors, they may choose between our price cap system or rate of return regulation.

46. We decline to adopt the use of average schedule settlements as a surrogate for cost studies under the incentive plan as proposed by Ronan. Average schedule companies may participate in the NECA pools, or may file their own tariffs pursuant to Section 61.39 of our rules. In the latter case, the historical average schedule settlements formulae serve as a surrogate for cost studies. We believe that these options are reasonable and sufficient to meet the needs of average schedule companies, without requiring a conversion to cost. Additionally, as with price caps, the pricing flexibility mechanism and the necessary regulatory oversight of company earnings require actual costs to develop rates.[60]

2. Adjustments to Historical Costs

47. *Notice.* The NPRM proposed two mechanisms for adjusting historical costs at the time of the biennial filing. Carriers could recognize "known and measurable" costs if the exclusion of such costs would cause the carrier to earn less than 100 basis points below the authorized rate of return. With such a showing, the carrier would retarget rates to earn 100 basis points below the authorized rate of return. Such showing would be subject to a higher burden of proof than would a purely historical cost showing. The NPRM asked for types of costs which would be included as "known and measurable."[61] The NPRM also proposed to permit carriers to recognize costs classified as "exogenous costs" within the meaning of that term in the price cap plan. A carrier could choose to claim exogenous costs either at the time of a biennial filing or at the time the cost occurred during the two-year rate period.[62]

48. *Comments.* While the proposal to recognize exogenous cost changes drew little comment,[63] the proposal to recognize other "known and measurable costs" created strong differences of opinion. AT&T argues that, if "known and measurable" costs are included initially in a carrier's rates, the carrier's incentive to reduce costs through actual efficiencies is substantially diminished.[64] AT&T further contends that the inclusion of "known and measurable" costs would complicate the implementation of tariffs by permitting the use of a mixture of historical and prospective costs, rather than historical costs alone.[65] To guard against overforecasting of "known and measurable" changes, AT&T argues, there would need to be some form of post-period audit to determine whether these changes actually occurred, at what magnitude they occurred, and whether access customers are entitled to refunds of excessive rates that were predicated on unrealized costs.[66]

49. AT&T argues that in no event should LECs obtain the benefits of rate-of-return regulation through guaranteed recovery of their normal business expenses while at the same time enjoying the generous pricing and earnings flexibility of the optional incentive plan.[67] Other parties contend that "known and measurable" costs are unnecessary in light of the proposal to permit mid-term rate corrections which protect LECs from inadequate earnings while at the same time preserving the LECs' incentives to become more efficient.[68] According to ICC, the mid-term revision is the appropriate forum in which the LEC should argue for recovery of such costs. AT&T argues that the definitions of "known and measurable" offered by the LECs would effectively allow the inclusion of virtually all of the ordinary costs of doing business.[69]

50. USTA argues that under its proposed definition of "known and measurable" changes, only instances where there is an objective confirmation of the future event causing a cost or demand change would qualify as "known and measurable."[70] Accordingly, USTA contends,

[60] We also find Ronan's request to extend the benefits of Long Term Support to small companies exiting the NECA pools to be beyond the scope of this proceeding.
[61] NPRM, 7 FCC Rcd at 5026.
[62] *Id.*
[63] GVNW Comments at 3; ALLTEL Comments at 5 (arguing that exogenous costs be reflected prospectively).
[64] AT&T Comments at 4. *See also* ICC Reply at 5.
[65] AT&T Comments at 4-5.
[66] *Id.* at 5. *See also* ICC Reply at 5.
[67] AT&T Reply at 4.
[68] *Id.* at 5-6. *See also* MCI Reply at 7 (supporting AT&T position); ICC Reply at 5.
[69] AT&T Reply at 3.
[70] USTA Comments at 14; *accord* Centel Comments at 7; JSI Comments at 5-6; GVNW Comments at 3; Lincoln Comments at

in view of the high confidence level required of changes considered to be "known and measurable," AT&T's concern that the costs "may not actually materialize during the two-year tariff period" is unfounded.[71] USTA also argues that we should establish a threshold requirement for recognizing "known and measurable" costs: such costs would be included only if, without them, rates would produce earnings at least 100 basis points below the authorized rate-of-return. USTA argues that this threshold should exclude all but the largest "known and measurable" changes from consideration.[72] Finally, USTA argues, the ability to make mid-term rate adjustments does not obviate the need for "known and measurable" changes, particularly under the Commission's proposal which would require a LEC to meet a heavy burden of proving that its current rates are unreasonable. Further, USTA states, mid-course adjustments would be prospective only, and would prevent LECs from recovering known and measurable changes that occur prior to the mid-course correction.[73]

51. *Discussion.* We continue to believe that exogenous costs, those listed for price caps in Section 61.45(d) of the Commission's Rules, should be used to adjust the historical costs used in the optional incentive plan. These are basically cost changes associated with Commission programs and rules, or other events outside the control of the LECs. As in the case of price cap LECs, adjustment for these changes should more accurately track costs, without distorting the LEC's incentives to become more efficient in areas that are within its control. Adopting the price cap list of exogenous factors should also be administratively feasible.

52. Upon reflection, however, we believe the arguments raised against adjustments to historical costs for "known and measurable" future events are persuasive. As AT&T points out, review of both the initial amounts of costs assumed to be "known and measurable" and, subsequently, of whether those amounts proved to be accurate, would be necessary but administratively difficult and intrusive. An important advantage of historical costs is to reduce the burdens of reviewing. Adding consideration of claimed "known and measurable" costs would largely forfeit this advantage.

53. Adjustments for "known and measurable" costs are also likely to be unduly favorable to LECs, in at least two ways. First, the potential cost changes that might qualify as "known and measurable" would be best known, and perhaps only known, to the LECs themselves. The LEC would have a substantial incentive in this situation to report only the potential cost increases, not reductions, or to target increases to shortly before the beginning of the rate period, while leaving offsetting savings until after the period had begun. Second, focusing only on cost changes ignores the equally important question of benefits. Introduction of a new capability such as SS7 may increase some costs (such as switching costs) but may well reduce others (such as transmission costs) while allowing the LEC to offer new services and options. Adjusting rules solely for the higher costs without recognizing the offsetting savings and other benefits, would be unduly generous to LECs and unfair to ratepayers.

54. Therefore, we believe AT&T is fundamentally correct, that including "known and measurable" prospective costs would undermine the plan's efficiency incentives. As in the case of price caps, the incentive plan places greater responsibility for operational decisions on the LEC than cost-plus rate of return regulation, while providing incentives in the form of higher profits for good decisions, and disincentives in the form of lower profits for bad decisions. Granting automatic rate adjustments for "known and measurable" changes would substantially eliminate such incentives. We accordingly conclude that the optional incentive plan should not permit adjustments to historical costs for "known and measurable" costs.

55. In the context of this optional incentive plan, we find that a system which recognizes exogenous cost changes, as defined in the price cap rules,[74] and that permits mid-term filings to correct rates that are unreasonable, strikes the best balance between our efficiency objectives and our statutory obligations to ensure reasonable rates. As in our price cap system, carriers operating under the incentive plan can claim exogenous costs either in the biennial filing or as exogenous costs occur during the two-year rate period.[75] Thus, for the limited class of costs that are defined as exogenous by our rules, LECs operating under the optional incentive plan can recover these costs when they are incurred, and need not wait for the biennial filing. Moreover, unlike the price cap system, which would ordinarily deny rate increases that are above the price cap or pricing band unless based on costs found to be exogenous, the optional incentive system merely delays recognition of such endogenous costs to the biennial cost review.

56. Mid-term tariff revisions provide further assurance that rates are producing reasonable results. While we have necessarily established a higher burden for mid-term filings, the existence of mid-term filings ensures that, for the majority of costs not recognized as exogenous, a sudden increase in costs relative to historical levels can be given early recognition in rates.

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4. For example, if a LEC wanted to (or had to) include SS7 implementation costs in its base period data, the LEC would need a signed contract or other firm documentation evidencing the planned installation of SS7 capability along with the precise costs involved, as well as other applicable showings. Such costs would not qualify for known and measurable treatment merely because the LEC had included the costs in its next year's budget. USTA Reply at 16.

71 USTA Comments at 16-17.

72 *Id.* at 17.

73 *Id.* at 17-18. *See also* PTI Reply at 4-6.

74 47 C.F.R. § 61.45(d). Changes recognized as exogenous under Section 61.45(d) are limited to those cost changes caused by: the completion of the amortization of depreciation reserve deficiencies; changes in the Uniform System of Accounts permitted or required by the Commission; changes in the Separations Manual; changes to the level of Long Term Support or Transitional Support obligations described in § 69.612; the reallocation of investment from regulated to nonregulated activities pursuant to § 64.901; inside wire amortization; and, such tax law changes and other extraordinary exogenous cost changes as the Commission shall permit or require.

75 As in the price cap system, exogenous cost showings can not be contingent upon a future event -- *e.g.*, the prospect that some cost might materialize due to future Commission action is not sufficient.

3. Carrier Common Line Rates

57. *Notice.* The NPRM stated that common line rates present a more complicated problem than other rates, because the recovery of common line costs is split between carrier common line rates, which are charged on a per minute basis to interexchange carriers, and subscriber line charge rates, which are charged on a per line basis to subscribers. A further complicating factor is that the amount of the per minute carrier common line charges changes with demand, since common line costs are essentially fixed.[76] We proposed that rates for optional incentive plan LECs be derived using costs from the most recent 12-month period.[77] To derive demand, the company would determine the average carrier common line usage and the percentage growth in usage over the most recent 24-month period. Demand for the rate period would be determined by a simple extrapolation of base period demand increased by base period percent growth.[78] The proposed methodology is consistent with current rate of return practice in which the benefits of demand growth are immediately flowed through to ratepayers. It differs in that rate of return practice permits the use of prospective data, while the proposal for the optional incentive plan relies solely on historical cost and demand. Thus, the LEC has incentives to reduce its costs and stimulate demand growth.

58. *Comments.* AT&T argues that the proposed method correctly captures prospective demand growth by tying it to actual, historical growth rates rather than speculative projections as to how demand will grow in the future. AT&T also states the proposal will be simple to administer.[79]

59 . USTA argues that the application of the proposed formula would result in ascribing the full benefit of growth in common line demand to the LECs' interexchange carrier customers and none to the LECs themselves, which is contrary to the Commission's decision in the price cap proceeding to credit LECs with at least 50 percent of the benefit of demand growth. USTA contends that, at the very least, the adjustment made in the formula to account for common line demand growth under optional incentive regulation should provide LECs with no less incentive to increase carrier common line productivity than afforded by the price cap plan. USTA proposed an alternative formula that it alleges would provide strong incentives for LECs to encourage the growth of common line demand.[80]

60. *Discussion.* We agree that the formula for common line demand adjustment proposed in the NPRM would deny LECs any credit for growth in interstate common line demand. On the other hand, we find that the formula proposed by USTA would be overly generous. As we did with the price cap plan, we find that permitting LECs to share in the benefits of demand growth creates a significant incentive for greater efficiency. We therefore adopt the common line formula that uses the historical growth in common line minutes of use, divided by two to compute carrier common line rates. This approach represents a middle ground between the method applied currently to rate of return LECs and the method applied to price cap LECS. This approach shares the price cap concept of crediting the LEC with 50 percent of the benefit of demand growth; however, it is not based on minutes per line, but is based on minutes alone, similar to the method currently used for rate of return carriers.

E. Eligibility and Optional Basis

61. *Notice.* The NPRM proposed that the incentive plan would be available to any non-price cap LEC that has exited the NECA pools. The plan would not be available to any company that participates in a multi-company tariff.[81] In addition, the NPRM concluded that any small and mid-size company incentive plan should be optional. However, carriers electing to file pursuant to the plan would have to participate for all their interstate rates.[82] The proposed rules would require average schedule companies to perform cost studies in support of rates filed pursuant to the incentive plan. Carriers electing the plan must remain under the plan for at least two years. If a carrier leaves the plan, it would maintain a company-specific tariff under Section 61.38 until the fourth year after the year in which it ceased its participation in the incentive plan.

62. *Comments.* The proposal that the incentive plan be available on an optional basis is supported by most commenting parties specifically and opposed by none.[83] Other parts of the proposal were more controversial.

63. USTA asserts that a LEC should be permitted to elect the optional incentive regulation plan for traffic sensitive rates while remaining a participant in the NECA common line pool.[84] USTA further states that only five non-price cap LECs do not participate in either NECA pool, while approximately 50 LECs participate in only NECA's common line pool.[85] USTA and AT&T argue that the primary goal of the plan should be to provide benefits of incentive regulation to the largest number of LECs possible, regardless of whether those LECs eventually move to price caps.[86] USTA further argues that a LEC's decision to continue in the NECA common line pool would largely be based on reasons p unrelated to the incentive plan and that other safeguards proposed would effectively preclude gaming or other abuse.[87]

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[76] NPRM, 7 FCC Rcd at 5028.

[77] In the case of Section 61.39 carriers that are average schedule companies, the use of the LEC's most recent common line settlements through the average schedules was proposed.

[78] NPRM (Erratum), 7 FCC Rcd 5501.

[79] AT&T Comments at 8-9.

[80] USTA Comments at 29; USTA Reply at 11-23, citing *LEC Price Cap Order,* 5 FCC Rcd 6786, 6794 (1990). *But see* AT&T Reply at 5 (USTA plan substantially reduces incentives to reduce costs and fails to give ratepayers the benefit of lower rates).

[81] NPRM, 7 FCC Rcd at 5027.

[82] *Id.* at 5027.

[83] Lincoln Comments at 8; PRTC Comments at 5-6; ITAG Comments at 2; GVNW Comments at 4; SBA Comments at 8-9; NTCA Comments at 5-7; OPASTCO Comments at 8.

[84] USTA Comments at 5; *see also* Alltel Comments at 7-8; PRTC Comments at 2-4; PTI Comments at 3-4; JSI comments at 9; ITAG Comments at 7; GVNW Comments at 8; SBA Comments at 10; USTA Reply at 4-6.

[85] USTA Comments at 6-7.

[86] *Id.* at 8. AT&T Reply at 5-7; *see also* PRTC Reply at 2.

[87] USTA Comments at 10 (noting that the Section 61.39 small company rules apply only to traffic sensitive rates).

64. MCI opposes bifurcation of the optional plan, citing the Commission's tentative conclusion that in order to maximize the benefits of an incentive plan, the company's total regulated interstate operations should be subject to the plan.[88] MCI contends that none of the comments favoring this form of optionality have adequately explained their positions. MCI argues that the LECs would have a financial incentive to report investments, expenses, reserves and revenues in a manner which would generate a traffic sensitive rate of return as high as possible. MCI states that if common line earnings suffer, the pooling process would "correct" these mythical earning deficiencies in the following year. MCI argues that this is merely an opportunity for LECs to increase total earnings without increasing efficiency.[89]

65. With respect to the provision allowing LECs to opt out of the incentive plan, USTA, and many of the commenting LECs, support the Commission's proposal that LECs be permitted to leave optional incentive regulation subject to appropriate safeguards, and that the proposed minimum two years in and four year out, will help ensure that LECs do not game the process by switching back-and-forth between the filing options.[90] USTA does request clarification that the proposal that a LEC must file "company-specific" rates when it leaves the incentive plan is not intended to deprive a group of affiliated telephone companies from filing a single tariff that is not an association tariff, as is now permitted under the Commission's rules.[91] USTA also argues that, to be consistent with current rules, a carrier leaving incentive regulation should be permitted to reenter, or enter for the first time, NECA's traffic sensitive pool. USTA argues that a requirement that the LEC cannot participate in the common line pool would be particularly severe in light of the proposal that the carrier cannot return to the incentive plan for four years.[92] USTA also argues that small LECs (carriers with less than 50,000 access lines) should be permitted to reenter both the common line and the traffic sensitive pool in order to ameliorate part of the risk faced by these companies due to their higher revenue variability.[93] ITAG states that companies should not be required to file tariffs under the more burdensome Section 61.38 if they drop out of the optional incentive regulation plan, but should be permitted to file a Section 61.39 tariff or return to the NECA pools.[94]

66. The ICC asserts that carriers that elect to participate in the optional incentive plan should commit to participate for longer than two years. While the ICC agrees that this plan should be optional for non-price cap LECs, the ICC notes that it is unlikely that much will be learned about whether a LEC choosing this plan has increased efficiencies or made other gains in service quality in just two years.[95]

67. *Discussion.* We will permit carriers to elect to employ the incentive plan to set rates for either their total interstate operations, or for their traffic sensitive rates only, while participating in the NECA pools for other rates. This additional flexibility is consistent with our attempt to maintain the balance of risk and reward we seek to maintain in this proceeding. Moreover, given that this plan is grounded in rate of return methods, we are not as concerned as we were in the price cap proceeding that applying different methods to different rates would permit LECs to game the system. Attempts to cost-shift would be detectable in two ways -- through the biennial tariff review process, which requires a showing of cost by basket, and, for a few of the carriers likely to elect the plan, through ARMIS, and the Commission staff's performing trend analysis and comparing reports from several carriers to divulge anomalies.[96] NECA will also monitor claims for costs within the pools, as it does now for LECs. These protections offer reassurance that LECs will not be able to use these diverse regulatory methods to produce unreasonable rates. Furthermore, we are persuaded by the arguments of USTA and those carriers most likely to elect this plan, that this form of optionality will greatly encourage participation. Because we believe the optional incentive plan constitutes improved rate of return regulation that will yield dividends to ratepayers, encouraging maximum participation is important.

68. While we agree that a carrier that fully participates in the plan experiences the strongest incentives for efficiency, even partial participation is better than none. A company may rationally elect the plan for traffic sensitive rates initially, gain confidence in the new regulatory system, and later move its common line rates into the plan. Such action would be consistent with our broader scheme of giving smaller carriers a continuum of choices of regulatory alternatives. With regard to the carrier's incentive to manipulate its books of account, the biennial tariff review, ARMIS, NECA pool monitoring, and the complaint process provide sufficient opportunity for MCI or others to challenge the carriers accounting methods and to seek remedies for improper cost shifting.

69. All commenting parties support the proposed optional nature of the plan. The optional character of our proposal is consistent with our recognition of the inherent diversity of the smaller companies. This optional feature also establishes the proper balance between meeting our regulatory responsibilities and a company's legitimate business needs. We therefore restate our commitment to maintaining the optionality of our regulatory alternatives for smaller carriers.

70. In the NPRM we proposed that carriers electing the plan be required to remain in the plan for only one two-year tariff period before they may exit the plan. We believe that requiring participation for a longer period, combined with adequate notice of the carriers intent to leave the plan will provide stronger protection against abuse. Therefore, we will establish four years, or two tariff periods, as the minimum for participation in the incen-

88 MCI Reply at 3.
89 *Id.* at 3-4.
90 *E.g.*, USTA Comments at 24-25. *See also* Lincoln Comments at 8; *but see* Centel Comments at 10 (arguing that LECs should be eligible to return after two years).
91 USTA Comments at 25.
92 *Id.* at 25-26. *See also* PRTC Comments at 4-5.
93 USTA Comments at 26.
94 ITAG Comments at 8. *See also* GVNW Comments at 4.
95 ICC Reply at 7.
96 The Commission's Automated Reporting Management Information System (ARMIS) is a database comprised of detailed cost and accounting information submitted by the larger LECS.

tive plan. In addition, carriers seeking to exit the incentive plan must provide notice to the Commission, two years before exiting the plan.

71. We next address the rules governing a carrier's election to abandon the incentive plan. The proposed restrictions are intended to assure that the plan creates long term incentives for efficiency, not opportunities for short term profits through switching between different regulatory plans. We proposed to deter the latter by limiting the carrier's choices if it wishes to leave the incentive plan. Although the election is not permanent, a carrier leaving the plan may not return to the NECA pools and must maintain its own tariffs under Section 61.38 of our rules, or become subject to price cap regulation. ITAG and GVNW argue that companies serving 50,000 lines or fewer should be permitted to leave the incentive plan and file tariffs pursuant to Section 61.39. We do not find the arguments compelling and remain concerned that the choice might be abused; however, we would consider requests for waiver to permit small companies leaving the incentive plan to follow Section 61.39 upon a showing of good cause, that no windfalls or other abuses would occur.[97]

F. New Services

72. *Notice.* The NPRM sought to streamline the introduction of new services which help the small or mid-size LEC compete with a nearby price cap LEC for customers. Under the proposed rules new services would receive streamlined tariff treatment, including a presumption of lawfulness, if the anticipated earnings are *de minimis* and the rates do not exceed the rate charged by the geographically closest price cap regulated LEC offering comparable service. The NPRM proposed that *de minimis* would be defined as 2 percent or less of the company's total operating revenue. According to the NPRM, if these parameters are not met, the carrier would be required to file section 61.38 cost support material to justify the rates.[98] After 12 months, costs and rates would be reviewed for inclusion in the proper basket and category, based on actual operating results.

73. *Comments.* Parties filed comments both on the issue of whether services are eligible for streamlined treatments and on the issue of what review applies at the next biennial filing. With respect to the first issue, most parties support streamlined tariff treatment of new services.[99] HWith respect to the definition of *de minimis*, USTA argues that the test for *de minimis* should include new services with projected revenues that meet either the 2 percent test or that will be less than $200,000 in aggregate on an annual basis. USTA asserts that the latter criterion will facilitate the introduction of new services by very small companies for whom the 2 percent standard alone would yield an unreasonably low threshold.[100]

74. Various commenters also seek to modify the requirement that the new service can be priced no higher than the price of a like service offered by the geographically closest price cap LEC. USTA suggests the price be no higher than any price cap LEC in the country.[101] NTCA argues that we should permit indexing of the rates of incentive plan carriers to those of price cap carriers, while MCI argues that we limit new prices to the tariffed industry average.[102] SBA asserts that the Commission must specify how a LEC should determine the LEC geographically closest so that carriers can avoid unnecessary costs associated with tariff investigations or complaints.[103] NTCA also argues that the closest price cap carrier may have little in common with the affected LEC, so that rates of one may not be applicable to the other.[104]

75. With respect to how new services are subsequently treated, USTA argues that the Commission should not require a burdensome cost-based filing within 12 months if the LEC continues to meet the *de minimis* revenue standard. It also contends that cost-based pricing of a new service could actually cause rates to increase and produce rate churn.[105] MCI agrees with the proposal that LECs 8 should make a cost-based filing after 12 months of operating experience.[106] MCI argues that the *de minimis* provision was proposed because conducting a cost of service study on a new service is difficult and the results may not be very reliable, given that there may be no direct information on costs. According to MCI, resetting the rates based on actual costs after one year, when better data are available, is most consistent with avoiding inaccurate and inefficient pricing signals in the market.[107]

76. *Discussion.* The purpose behind our new services proposal is to provide an administratively simple means of permitting small and mid-size LECs to introduce new services and compete with neighboring price cap LECs for customers. For purposes of the incentive plan and the Section 61.39 rules, the new service test of price cap shall apply. In this Order, we seek to provide small and mid-size LECs with the ability to introduce new services quickly, as well as to stimulate rivalry among LECs for new, innovative service offerings. This process also furthers our policy that innovative new services should be made available to the public as quickly as possible.[108]

77. Given these goals and the record support for them, we modify the new services criteria as follows. Except in cases in which the Commission specifically establishes requirements for a new service,[109] carriers electing the optional incentive plan may introduce any new service on a streamlined basis, regardless of the size of potential

97 We agree with USTA that our requirement that a LEC file "company-specific" rates when it leaves the incentive plan is not intended to deprive a group of affiliated telephone companies from filing a single tariff that is not an association tariff.

98 NPRM, 7 FCC Rcd at 5026.

99 *See e.g.*, Lincoln Comments at 6-7; Centel Comments at 8; ICC Reply at 6-7.

100 USTA Comments at 20.

101 *Id.; see also* PRTC Comments at 8; ALLTEL Comments at 6; Taconic Comments at 7; JSI Comments at 6-7; ITAG Comments at 7.

102 NTCA Comments at 10-11; MCI Reply at 12-13.

103 SBA Comments at 18.

104 NTCA Comments at 10-11. *See also* GVNW Comments at 3 (NECA rates are a better surrogate).

105 USTA Comments at 19. *Accord* Taconic Comments at 7; ICC Reply at 7.

106 MCI Reply at 10.

107 *Id.* at 10-12.

108 *See* Section 7 of the Communications Act, 47 U.S.C. § 157.

109 *E.g.*, Bell Operating Companies' Tariffs for the 800 Service Management System, Tariff F.C.C. No. 1 and 800 Data Base Access Tariffs, DA 93-491, (released Apr. 28, 1993).

revenues, so long as the price of the new service is at or below that of any neighboring price cap LEC. A new service that is not like a neighboring price cap LEC's service is not eligible for streamlined review, and must be cost supported using prospective data, as required by Section 61.38 of the Commission's rules. For services which are like a neighboring price cap LEC's services, streamlining shall mean the transmittal introducing the new service shall be presumed lawful, that no cost support is required, and that the transmittal can be filed on 14 days' notice. In place of cost support, the carrier shall attach a brief explanation of why the service is like an existing service offered by the closest price cap LEC, and an explanation or statements that the price is no higher than the price charged by the other LEC.[110]

78. We find that this structure is simple and should generally avoid unreasonable rates. For practical purposes, the upper limit on new service prices is likely to be the price charged by a neighboring LEC.[111] The lower limit on pricing is only a concern to the extent that a carrier might seek to set predatory prices. At this time, given the nascent state of competition for interstate access, and the small and mid-sized LECs' limited size, the potential for predatory pricing is extremely remote for the group of smaller carriers eligible for the optional incentive plan. Carriers have no incentive to price at a predatory level.[112] In addition, we impose no revenue limit specific to new services. Revenue from new services would factor into the LECs overall earnings and be subject to the same earnings limits as other services. Given that there is an adequate check on the reasonableness of new service pricing for price cap LECs, we perceive no utility in making the new services provision more complex by imposing requirements such as a *de minimis* showing or 12-month cost showings. The costs and demand levels associated with new services will simply be folded into the biennial cost-based tariff review process.[113] In the event anticompetitive behavior does occur, the injured party may provide evidence sufficient to overcome the presumption of reasonableness or raise the matter in a complaint.

79. We disagree with commenters that determining which price cap LEC is closest is a difficult question. In most cases, the service area of the optional incentive plan LEC seeking to make a competitive response will border the service area of the price cap LEC, or be associated with a Bell Operating Company or General Telephone Operating Company LATA. If the optional incentive plan LEC's service areas abut more than one price cap LEC, the cap becomes the highest rate charged by any adjoining price cap LEC. Therefore, there should be no ambiguity in determining which price becomes the cap for purposes of streamlined new services filings.

G. Infrastructure and Service Quality Reporting

80. *Notice.* The NPRM proposes that incentive plan carriers file quarterly service quality reports and biennial infrastructure reports. The NPRM tentatively concludes that these reports are necessary to protect ratepayers and otherwise allay concerns that a company may simply pursue the most cost effective means of maintaining its network to the detriment of service quality, and ultimately to the detriment of the company's infrastructure.[114]

81. *Comments.* According to USTA, LECs have a strong incentive to maintain a high level of service quality, and a strong financial disincentive to jeopardize customer relations by allowing service quality and network plant to deteriorate.[115] In view of the differences between optional incentive regulation and price cap regulation, the incentive plan does not require the same service quality reporting as price caps, USTA contends. For these reasons, USTA proposes that carriers electing optional incentive regulation should file reports similar, but not identical to the reports of price cap LECs. Further, USTA asserts that these reports should be filed on an annual, rather than a quarterly basis.[116] USTA proposes that the service quality reports include:

a. installation interval reports, reflecting the percentage of service installations completed within carrier established intervals;

b. repair interval reports, reflecting the average total number of hours to complete requested repairs;

c. network blockage reports, reflecting the ratio of blocked call attempts to total attempts at the busy hour; and,

d. switch downtime reports, reflecting the amount of time during the reporting period that a switch is totally down.[117]

82. USTA also argues that the Commission should not adopt new and burdensome infrastructure reporting requirements for LECS under the optional incentive regulation plan.[118] USTA states that in the price cap proceeding the Commission stated that it was less concerned with collecting infrastructure data from smaller price cap LECs, because "infrastructure monitoring of the largest eight LECS will provide a good indication of the general state of the infrastructure nationwide."[119] USTA contends

[110] The presumption of lawfulness could be overcome with a showing that the rate filed is greater than the nearest price cap LEC's rate, or a persuasive argument that the service is not "like."

[111] It is, of course, possible that a low cost small or mid-sized company could border the territory of a high cost price cap LEC, rendering the new services cap unreasonable. In such a situation, should a optional incentive plan carrier elect to price at the maximum allowed, the complaint process is available to customers to obtain corrective action.

[112] *See LEC Price Cap Order* at 6824.

[113] This case is distinguishable from the concerns raised with respect to AT&T's Tariff 15. In Tariff 15, matching rates were found to be anticompetitive. With small carriers matching rates of the largest LECs, competition, because the small carriers lack market power, competition is enhanced by the addition of a second provider of a service.

[114] NPRM, 7 FCC Rcd at 5026-27.

[115] USTA Comments at 22.

[116] *Id.* at 23; *accord* MCI Reply at 13; ALLTEL Comments at 6; Lincoln Comments at 8; JSI Comments at 8-9; GVNW Comments at 4; ITAG Comments at 7; SBA Comments at 13; *see also* NTCA Comments at 7-8 (discussing service quality of small carriers). *But see* Centel Comments at 9 (objecting to any service quality or infrastructure monitoring).

[117] USTA Comments at 23-24.

[118] USTA Reply at 13.

[119] *Id.* at 14, citing *LEC Price Cap Order*, 5 FCC Rcd at n.479.

that to avoid placing unnecessary burdens on these carriers, and to ensure the widest participation in the incentive plan, the Commission should not adopt new infrastructure reporting requirements.[120]

83. *Discussion*. In the NPRM we sought a balance between our need to monitor infrastructure maintenance and developments, as well as service quality, of carriers participating in any type of incentive regulation and our desire to avoid the imposition of additional regulatory and administrative burden. We believe that the service quality reporting requirements proposed in the NPRM may be reduced, without diminishing the value of the information to the Commission. At the same time, we would be substantially reducing the reporting burden from that proposed in the NPRM. Therefore we will require incentive plan carriers to file the information required on the price cap FCC Form 43-05 service quality reports, on an annual basis.

84. With respect to infrastructure reports, we believe that annual infrastructure reports are preferable to the biennial infrastructure reports proposed in the NPRM. We believe this incentive plan will encourage companies to modernize their networks, resulting in greater efficiency, yielding lower costs and increased demand. In addition, the plan should prompt companies to modernize their networks. Thus, we conclude that it is in the public interest to monitor infrastructure developments annually. We further believe that the requirement of annual reports is not burdensome even for the smaller carriers. Therefore, incentive plan carriers will be required to file our Form 43-07 infrastructure reports each year in the same manner as price cap LECs.

H. Mergers and Acquisitions Under the Incentive Plan

85. *Notice*. The NPRM proposes that optional incentive plan carriers acquiring small, non-incentive plan carriers, would be required to convert the acquired companies to the incentive plan, unless the acquired company is an average schedule company. If the acquired company is an average schedule company, conversion to the incentive plan is optional. The NPRM also proposes that a non-incentive plan carrier acquiring an incentive plan carrier would be required to convert to the incentive plan.[121] This proposal tracks requirements in the price cap plan.

86. *Comments*. ALLTEL argues that the acquisition by an incentive plan carrier of a non-incentive plan carrier or the purchase by a non-incentive plan carrier of an incentive plan carrier, should not trigger any requirement to convert either carrier to a different plan. ALLTEL argues that each company should determine its regulatory methodology based on its unique characteristics.[122] JSI asserts that Section 61.39 and baseline regulated LECs should not be required to convert to the incentive plan if they acquire exchanges from an existing incentive plan LEC.[123] NTCA urges the adoption of a similar rule to that adopted in CC Docket No. 89-2, permitting LECS to retain their pre-transaction pooling status after mergers or acquisitions. NTCA states that those rules require pooling status waivers only where carriers, as the result of an acquisition or merger, would be returning more than 50,000 access lines to pooling status.[124]

87. *Discussion*. We adopt the NPRM's proposed rules addressing mergers and acquisitions involving a carrier subject to incentive regulation. As a point of clarification, if an acquiring company participates in the incentive plan for traffic sensitive rates only, the acquired properties would be converted to the incentive plan for traffic sensitive rates only as well.[125]

88. As NTCA states, in CC Docket No. 89-2, we adopted a rule under which LECs involved in mergers and acquisitions are permitted to retain their pre-transaction pooling status.[126] That rule was adopted in an effort to keep pooling rules neutral with regard to mergers and acquisitions. NTCA urges adoption of a similar rule with regard to acquisitions involving incentive plan carriers. We find that the reasoning for the price cap acquisitions rule is more pertinent to the incentive plan than the pooling rule.[127] The incentives and limitations facing a company that has both incentive plan and non-incentive plan affiliates would be very different from those facing a company that has both pooled and non-pooled affiliates. Companies that are allowed to retain both pooled and non-pooled affiliates under the limited exception authorized in the rules adopted in Docket 89-2 are all subject to non-incentive regulation. Thus, there is little incentive to shift costs between pooled and non-pooled affiliates, since all such companies' earnings are subject to the same earnings limits. By contrast, a company with both incentive plan and non-incentive plan affiliates has a significant incentive to shift costs from its incentive plan affiliates to its non-incentive affiliates, since the total dollars these latter companies will earn will be increased as their rate bases increase and they are not restricted to their actual historical costs. This difference justifies requiring the conversion rules described in the NPRM. As with the price cap rules, we will consider granting waiver petitions, on a case-by-case basis, for good cause shown to the mergers and acquisitions rules we herein adopt.

IV. HISTORICAL COST TARIFFS FOR SMALL COMPANIES (SECTION 61.39)

89. Section 61.39 permits small telephone companies to file tariffs for their traffic sensitive rates every two years in lieu of participating in the NECA traffic sensitive pool. The rates are developed from the company's actual historical costs, or historical average schedule settlements. Eligibility is limited to LECs serving 50,000 or fewer access lines, realizing total annual revenues of $40 million or less. In 1991, 39 small companies filed, on a non-pooled basis, traffic sensitive rates under Section 61.39. In this section of this Order we add an additional regulatory

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120 *Id.* at 14-15.
121 NPRM, 7 FCC Rcd at 5030, 5033.
122 ALLTEL Comments at 9-10.
123 JSI Comments at 14-15.
124 NTCA Comments at 15-16; *see also* USTA Reply at 21-22; NECA Reply at 11-12.
125 SBA's suggestion, that we permit baseline carriers to merge without FCC approval, is beyond the scope of this proceeding.
126 Amendment of Part 69 of the Commission's Rules Relating to the Common Line Pool Status of Local Exchange carriers Involved in Mergers or Acquisitions, CC Docket No. 89-2, 5 FCC Rcd 231 (1989).
127 *See LEC Price Cap Order* at 6821.

option for some small companies by expanding these rules to provide for similar regulatory treatment of common line rates.

Expansion to Common Line

90. *Notice.* The NPRM proposed extending existing Section 61.39 rules to include common line tariffs. Common line rates would be based on historical costs (or the most recent average schedule settlements) and apply historical demand growth. Cost support would not be filed with the transmittal, except, cost support for SLC calculations. The NPRM tentatively applies the same common line formula for Section 61.39 carriers as is used for optional incentive plan carriers. Commission staff and LEC customers would be eligible to make reasonable requests for cost support data. Eligible companies could file either traffic sensitive rates or traffic sensitive and common line rates under Section 61.39.[128]

91. *Comments.* The LEC industry generally supports the Commission's proposal to extend the Section 61.39 filing option to include common line rates.[129] Taconic states that its participation in Section 61.39 regulation for its traffic sensitive rates has been a positive experience for the company and beneficial to its customers.[130] NTCA states that the current traffic sensitive option has not threatened pooling arrangements or the use of average schedules and, therefore, extending the option also should not introduce any substantial public interest detriments.[131]

92. With respect to the treatment of common line, USTA urges that we adopt a carrier common line demand adjustment formula identical to the formula it proposes for the optional incentive plan.[132] Similarly, ITAG offers a slightly different formula intended to split the benefits of demand growth between LECs and their interstate customers.[133] JSI asks that LECs be permitted to file end user rates under Section 61.39, but remain in the common line and traffic sensitive pools.[134] JSI asserts that the option of filing end user access charges while remaining in the common line pool exists today; however, such rates must comply with Section 61.38.[135]

93. Commenters also raise various other issues. Taconic urges that we apply the new services rules for incentive plan regulation to carriers filing under Section 61.39. Taconic argues that the new service rules should be modified to permit a Section 61.39 carrier to match the rate of any price cap LEC in the country. In addition, Taconic argues that having to perform subsequent historical cost studies to validate pricing for new services that only generate *de minimis* revenues would be overly burdensome and inefficient.[136] JSI asserts that the Commission should expand Section 61.39 to permit new service offerings to be treated as *prima facie* lawful and filed on 14 days' notice, subject to the two percent *de minimis* rule proposed for the incentive plan.[137] USTA asks that the Commission clarify that a reasonable request by an interexchange carrier to review a Section 61.39 carrier's cost support data must be made during the applicable tariff review period.[138] Taconic asks that the Commission permit carriers the flexibility to return to either or both NECA pools since the impact of competition, state-mandated rulings, and technological changes standards are unforeseeable and substantially increase risks to smaller carriers.[139]

94. *Discussion.* Commenting parties argue that the application of Section 61.39 to traffic sensitive rates has been a success. Our own review of the rates filed pursuant to Section 61.39 in comparison with those rate filed by NECA and other carriers using traditional rate of return principles demonstrates the success of these rules. As we stated in the NPRM, Section 61.39 rates have been consistently lower than NECA rates for traffic sensitive rate elements. We also find that the rates filed by companies using Section 61.39 have been compensatory. We therefore expand Section 61.39 to include common line rate elements.

95. We adopt the treatment of subscriber line charges as proposed in the NPRM. We also adopt the same demand growth adjustment formula as for the optional incentive plan discussed in Section III. D. 3 above. Like the optional incentive plan, these small company rules present a two-year tariff period, based on historical costs, and the concept of a regulatory lag. We also include the same streamlined new services approach. Commenters have offered no compelling reason to provide a demand growth formula different from that of the optional incentive plan. We believe this formula strikes the best balance between simplicity of administration and fairness to companies and customers. As requested by Taconic, mid-course corrections will be evaluated on a case-by-case basis; and, NECA is directed to file terms and conditions for the common line tariffs under Section 61.39. We will consider carriers' petitions for waiver of applicable rules to permit them to return to NECA pools using the same principles we have in the past.

96. In addition, we also adopt the new services rules applicable to the incentive plan for Section 61.39 carriers. Our commitment to the expeditious deployment of new services is equally strong for the smallest carriers as for the larger LECs, and we believe that the lower regulatory burdens and optional regulatory flexibility are necessary to ensure the smallest LECs have an opportunity to make a competitive response to other new service offerings.[140]

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128 NPRM, 7 FCC Rcd at 5028.

129 USTA Comments at 35. *See also* Taconic Comments at 3; GVNW Comments at 5 (arguing that the LEC should retain the option of returning to NECA pools on an annual basis).

130 Taconic Comments at 3.

131 NTCA Comments at 11.

132 USTA Comments at 36. *See also* GVNW Comments at 5.

133 ITAG Comments at 8-10. ITAG's proposal requires that we select both an inflation adjustment and a productivity offset factor, similar to our price cap plan. However, ITAG argues that the price cap values established for the productivity offset factor are too high to apply in this context.

134 JSI Comments at 11.

135 *Id.* at n.19.

136 Taconic Comments at 5-6 (requesting that common line mid-course filings be evaluated on a case-by-case basis).

137 JSI Comments at 11-13.

138 USTA Comments at 37.

139 Taconic Comments at 4.

140 As a point of clarification, we point out that LECs filing tariffs pursuant to Section 61.39 may lower rates below those derived from historical costs as long as the rates can be shown to be cost-based.

We decline to adopt modifications suggested by the parties for the same reasons we refused to adopt them for the incentive plan carriers.

V. BASELINE RATE OF RETURN REGULATION (SECTION 61.38 AND PART 69)

97. Current rules generally require carriers subject to rate of return regulation, including NECA filing on behalf of carriers participating in either the common line or traffic sensitive pools, to file tariffs with the Commission every year.[141] Supporting information required with annual tariff filings includes: a cost of service study for the previous year; a study of projected costs for the tariff period; and estimates of the effect of proposed tariff changes on traffic and revenues.[142] The specific data formats for the supporting information are detailed in a Tariff Review Plan (TRP), which is released by the Common Carrier Bureau each year.[143] The level of cost, demand, and revenue data required by the TRP varies, with greater detail demanded of the larger carriers. The TRP divides companies into three groups -- Tier 1, Tier 2A, and Tier 2B -- for purposes of establishing different levels of cost support data that must be filed as well as reflecting different regulatory requirements applicable to different classes of carriers.[144] The NPRM and this Order refer to these existing rate of return requirements as the "baseline" requirements for rate of return carriers. Pursuant to this Order, baseline regulation is applicable to NECA and individual companies or groups of companies that choose not to participate in the NECA pools and choose not to elect one of the other two alternative regulatory options. The rules and level of detail carriers are required to file in annual tariff filings will be substantially the same as those that were applied to all LECs prior to the implementation of price caps.[145]

98. While we believe it is important to offer small and mid-size LECs the opportunity to continue to file rates pursuant to existing rate of return regulation, due in large measure to the diversity of this group, we believe some simplification can be introduced that will not substantially alter the *status quo*, particularly for those carriers that participate in the NECA pools. Therefore, we amend our rules to require baseline tariff filings every two years, except for NECA. This action does not prevent a carrier from filing more frequently, but merely provides the opportunity to file tariffs less frequently if the carrier chooses. We continue to require NECA to file annual tariffs for the reasons stated below.

A. Frequency of tariff filings

99. *Notice.* The NPRM proposed that carriers filing tariffs under Section 61.38 may file only every two years.

100. *Comments.* USTA supports the biennial tariff filing proposal as long as baseline carriers retain the option of filing more frequently. USTA asserts that the ability to make mid-course adjustments when appropriate must be retained.[146] The SBA concurs with the Commission's finding that biennial filings will not impede our statutory mission.[147] AT&T also states that annual filings are not necessary for the small LECs remaining under baseline regulation, and that biennial filings will reduce administrative costs for both the Commission and all other interested parties.[148]

101. NECA asserts that it must have the ability to file annual tariff filings.[149] Supporting its contention that biennial filings would be inequitable, NECA states that based on its current view of 1990-1991 cost and demand, if NECA had used 1989 as the base year, it would have experienced a revenue shortfall of $31 million and pool earnings approximately 125 basis points below authorized (10.01 percent) would have resulted.[150] NECA adds that the Commission has no statutory obligation to prescribe tariff intervals, and in doing so, may well cause carriers to underearn.[151]

102. *Discussion.* The purpose underlying our proposal to require baseline tariff filings every two years instead of annually was that biennial filings would still permit us to meet our statutory obligations to assure that rates are reasonable while substantially reducing administrative burdens on companies. At the same time, we would not be precluding a carrier subject to baseline regulation from filing more frequently. Because biennial filings are considered an option, annual filings made by baseline carriers would not be considered mid-course filings. Therefore, we adopt biennial filing requirements for baseline carriers, except for NECA. Because NECA administers pools for a large number of small carriers, projecting costs and demand for greater than one-year periods is difficult. We believe, at this time, requiring NECA to file information projecting data for two years would be unnecessarily complex. Therefore, NECA will continue to be required to file tariffs annually.

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141 47 C.F.R. § 69.3. As discussed above, current rules provide that small companies, serving 50,000 access lines or fewer, that qualify as NECA subset 3 carriers (annual operating revenues of $40 million or less), may opt to file traffic sensitive rates every other year. 47 C.F.R. § 69.3(f).

142 47 C.F.R. § 61.38(b).

143 *See, e.g.*, Commission Requirements for Cost Support Material To Be Filed with 1992 Annual Access Tariffs, 7 FCC Rcd 1477 (1992)(*TRP Order)*.

144 *Id.* at 1478.

145 This level of detail was deemed necessary for the Commission to review adequately tariff proposals of the largest carriers, when all LECs were subject to the same form of regulation and all participated in the common line pool administered by NECA. As already noted, approximately 94 percent of the LEC industry (access lines, revenues and minutes of use) is now subject to price cap regulation and all pooling is optional.

146 USTA Comments at 34. *See also* ALLTEL Comments at 8; Lincoln Comments at 8.

147 SBA Comments at 19.

148 AT&T Comments at 9.

149 NECA Comments at 3.

150 NECA notes that, if a purely historical approach had been substituted for a prospective methodology, it would have experienced an earnings shortfall of $29 million. NECA states that it has performed additional analysis on the data underlying its currently effective rates, using various models for trending historical data to produce test period revenue requirements and demand. NECA states that each analysis based on historical data demonstrated that it would have experienced significant revenue shortfalls and underearnings with the biennial filing requirement. NECA Comments at n.14.

151 NECA Reply at 6-7.

B. Historical Versus Prospective Costs

103. *Notice.* The NPRM suggested that simple extrapolations of historical costs would be less burdensome than the type of projections now used.

104. *Comments.* NECA argues that it must retain the ability to base rates on prospective costs.[152] NECA does agree that the use of historical data and trends to determine what prospective costs and demand will be is important. NECA disagrees, however, that historical data should be required as the sole basis for establishing compensatory prospective rates. NECA argues that an important component of ratemaking is consideration of current factors such as technological advances and FCC rule changes.[153] NECA also asserts that a shift to historical costs requires complex rule changes, which are beyond the scope of this docket.[154] USTA also argues that reliance on historical costs and/or simple extrapolations will not permit baseline LECs and NECA to fully account for future cost-intensive events, such as conversion to SS7 and 800 database implementation, state infrastructure requirements, and changes to the North American numbering plan.[155] USTA further argues that use of historical costs and demand under baseline regulation might bias long-term earnings results to the detriment of rate-of-return carriers.[156] Other carriers argue strongly that use of an historical-only cost support approach should be optional.[157]

105. AT&T and MCI support the Commission's proposal that small and mid-size rate-of-return LECs file projected costs and demand data "developed as simple extrapolations of historical costs and demand."[158] AT&T asserts that historical data are ascertainable and verifiable, and basing projections on extrapolations of historical trends is a straightforward and consistent forecasting methodology. AT&T states that this method would reduce filing burdens of companies and simplify the overall tariff filing process.[159]

106. *Discussion.* Based on the record before us, we are not prepared at this time to introduce substantial reform into the baseline process. Most comments addressing baseline reform came from small LECs opposing reform. No sufficient record was established refuting this opposition or supporting any clear direction for baseline reform. Further, such reform would radically alter the optional nature of other regulatory programs established in this proceeding. Finally, a number of proceedings remain open which, to varying degrees, address fundamental aspects of baseline regulation. For example, the Commission recently adopted a Notice of Proposed Rulemaking to establish safeguards to improve the administration of the interstate access tariff and revenue distribution processes.[160] In addition, NECA's most recent revision to its Universal Service Fund rates are under investigation.[161] While these other proceedings are pending, NECA has not been forthcoming with workable proposals for reform and has argued strongly against those proffered in the NPRM. We believe that a greater reliance on historical costs remains a worthy objective and should be a basis of future discussions.[162]

C. Treatment of New Services and Pricing Flexibility

107. *Notice.* The NPRM proposed streamlined treatment for new services similar to that proposed for the optional incentive regulation plan.[163] The NPRM did not propose to give baseline rate of return carriers added pricing flexibility.

108. *Comments.* NECA contends that because it is difficult for small companies and NECA to develop new service rates under the current rules in a timely manner, efforts to simplify the introduction of new services would benefit NECA companies. NECA argues that the streamlined procedures for new services should include a presumption of lawfulness for new services projecting revenues of less than 2 percent of the combined common line and traffic sensitive pools' total interstate access revenue requirement. NECA also asks that the Commission authorize NECA to set its pool rates for new services at a level not to exceed the highest filed price cap carrier rate in the country.[164] Asserting that small and mid-size company rates are typically much higher than those of price cap carriers, NECA asks that the Commission also permit NECA the option of filing new service rates based on a ratio of price cap element to subelement rates, as long as the rate meets the *de minimis* level of revenues standard.[165]

109. MCI maintains that the rates for a new service should be determined using total service long run in-

[152] NECA Comments at 5-9.

[153] NECA Reply at 5 (also arguing that the administrative savings of a purely historical approach have not been calculated based on existing tariff filing requirements).

[154] NECA Comments at 6-9 (citing the annual certification of average schedule carriers and the pool notification rules as two rules that would have to be changed).

[155] USTA Comments at 31-32 (arguing that the Commission should focus instead on simplifying its tariff review plan requirements). *See also* NECA Comments at 6-9.

[156] USTA Comments at 32-35 (arguing that a LEC under baseline regulation should be permitted to earn up to 100 basis points above the authorized rate of return before its rates are considered to be unreasonable).

[157] ALLTEL Comments at 8; Lincoln Comments at 9; JSI Comments at 13-14; SBA Comments at 21.

[158] AT&T Comments at 9; MCI Reply at 13.

[159] *Id.*

[160] Safeguards to Improve the Administration of the Interstate Access Tariff and Revenue Distribution Processes, CC Docket no. 93-6, RM 7736, released February 11, 1993.

[161] National Exchange Carrier Association, FCC Tariff No. 5, Transmittal No. 518.

[162] While simplification of our tariff review plan is a goal we share with the industry, the recommendations made by USTA and NECA are beyond the scope of this proceeding. *See* NECA Comments at 8-9 (recommending elimination of most TRP reports); *see also* USTA Comments at 30-31.

[163] NPRM, 7 FCC Rcd at 5029-30.

[164] NECA Comments at 9-10. *See also* NTCA Comments at 12; Lincoln Comments at 9; JSI Comments at 13; *but see* SBA Comments at 23 (allow new service rates to be based on a like service of any similarly-situated carrier, regardless of the type of regulation used to file the rate being used); NECA Reply at 9-10 (presenting a national average ratio approach comparing average price cap rates to subelement rates as the test of whether a new service should be streamlined).

[165] *See* NTCA Comments at 3 (arguing for more fundamental deregulation of small companies).

cremental cost prospective forecasting.[166] According to MCI, a rate of return LEC must not be given a choice of alternative methods by which to calculate different rates it charges.[167]

110. With respect to pricing flexibility, NECA proposes that traditional rate of return carriers should be permitted the option to change rates by 5 percent up or down during the tariff period.[168] NECA proposes that these filings should be made on 14 days' notice with a presumption of lawfulness provided that a showing of revenue neutrality on a prospective basis is included in the filing. NECA also recommends that rate relationships established through the use of this pricing flexibility should be permitted to continue into subsequent tariff periods. Under this NECA proposal, the option could be exercised if it results in no cumulative revenue impact based on prospective test period demand as measured within either the traffic sensitive-switched or traffic sensitive-special access rate groupings. NECA notes that it is not proposing pricing flexibility for common line or end user rate elements. NTCA asserts that the pricing flexibility components of the optional incentive regulation plan should be extended to the rest of the non-price cap industry.

111. The ICC argues that the NECA and OPASTCO proposals appear to provide artificial incentives to encourage additional pooling. According to ICC, LECs that wish greater flexibility in pricing must be willing to bear some risk by ensuring ratepayers that they will become more efficient. Bearing greater risk demands exiting the NECA pools.[169]

112. *Discussion.* We concluded above that, with the exception of permitting baseline companies other than NECA to have the option of filing tariffs on a biennial basis, justified by cost and demand support, baseline regulation will remain unchanged. Therefore, no additional risk is being imposed on baseline regulated carriers. Accordingly, it is inappropriate to provide any reward as might be afforded by streamlined treatment of new services or broader earnings bands. In addition, the parties have not justified pricing flexibility at this time, particularly for carriers participating in pools. Companies seeking such flexibility can elect one of the other options we are establishing in this Order.[170]

D. Incentive Regulation and Regulatory Reform within NECA

113. *Notice.* The NPRM sought comment on means of permitting incentive options within the NECA pools.[171]

114. *Comments.* NECA, although not proposing any specific incentive-based options here, proposes a rule revision which would enable the implementation of incentive options within the pool in the future through NECA filing a tariff.[172] NTCA agrees that NECA should be afforded maximum flexibility to design a plan to introduce incentives to become more efficient to the pools.[173]

115. NTCA and NECA assert that more telephone companies should be permitted to receive settlements based on interstate average schedules.[174] However, the ICC opposes greater participation in average schedule costing methodologies. The ICC argues that movement away from the pooling process is the more appropriate form of regulation.[175]

116. *Discussion.* We are not adopting NECA's proposal to permit it to introduce incentive regulation into the pool settlement process by filing a tariff. Important changes in regulatory mechanisms are more properly evaluated in a notice and comment proceeding. However, we encourage NECA to continue to work on reforms to introduce optional incentive plans into the pooling process, which would be considered in the context of a separate proceeding, a waiver petition or a rulemaking.[176] We also find requests to permit cost companies to convert to average schedule status to be beyond the scope of this proceeding.

VI. IMPLEMENTATION SCHEDULE

117. We will schedule implementation of these rules for an effective date of January 1, 1994. We anticipate that the Common Carrier Bureau can implement appropriate mechanisms to meet this schedule, including revisions to the annual Tariff Review Plan.

VII. REGULATORY FLEXIBILITY ANALYSIS AND PAPERWORK REDUCTION

118. *Notice.* The NPRM concludes that the Regulatory Flexibility Act is not applicable to this proceeding based upon the Commission's prior findings that all LECs are dominant.[177]

119. *Comments.* The SBA asserts that the Commission's position represents a constricted view of the Regulatory Flexibility Act; the SBA gives a broader interpretation to the Act. SBA contends that the Regulatory Flexibility Act also permits an agency for purposes of complying with the Act to select a different definition of small business after consultation with the Office of Advocacy of the

[166] MCI notes: In the Matter of transport Rate Structure and pricing, CC Docket No. 91-213, Comments of MCI Telecommunications, November 22, 1991, p. 18.

[167] MCI Comments at 13-14.

[168] NECA Comments at 13-14.

[169] ICC Reply at 7-8.

[170] Some commenters have suggested we increase the buffer zone around baseline carriers earnings to 100 basis points. Centel Comments at 11; NECA Reply at 10. *But see* MCI Reply at 18. This issue is beyond the scope of this proceeding and is more appropriately raised in CC Docket No. 92-133.

[171] NPRM, 7 FCC Rcd at 5030.

[172] NECA Comments at 16. *See also* ALLTEL Comments at 10; GVNW Comments at 6; NTCA Reply at 9-10.

[173] NECA also proposes Part 69 rule changes to reflect the settlement methods in place since 1984 and to remove the inaccurate references to computing hypothetical net balances. NECA states that existing sections 69.608 through 69.610 have never been used for settlement purposes. NECA Comments at 20-21. *See also* NTCA Comments at 13-14. These issues are beyond the scope of this docket.

[174] NTCA Comments at 14; NECA Comments at 16-20; *see also* USTA Reply at 20-21; JSI Reply at 2-3; NTCA Reply at 10-11.

[175] ICC Reply at 8.

[176] Similarly, MCI's suggestion that we consider Universal Service Fund reform is beyond the scope of this docket. *See* MCI Comments at 2-3.

[177] NPRM, 7 FCC Rcd at 5031.

SBA. Nothing in the Act, according to SBA, requires an agency to adopt the definition of a "small entity" provided in Section 3 of the Small Business Act to carry out its statutory mandate. The SBA interprets the Act to give the FCC sufficient discretion to adopt one size standard for regulatory purposes and another for compliance with the analytical requirements of the Act. Therefore, SBA asserts, the Commission can analyze the impact of these rules while maintaining its distinction between dominant and non-dominant common carriers.[178] SBA continues, that even if the Commission asserts that such dual standards are unworkable, SBA disagrees with the conclusion that small LECs are dominant. SBA states that the Commission argues that small LECs are monopoly providers of telecommunication services and by definition dominant; yet, the Commission scatters throughout the NPRM references to the competition faced by smaller LECs. The SBA states that Commission precedent exists for disparate regulatory treatment of different portion of an individual carrier's service.[179]

120. *Discussion.* We certify that the Regulatory Flexibility Act[180] is not applicable to the rule changes we adopt in this proceeding. Thus, this Commission is not required by the terms of that Act to apply the formal procedures set forth therein. Accordingly, we reject the assertions of SBA to the contrary.

121. As part of our analysis of the regulation adopted in this Memorandum Opinion and Order, however, this Commission has considered the impact of the proposal on small telephone companies, *i.e.,* those serving 50,000 or fewer access lines. As a result of our decision to make all of the new regulatory regimes optional, no small carrier will be forced to change the method by which it is regulated. All support and subsidy mechanisms, such as our High Cost Fund and long term support mechanism, remain in effect. The average schedule status of companies is not challenged. These rules permit greater flexibility and introduce the potential rewards of incentive regulation on an optional basis, while essentially preserving the *status quo* for companies that do not deem it appropriate to change.

122. Public reporting burden for this collection of service quality and infrastructure reporting information is estimated to average 833 hours per service quality response, and 10 hours per infrastructure response.

VIII. ORDERING CLAUSES

123. Accordingly, IT IS ORDERED that, pursuant to Sections 4(i), 4(j), 201-205, 303(r), and 403 of the Communications Act of 1934, 47 U.S.C. §§ 154(i), 154(j), 201-205, 303(r), 403, Part 61, Part 65, and Part 69, and Sections 61.38, 61.39, 61.50, 61.58, 65/700, and 69.3, ARE AMENDED as set forth in Appendix B to this Order.

124. IT IS FURTHER ORDERED that this Report and Order will be effective thirty days after publication in the Federal Register.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

APPENDIX A

COMMENTERS

ALLTEL Service Corporation (ALLTEL)

American Telephone and Telegraph Company (AT&T)

Central Telephone Company (Centel)

Fred Williamson & Associates, Inc. (FW&A)

GVNW, Inc./Management (GVNW)

Illinois Commerce Commission (ICC)

Independent Telephone Access Group (ITAG)

> The members of ITAG are: Champaign Telephone Company, Chillicothe Telephone Company, Chouteau Telephone Company, Granite State Telephone Company, Inc., Mashell Telephone Company, Inc., Millry Telephone Company, Inc., Northern Arkansas Telephone Company, Inc., Pigeon Telephone Company, Totah Telephone Company, Waitsfield-Fayston Telephone Company, Inc., and Western New Mexico Telephone Company.

John Staurulakis, Inc. (JSI)

Lincoln Telephone and Telegraph Company (Lincoln)

MCI Telecommunications Corporation (MCI)

National Exchange Carrier Association (NECA)

National Telephone Cooperative Association (NTCA)

National Association of Regulatory Utility Commissioners (NARUC)

Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO)

PTI Communications (PTIC)

Puerto Rico Telephone Company (PRTC)

Ronan Telephone Company (Ronan)

Taconic Telephone Corp. (Taconic)

Tallon, Cheeseman and Associates, Inc. (TCA)

U.S. Small Business Administration (SBA)

United States Telephone Association (USTA)

The following filed reply comments in support of Comments filed by GVNW:

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178 SBA Comments at 25-26.

179 SBA Comments at 25-27.

180 Because of the nature of local exchange and access service, this Commission has concluded that small telephone companies are dominant in their fields of operation and therefore are not small entities as defined by the Regulatory Flexibility Act. *See* MTS and WATS Market Structure, 93 FCC 2d 241, 338-39 (1983).

Arnold Reinhold, Cambridge Tel. Co., Canby Tel. Assn., Citizens Tel. Co., Concord Tel. Co., Cordova Tel. Co., Dell Tel. Coop., Emery Tel. Co., Farmers Mutual Tel. Co., Home Tel. Co., Manti Tel. Co., McDaniel Tel. Co., Plains Cooperative Tel. Co., Roggen Tel. Coop., Siskiyou Tel. Co., South Central Tel. Co., and Western River Tel. Co.

APPENDIX B

AMENDMENTS TO THE CODE OF FEDERAL REGULATIONS

Title 47 of the CFR, Parts 61, 65, and 69 are amended as follows:

PART 61 -- TARIFFS

1. The authority citation for Part 61 continues to read as follows:

AUTHORITY: Sec. 4, 48 Stat. 1066, as amended; 47 U.S.C. 154. Interpret or apply Sec. 203, 48 Stat. 1070; 47 U.S.C. 203.

2. Section 61.3 is amended by revising paragraph (e) to read as follows:

§ 61.3 Definitions.

* * * * *

(e) *Base period.* For carriers subject to §§ 61.41-49, the 12-month period ending six months prior to the effective date of annual price cap tariffs, or for carriers regulated under § 61.50, the 24-month period ending six months prior to the effective date of biennial optional incentive plan tariffs.

* * * * *

3. Section 61.38 is amended by revising paragraph (a) to read as follows:

§ 61.38 Supporting Information to be submitted with letters of transmittal.

(a) *Scope.* This Section applies to dominant carriers whose gross annual revenue exceed $500,000 for the most recent 12 month period of operations or are estimated to exceed $500,000 for a representative 12 month period. Local exchange carriers serving 50,000 or fewer access lines in a given study area that are described as subset 3 carriers in § 69.602 of this chapter may submit Access Tariff filings for that study area pursuant to either this section or § 61.39. However, the Commission may require any carrier to submit such information as may be necessary for a review of a tariff filing. This section (other than the preceding sentence of this paragraph) shall not apply to tariff filings proposing rates for services identified in §§ 61.42 (a), (b), (d), (e), and (g), promotional offerings that relate to services subject to price cap regulation, tariff filings proposing rates for services identified in §61.50, or to tariff filings, other than promotional filings, filed on 14 days' notice pursuant to § 61.58(c)(6).

* * * * *

4. Section 61.39 is amended by revising paragraphs (a) and (b), and adding a new paragraphs (c) and (d) to read as follows:

§ 61.39 Optional supporting information to be submitted with letters of transmittal for Access Tariff filings effective on or after April 1, 1989, by local exchange carriers serving 50,000 or fewer access lines in a given study area that are described as subset 3 carriers in Sec. 69.602.

(a) *Scope.* This Section provides for an optional method of filing for any local exchange carrier that is described as subset 3 carrier in § 69.602, which elects to issue its own Access Tariff for a period commencing on or after April 1, 1989, and which serves 50,000 or fewer access lines in a study area as determined under § 36.611(a)(8) of the Commission's Rules. However, the Commission may require any carrier to submit such information as may be necessary for review of a tariff filing. This section (other than the preceding sentence of this paragraph) shall not apply to tariff filings proposing rates for services identified in § 61.42(d), (e), and (g), which filings are submitted by carriers subject to price cap regulation, or to tariff filings proposing rates for services identified in § 61.50, which filings are submitted by carriers subject to optional incentive regulation.

(b) *Explanation and data supporting tariff changes.* The material to be submitted for either a tariff change or a new tariff which affects rates or charges must include an explanation of the filing in the transmittal as required by § 61.33. The basis for ratemaking must comply with the following requirements. Except as provided in paragraph (b)(5) of this section, it is not necessary to submit this supporting data at the time of filing. However, the local exchange carrier should be prepared to submit the data promptly upon reasonable request by the Commission or interested parties.

(1) For a tariff change, the local exchange carrier that is a cost schedule carrier must propose Traffic Sensitive rates based on the following:

(i) For the first period, a cost of service study for Traffic Sensitive elements for the most recent 12 month period with related demand for the same period.

(ii) For subsequent filings, a cost of service study for Traffic Sensitive elements for the total period since the local exchange carrier's last annual filing, with related demand for the same period.

(2) For a tariff change, the local exchange company that is an average schedule carrier must propose Traffic Sensitive rates based on the following:

(i) For the first period, the local exchange carrier's most recent annual Traffic Sensitive settlement from the National Exchange Carrier Association pool.

(ii) For subsequent filings, an amount calculated to reflect the Traffic Sensitive average schedule pool settlement the carrier would have received if the carrier had continued to participate, based upon the most recent average schedule formulas approved by the Commission.

(3) For a tariff change, the local exchange carrier that is a cost schedule carrier must propose Common Line rates based on the following:

(i) For the first period the Carrier Common Line revenue requirement shall be determined by a cost of service study for the most recent 12 month period. The Carrier Common Line revenue requirement shall be divided by a factor equal to the demand over the preceding 12-month period, multiplied by the ratio of Carrier Common Line minutes of use during the most recent 12-month period over Carrier Common Line minutes of use in the preceding 12-month period.

(ii) For subsequent filings, the Carrier Common Line revenue requirement shall be determined by a cost of service study for the total period since the carrier's last biennial access filing. The Carrier Common Line revenue requirement determined in this manner shall be divided by a factor equal to the demand over the preceding 12-month period, multiplied by the ratio of Carrier Common Line minutes of use during the most recent 12-month period over Carrier Common Line minutes of use in the preceding 12-month period.

(4) For a tariff change, the local exchange carrier which is an average schedule carrier must propose common line rates based on the following:

(i) For the first period, the local exchange carrier's most recent annual Common Line settlement from the National Exchange Carrier Association that is conclusively binding upon the carrier and the Association. This carrier common line settlement amount shall be divided by a factor equal to the demand over the preceding 12-month period, multiplied by the ratio of Carrier Common Line minutes of use during the most recent 12-month period over Carrier Common Line minutes of use in the preceding 12-month period.

(ii) For subsequent filings, an amount calculated to reflect the average schedule pools settlement the carrier would have received if the carrier had continued to participate, based upon the most recent average schedule Common Line formulas approved by the Commission. This amount shall be divided by a factor equal to the demand over the preceding 12-month period, multiplied by the ratio of Carrier Common Line minutes of use during the most recent 12-month period over Carrier Common Line minutes of use in the preceding 12-month period.

(5) For End User Common Line charges included in a tariff pursuant to this Section, the local exchange carrier must provide supporting information for the two-year historical period with its letter of transmittal in accordance with §61.38.

* * * * *

(d) Rates for a new service that is the same as that offered by a price cap regulated local exchange carrier providing service in an adjacent serving area are deemed presumptively lawful, if the proposed rates, in the aggregate, are no greater than the rates established by the price cap local exchange carrier. Tariff filings made pursuant to this paragraph must include the following:

(1) A brief explanation of why the service is like an existing service offered by a geographically adjacent price cap regulated local exchange carrier; and

(2) Data to establish compliance with this subsection that, in aggregate, the proposed rates for the new service are no greater than those in effect for the same or comparable service offered by that same geographically adjacent price cap regulated local exchange carrier. Compliance may be shown through submission of applicable tariff pages of the adjacent carrier; a showing that the serving areas are adjacent; any necessary explanations and work sheets.

(e) Average schedule companies filing pursuant to this Section shall retain their status as average schedule companies.

* * * * *

5. Section 61.45 is amended by revising paragraph (d)(2) to read as follows:

* * * * *

(d) (2) Local exchange carriers specified in § 61.41(a)(2) or (a)(3) shall also make such temporary exogenous cost changes as may be necessary to reduce PCIs to give full effect to any sharing of base period earnings required by the sharing mechanism set forth in the Commission's Second Report and Order in Common carrier Docket No. 87-313, FCC 90-314, sdopted September 19, 1990. Such exogenous cost changes shall include interest, computed at the prescribed rate of return, from the day after the end of the period giving rise to the adjustment, to the midpoint of the period when the adjustment is in effect.

* * * * *

6. Section 61.50 is added to read as follows:

§ 61.50 *Scope*. Optional incentive regulation for rate of return local exchange carriers.

(a) This section shall apply on an elective basis, to local exchange carriers for either traffic sensitive rates only or for both traffic sensitive and common line rates. Carriers electing the plan for traffic sensitive rates only must participate in the Association common line pool. Affiliation with average schedule companies shall not bar a carrier from electing optional incentive regulation provided the carrier is otherwise eligible.

(b) If a telephone company, or any one of a group of affiliated telephone companies, files an optional incentive regulation tariff in one study area, that telephone company and its affiliates, except its average schedule affiliates, must file incentive plan tariffs in all their study areas.

(c) The following rules apply to telephone companies subject to this section, that become involved in mergers, acquisitions, or similar transactions, except that mergers with, acquisitions by, or other similar transactions with companies subject to price cap regulation, as that term is defined in § 61.3(w), shall be governed by § 61.41(c).

(1) Any telephone company subject to this section that is a party to a merger, acquisition, or similar transaction, shall continue to be subject to incentive regulation notwithstanding such transaction.

(2) Where a telephone company subject to this section acquires, is acquired by, merged with, or otherwise becomes affiliated with a telephone company that is not subject to this section, the latter telephone company shall become subject to optional incentive plan regulation no later than one year following the effective date of such merger, acquisition, or similar transaction and shall accordingly file optional incentive plan tariffs to be effective no later than that date in accordance with the applicable provisions of this Part 61.

(3) Notwithstanding the provisions of paragraph (c) (2) of this section, when a telephone company subject to optional incentive plan regulation acquires, is acquired by, mergers with, or otherwise becomes affiliated with a telephone company that qualifies as an "average schedule" company, the latter company may retain its "average schedule" status or become subject to optional incentive plan regulations in accordance with § 69.3(i)(3) of this chapter and the requirements referenced in that section.

(d) Local exchange carriers that are subject to this section shall not withdraw from optional incentive regulation until the end of two, two-year tariff periods. If a local exchange carrier withdraws from optional incentive plan regulation, it must file company-specific tariffs under the provisions of § 61.38 for four years before it may again elect to enter incentive plan regulation; such carrier may not participate in the applicable Association tariff during that four years. After the four year period, the carrier may either return to the incentive plan, or remain under § 61.38 regulation.

(e) Each local exchange carrier subject to this section shall establish the baskets of services, including service categories, as identified in § 61.42 (d) and (e).

(f) Each local exchange carrier subject to optional incentive regulation shall exclude from its baskets such services or portions of such services as the Commission has designated or may hereafter designate by order.

(g) New services, other than those within the scope of paragraph (f) of this section, must be included in the affected basket at the first two-year tariff filing following completion of the two-year tariff period in which they are introduced. To the extent that such new services are permitted or required to be included in new or existing service categories within the assigned basket, they shall be so included at the first two-year tariff filing following completion of the two-year tariff period in which they are introduced.

(h)(1) Except as provided in paragraph (c)(4) of this section, in connection with any optional incentive plan tariff filings proposing rate changes, the carrier must calculate an index for each affected basket as determined by the Common Carrier Bureau.

(2) In connection with any tariff filed under this section proposing changes to rates for services in the basket designated in paragraph (e) of this section, the maximum allowable increase or decrease in a basket shall be limited to ten percent over the two-year tariff period.

(i) Rates for a new service that is the same as that offered by a price cap regulated local exchange carrier providing service in an adjacent serving area are deemed presumptively lawful, if the proposed rates, in the aggregate, are no greater than the rate established by the price cap local exchange carrier. Tariff filings made pursuant to this paragraph must include the following:

(1) A brief explanation of why the service is like an existing service offered by a geographically adjacent price cap regulated local exchange carrier; and

(2) Data to establish compliance with this subsection that, in aggregate, the proposed rates for the new service are no greater than those in effect for the same or comparable service offered by that same geographically adjacent price cap regulated local exchange carrier.

(j) The maximum allowable rate of return on earnings based on rates filed by a local exchange carrier subject to this section, shall be determined by adding a fixed increment of one and one-half percent to the carrier's prescribed rate of return. Rates of local exchange carriers subject to this section that result in earnings less than three-quarters percent below the carrier's prescribed rate of return may be retargeted to three-quarters percent below the carrier's prescribed rate of return, in a mid-course tariff filing.

(k) Local exchange carriers filing common line rates under this section must propose Carrier Common Line rates based on the following:

(1) For the first period the Carrier Common Line revenue requirement shall be determined by a cost of service study for the most recent 12 month period. The Carrier Common Line revenue requirement shall be divided by a factor equal to the demand over the preceding 12-month period, multiplied by the ratio of Carrier Common Line minutes of use during the most recent 12-month period over Carrier Common Line minutes of use in the preceding 12-month period.

(2) For subsequent filings, the Carrier Common Line revenue requirement shall be determined by a cost of service study for the total period since the carrier's last biennial access filing. The Carrier Common Line revenue requirement determined in this manner shall be divided by a factor equal to the demand over the preceding 12-month period, multiplied by the ratio of Carrier Common Line minutes of use during the most recent 12-month period over Carrier Common Line minutes of use in the preceding 12-month period.

7. Section 61.58 is amended by adding new paragraph (e) to read as follows:

§ 61.58 Notice requirements.

* * * * *

(e) *Carriers subject to optional incentive regulation.* This paragraph applies only to carriers subject to Section 61.50 of this Part. Such carriers must file tariffs according to the following notice periods: H&1 (1) For initial and renewal tariff filings whose effective date coincides with the start of any two-year tariff period as defined in § 69.3(f) of this chapter, filings must be made on not less than 90 days' notice.

(2) For rate revisions made pursuant to § 61.50 (g) and (i), and § 61.39(d), tariff filings must be made on not less than 14 days' notice.

PART 65 -- INTERSTATE RATE OF RETURN PRESCRIPTION AND METHODOLOGIES

1. The Authority citation for Part 65 continues to read as follows:

AUTHORITY: Secs. 4, 201, 202, 203, 205, 218, 403, 48 Stat., 1006, 1072, 1077, 1094, as amended, 47 U.S.C. 154, 201, 202, 203, 205, 218, 403, unless otherwise noted.

2. Section 65.700 is amended by adding a new paragraph (d) to read as follows:

§ 65.700 Determining the maximum allowable rate of return.

* * * * *

(d) The maximum allowable rate of return for rates filed by local exchange carrier subject to § 61.50 shall be determined by adding a fixed increment of one and one-half percent to the carriers prescribed rate of return.

PART 69 -- ACCESS CHARGES

1. The Authority citation for Part 69 continues to read as follows:

AUTHORITY: Secs. 4, 201, 202, 203, 205, 218, 403, 48 Stat, 1066, 1070, 1072, 1077, 1094, as amended 47 U.S.C. §§ 154, 201, 202, 203, 205, 218, 403, unless otherwise noted.

2. Section 69.3 is amended by revising the first sentence of paragraph (a), revising the first sentence of paragraph (e), and paragraph (i) introductory text, paragraph (i)(1), paragraph (i)(3) and adding a new paragraph (j) to read as follows:

§ 69.3 Filing of access service tariffs.

(a) Except as provided in paragraphs (g) and (h) of this section, a tariff for access service shall be filed with this Commission for a two-year period. * * *

* * * * *

(e) A telephone company or group of telephone companies may file a tariff that is not an association tariff, except that a group rate for non-affiliated telephone companies may not be filed under Section 61.50; *e.g.*, the Association. * * *

* * * * *

(i) The following rules apply to the withdrawal from Association tariffs under the provision of paragraphs (e)(6) or (e)(9) of this section or both by telephone companies electing to file price cap tariffs pursuant to § 69.3(h) or optional incentive plan tariffs pursuant to § 61.50 of this chapter.

(1) In addition to the withdrawal provisions of § 69.3(e)(6) and (9), a telephone company or group of affiliated telephone companies that participates in one or more Association tariffs during the current tariff year and that elects to file price cap tariffs or optional incentive regulation tariffs effective July 1 of the following tariff year, shall give the Association at least 6 months' notice that it is withdrawing from Association tariffs, subject to the terms of this Rule, to participate in price cap regulation or optional incentive regulation.

* * * * *

(3) Notwithstanding the provisions of § 69.3(e)(3), (6), and (9), in the event a telephone company withdraws from all Association tariffs for the purpose of filing price cap tariffs or optional incentive plan tariffs, such company shall exclude from such withdrawal all "average schedule" affiliates and all affiliates so excluded shall be specified in the withdrawal. However, such company may include one or more "average schedule" affiliates in price cap regulation or optional incentive plan regulation provided that each price cap or optional incentive plan affiliate relinquishes "average schedule" status and withdraws from all Association tariffs and any tariff filed pursuant to 61.39(b)(2) of this chapter. *See generally* §§ 69.605(c), 61.39(b) of this chapter; MTS and WATS Market Structure: Average Schedule Companies, Report and Order, 103 FCC 2d 1026-1027 (1986).

* * * * *

(j) A telephone company or group of affiliated telephone companies that participates in an association tariff and elects to file its own tariff pursuant to § 61.50 effective January 1, 1994 shall notify the association not later than September 1, 1993 that it will no longer participate in the association tariff. This January 1, 1994 filing shall be for an 18-month tariff period. A telephone company or group of affiliated telephone companies that participates in an association tariff and elects to file its own tariff pursuant to § 61.50 effective July 1, 1994 or thereafter pursuant to § 69.3(a) shall notify the association not later than December 31 of the preceding year that it will no longer participate in that association tariff.

Concurring Statement of Commissioner Ervin S. Duggan

In Re: Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation (CC Docket 92-135)

I concur in the Commission's decision today to allow an adjustment for growth in demand when calculating the carrier common line formula for small telephone companies choosing the optional incentive regulation plan.

I dissented on this point in the local telephone company price caps proceeding for the following reason: In its 1990 price caps decision, the FCC adopted a formula for calculating the effect of demand growth on the carrier common line rate element.[1] That formula handed local telephone companies half the benefit of the increase in

[1] *Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order* (Docket No. 87-313), 5 FCC Rcd 6786 (1990), *aff'd sub. nom. National Rural Telecommunications Association v. FCC* (D.C. Cir., March 26, 1993).

minutes of use over non-traffic sensitive subscriber lines, and gave the other half to customers. The majority's rationale, which I could not accept, was that local telephone companies are somehow partially responsible for stimulating interstate demand growth over subscriber lines, and that the telephone companies should benefit from that demand growth through an adjustment to the carrier common line formula.[2] I disagreed with the proposition that local telephone companies in fact are able to stimulate interstate demand growth, and so I dissented from the price cap carrier common line formula.[3]

I concur today, despite my problems with the common line formula, because consistency dictates that the Commission give to smaller telephone companies choosing incentive regulation the same treatment it gave the larger companies.

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[2] *Id.*, 5 FCC Rcd at 6793-95.
[3] *Id.*, 5 FCC Rcd at 6859-61.