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AT&T

295 North Maple Avenue
Basking Ridge, NJ 07920

October 28, 1994

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, D.C. 20554

Re: Ex Parte Presentation
CC Docket No. 94-1
Price Cap Performance Review For Local Exchange Carriers

Dear Mr. Caton:

On Thursday, October 27, 1994, Dick Potter and I met with Alex Belinfante, Anthony Bush, and Mark Uretsky of the Common Carrier Bureau in connection with the above referenced docket. At this meeting AT&T presented an updated version of its Direct productivity model (originally included as Appendix B of AT&T's Comments, filed May 9, 1994 and placed on the electronic record in an *ex parte* submission on September 30, 1994). In particular, this update adds 2Q94 ARMIS data to the model and removes some extraneous text that was included in some cells. A diskette displaying the updated 1Q91-2Q94 model is also submitted for the record. The addition of this extra quarter of data changes the results only slightly: demonstrating an achieved X of between 5.62% and 5.76%. Also provided in this electronic submission is a schematic step-by-step example showing how the Direct productivity model works to mimic the operation of the Commission's price cap formulas.

Another matter discussed at this meeting was Table 2 of Pacific Telesis' Reply Comments on this docket, filed June 29, 1994. Pacific characterized this Table as a replication of the methodology used in AT&T's productivity model, and stated that its "replication" generated a productivity offset of 4.28% for Pacific Bell. In an *ex parte* presentation to Commission staff members on September 1, 1994, AT&T cited a very significant error in Pacific's tax gross-up calculations contained in Note 3 of their Table 2.[1] When this arithmetic error in Pacific's Table is corrected, the productivity level that this Table calculates for Pacific Bell rises to about 6%. The Commission staff requested AT&T to discuss this matter with Pacific Telesis and attempt to resolve the source of these differences.

Since that time, AT&T has had several discussions with Pacific Telesis in which we demonstrated to them the error in their Table's tax gross-up formula. While Pacific agreed that the tax gross-up formula was in error, and provided AT&T with the necessary input data to calculate a productivity result using the corrected gross-up

[1] The formula used by Pacific was: (C*11.25%-B)*(.34/(1-.34)) + F. The correct formula (assuming that Pacific's tax rate was actually 34%) is: (C*11.25%-B)*(1/(1-.34)) + F.

methodology, Pacific has declined to agree that the resulting 6% productivity level properly measures Pacific's productivity. While AT&T does not completely agree with the overall methodology that Pacific incorporates in its Table 2 model, it is important to note that when this methodology uses the correct mathematical tax gross-up formula, it produces results entirely consistent with AT&T's more accurate Direct model.

Also at this meeting we discussed the submissions by USTA on Total Factor Productivity and its version of an updated "Frentrup-Uretsky" study. AT&T indicated several reasons why it found these methodologies to be inapposite for calculating LEC productivity according to how such productivity is measured under the Commission's price cap formulas. In addition, AT&T pointed out several very significant errors in the execution of these USTA studies that have biased downwards their projections of LEC X.

Two copies of this Notice and its attachments are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's Rules. Because of the late hour of our meeting, this Notice is being filed on the following day.

Sincerely,

Richard N. Clarke

Richard N. Clarke

Attachments

cc: Alex Belinfante
Anthony Bush
Mark Uretsky

SIMPLIFIED EXAMPLE OF THE OPERATION OF THE DIRECT MODEL

Assumes one basket, one period, no Zs, no sharing, and no under-cap pricing

	Step #	Actual	Step #	@ Test X
Financial (ARMIS) Calculations				
Revenue	1	1000	18	960
Expenses	2	600		600
Taxes	3	150	19	135
Tax Rate	4	37.5%		37.5%
Return	5	250	20	225
Avg. Net Investment (ANI)	6	2000		2000
ROR	7	12.50%	21	11.26%
Return@11.25%	8	225		
Revenue@11.25%	9	960		
Price Cap (TRP) Calculations				
GNPPI	10	4.0%		4.0%
X	11	3.0%	15	7.0%
1 + GNPPI - X	12	1.01	16	0.97
Previous PCI	13	1.00		1.00
PCI	14	1.01	17	0.97

Explanation of Steps

1	Data from ARMIS	15	Introduce possible value for Test X
2	Data from ARMIS	16	= 1 + GNPPI - Test X
3	Data from ARMIS	17	= Previous PCI * (1 + GNPPI - Test X)
4	= Taxes / (Revenue-Expenses)	18	= (Test PCI / Actual PCI) * Actual Revenue
5	= Revenue - Expenses - Taxes	19	= Taxes / (Revenue-Expenses)
6	Data from ARMIS	20	= Revenue - Expenses - Taxes
7	= Return / ANI	21	= Return / ANI
8	= .1125 * ANI		
9	= (Return@11.25% / (1-Tax Rate)) + Expenses		Depending on whether Step 20 produces a Return that
10	Data from TRP		equals Return@11.25%, iterate back to Step 15 and
11	Data from TRP		choose another value for Test X. Continue until Step 20
12	= 1 + GNPPI - Actual X		produces a Return that equals Return@11.25%.
13	Data from TRP (or initialized value)		Achievement of this is verified when Step 21 produces a
14	= Previous PCI * (1 + GNPPI - Actual X)		Test ROR equal to 11.25%.