UNITED STATES
TELEPHONE
ASSOCIATION

May 28, 1996

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street, NW - Room 222
Washington, DC 20554

Ex Parte
CC Docket 94-1
4th FNPRM

Dear Mr. Caton,

On May 28, 1996, Whit Jordan, Jeff Olson, Jeff Pursley and Frank McKennedy, representing the United States Telephone Association (USTA), met with Greg Rosston, Acting Chief Economist of the Common Carrier Bureau and Anthony Bush of the Competitive Pricing Division, of the Common Carrier Bureau.

The purpose of the meeting was to review generally USTA's position in the Price Cap Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1 and to set out the fundamental flaws, errors and misstatements made by MCI, CARE and Ad Hoc regarding selection of a LEC productivity factor.

Enclosed are an original and two copies of this letter and an attached document left with the staff. Please include them in the public record of this proceeding.

Respectfully submitted,

Frank McKennedy
Director-Legal & Regulatory Affairs

attachment

cc: Gregory Rosston
Anthony Bush

What Is Expected from Price Cap Regulation

- Price cap regulation is designed to provide incentives for companies to become more productive through the promise of increased profits.

- Both the original and interim Price Cap plans anticipated that LEC earnings would be greater than 12.25%.

- LEC earnings, after five years of Price Caps, should be greater than 11.25%.

The Effect of the Productivity Components

- The existing productivity components (X-Factor and "g/2") resulted in a $600M reduction in the LEC PCIs.

- This is determined from the average 5.05% X-Factor and the average 1.51% "g/2" applicable to Carrier Common Line -- resulting in a 2.8% reduction in price cap indexes.

  - This is a 5.3% reduction in real terms.

- <u>The productivity components in the current price cap plan are not too low</u>.

- CARE incorrectly links its proposed productivity offset to a perceived accounting earnings "problem" -- based on what it feels a LEC should earn.

Productivity Offset and "g/2" Effects in 1996 Annual Filing

	Common Line	**Traffic Sensitive**	**Trunking**	**TOTAL**
"R" Value	$10.362,451,569	$4,320,332,719	$6,779,586,785	$21,462,371,073
GDP-PI	2.4960%	2.4960%	2.4960%	N/A
X-Factor	5.05%	5.05%	5.05%	N/A
"g/2" Value	1.51%	N/A	N/A	N/A
$ Impact	($314.225.834)	($110.341.298)	($173.150.646)	**(597,717,778)**
% Impact	-3.0%	-2.6%	-2.6%	**-2.8%**

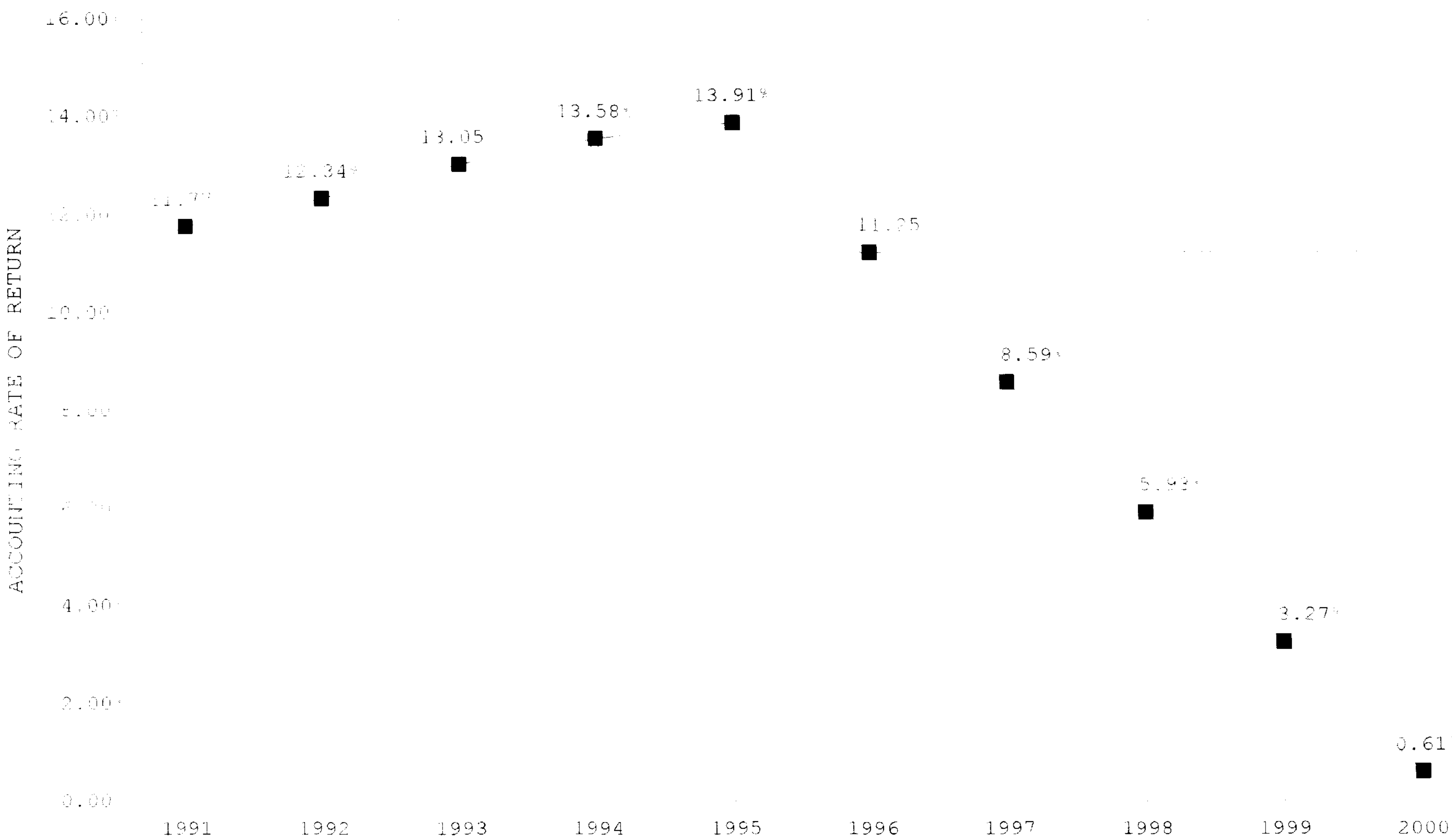
Any Perceived "Problem" with Accounting Earnings Are an Ill Conceived Level Issue, Not an "X-Factor" Issue

- MCI, CARE and Ad Hoc attempt to recapture five years of accounting earnings growth in a single year, using the long-term X-Factor as the vehicle.

- The earnings analyses of MCI, CARE and Ad Hoc are not credible or fundamentally sound studies of LEC productivity. This incorrectly results in their estimates of 8.8% to 10.3% for X-Factor.

- Those studies that advocate higher X-Factors are thinly veiled attempts to drive LEC prices and accounting earnings below reasonable levels.

ACCOUNTING EARNINGS EFFECT OF CARE'S 10% X-FACTOR METHOD



Why Most LECs Did Not Choose the 12.75% ROR Regulation Option

- The current LEC price cap options are not productivity choices but rather sharing choices.

- The choice has been between ROR regulation at 12.75% (the 4.0% X-Factor option) and price caps with no sharing (the 5.3% X-Factor option).

    - The "middle" option (4.7% X-Factor) was never in play.

- This is due to fact that:

    - For no LEC was the price cap option selection (in either the 1995 or the 1996 Annual Filing) a true "test" of productivity.

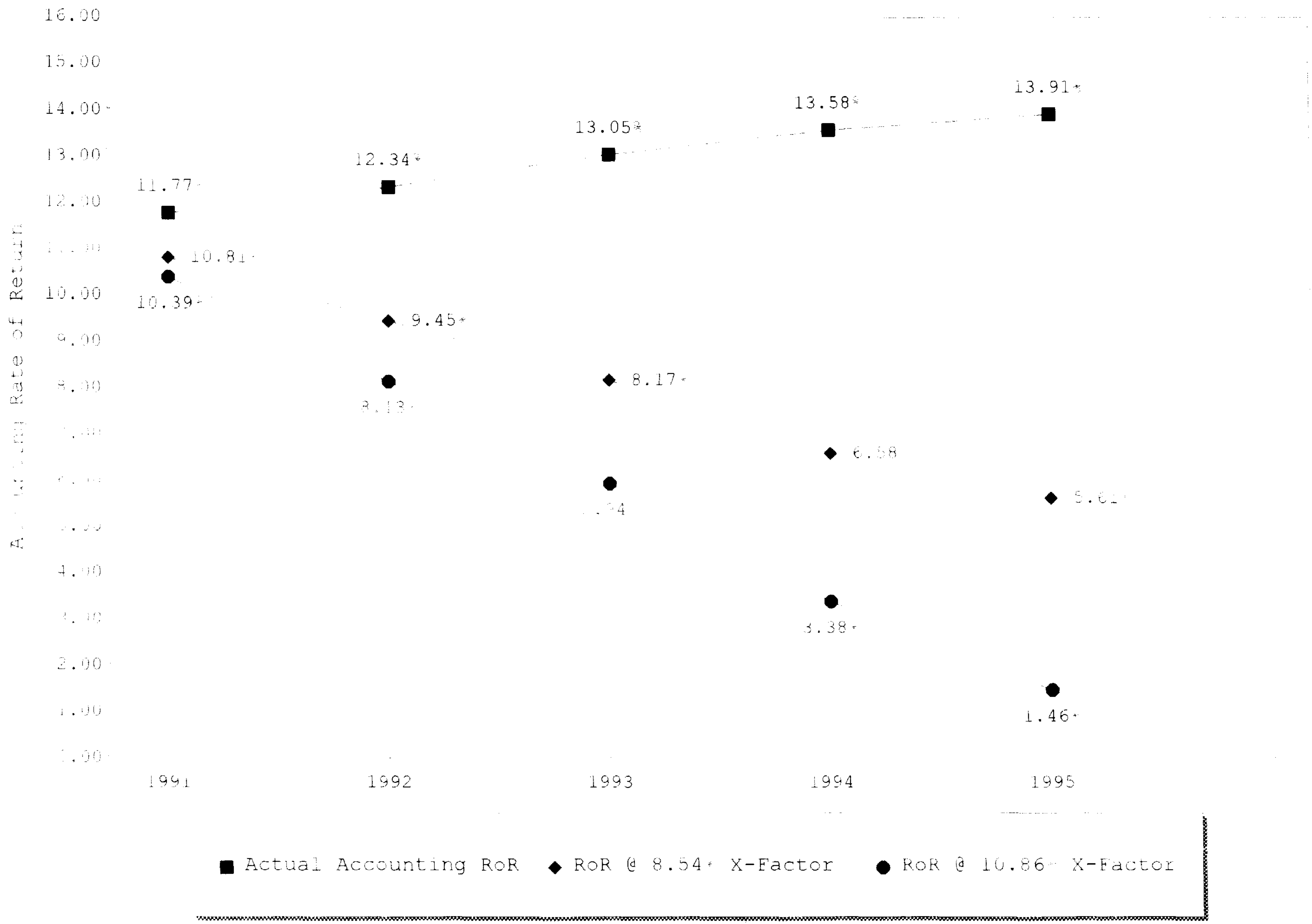
    - Selections were affected by factors completely unrelated to productivity, including: the extent to which study areas were priced below caps; and changes to sharing mechanics (the "add-back" additive); influences from the investment community.

    - Some LECs were able to select the no-sharing option only with the assurance that a lower X-Factor would be subsequently available as accounting earnings were driven lower in the future.

CARE's Productivity Estimates Are Grossly Exaggerated -- CARE Again Claims the Sky Is Falling

- CARE members incorrectly estimate LEC productivity to be between 8.54% and 10.86%.
- CARE stated that access prices would rise $500M in the 1996 annual filing.
  - Price cap LEC access prices went up only $14M. This amount included an $89M price increase by Sprint. Absent Sprint, LEC access prices fell by $75M.
- CARE members' productivity estimates completely ignore common sense.

Interstate Accounting RoRs for Price Cap LECs



What Would Be Required for a LEC to Keep Pace with a 10% X-Factor

- In order to keep pace with a 10% X-Factor in today's environment, a LEC would have to:

    - generate 18% minute growth each year, nearly three times the current rate. Total LEC minute demand would have to double in absolute levels every four years;

    <u>or</u>

    - cut all employment levels, all employee-related expenses, all-retiree-related expense and all expenses not directly associated with capital recovery and plant maintenance by 12% every year. LECs would have about one-half of the current employment and non-capital expense levels in five years [reductions of 235,000 in employees and $12.5 billion in expenses].

    - It will be difficult for incumbent LECs to maintain existing demand levels and impossible to generate the kind of demand growth implied above -- given current market conditions and especially given the effects of competition and the implementation of the Telecommunications Act of 1996.

Moreover, the Recent Accounting Analyses Are Fundamentally Flawed

- MCI, CARE, and Ad Hoc filed an analysis of the 1995 annual filing that purports to show LECs would have to anticipate at least 8.54% productivity to elect the no-sharing option.

  - This flawed analysis assumes LECs started from a hypothetical 1994 11.25% rate of return, rather than the actual 13.78%.
    - LEC earnings did not average nor should have been expected to average 11.25% after five years of price cap regulation.
    - Those LECs earning near 11.25% <u>did not</u> elect the no-sharing option.

  - CARE also incorrectly assumes a composite tax rate of 34%. LECs average approximately 40%.

  - When CARE's pseudo-analysis is run using the facts at the time the LEC elections were made, it shows that LECs' accounting productivity would only need to be 2.85% to elect the no-sharing option in the 1995 annual filing.

  - An analogy to what CARE is doing would be taking a 10 second time from a 100 meter dash and saying that LECs can run a 500 meter race in the same 10 second time. This is impossible even for Carl Lewis.

Analysis of MCI's Figure 1

Starting Rate of Return:	(RoR)	13.78%
Price Cap Revenue, 000:	(Rev)	21,618,490
Net Investment, 000:	(Inv)	30,828,507
Composite Income Tax Rate:	(TaxRate)	40.00%

50/50 Sharing @		N/A	12.25%	12.25%	N/A
100 Sharing @		N/A	13.25%	16.25%	N/A

Acctg RoR Prod	4.0%	X-FACTOR (X) 4.0%	4.7%	5.3%
-2.14%	11.20%	11.20%	10.90%	10.65%
-0.95%	11.70%	11.70%	11.40%	11.15%
-0.71%	11.80%	11.80%	11.50%	11.25%
0.24%	12.20%	12.20%	11.90%	11.65%
1.43%	12.70%	12.47%	12.33%	12.15%
2.61%	13.20%	12.72%	12.58%	12.65%
2.85%	**13.30%**	**12.75%**	**12.63%**	**12.75%**
3.80%	13.70%	12.75%	12.83%	13.15%
4.99%	14.20%	12.75%	13.08%	13.65%
6.18%	14.70%	12.75%	13.33%	14.15%
7.37%	15.20%	12.75%	13.58%	14.65%
8.56%	15.70%	12.75%	13.83%	15.15%
9.74%	16.20%	12.75%	14.08%	15.65%
10.93%	16.70%	12.75%	14.25%	16.15%
12.12%	17.20%	12.75%	14.25%	16.65%

MCI's Formula: AdjRoR = RoR+[Rev*(1-TaxRate)*(Prod-X)]/Inv

Source for Original Analysis: MCI Reply Comments, CC Docket No. 94-1, 4th FNPRM, Filed March 1, 1996

Moreover, the Recent Accounting Analyses Are Fundamentally Flawed (Cont'd.)

- Ad Hoc also uses this same flawed method to analyze the 1994 annual filing, in which most LECs elected the lowest X-factor, 3.3%.
    - Ad Hoc claims that its analysis shows that LEC productivity is no greater than 7.45%. <u>Curiously, this ceiling is lower than the 8.54% floor calculated by Ad Hoc.</u>
- Ad Hoc adds an add-back adjustment to the break-even rate of return to arrive at a contrived productivity ceiling of 10.86%. slightly higher than Ad Hoc's advocated X-factor of 10.3%.
    - It is a ludicrous implication that add-back raises LEC productivity. Add-back simply raises the starting rate of return thereby reducing the level of productivity a LEC would have to achieve to elect the no-sharing option over the 12.75% Rate of Return option.
- When Ad Hoc's further accounting analysis is run using the facts at the time the LEC elections were made, it shows that LEC accounting productivity is no greater 3.47%.
- Thus, using the facts, this analysis of MCI, CARE and Ad Hoc concludes that LEC accounting productivity is between 2.85% and 3.47%.

Analysis of Ad Hoc's Figure 2

Starting Rate of Return:	(RoR)	13.03%		
Price Cap Revenue, 000:	(Rev)	21,618.490		
Net Investment, 000:	(Inv)	30,828.507		
Composite Income Tax Rate:	(TaxRate)	40.00%		
50/50 Sharing @		N/A	0.1225	0.1325
100 Sharing @		N/A	0.1625	0.1725

Acctg RoR Prod	X-FACTOR (X) 3.3%	3.3%	4.3%
-0.93%	11.25%	11.25%	10.83%
0.26%	11.75%	11.75%	11.33%
1.45%	12.25%	12.25%	11.83%
2.04%	12.50%	12.38%	12.08%
3.47%	**13.10%**	**12.68%**	**12.68%**
3.82%	13.25%	12.75%	12.83%
5.01%	13.75%	13.00%	13.29%
6.20%	14.25%	13.25%	13.54%
7.39%	14.75%	13.50%	13.79%
8.58%	15.25%	13.75%	14.04%
9.76%	15.75%	14.00%	14.29%
10.95%	16.25%	14.25%	14.54%
11.67%	16.55%	14.25%	14.69%
12.14%	16.75%	14.25%	14.79%
13.33%	17.25%	14.25%	15.04%

Formula Used By Ad Hoc: AdjRoR = RoR+[Rev*(1-TaxRate)*(Prod-X)]/Inv

Source for Original Analysis: Ad Hoc Ex-Parte in CC Docket No. 94-1, 4th FNPRM, Filed April 9, 1996

The FCC's Own Accounting Analyses, the Frentrup-Uretsky and Bush-Uretsky Studies, Conclude That LEC Accounting Productivity Is No Greater than 5.0%

- This occurred during a period which saw the rapid decline in interest rates and faster interstate demand growth as a result of historical shifts from interstate to state and other historical anomalies.

- These events were unique and cannot be expected to occur again in the near future.

The Commission Should Regulate Prices, Not Earnings. It Should Not Regulate Both.

- Greater economic efficiencies would be realized if only prices were regulated.

- LEC earnings are below those of IXCs and other firms when compared on a consistent basis.

- A self-correcting method that is economically meaningful is needed.

General Criteria for an X-Factor

- Must be economically meaningful.
- Should pass future LEC unit cost reductions through to consumers.
- Should be simply calculated and based on accessible and verifiable data.

The Record Shows:

- TFP is the most economically sound measure of LEC productivity.
- All parties agree that TFP is around 3.0%.

Adjustments Proposed by Ad Hoc, AT&T and/or Sprint

- CARE uses accounting earnings to justify uneconomic adjustments to the TFP:

  - Input Price
  - Interstate
  - Hedonics
  - CCL
  - CPD

Accounting Earnings Are Not Economic Measures of Productivity -- They Are Arbitrary