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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	)	CC Docket No. 96-112

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REPLY COMMENTS OF AT&T CORP.

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SUMMARY

The comments confirm the compelling need for the Commission to amend its Part 64 rules to achieve an appropriate allocation of costs between the incumbent LECs' regulated and nonregulated activities. The ILECs' position to the contrary is clearly at odds with the Commission's statutory mandate, under the 1996 Telecommunications Act, to ensure cost-based rates for telephone services and to promote competition.

The non-ILEC commenters also uniformly support application of Part 64 cost allocation rules to all incumbent LECs, even price cap LECs that have not chosen a sharing obligation. The resulting allocation of LEC costs from regulated to nonregulated activities can lawfully be accomplished through an exogenous cost adjustment, which would not be redundant of the PCI adjustments that would occur under the X-factor productivity offset.

The non-ILEC commenters also overwhelmingly agree that a fixed allocator for loop and switching plant costs is the preferred method. The most logical and practical approach to calculating a fixed allocation factor is one based on TSLRIC studies. Use of TSLRIC studies has the additional benefit of eliminating the need to establish a separate allocation for spare facilities. Finally, the commenters generally agree that the Commission should not

depart from its current allocation method which allocates network-related expenses based on the network plant allocation.

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REPLY COMMENTS OF AT&T CORP.

Pursuant to the Commission's Notice of Proposed Rulemaking ("Notice") in this proceeding, AT&T Corp. ("AT&T") hereby replies to comments[1] on the Commission's proposal to amend its cost allocation rules regarding an incumbent local exchange carrier's ("LEC's") use of the same network facilities to offer both regulated and nonregulated services (such as video programming).

I. Part 64 Cost Allocations Are Critical To Achieving The Goals Of The 1996 Act.

AT&T demonstrated in its comments (at 1-3) that the Commission's Part 64 rules are necessary to ensure that prices for telephone services reflect their true economic costs and thus promote fair competition in both the telephone and video programming services markets, consistent

[1] See Attachment A for a list of commenters.

with the procompetitive goals of the 1996 Act.[2] The need for amendment of these rules to effect a reasonable allocation of the incumbent LECs' ("ILECs'") shared facilities was recognized by state commissions and consumer groups,[3] as well as by the ILECs' cable competitors[4] and access customers.[5] The ILECs, on the other hand, predictably argue that the rules are unnecessary to achieve an appropriate allocation of costs between their regulated and nonregulated activities, and would inhibit the procompetitive goals of the 1996 Act.[6] They urge instead forbearance from application of the Part 64 rules.[7]

The ILECs' position is clearly at odds with the underlying obligations of the Commission to ensure cost-

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[2] Telecommunications Act of 1996, Pub. L. No. 104-104, 101 Stat. 56 (1996) (hereinafter the "1996 Act").

[3] Alabama PSC at 2; California PUC at 2; Florida PSC at 1; NYDPS at 2; Pennsylvania OCA at 3-4.

[4] CCTA at 2-3; Continental at 2-3; Cox at 1-4; NCTA at 1-4; Scripps Howard at 1-5.

[5] GCI at 1-2; MCI at 3-4.

[6] Ameritech at 4-10; Bell Atlantic at 1-3; BellSouth at 1-10; GTE at 1-5; NYNEX at 1-9; Pacific Bell at 1-6; Sprint at 1-7; SNET at 4-9; SWBT at 4-9; USTA 4-15; U S WEST at 1-8.

[7] See, e.g., Ameritech at 3 ("the Commission should forbear from applying its cost allocation rules to pure price cap carriers"); Bell Atlantic at 2; BellSouth at 3-4, 8-10; GTE at 2-3; NYNEX at 2-3; USTA at 4-6.

based rates for telephone services and to promote competition. In the Commission's Universal Service proceeding, the Commission made clear its statutory mandate under Section 254(b)(4) of the 1996 Act to remove all uneconomic subsidies from access charges, so that contributions to universal service are accomplished on a nondiscriminatory basis.[8] In the Local Competition proceeding,[9] the Commission again addressed its statutory obligations under Section 251 and 252 of the 1996 Act to establish cost-based pricing for interconnection and unbundled network elements, in order to protect against ILEC discrimination toward its potential competitors in local markets and its eventual interexchange competitors.[10] The Commission's impending access charge reform docket is also intended to create a structure in which access charges are cost-based.[11]

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[8] Federal-State Joint Board on Universal Service, Notice of Proposed Rulemaking and Order Establishing Joint Board, CC Docket No. 96-45, paras. 28-30, 61-65, 112-115, released March 8, 1996 ("Universal Service NPRM").

[9] Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Notice of Proposed Rulemaking, released April 19, 1996 ("Local Competition NPRM").

[10] Id., paras. 124, 135, 155.

[11] Id., para. 3.

The overarching theme of these crucial Commission proceedings is the need for prices for those services over which the ILECs retain monopoly power to reflect their true economic costs. So long as there is no workable local competition, cost-based interconnection, or access charge reform, the ILECs retain the incentive to overallocate costs to the regulated services on which their would-be competitors remain dependent.[12] Clearly, strong safeguards are needed to ensure that the customers of the ILECs' local services, interconnection services and basic network elements are not burdened by these costs.[13]

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[12] In a recent order on Open Video Systems, the Commission reaffirmed its reliance on Part 64 cost allocation rules "to protect regulated telephone ratepayers from a misallocation of costs that could lead to excessive telephony rates." See Implementation of Section 302 of the Telecommunications Act of 1996 Open Video Systems, Second Report and Order, CS Docket No. 96-46, para. 248 (citing the instant proceeding), released June 3, 1996.

[13] CCTA's comments illustrate the fact that the current cost allocation process has not been successful in preventing cross-subsidization by monopoly LECs. CCTA (at 8-11) cites numerous instances, dating back to 1990, where this Commission found that Pacific Bell engaged in cross-subsidization, including underallocation of travel expenses to nonregulated activities; overreporting of technicians' costs to regulated activities; overreporting of labor expenses to regulated accounts; and inaccurate reporting of time charges for working on nonregulated products to regulated services.

II. Part 64 Cost Allocations Should Apply To All ILECs, Including Those That Do Not Share.

The ILECs argue that, absent total forbearance, the Commission should at least refrain from applying the Part 64 rules to those ILECs that have not chosen an interstate sharing obligation.[14] However, allocation between the ILECs' regulated and nonregulated activities is necessary even for those price cap LECs that have not chosen a sharing obligation, in order to allocate correctly certain costs that are currently in the LECs' regulated accounts.[15] Those costs, which are associated with investments that will benefit the LECs' emerging competitive service, must be reallocated to those nonregulated services, or else price cap LECs will continue to benefit by their ability to set their price cap indices ("PCIs"), and hence their prices, for noncompetitive, regulated services -- including critical access services -- at higher levels than would otherwise be justified.[16]

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[14] See, e.g., Ameritech at 3; BellSouth at 4-5.

[15] Because Part 64 rules affect intrastate allocated costs as well as interstate allocated costs, the absence of an interstate sharing obligation does not eliminate the need to ensure that these costs are allocated appropriately.

[16] See, e.g., Cox at 10-11; NCTA at 24 ("local telephone ratepayers have underwritten the research and development enabling the creation of a . . . network which will be used . . . to provide not only telephone services but also video services"). Alabama PSC notes (at 7) that "[t]he reallocation of costs to nonregulated services is

(footnote continued on following page)

Contrary to several LECs' claims,[17] it is appropriate and lawful for the Commission to achieve the reallocations contemplated under the proposed revised Part 64 rules through an exogenous cost adjustment.[18] The Commission has already resolved this issue by explicitly finding that an exogenous cost adjustment is required whenever regulated investment is reallocated to nonregulated activities, in order to register the effect of such reallocations in a price cap context.[19] Although the Commission subsequently limited exogenous cost treatment to "economic cost" changes, it continued to include, as an exogenous cost change, those cost changes "caused by administrative . . . requirements beyond the control of the carriers that are not reflected in the GDP-PI."[20] Because

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(footnote continued from previous page)

meaningless if that reallocation is not reflected in the prices for regulated services." See also California PUC at 2-3; Florida PSC at 1-2; MCI at 12-14.

[17] USTA at 13; Bell Atlantic at 4; Pacific Bell at 16.

[18] See Section 61.45(d)(1)(v) of the Commission's Rules, 47 C.F.R. § 61.45(d)(1)(v), which requires an exogenous cost adjustment for the allocation of investment from regulated to nonregulated activities.

[19] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6807-08 (1990), modified on recon., 6 FCC Rcd 2637 (1991).

[20] Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8961, 9090 (1995).

the GDP-PI only recognizes economy-wide inflation-related occurrences, it would not include the Part 64 reallocations contemplated in this proceeding, which clearly remain under the definition of exogenous costs.

Certain LECs also contend that requiring an exogenous cost adjustment here is inconsistent with the Commission's intent to move away from exogenous cost treatment, because the "link" between the setting of the LECs' initial price caps (which were based on rate-of-return rates) and the cost changes required under the Commission's existing rules has become "more distant."[21] This argument is misplaced. The initial price cap rates were based on the LECs' regulated network costs, which, in 1990, accounted for virtually 100 percent of their total network costs. Even if the LECs did not upgrade their networks to provide video services since 1990, those networks -- and the associated engineering, maintenance, marketing, sales and other activities -- will now be used to provide both regulated, telephone service and nonregulated, video programming service. As a result of this shared use, it is

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[21] See, e.g., Ameritech at 5 ("a pure price cap carrier has no incentive to engage in 'unreasonable cost shifting' because regulated prices would be unaffected by 'cost misallocations of joint and common costs' or a misallocation of costs from 'affiliate transactions'") (citations omitted); BellSouth at 4, 11-12.

inappropriate to continue to associate all of these costs with regulated activities and to charge regulated price cap rates that are targeted to recover these total network costs.[22]

Moreover, in light of the significant recent ILEC investments which are intended to benefit nonregulated services and are today included in the ILECs' regulated accounts,[23] Part 64 allocations are critical to removing such investments from those accounts and thereby lowering the ILECs' PCIs.[24] Thus, just as exogenous cost adjustments were needed in the early days of price cap regulation to

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[22] BellSouth is thus wrong when it argues (at 11-14) that because it had invested very little in plant that is suitable to provide nonregulated services when the LECs' price cap indices were initially set, there is no need for an exogenous cost adjustment to lower its PCIs.

[23] Economists Selwyn and Kravtin estimate that as much as $25 billion of historic net total plant in service cannot be explained by basic service demand growth over the 1990 to 1995 period. See May 29, 1996 Affidavit of Lee L. Selwyn & Patricia D. Kravtin, and Analysis of LEC Embedded Investment, Appendix C at 6 ("Selwyn & Kravtin Aff.")(Appendix C of AT&T's Reply Comments in the Local Competition proceeding, filed May 30, 1996). Moreover, Selwyn and Kravtin found that only a relatively small fraction of the gross additions in digital switching and outside plant since January 1, 1990, can be shown to have been required to support growth in basic service demand. Selwyn & Kravtin Aff., para. 5.

[24] Because all LECs were subject to sharing prior to 1995, the investments in nonregulated activities had the effect of lowering the LECs' rate-of-return and, consequently, their sharing obligation.

exclude costs that were inappropriately included in regulated accounts, the same exogenous cost treatment is necessary today to remove costs that are not legitimately associated with, and are not intended for the benefit of, regulated activities.

Finally, such cost allocation will not be redundant of the PCI adjustments that will occur with application of the X-factor productivity offset, as several LECs contend.[25] The LECs assume, incorrectly, that the current X-factor calculation includes efficiencies gained from a LEC's nonregulated activities.[26] The X-factor calculation that the Commission has adopted examines the LECs' efficiencies in operating its regulated, and only its regulated, activities. Moreover, removal of costs associated with the LECs' nonregulated activities on a prospective basis through an exogenous cost adjustment will have no effect on the current X-factor, which is based on historical data.

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[25] See, e.g., Bell Atlantic at 5; USTA at 13; BellSouth at 14; Pacific Bell at 17.

[26] See, e.g., USTA at 13 (the Commission has tentatively concluded that a moving average Total Factor Productivity ("TFP") methodology should be adopted for its long-term price cap regulation); NYNEX at 22-23. This attempt to argue that because the X-factor may, sometime in the future, include the effect of all exogenous costs, is too speculative and ignores the current applicability of the Commission's existing rules.

In fact, the LECs have benefited to date from the inclusion, in their historical regulated accounts, of costs which will be associated with nonregulated activities. To the extent that the LECs were disproportionately less productive in the provision of such nonregulated services, this has caused their productivity, and hence their X-factor, to be lower than it otherwise would have been. Thus, the LECs have failed to support their contention that they will be harmed by treating the allocations proposed in this rulemaking as exogenous cost changes.

III. Commenters Support Amending The Cost Allocation Rules.

The non-LEC commenters overwhelmingly agree that a fixed allocator for loop plant costs is the most appropriate allocation method, because "traditional methodologies of direct allocation and allocation based on usage are not adequate to assign costs in an integrated, hybrid network, given the high levels of common costs."[27] While there is no consensus on the exact fixed allocator, it is clear that one is needed.[28]

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[27] CCTA at 17. See also MCI at 5; Cox at 8-10; Florida PSC at 2-3; GCI at 4; TWC at 10-11.

[28] See, e.g., Alabama PSC at 6 and NYDPS at 4 (support a 50% split on an interim basis); CCTA at 17-19 (based on TSLRIC studies the allocation factor should be 76% to nonregulated); NCTA at 20 (allocate 75% of common costs to video services).

AT&T recommends its approach as the most logical and practical method to calculate a fixed allocation factor.[29] Allocating costs based on TSLRIC studies has the advantage of creating fixed allocation factors that will be unique to each LEC.[30] This will leave carriers free to "utilize different types of technologies and platforms, and offer different service features,"[31] while allocating costs

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[29] See AT&T at 4-8. The concept of Total Service Long Run Incremental Cost ("TSLRIC") is supported both by cable operators (NCTA at 18-20) and LECs (Pacific Bell at 9 -- "joint costs should be allocated in a manner that most closely approximates the long run incremental costs of each service or group of services"). See also MCI at 6-8 (recommends allocation methodology based on stand-alone costs, using the Hatfield model to compute the allocator).

In the interim, AT&T recommends that the Commission establish a fixed factor that assigns 50 percent of the shared costs, including costs associated with spare facilities, to regulated activities and 50 percent to nonregulated activities. Several non-LEC commenters support the use of an interim 50 percent fixed factor. See, e.g., Alabama PSC at 6; NYDPS at 4; California PUC at 4; GCI at 4.

[30] This addresses the concerns of GTE (at 7) and others that adoption of a single fixed allocation factor applicable to all LECS would discourage investment in integrated networks by not recognizing the unique cost structures of the carriers. See also US WEST (at 6) (concern that a "one-size-fits-all" approach to cost allocation is not feasible).

[31] NYNEX at 7.

on a reasonable economic basis to regulated and nonregulated activities.[32]

This same fixed-factor approach should also be applied to switching plant.[33] As NCTA notes (at 13), a fixed factor to allocate costs for switching plant should be used because technological advancements reduce the extent to which switching costs relate to usage. GSA mirrors this view, noting (at 4) that "[b]ecause the outside plant facilities are primarily traffic insensitive, a usage-based allocation process will not result in a cost causative allocation."[34]

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[32] The ILECs argue that competition in the video marketplace will be harmed, not benefited, if too large a percentage of their costs are allocated to their nonregulated activities. See, e.g., BellSouth at 5-6. They suggest that allocations to nonregulated activities should be well below the percentage splits suggested by public utility commissions, cable operators, and access customers. For example, Bell Atlantic suggests (at 9-10) an allocation factor to nonregulated activities of between 25-30%. However, their argument lacks merit as they fail to provide empirical proof for this outcome and, more importantly, they fail entirely to address the detrimental effect such an allocation factor would have on competition in the local telephone market, where they are the monopoly providers.

[33] See AT&T at 8-9.

[34] See also Cox at 4-5, 8; NCTA at 13 (technological advancements associated with newer technologies such as video services "reduce the extent to which switching costs relate to usage").

The majority of non-LEC commenters agree that subscribers of regulated services should not pay rates designed to recover costs of spare capacity that eventually will be used for video programming.[35] AT&T's TSLRIC proposal would eliminate the need to establish a separate allocation for such spare facilities. If the TSLRIC studies are performed properly (capturing all forward-looking costs, assuming that the most technologically advanced equipment is used), those studies will include all of the LEC's economic spare facilities; that is, the costs of the facilities that will be needed to provide service over the long run. Such spare facilities costs would then be allocated pursuant to the allocation formulas applied to loop and switching plant costs.

Finally, the commenters confirm that the Commission should not depart from its current allocation method which allocates network-related expenses based on the network plant allocation.[36] Thus, the allocation of the expenses follows the primary account. AT&T agrees with those commenters that support the use of the fixed factor

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[35] See, e.g., CCTA at 21; Continental at 8; GCI at 5-6; MCI at 14-16.

[36] See, e.g., Pacific Bell at 19; SWBT at 18-19; USTA at 19.

used to allocate costs for loop and switching plant as the factor to be applied to the related expenses.[37]

CONCLUSION

WHEREFORE, for the reasons stated above, it is critical that the Part 64 cost allocation rules continue to apply to all incumbent LECs, whether or not they are price cap LECs or are subject to a sharing obligation. AT&T further supports exogenous cost treatment for costs that are reallocated to nonregulated accounts. Finally, AT&T recommends that the Commission amend its Part 64 cost allocation rules as described above and in AT&T's comments.

Respectfully submitted,

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[37] See, e.g., NCTA at 14.

ATTACHMENT A

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CC Docket No. 96-112

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Scripps Howard Cable Company ("Scripps Howard")
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CERTIFICATE OF SERVICE

I, Rena Martens, do hereby certify that on this 12th day of June, 1996, a copy of the foregoing "AT&T's Reply Comments to Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services" was mailed by U.S. first class mail, postage prepaid, to the parties listed on the attached Service List.

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