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June 28, 1996

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JUN 28 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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

Re: Ex Parte CC Docket No. 96-98 - Implementation of the Local
Competition Provisions of the Telecommunications Act of 1996

Dear Mr. Caton:

An Avoided Retail Cost Model is discussed in Appendix E of the Reply Comments of AT&T Corp. in CC Docket No. 96-98. In response to a request from the Commission Staff, I provided to the Staff today an explanation of a regression model that explains the relationship between indirect and direct costs as used in the model.

Copies of that explanation is attached to this correspondence.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Sincerely,

Attachment:

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Establishing the Relationship Between Direct and Indirect Operating Costs

Common sense and past experience suggest that there is a direct relationship between the level of a firm's direct operating expenses in any given time period and its propensity to spend on "indirect" or overhead functions, such as finance and accounting, legal, external relations, human resources, or executive and planning activities. In many cases, such expenses are incurred as a direct result of the firm's retail activities. A sales office, for example, would generate supporting activity from a personnel organization, salary and benefit administration, real estate or space management, information management, legal staff and executive personnel. Other indirect expenses, e.g., the corporate headquarters establishment, are both justified and supported by the overall size of the firm. That such expenses are not always linked directly through financial systems to the causing event is a legacy of the origins of accounting systems as tools to generate external financial reports, rather than evidence of their fixed or invariable nature.

A linear regression analysis was performed to test the hypothesis that these indirect costs are, in fact, variable. The raw data for the cross sectional analysis were extracted from the 1995 ARMIS 43-02 financial reports for eighteen Tier 1 operating companies, including the RBOCs, GTE/Contel, SNET, United, Cincinnati Bell, ALLTEL, Centel, Rochester Telephone Company, Lincoln Telephone Company, Citizens of New York, Commonwealth, and the Puerto Rico Telephone Company. The dependent variable describing indirect costs was defined as Corporate Operations Expense, (which is the sum of Executive and Planning Expense and General and Administrative Expense). To highlight the direct link between indirect and direct expenses that is proposed in the Avoided Cost Model, the independent, or explanatory variable describing direct costs was defined as Total Operating Expenses, less Corporate Operations Expense.¹

The results of this analysis are summarized below:

$$\text{Corp. Opr. Exp.} = a + b(\text{Total Opr. Exp.} - \text{Corp. Opr. Exp.}) + \varepsilon$$

where the estimated coefficients are:

$$a = 8305 \pm 64,744, \quad t \text{ stat} = .128 \quad p = .90$$

$$b = .1862 \pm .0137, \quad t \text{ stat} = 13.55 \quad p = < 0$$

$$R \text{ Sq.} = .92$$

¹ In an alternative analysis performed to support the development of a variable overhead loading factor used in AT&T's and MCI's Hatfield TSLRIC model, a different specification of the independent variable was required. In that analysis, the independent variable was defined to be Total Revenues, less Corporate Operations Expense. The statistical results obtained are completely consistent with those reported here.

These results indicate that there is a statistically significant and positive relationship between indirect and direct costs, and that, indeed, almost all variation in indirect costs can be attributed to the scale and scope of the firm's operations, or its direct costs. Furthermore, the statistically insignificant intercept supports the hypothesis that *truly fixed* costs are an insignificantly small portion of total operating costs.