EX PARTE

UNITED STATES
TELEPHONE
ASSOCIATION

July 1, 1996

RECEIVED

JUL 1 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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

RE: Ex Parte Contact, CC Docket No. 94-1, Fourth Further Notice

Dear Mr. Caton,

On Monday, July 1, 1996, Laurits Christensen, Jeff Olson, Jeff Pursley, Whit Jordan, Maureen Keenan and Frank McKennedy, representing the United States Telephone Association (USTA), met with Les Selzer, Anthony Bush, Lori Huthoefer and Alexander Belinfante of the FCC's Common Carrier Bureau Competitions Pricing Division. The purpose of the meeting was to review USTA's positions in this proceeding and discuss related issues.

Enclosed are an original and two copies of this letter and the document left with the staff. Please place these items into the public record in this proceeding.

Sincerely,

Frank McKennedy

Frank McKennedy
Director-Legal & Regulatory
Affairs

Attachment

cc: Les Selzer
Anthony Bush
Lori Huthoefer
Alexander Belinfante

(+ 2

LEC Price Cap Review
Fourth Further Notice of Proposed Rulemaking

Total factor productivity (TFP) is the proper way to measure productivity.

- The Christensen TFP method should be used by FCC to set "X."
- No party has contradicted the Christensen finding that LEC TFP growth has averaged about 3.1% (five-year moving average ending in 1994).

Opening of markets to competition necessarily requires:

- Less emphasis on increasing the "X" that applies only to LECs.
- More emphasis on regulatory parity and allowing markets to work.

An input inflation adjustment term should not be added to X.

- Inclusion would not change trend of price cap indexes.
- Correct tests show that the average "input inflation differential" is zero.
- There was no permanent shift in input inflation differential at Divestiture.
- Analysis of input inflation differences must utilize LEC and U.S. data that employ consistent measurement methods.

There should be no interstate adjustment to total TFP results.

- There is no economically valid procedure for measuring interstate TFP.
- The existence of joint and common costs means that interstate TFP cannot be meaningfully measured or defined.
- Inputs / input growth cannot be meaningfully attributed to interstate only.
- AT&T's claim that interstate inputs can be assumed to grow at same rate as total is wrong.

USTA strongly supports a moving average X.

- Ensures that any future gains are flowed through to customers.
- Facilitates removal of sharing, which should happen anyway.
- Including a "Consumer Productivity Dividend" (CPD) add-on to the moving average would be double counting, flowing back more productivity gain than actually experienced. The CPD should be eliminated.

Christensen TFP Results

The Christensen TFP approach, as documented in the USTA TFP Review Plan, is the only model proposed by any party that addresses all of the necessary criteria and substantive comments raised by the Commission.

- **All data are publicly available and verifiable.**

- **The TFP calculations are performed and documented in single spreadsheet (TFP Review Plan).**
  - **USTA adopted the Commission's Tariff Review Plan standards for development of documentation.**
  - **All calculations are displayed.**
  - **All data sources are documented.**

- **The study includes the following price cap LECs:**
  Ameritech, Bell Atlantic, BellSouth, GTE (including former Contel), Lincoln, Nevada, NYNEX, Pacific, SNET, SWBT, Sprint (United, Centel), US West.

- **The study begins in 1988, eliminating the need for nonpublic data associated with the Commission's fundamental accounting changes implemented effective 1-1-88.**
  - **Includes results through 1994.**

Input Inflation Adjustment

An input inflation adjustment must be evaluated on critical practical considerations, including volatility, consistency, incentives and parity.

- **The input inflation differential is statistically zero in the long run.**
- **As proposed in the record in this proceeding thus far, inclusion of an input inflation differential would significantly add to volatility in price cap indexes (and therefore prices) without providing any offsetting consumer benefit. (The LEC input inflation measures in the record are extremely volatile.)**
- **AT&T does not test whether, on average, the input inflation growth rates (U.S. and LEC) are the same, i.e., whether the average input inflation differential is zero. AT&T, through its consultant (Norsworthy), tests the wrong question -- whether the two series are "exactly the same." As a result, AT&T's test proves nothing useful in this proceeding.**
- **The reason a statistical test for equality of averages is needed in the first place is the high degree of volatility potentially caused by an "input price" adjustment term.**
- **Any examination of the extent to which LEC input inflation differs from U.S. economy-wide input inflation must use consistent methods for calibrating inflation trends.**
- **TFP and input price measurement must be based on the same "model." The model must be based on sound and well-tested methods and use publicly-available data that can be verified.**
- **Methods and data sources must not be "cherry-picked" to yield "desired" results.**

- **To determine an accurate estimate of input inflation differential (together with an accurate TFP differential), methods and data sources must be consistent with the U.S. measures of economy-wide TFP and input inflation.**

  Areas for consistency:
  - **Any use of hedonic (quality-adjusted) price indexes**
  - **Opportunity cost of capital**
  - **Economic depreciation rates**

- **The regulatory paradigm must provide incentives for efficiency to the regulated carriers and create reasonable regulatory parity among different categories of telecommunications providers.**

- **The filings of Ad Hoc and AT&T (which suggest input inflation differentials) fail when judged against these important standards.**

<u>Sectors of the Economy</u>

The Christensen results are robust regardless of which sector of the U.S. economy is utilized.

- **The estimates of the LEC TFP differential and the input inflation differentials are virtually unchanged when alternative definitions of the overall U.S. economy are utilized.**

  - **The Christensen results are robust with respect to the use of the nonfarm private business sector instead of the private business sector.**

  - **The input inflation differential is still not statistically significant from zero if one utilizes the nonfarm private business sector of the U.S. economy, as recommended by AT&T (Norsworthy).**

Total Company TFP without Flawed Interstate "Adders"

Ad hoc adjustments to total company TFP results based on interstate results are not appropriate.

- **Because of the existence of joint and common costs, TFP results cannot be meaningfully "assigned" to the interstate jurisdiction.**
    - **Because the LECs' production functions are not separable, interstate TFP cannot be defined.**
    - **The nonseparability of the production function is explicitly recognized in the Commission's Part 32 Accounting Rules and other Commission rules. This fact is properly treated in the Christensen TFP methods.**

Opportunity Cost of Capital in TFP Model

- **TFP theory calls for the real opportunity cost of capital for the entity in question.**
- **Practitioners typically use an "external" measure to best represent the opportunity cost of capital for regulated firms and industries.**
- **Use of actual return to capital presents problems of accuracy and perpetuates rate-of-return regulation concepts.**

Carrier Common Line

- **The Christensen TFP method includes all outputs including CCL minutes, and all inputs, including NTS costs.**

- **As a result, the Christensen TFP method captures the entire effects of CCL minutes growth relative to NTS cost growth.**

    - **See Lincoln Tel. Reply Comments, Attachment a for a demonstration that the Christensen TFP method fully captures the effects of CCL minutes growth.**

- **Retaining "g/2" in the Common Line price cap index formula would be double counting productivity growth.**

- **Fundamental reforms in Common Line recovery already underway and scheduled to occur will substantially alter the rigid rate structure upon which the "g/2" price cap adjustment was based. These Common Line reforms include:**

    - **The Universal Service proceeding (CC Docket No. 96-45)**
    - **The numerous common line recovery waivers already granted and under consideration (e.g., NYNEX USPP, Ameritech Customers First)**
    - **The upcoming Access Reform proceeding**