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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

Whitney Hatch  
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July 12, 1996

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

**EX PARTE: Implementation of Local Competition  
CC Docket No. 96-98**

Dear Mr. Caton:

Today I provided the attached letter outlining GTE's principles for a forward-looking cost study methodology to Pete Belvin of Commissioner Quello's office in response to her request. Please incorporate this letter and its attachments into the record of the above-captioned proceeding.

Please call me if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Whitney Hatch", is written over a horizontal line.

Whitney Hatch

Attachment

c: J. Casserly  
J. Farrell  
D. Gonzalez  
R. Keeney  
E. Maxwell  
R. Metzger  
J. Nakahata  
R. Pepper  
G. Rosston  
J. Schlicting  
R. Welch

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202 463 5290

July 12, 1996

Ms. Pete Belvin  
Senior Legal Advisor - Room 802  
Federal Communications Commission  
1919 M Street, NW  
Washington, DC 20554

**RE: Essential Cost/Pricing Principles**

Dear Pete:

In response to your request yesterday, I am providing you with an outline of essential principles for forward-looking cost methodologies. To the extent the Commission believes its pricing standards for unbundled elements should be based on forward-looking, long-run incremental costs, GTE recommends that the Commission adopt these principles in lieu of specific pricing formulae or rate proxies. By doing so, the Commission would permit negotiating parties the flexibility to use costing methodologies best suited to their particular situation while ensuring that each method adheres to fundamental Commission requirements. These principles would be ideally suited for use by the states in the arbitration process.

The first document outlines these principles. The second document compares GTE's recommended principles to those embodied in both the "Hatfield" version of TSLRIC and a fully distributed cost methodology. For your information, these principles are reasonably reflected in that portion of the "BCM" Model 2.0 which relates to unbundled loops.

Please let me know if you have any questions. We would be glad to discuss these in more detail if you are interested.

Sincerely,

Whitney Hatch

Attachment  
c: FCC Secretary

## Forward Looking Cost Study Methodology Principles

If the FCC adopts regulations for pricing network elements, interconnection and collocation, GTE recommends that the following principles be applied.

- I. Pricing of network elements, interconnection and collocation should send the correct economic signal to efficient competitors.
  - A. Competitors should be able to obtain unbundled network elements without first replicating entire LEC networks all at once.
  - B. Interconnectors should pay costs similar to what an ILEC experiences in providing services, including the ILEC economies of scale.
  - C. The Hatfield method does not meet these objectives because it ignores large chunks of ILEC costs, would discourage facilities-based competition and does not emulate the forward-looking costs ILECs face in the real world.
  - D. Pricing network elements unreasonably low will discourage facilities-based competition.
- II. Any costing standard the Commission adopts must give the parties sufficient flexibility to be able to negotiate fair interconnection prices, rather than forcing a single solution on negotiators.
  - A. Setting a rigid minimum costing standard will eliminate the parties' motivations to negotiate.
  - B. Flexibility ensures that all parties, especially interconnectors, can tailor interconnection agreements to suit their own needs.
- III. A properly constructed cost methodology would determine the economic costs of building and operating the local telephone network as a whole, broken down into network elements as required by the Act.
  - A. The study should examine the forward-looking costs of building and operating the network.
  - B. Projected costs, investment and expenses, should be based on the efficient network using the technology the LEC actually expects to build and operate, not some hypothetical or idealized model.
  - C. Forward-looking costs should be viewed long enough in the future that fluctuations in investment, i.e., lumpy investments, are relatively smooth.
  - D. Costs should be based on additions to the network installed in reasonable increments, rather than all at once, and based on expected growth, rather than assuming that current demand will be static.

- IV. A cost study should capture all direct and indirect costs of building and operating a network.
- A. Network costs include the joint and common costs associated with building a network.
    - 1. Switching services and switched-based vertical features utilize such common equipment as the central processor.
    - 2. Switching equipment requires support structures such as land, buildings, power and environmental conditioning.
    - 3. These costs would be assigned to network elements based on their proportional share of these costs in accordance with a mathematical formula.
  - B. Enterprise management costs, such as human resources, payroll, and executive, are incurred in operating the network and would be assigned to network elements based on a high-level allocator, such as relative investment or number of employees
  - C. Scale economies would be shared with interconnectors because joint and common costs, which do not increase in the same proportion as the size of the network does, would be reflected in declining average unit costs as the size of the network increases.
  - D. Costs that are not directly incurred in building and operating a network, such as retailing, would not be assigned to network elements, including their proportionate share of joint and common costs and overheads.
  - E. Costs are not based on a rate-of-return. embedded investment costing methodology

## Cost Model Comparison

Principle	Hatfield TSLRIC	Fully Distributed Cost	Proper Cost Methodology
Forward Looking Costs	Uses forward-looking costs	Uses existing costs	Uses forward-looking costs
Least Cost Technology	Uses available, least cost technology if network built today from scratch	Uses existing technology, which was the least cost available when deployed	Uses a mixture of existing and future least cost technology
Definition of long run	Assumes all investment made at once	Not applicable	Period long enough so lumpy investment is relatively smooth
Future Demand	Uses current demand and assumes that there will be no future growth in demand	Adjustments for near-term demand growth are included through embedded investment's unused capacity	Adjusts data to reflect incremental cost of multi-year investment decisions to reflect demand growth
Joint and Common Costs	Includes no joint costs; more recent version adds some depending on how network elements are defined	Allocates joint and common costs among service categories based on high-level factors	Allocates joint and common costs among network elements based on medium- to high-level factors
Enterprise management costs	Includes no corporate overheads	Allocates corporate overheads based on high-level factors	Allocates corporate overheads based on high-level factors
Economies of scale reflected in cost?	yes	yes	yes
Exclusion of selected direct costs	Unclear how precise any exclusion is, given model methodology	Excludes selected direct costs, plus associated joint and common costs	Excludes selected direct costs, plus associated joint and common costs
Rate of return methodology?	Not based on rate of return methodology	Based on rate of return methodology	Not based on rate of return methodology