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UNITED STATES
TELEPHONE
ASSOCIATION

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

Ex parte
CC Docket No. 94-1, Fourth FNPRM

July 16, 1996

Dear Mr. Caton:

On Tuesday, July 16, 1996, Jeff Olson, Maureen Keenan, Jeff Pursley and Frank McKennedy, representing the United States Telephone Association (USTA), met with Les Selzer, Anthony Bush, Lori Huthoefer, Raj Kannan and Steve Spaeth of the FCC's Common Carrier Bureau, Competitive Pricing Division. The purpose of the meeting was to discuss issues related to this proceeding.

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 G. McKennedy
Director-Legal & Regulatory Affairs

Attachment

cc w/o attach: Les Selzer
Anthony Bush
Lori Huthoefer
Raj Kannan
Steve Spaeth

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LEC Price Cap Regulation

A "Direct Method" of price caps was used by the Interstate Commerce Commission (ICC) in regulating railroad prices. The FCC has asked about the appropriateness of a similar method for price cap LECs.

In any discussion of a direct method, it is critical to distinguish between:

1. **The specific TFP and input inflation measurement methods adopted by the ICC versus those that might be adopted by the FCC.**

2. **The specific mechanics of the Railroad "direct method" versus the mechanics of any other "direct methods."**

1. **The specific TFP and input inflation measurement methods adopted by <u>the ICC versus those that might be adopted by the FCC.</u>**

- **The ICC did not develop its input inflation measure and its TFP measure together. Instead, it developed its input price measure, known as the Railroad Cost Adjustment Factor (RCAF) Unadjusted, well before it determined the need to measure TFP.**

- **Christensen Associates, testifying on behalf of consumers, subsequently recommended and developed a railroad TFP measure that was internally consistent with the measure of input inflation that had already been adopted by the ICC. The ICC adopted the recommendation of its contract consultant (Reebie Assoc.), which was to use the proposed Christensen TFP methodology, with certain minor adjustments.**

- **In order to consider a "direct method" for the LEC price cap plan, the input inflation measure must be developed in conjunction with the TFP measure, using the same methods, consistent data and meaningful economic concepts.**

  * **The Commission established the criteria that the productivity measurement must be economically meaningful.**

  * **The Commission should use economic measures of capital inputs, including economic depreciation rates, opportunity cost of capital (rather than accounting return to capital).**

  * **Because the RCAF Unadjusted price cap that had been in use for years relied on accounting measures rather than economic measures, the ICC chose not to change the RCAF methodologies and used the same accounting measures in its TFP calculation.**

  * **Because the Christensen TFP Study for LECs submitted by USTA uses economic measures for both TFP and input price calculations, it achieves the same consistency that the ICC sought when it chose to use accounting measures for TFP.**

2. **The specific mechanics of the Railroad "direct method" versus the <u>mechanics of any other "direct methods."</u>**

- **The specific version of a "direct method" used in the railroad industry used different mechanics than a "direct method" that might be used for the price cap LECs.**

  Our understanding is that the Railroad price cap regulation approach contains the following characteristics:

  - **The price cap index is calculated and updated each quarter.**

  - **An annualized input inflation (RCAF Unadjusted) <u>reduced</u> by a 5-year moving average of accounting-based TFP. ICC chose 5 years as a balance between the goals of stability and currency.**

  - **A measure of railroad input inflation had been published since 1939. The RCAF input inflation measure had been utilized in the price cap index for approximately eight years (1981-1989) before a productivity adjustment was included.**

  - **Following the Staggers Rail Act (1980), broad categories of rail carriage were removed from rate regulation. Any carrier and any customer could enter into private contracts.**

  - **A large fraction of railroad prices are negotiated in private contracts. For example, as of June 1995, 62% of coal and 57% of grain tonnage was under contract.**

  - **TFP calculated for the total industry, including both RCAF regulated and nonregulated services.**

  - **No earnings sharing.**

  - **Carriers were allowed to discontinue serving low-density, unprofitable lines. This increased achieved productivity.**

- **A "direct method," if applied to the LECs, must recognize:**

  - **A 5-year moving average TFP growth is a reasonable estimate of recent TFP growth that would flow through changes to customers.**

  - **1-year LEC input inflation measure is highly volatile.**

  - **The measure of input inflation that the FCC might use in a direct method for LECs is not known (the methods have not been specified, specific historical values and volatility have not been observed), contrary to the long experience with input inflation measures in the railroad industry.**

    * **The FCC should endorse use of the Christensen TFP Study and accompanying input inflation data for evaluation of a direct method.**

  - **In addition to the economic theory and incentives, it is critical to consider the practical application and measurement issues.**

  - **The LECs should have an opportunity to evaluate the FCC's recommended methods for measuring LEC input inflation (the absolute values of the calculations and the volatility of the results over time) in evaluating their potential support for a direct method.**

*** Decisions to be made by the FCC on a number of aspects of TFP measurement will dramatically affect the absolute values of measured LEC input inflation and the volatility of year-to-year results -- including treatment of: opportunity cost of capital, depreciation rates, capital gains and other capital input measurement items.**

*** When TFP and input inflation are measured over the same time periods using the same data and methods (a decision the Commission will have to make), changes in methods for labor input and materials input tend to have equal and offsetting effects on the results of price cap index determined using such a "direct model."**

- **The LECs do not now currently have the broad ability to negotiate contracts for specific common carriage (prices and terms) that has been fundamental part of railroad regulation since the enactment of the Staggers Rail Act in 1980. Contract carriage should be available to LECs in appropriate situations.**