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Suite 1000
1120 20th Street, N.W.
Washington, DC 20036
202 457-3810

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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

Dear Mr. Caton:

Re: Ex Parte CC Docket 92-77 and 96-128

Yesterday, September 11, 1996, Donna Heflin, and Safir Rammah of AT&T, had a telephone discussion with John Scott, Raj Kannan and Allen A. Barna, of the Common Carrier Bureau. During this telephone discussion, the attached material, relating to the above mentioned docket was discussed.

Due to the late hour of this telephone discussion two copies of this Notice are being submitted today to the Secretary of the FCC in accordance with Section 1.1206(a)1.

Sincerely,

Brian W. Masterson

Brian W. Masterson
Director, Government Affairs

Attachment

cc: Allen A. Barna
Raj Kannan
John Scott

Notes on the Proper Methodology to Calculate Inmate CPE Exogenous Costs

Safir Rammah
AT&T

LECs' methodologies for the calculation of exogenous costs for the deregulation of inmate CPE generally fall under the following two broad categories.

Method 1: Some LECs (Ameritech, SW Bell) have calculated the exogenous cost as equal to their current Inmate CPE part 69 revenue requirement.

Method 2: Other LECs, have calculated the exogenous amount either (a) equal to their 1990 or current inmate CPE Part 69 revenue requirement, adjusted for % change in Common Line PCI since 1990, i.e., Pacific of California, US West, or (b) equal to the same % of Common Line revenues as their current Inmate CPE Part 69 revenue requirement is of the total Part 69 Pay category revenue requirement, i.e., NYNEX.

Discussion: The main difference between the two methodologies is that while Method 1 assumes a link between LECs' regulated costs and their regulated prices, Method 2 assumes no such relationship under price caps. As such, to determine the appropriate methodology we must first determine whether there is any link between LECs' regulated costs and prices under price caps.

The LECs' regulated costs have continued to impact their prices under price caps for two reasons:

1) Sharing/LFA mechanism: Any changes in LECs' costs under price caps have impacted the regulated rate of return, and as a result have impacted their prices.

2) In addition, changes in LECs' costs under price caps have impacted their interim X-factor that was adopted in 1995. The underlying studies for the calculation of this revised X-factor were based on LECs' efficiencies in regulated operations under price caps. The proposed X-factor revision in Docket 94-1 will also take into consideration LECs' regulated operations under price caps.

On a number of occasions, the Commission has recognized this relationship between LECs' regulated costs and prices under price cap. For example, in its NPRM in CC Docket 96-150, released 7-18-96, the Commission stated that, "Under rate of return, <u>price caps with sharing</u> (either for interstate or intrastate services), or <u>price caps that may be adjusted in the future</u>.....an incumbent local exchange carrier may have an incentive to misallocate to its regulated core business costs that would be properly allocated to its competitive ventures." [para. 6, emphasis provided]. There would be no such incentive

without a link between LECs' regulated costs and prices, which the Commission correctly recognized exists under price caps due to sharing and X-factor revisions.

Thus, any methodology for the calculation of inmate CPE exogenous costs that is based on the assumption of 'no link' between LECs' costs and prices under price caps must be rejected.

Theoretically, if LECs have met their productivity objective under price caps, their annually adjusted revenues should track their annual costs. Thus, it appears that an exogenous cost amount equal to a LEC's current inmate CPE Part 69 revenue requirement may be the most appropriate methodology to calculate inmate CPE exogenous cost adjustment, for the following reasons.

1. It recognizes the fact that LECs' regulated prices have continued to be impacted by their regulated costs under price caps.

2. Although, LECs are now allowed to earn unlimited rate of return under 5.3 X-factor option, this methodology only removes the current revenue requirement at 11.25% rate of return, the same rate of return that LECs were allowed to earn before price caps. This does not deprive the LECs of any efficiency gains they have achieved under price cap.

3. If for some reason we decide to base the inmate CPE exogenous cost calculation on 1990 revenue requirement, we have to deal with the issue of time value of money. 1996 dollars are not equal to 1990 dollars. The easy solution is to use the most current revenue requirement to determine the exogenous cost adjustment.

4. Calculating the exogenous cost amount as equal to the same percentage of current CL revenues that the current Inmate CPE revenue requirement is of the total CL revenue requirement does not make any sense. It can be improved to some degree, if instead a PCI adjustment is made equal to the same percentage that the 1990 Inmate CPE revenue requirement was of 1990 CL revenue requirement. [The initial PCI of 100 was set as equal to total CL revenues, that were equal to total CL revenue requirement plus LTS].

5. Most of the exogenous cost changes under price caps, related to separations or accounting changes, have been calculated based on the resulting change in the most recent revenue requirement. Inmate CPE exogenous cost calculation should also be based on this well established methodology.

Note: <u>The Payphone IOT and Inmate CPE revenue requirements filed by most LECs, in their Inmate CPE tariffs, appear to be incorrect and need to be verified.</u> Once the payphone IOT revenue requirement is properly calculated, the inmate CPE revenue requirement can be determined equal to the same percentage of payphone IOT revenue requirement as the Inmate CPE lines are of the total payphone lines.