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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

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

**Ex parte**

CC Docket No. 94-1, Second FNPRM  
CC Docket No. 94-1, Fourth FNPRM

November 19, 1996

Dear Mr. Caton:

On Monday, November 18, 1996, Whit Jordan, John Lube, Tom Whitaker, and Frank McKennedy, representing the United States Telephone Association (USTA), met with Jim Schlichting, Chief of the Competitive Pricing Division (CPD) of the Common Carrier Bureau and CPD staff members Jane Jackson and Jay Atkinson. The purpose of the meeting was to review the LEC industry rebuttals filed in the reply comments in CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, regarding the MCI MiCRA study.

Due to the late adjournment of the meeting an original and three copies of this letter and the attached documents left with the FCC staff are being filed today, the next business day, with the Secretary of the Commission. Please include copies in the public records for Dockets 94-1, Second FNPRM and Fourth FNPRM.

Sincerely,

  
Frank G. McKennedy  
Director-Legal & Regulatory  
Affairs

Attachment:

cc w/o attach:

Jim Schlichting

Jane Jackson

Jay Atkinson

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**United States Telephone Association  
Capital Recovery Team**

**Price Caps  
& Access Reform**

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OFFICE OF SECRETARY

**November 18, 1996**

# USTA Capital Recovery Team

## Purpose of Visit

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- Respond to the MiCRA study.
- Show that MiCRA compared the FCC's lives with the FCC's lives, and found them to be the same.
- Explain the depreciation problem.
- Access reform proceeding is an appropriate proceeding to address recovery of LEC investment.

# USTA Capital Recovery Team

## Reply Comments Responsive to the MiCRA Study and Depreciation

<u>Tab</u>	<u>Party</u>	<u>References to the MiCRA Study and Depreciation</u>
1	USTA	<ul style="list-style-type: none"><li>• Pages v, 17-18</li><li>• Attachment C (Dr. James H. Vander Weide; pages 17-19)</li><li>• Attachment D (Technology Futures, Inc.)</li></ul>
2	Ameritech	<ul style="list-style-type: none"><li>• Pages 3-4</li></ul>
3	Bell Atlantic	<ul style="list-style-type: none"><li>• Attachment 2 (Dr. James H. Vander Weide; pages 17-19)</li></ul>
4	NYNEX	<ul style="list-style-type: none"><li>• Pages 11, 18-19</li><li>• Attachment C (Dr. James H. Vander Weide; pages 17-19)</li><li>• Attachment D (Technology Futures, Inc.)</li></ul>
5	Pacific/Nevada	<ul style="list-style-type: none"><li>• Pages 13-14</li></ul>
6	Southwestern Bell	<ul style="list-style-type: none"><li>• Page 13</li><li>• Appendix A</li></ul>
7	U S West	<ul style="list-style-type: none"><li>• Pages 23-28</li></ul>

# **USTA Capital Recovery Team**

## **MiCRA's Circular Logic**

- **MiCRA uses the FCC's prescribed factors (i.e., lives and net salvage) to calculate theoretical depreciation reserves.**
- **MiCRA compares these theoretical depreciation reserves to the LECs' booked depreciation reserves.**
- **The LECs' booked depreciation reserves largely reflect the FCC's prescribed factors.**
- **MiCRA observes that there is a relatively-small difference between the theoretical reserves and the booked reserves.**
- **Since both the booked reserves and the theoretical reserves reflect the FCC's prescribed factors, a large difference is not likely.**
- **Therefore, MiCRA's comparison is circular, and does not prove that a depreciation problem does not exist.**

# USTA Capital Recovery Team

## The Depreciation Problem

- The depreciation problem lies with the FCC's prescribed factors.
- Recent life prescriptions have been overly influenced by retirements.
- Retirements are not a good predictor of the future life of a technology in an environment of increasing competition and rapid technological advancement.
- Lives in this environment are driven by economic obsolescence.
- Economic obsolescence begins to occur long before retirements.

“nonphysical causes [for the depreciation of assets] are likely to be present long before direct evidence of their existence appears. ... Therefore, any obsolescence must be reflected in depreciation provisions [i.e., lives and rates] even if it has yet to cause any retirements. Thus, future events are to be anticipated and reflected in depreciation rates. Nonphysical causes ... often do not receive recognition in the [regulatory] process until after they have caused retirements.” (Robert L. Hahne and Gregory E. Aliff, Accounting for Public Utilities, Times Mirror Books, 1995, page 6-10.)

- The economic depreciation used by other telecommunications companies (such as MCI) clearly demonstrate that the FCC's prescribed lives are too long. The next two pages, excerpted from USTA's March 1, 1996 Reply Comments in CC Docket No. 94-1, illustrate this.
- Comparing economic theoretical reserves (i.e., calculated using economic lives) with the LECs' booked reserves reveals a very significant shortfall in the LECs' booked reserves (i.e., the “depreciation problem”).

EXCERPT FROM  
 USTA'S REPLY COMMENTS,  
 ATT. D, CC DOCKET 94-1,  
 FILED MARCH 1, 1996

**Table 3**  
**COMPARATIVE LIVES OF TELECOMMUNICATIONS**  
 (Lives in Years)

Plant Category	Cable TV	AT&T	LECs	TFI
Distribution Facilities	10-15 (Coax & Fiber Cable)	3.4-15(Metallic Cable)	20-30(Metallic Cable)	14-16(Metallic Cable)
Circuit Eqpt	7-14	2.5(Analog) 7.2(Digital)	8-11(Analog) 11-13(Digital)	6-9(Analog) 8-9(Digital)
Digital Switch	NA	9.7	16-18	9-11 ✓
Non-Metallic Cable (Fiber)	See Distrib. Facilities	20	25-30	15-20
Vehicles	3-7	6.6	7.5-9.5	NA
Furniture & Office Eqpt	9-11	5.6(Furniture) 9.3(Ofc Eqpt)	15-20(Furn) 10-15(Ofc Eq)	NA

1. **Cable TV Asset Lives** - This column shows the ranges of asset lives the FCC has established for use by cable providers pursuant to the Cable Act of 1992 and the FCC's Order in MM Docket No. 93-215 and CS Docket No. 94-28, released January 26, 1996.
2. **AT&T Asset Lives** - This column lists the lives ordered in CC Docket No. 95-32, AT&T's depreciation prescription as of January 1, 1994.
3. **LEC Asset Lives** - These life range are currently used by the FCC to prescribe depreciation rates for LECs under the procedures adopted in CC Docket No. 92-296.
4. **TFI Recommended Asset Lives** - These lives result from TFI's most recent studies for LEC assets as described in Table 1.

Table 4  
CONVERGING INDUSTRIES DEPRECIATION COMPARISON

Company	% 1995 Depr Rate	Depr Resv % (12/31/94)	Derived Remaining Life(yrs) <sup>4</sup>
<b>Cable/Entertainment</b>			
Time Warner	32.6		
Comcast	24.7		
Viacom	24.2		
Cablevision	21.2		
Walt Disney	20.2		
Jones Cable	14.8		
TCI	12.6		
Cox	11.0		
AVERAGE	18.5	33	3.6
<b>High Tech Mfgs</b>			
Dell	18.3		
IBM	13.6		
Hewlett Packard	13.0		
Motorola	12.4		
Apple	11.7		
Compaq	11.1		
AVERAGE	13.2	57	3.3
<b>IXC/CAPS</b>			
MFS	13.0		
AT&T	9.3		
MCI	8.9		
AVERAGE	9.3	47	5.7
<b>LECs</b>			
SNET	7.9		
Sprint	7.9		
Rochester	7.8		
Bell Atlantic	7.5		
GTE	7.4		
BellSouth	7.3		
Southwestern Bell	7.2		
US West	7.2		
Ameritech	7.1		
NYNEX	7.1		
Pacific Telesis	7.0		
AVERAGE	7.3	41	8.1

<sup>4</sup> The derived Remaining Life is calculated by (100% - Depreciation Reserve %) / Depreciation Rate. The Net Salvage is assumed to be zero.

**REPLY COMMENTS  
RESPONSIVE TO THE  
MiCRA STUDY AND  
DEPRECIATION**

INDEX

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Before the  
FEDERAL COMMUNICATIONS COMMISSION

Washington, DC 20554

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

In the Matter of: )

Price Cap Performance Review )  
for Local Exchange Carriers )

BUCKET FILE COPY DUPLICATE

CC Docket No. 94-1

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**Reply Comments of the United States Telephone Association on Fourth  
Further Notice of Proposed Rulemaking**

Mary McDermott  
Linda Kent  
Charles D. Cosson

U.S. Telephone Association  
1401 H Street, NW  
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(202) 326-7249

March 1, 1996

The simplified method is also administratively simple - all the data needed to calculate the TFP-based rolling average productivity offset can be displayed in a 19 page TFP Review Plan, such as that provided by USTA as Attachment B to its initial comments.

The simplified Christensen TFP method recognizes that there is no inherent meaningful differential between the rate of growth in input prices for LECs, and the rate of growth in input prices for the U.S. economy. Proper analysis of this differential reveals that the result is essentially zero. No party demonstrates that the long-term differential is anything other than zero. Additionally, the attached Christensen Reply demonstrates that examination of short-term data confirms that the differential is merely "random noise" - in the 1989-94 period the differential was in fact positive. The comments advocating an input price adjustment provide no meaningful analysis, and instead appear to argue, without support, that an input price adjustment should be included simply because it increases the productivity offset. To the extent that these parties calculate an input price adjustment, they do so using inconsistent data sets - the LEC input price index is adjusted in a manner not performed on the index for the U.S. economy. Such an approach is inconsistent with the goal of an economically meaningful productivity offset.

The simplified Christensen TFP method also recognizes that no meaningful productivity offset can be developed on an interstate-only basis, because interstate and intrastate services share common inputs. Any artificial allocation of inputs between jurisdiction would be arbitrary and not provide any accurate measure of productivity. The commenters advocating an interstate-only productivity offset essentially acknowledge that interstate-only productivity cannot be meaningfully measured. Instead, they rely on an unjustified assumption that total company input can be used as a proxy for interstate-only input. An interstate-only productivity offset is not legally required under Smith v. Illinois Bell, 282 U.S. 133 (1930). If Smith were read to require that result, neither the FCC nor a state Commission could utilize GNP-PI (or GDP-PI), nationwide measures of the cost of capital, or any other economy-wide figures in adjusting price cap indexes. This absurd result was never contemplated by Smith.

The simplified Christensen TFP method properly calculates the elements of TFP. Christensen properly uses economic depreciation rates, rather than the rates prescribed by regulation. MCI provided a study by MiCRA which advocates regulated depreciation rates. As discussed in the TFI Study included as Attachment D to these replies, the MiCRA paper is premised on assumptions concerning the economic lives of telephone plant that ignore the substantial changes that are transforming the telecommunications industry. Other telecommunications firms, such as cable operators and long-distance providers who will be competing head-to-head with telephone companies, utilize far shorter lives than those prescribed by regulators for virtually identical plant. It is more likely that MCI advocates continued use of regulated depreciation rates because inadequate depreciation resulted in artificially lower prices for interexchange carriers and other access customers.

nationwide measures of the cost of capital, or any other economy-wide figures in adjusting price cap indexes for local rates. By Ad Hoc and AT&T's reading, regulators must instead develop measures of inflation based on jurisdictionally separated costs.<sup>6</sup> This absurd result was never contemplated by Smith.

**C. The Simplified Christensen TFP Methodology Properly Calculates the Elements of TFP**

**1) The Simplified Christensen Study Properly Utilizes An Economic Rate of Depreciation**

MCI submitted with its comments a study prepared by Baseman and Van Gieson which, MCI claims, demonstrates that the Commission's current depreciation rates adequately reflect the economic life of telephone company assets. See Baseman and Gieson, "Depreciation Policy in the Telecommunications Industry: Implications for Cost Recovery by the Local Exchange Carriers," December 1995, attached to MCI Comments ("MiCRA Study"). As discussed in the attached paper by Technology Futures, Inc. ("TFI Study"), the MiCRA Study makes a number of incorrect assumptions and relies on circular reasoning. Additionally, the MiCRA Study ignores the fact that price cap LECs have determined that the use of regulated depreciation rates, under the criteria prescribed by FASB 71, is no longer appropriate. As a consequence of the excessively long depreciation rates prescribed by the Commission, LECs took a total charge of approximately \$40 billion dollars to bring their depreciation reserves in line with the facts of a competitive marketplace, and coincident with the conversion to price cap regulation.

MCI's support of regulated depreciation lives can perhaps more likely be explained by the following analysis. One of the primary assumptions of FASB 71 and the continued use of long depreciation lives set by regulators is that past costs could be included in future prices

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<sup>6</sup>In fact, by this reading, the Commission's use of GNP-PI for AT&T's own price cap plan would be unlawful.

because regulators also controlled the rate of return and were willing to risk future price increases in return for artificially lower prices in the present. These lower rates, despite inadequate depreciation, essentially resulted in artificially lower prices for interexchange carriers and other access customers. MCI therefore advocates continued use of regulated depreciation rates in order to perpetuate this windfall.<sup>7</sup>

As discussed in the TFI Study included as Attachment D to these comments, the MiCRA paper is premised on assumptions concerning the economic lives of telephone plant that ignore the substantial technology, regulatory, and market changes that are transforming the telecommunications industry. Other telecommunications firms, such as cable operators and long-distance providers who will be competing head-to-head with telephone companies, utilize far shorter lives than those prescribed by regulators for virtually identical plant. See TFI Study, Attachment D, at 1-2. In order to meaningfully measure productivity, a TFP study should utilize a measure of capital stock which recognizes differences between book depreciation and economic depreciation. The Christensen simplified TFP method recognizes this fact, and utilizes a meaningful, publically available measure of depreciation lives, that used by the BEA and BLS for the comparable analysis of U.S. productivity. See Christensen Reply at 19-20.

## 2) The Simplified Christensen Method Properly Calculates the Labor Index

Ad Hoc recommended that the TFP labor index used in the simplified Christensen TFP method be adjusted to account for one time events including "golden handshakes" given to encourage early retirements and for OPEB related expenses. Ad Hoc recommends that such

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<sup>7</sup>In order to present an accurate picture on their balance sheet, LECs determined that they must take a one-time charge (collectively about \$40 billion) and write up their depreciation reserve to reflect the depreciated value which should have been recognized, but was not, under their depreciation rates. Pursuant to separations rules, 25% of this \$40 billion reflects a direct benefit to MCI and other interexchange carriers.

# **ATTACHMENT C**

## **Affidavit of Dr. James H. Vander Weide in Support of Reply Comments of the United States Telephone Association**

**James H. Vander Weide**

**James H. Vander Weide Co.**

**USTA Reply Comments 3/1/96**

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

In the Matter of

Price Cap Performance Review  
for Local Exchange Carriers

Fourth Further Notice of Proposed Rulemaking

CC Docket 94-1

AFFIDAVIT OF DR. JAMES H. VANDER WEIDE  
IN SUPPORT OF REPLY COMMENTS OF  
THE UNITED STATES TELEPHONE ASSOCIATION

March 1, 1996

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**VI. MCI's depreciation study fails to distinguish between accounting concepts and economic concepts.**

28. In their initial response to the FCC's price cap performance review for local exchange carriers, the LECs' demonstrated that their accounting profits for the price cap period, 1991 – 1993, were distorted by inadequate depreciation reserves.<sup>13</sup> MCI now attempts to refute the LECs' results through a depreciation study prepared by Kenneth C. Baseman and Harold Van Gieson. The Baseman/Van Gieson study presents data on the RBOCs' FCC-prescribed depreciation reserve deficit from 1983 to 1994. Since the FCC-prescribed depreciation reserve deficit declined from \$21 billion in 1983 to \$3.16 billion in 1994, Baseman and Van Gieson argue that the RBOCs' profits are not distorted by inadequate depreciation reserves.<sup>14</sup>

29. Despite their assertion to the contrary, the Baseman/Van Gieson study *does not* support their conclusion that the RBOCs' "current depreciation rates are adequate." Like the Norsworthy productivity study sponsored by AT&T, the Baseman/Van Gieson study fails to distinguish between accounting concepts and economic concepts. The accounting depreciation rates studied by Baseman and Van Gieson are designed to allocate the original or historical cost of the RBOCs' investments over their assumed useful lives. Many of the RBOCs' assets have useful lives ranging from 10 to 20 years. Even assuming for the moment that these useful lives

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<sup>13</sup>*Comments of the United States Telephone Association, CC Docket No. 94-1, p. 16, filed May 9, 1994.*

<sup>14</sup>Baseman and Van Gieson, *op.cit.*, page 4.

are not too long in today's environment of rapid technological changes, in a period of inflation, accounting depreciation is *never* sufficient to measure the cost of replacing long-lived assets. Economists, therefore, measure depreciation based on the replacement cost of assets, not the original or historical cost. Since the replacement cost of the RBOCs' assets exceeds their historical cost, the RBOCs' current depreciation rates are inadequate to cover the cost of replacing their assets.

30. The Baseman/Van Gieson study suffers from several additional flaws that invalidate their conclusions. First, the Baseman/Van Gieson study is based primarily on FCC-approved depreciation rates rather than market-determined depreciation rates. As noted in my previous affidavit in this docket, the RBOCs' depreciation rates are significantly less than the depreciation rates of competitors such as AT&T, whose depreciation rates effectively are unregulated. If the price cap LECs had used the same depreciation rates as AT&T during the price cap period 1991 – 1994, the LECs' average accounting rate of return would have been reported as 8.17%. While still failing to measure the true *economic* returns of the price cap LECs, this accounting return does illustrate the significant effect of inadequate depreciation on the LECs' reported accounting rates of return during the price cap period. Second, Baseman and Van Gieson report a significant increase in the depreciation reserve deficits when they include only those states with depreciation hearings in 1995. Thus, contrary to Baseman and Van Gieson's assertions, according to the most recent data, the depreciation reserve deficit is now dramatically greater than Baseman

and Van Gieson's first estimate. Third, Baseman and Van Gieson did not measure the effect of the RBOCs' depreciation reserve deficits on their reported rates of return.

**VII. Retaining a sharing requirement in today's competitive access environment serves no useful economic function and is counterproductive.**

31. The Respondents recommend that the Commission retain some form of sharing in the price cap plan. Their arguments to retain sharing again ignore the significant differences between accounting and economic rates of return. The Commission's current sharing rules are based on a calculation of a LEC's achieved accounting rate of return during the previous year. As noted in Section IV, the LECs' accounting rates of return exceed their economic rates of return. As long as the sharing rules are based on the LECs' accounting rates of return, the LECs may have to share their earnings with ratepayers even though their economic rate of return is not in excess of the Commission's estimate of their cost of capital. Thus, the sharing rules, based on accounting earnings, deny investors their right to earn a fair and reasonable rate of return for the use of their property invested in the LECs' telecommunications networks.

32. As the Commission has correctly recognized,<sup>15</sup> sharing also blunts the incentives of the LECs to reduce costs, invest in new telecommunications infrastructure, and introduce new products and services.

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<sup>15</sup>*Price Cap Performance Review for Local Exchange Carriers*, 9 FCC Rcd 1687 at §11 (1994).

# **ATTACHMENT D**

## **“Implications of Technology Change and Competition on the Local Exchange Carriers”**

**Adrian J. Poitras  
Lawrence K. Vanston**

**Technology Futures, Inc.**

**USTA Reply Comments 3/1/96**

**IMPLICATIONS OF TECHNOLOGY CHANGE  
AND COMPETITION ON THE  
DEPRECIATION REQUIREMENTS OF THE  
LOCAL EXCHANGE CARRIERS**

Adrian J. Poitras

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Prepared on Behalf of the United States Telephone Association

## EXECUTIVE SUMMARY

Microeconomic Consulting and Research Associates, Inc. (MiCRA) has filed in support of MCI in response to the claims of local exchange carriers regarding the continuing problems with depreciation. The conclusions of MiCRA's research are wrong, and result from improper assumptions along with a failure to understand the technology issues underlying the LEC assertions. TFI demonstrates herein that:

- LEC regulated depreciation rates and reserves are substantially below proper economic rates and reserves;
- Technology and competition pose serious cost recovery problems for LECs which must be resolved now;
- The pace of technology change and competition have caused overstatement of regulated lives for key network assets; and
- Discontinuance of FAS 71 for financial reporting is material evidence of the scope and magnitude of this problem.

As TFI shows in its review, MiCRA is erroneous in its conclusion that "complaints about allowable depreciation reserves and current expenses are unwarranted." The real evidence regarding technology change and competition leads to the opposite conclusion. The MiCRA conclusions are fundamentally flawed due to the failure to consider the impact of correct lives in the depreciation rate and reserve requirement calculations.