upper service band index limit would contain the term:

$$(R + \Delta Z)/R$$

The R value would reflect access services in the service category or zone and the $\Delta Z$ exogenous changes applied to the service category or zone. This formula effectively prevents any cost shifting between zones or service categories.

In addition, the Act contains numerous safeguards to ensure that competitors can utilize unbundled elements to compete with incumbent LECs.[85] Any concerns about potential incumbent LEC anti-competitive behavior have been assuaged. USTA urges the Commission to adopt its proposed price cap basket structure which will allow incumbent LECS a modicum of additional pricing flexibility and which will group services according to functionality.

**B. Recommendations to Increase the X-Factor Must Be Rejected.**

Several parties make unreasonable claims that the productivity offset (X-Factor) in the LEC price cap plan should be increased.[86] Evidence in this proceeding[87] and in the Price Cap

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[85]*See*, Section 251.

[86]AT&T, pp. 69-72; MCI, pp. 24-28; Ad Hoc, p. 70. *See also*, CARE ex parte, CC Docket No. 94-1, Fourth FNPRM, filed April 16, 1996.

[87]*See* USTA Comments: Attachment 5, "Updated Results for the Simplified TFPRP Model and Response to Productivity Questions in FCC's Access Reform Proceeding," Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen (Christensen Update); Attachment 6 "Critique of the AT&T Performance-Based Model." Christensen Associates (Critique of AT&T); and Attachment 7, USTA Ex Parte in CC Docket No. 94-1, "Response to MCI Productivity Analysis," (Response to MCI); and Attachment 4, "Affidavit of Dr. James H. Vander Weide" (Vander Weide). Dr. Vander Weide's previous affidavit submitted in CC Docket 94-1 is appended hereto at Attachment 9. USTA is providing the work papers associated with the Christensen Update and the Critique of AT&T's Norsworthy study as Attachments 10 and 11, respectively.

Performance Review[88] demonstrates that the numerous conceptual and computational errors in the X-Factor recommendations of AT&T, MCI and Ad Hoc lead to an inescapable conclusion that these recommendations are not economically sound. Specifically, USTA filed four relevant attachments in its comments in this proceeding.

The Christensen Update presented updated total factor productivity (TFP) results through 1995. Those results show that, historically, LEC productivity growth has exceeded U.S. economy productivity growth by 2.7 percent per year.

The Critique of AT&T demonstrates that the so-called "productivity" analysis of the study method relied upon by AT&T is one that is replete with errors and based on a series of fundamentally incorrect methods. The analysis incorrectly measures every component of productivity (i.e., capital input , labor input and materials, rents and services input, and output, from both a quantity perspective and a price perspective). This analysis cannot be relied upon to support an increase in the X-factor.

USTA's Response to MCI exposes the MCI methods as both conceptually and quantifiably in error. In the earlier price cap review proceeding, MCI computed an X-Factor

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[88]*See* USTA Comments, CC Docket No. 94-1, Fourth FNPRM, pp. 1-33, Attachment A "Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans including Response to Appendix F, Christensen, Schoech and Meitzen, Christensen Associates, and Attachment B, "Total Factor Productivity Review Plan," and Attachment C, "Economic Evaluation of Issues for the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review," Taylor and Zarkadas, NERA, filed January 11, 1996;. and USTA Reply Comments, CC Docket No. 94-1, Fourth FNPRM, pp. 6-21, Attachment A, "Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans: Reply Comments," Christensen, Schoech and Meitzen, and Attachment B, "Economic Evaluation of Issues for the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review: Reply Comments," Taylor, Tardiff, and Zarkadas, NERA, filed March 1, 1996.

based on the accounting earnings results of the price cap LECs. While USTA had already presented proper evidence that completely discredited the MCI approach, MCI and other members of the CARE group again attempt to rely on the flawed MCI computations.

MCI never even attempted to measure LEC productivity. MCI's expressed intent was to determine how large the X-Factor would have to be to force -- as a result of a single year's application of a new higher X-Factor -- the price cap LECs' average interstate accounting earnings back to their starting point five years ago. Application of such an X-factor would immediately eliminate all of the financial incentives for increased efficiencies present in the LEC price cap plan since its inception. MCI's approach is aimed at regulating earnings, not prices, and providing disincentives, not incentives. This approach must be summarily rejected.

Moreover, MCI's computations, and therefore CARE's ex partes relying on MCI, are incorrect. MCI's method essentially observes how "far" the price cap LECs have been able to "run" over a five year period and incorrectly assumes that in the future this same "distance" can be covered in a single year. This results in "speed" calculations by MCI that are dramatically overstated. This approach would eliminate the earnings of the price cap LECs achieved through increased productivity. Further, USTA shows that, even within MCI's flawed earnings-based framework, correct math would yield a much lower X-Factor estimate of approximately 2.85 percent, very close to the Christensen productivity results.

The objective of MCI in recommending such an X-Factor is to eradicate more than 50 percent of price cap LECs' interstate access revenues over a five-year period. As discussed above, such outrageous reductions will only serve to eliminate every positive incentive to invest in the infrastructure. Congress certainly did not contemplate such a result. MCI's estimate of a

15.2 percent X-Factor must be rejected.[89]

AT&T claims that removing interstate loop cost recovery from price caps might actually raise the ability of price cap LECs to achieve productivity. AT&T's claim is incorrect. AT&T asserts that by no longer assessing the CCL charge on a per-minute basis and removing all loop recovery from price caps, a larger portion of the LECs' regulated revenue would be recovered on a per-minute basis.[90] Thus, while AT&T is recommending reductions in the portion of LEC access prices to be billed on a per-minute basis, AT&T concludes that a larger portion of LEC price cap prices will be charged on a per-minute basis, requiring an increase in the X-Factor to above 8.8 percent. AT&T's assumptions regarding the attribution of cost growth to the services AT&T would remove from price caps is incorrect. AT&T assumes incorrectly that the costs associated with per-minute services would grow at exactly the same rate and be incurred exactly in proportion to the costs associated with the rate elements that AT&T would remove from price cap regulation. USTA has already shown the fallacy of such an assumption.[91] In Attachment 12 appended hereto, Christensen also refutes AT&T's assertions regarding the future rate of productivity measurement.[92]

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[89]MCI recommends a Consumer Productivity Dividend (CPD) of between 5.2 percent and approximately 13 percent per year (depending on how one interprets MCI's approach), claiming that the intent of the CPD was a means to drive prices to economic costs. MCI is wrong. The Commission imposed a CPD to "assign the first benefits of productivity gains to customers." LEC Price Cap Order, para. 76. Of course, the customers that benefit are MCI and AT&T.

[90]AT&T at 70-71.

[91]USTA at 22; USTA Reply Comments, CC Docket No. 94-1, Fourth FNPRM, filed March 1, 1996 at 20-21, Attachment A, and Attachment B.

[92]Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen, "The TFPRP Provides the Best Basis for Determining the Rate of LEC TFP Growth," February 14, 1997 at Attachment

As noted above, AT&T's productivity analysis contains serious numerical and theoretical errors. Thus, AT&T's suggestion that the Commission should add to those errors with an unfounded increase associated with Common Line rate restructuring is clearly wrong.

USTA's access reform proposal does not immediately remove Common Line from price cap regulation. It is logical that the X-Factor should be reduced when interstate revenue growth is slowed, as would be the case when per-minute revenue growth is forfeited for per-line revenue growth in the restructuring of Common Line. USTA demonstrated that access reform rate restructuring will lower interstate revenue growth and the productivity potential of the price cap LECs.[93] Accounting for the major portion of the rate restructuring proposed by USTA, historical productivity differential results must be reduced by 0.4 percent per year to 2.3 percent per year.

AT&T suggests that, if access prices were set at its estimated TELRIC levels, "a great deal" of additional demand for access would be stimulated.[94] This is a case of "the tail wagging the dog." The primary effect of any prescriptive price reduction would be a reduction in access revenues caused by the price decrease. Any prescriptive access price reductions will reduce the price cap LECs' ability to sustain any given level of productivity offset.

Finally, the Vander Weide Affidavit demonstrates that the accounting earnings results of the price cap LECs cannot serve as the basis for any recommendation that earnings results are reason to raise the X-Factor. Dr. Vander Weide demonstrates that the LECs' economic rate of

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[93]USTA Comments at 19-21 and Attachment 5 at 6-8.

[94]AT&T at 71.

return during the 1991-95 time period was significantly less than the Commission's 11.25 percent benchmark rate of return.[95] Dr. Vander Weide computes the economic rate of return on investment in the same manner as the rate of return represcription methods used by the Commission in determining the benchmark 11.25 percent rate of return.[96] That achieved economic rate of return was 8.75 percent over 1991-95. Thus, no access price reductions are warranted due to the earnings results of the price cap LECs.

**C. Reinitialization of Rates is Not Warranted.**

As Sidak and Spulber point out, the proposals to reinitialize the price cap indices is merely a thinly-disguised means of lowering access charges by regulatory fiat rather than through the operation of a competitive marketplace. "The motivation of AT&T, MCI and other entrants in calling for reinitialization is evident as well--they seek to obtain access below economic cost so as to free ride on the incumbent LEC's network."[97]

Reinitialization improperly reimposes rate of return regulation on price cap LECs. Further, the Commission should acknowledge its previous determination that a rate of return represcription is completely inconsistent with price cap regulation. "[I]t would be inappropriate

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[95]Vander Weide, pp. 4-5 and Schedule 1.

[96]Dr. Vander Weide's economic rate of return calculations uses cash flows and market values (as used in the Commission's setting of the rate of return benchmark). Accounting earnings, by contrast, use accrued accounting income, book values and other reporting conventions required by the Commission for its accounting earnings monitoring. Dr. Vander Weide's analysis demonstrate the significant inconsistencies that exist when parties use the current Commission rate of return benchmark (which was established using one set of rules and market perspectives) to judge the accounting earnings results reported using another set of the Commissions rules (that are fundamentally at odds with the perspective utilized for the benchmark setting).

[97]Sidak and Spulber at 43.

to require the participation of the RHCs in future represcription proceedings absent other compelling factors. The only compelling factor raised in the comments is the impact of a rate of return represcription on price cap LECs. Under our present rules, that impact arises in only limited areas. These include possible changes in the amounts that price cap LECs receive from the Universal Service Fund or pay for long-term support of NECA's common line pool; possible changes in price cap LECs' accounting for those affiliate transactions that our rules require LECs to record at costs; and possible changes to the amounts those LECs pay the Telecommunications Relay Services Fund...".[98]

Nor is there any validity to AT&T's arguments that reinitialization will be easy to administer.[99] The social costs of impeding the benefits of competition and further distorting prices for telecommunications services which will have a detrimental impact on end users far outweigh any alleged administrative benefits.

At Attachment 13 appended hereto, Dr. Randall Billingsley refutes the assertions of MCI, GSA/DOD and AT&T regarding the need to reinitialize the current rate of return.[100] Dr. Billingsley updates his previous study with current data on capital structure and cost of debt and cost of equity.

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[98]Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, CC Docket No. 92-133, Report and Order, 10 FCC Rcd 6788, 6818 (1995).

[99]AT&T at 22.

[100]Statement of Dr. Randall Billingsley, February 14, 1997, Attachment 13.

MCI resubmitted evidence from the Preliminary Rate of Return Inquiry that claims that a ten percent rate of return will fully compensate incumbent LEC shareholders.[101] Dr. Billingsley shows that MCI's claim is incorrect. GSA/DOD ignore relevant factors that demonstrate that the current return is supported.[102] Finally, AT&T bases its assertions on a misapplication of market and book values.[103] Dr. Billingsley concludes that a represcription should not be undertaken given the increasing risks as a result of the Act and the uncertainties associated with its implementation.

**D. Equal Access Costs Should Not Be Treated as an Exogenous Adjustment.**

AT&T recommends an exogenous reduction in interstate access rates associated with the expiration of a specific amortization of certain equal access costs booked to specific accounts.[104] The Commission has already reviewed this decision on several occasions and has concluded that no exogenous reduction is warranted.

The equal access reconfiguration amortization was implemented by the Commission as a means of preventing rate shock, leveling rates over an eight year period, and providing the LECs with an explicit legal guarantee of recovery of a specific subset of costs related to regulatory obligation of equal access implementation.[105]

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[101]MCI at 25.

[102]GSA/DOD at 20.

[103]Kravtin and Selwyn at 17-18.

[104]AT&T at 68-69 and Appendix F.

[105]Petitions for Recovery of Equal Access and Network Reconfiguration Costs, *Memorandum Opinion and Order*, 1 FCC Rcd 434.437 (1986).

The specific equal access costs originally reflected in the amortization accounts now have been fully amortized. That event does not signal an exogenous adjustment. AT&T incorrectly states that incumbent LECs' equal access costs have already been fully recovered.[106] Significant equal access costs remain. For example, each time an incumbent LEC purchases a new digital switch, buys switch generic software that is equal-access capable, or maintains existing investments which support equal access capabilities . it incurs additional equal access costs. These ongoing equal access costs essentially replace the specific amounts previously recorded in the accounts reflected in the specific amortization amounts for which a legal guarantee was established. The magnitude of the current equal access costs are substantial and are spread across a wide array of specific Part 32 accounts. Thus, none of these ongoing equal access costs were reflected in the amortization amounts referred to by AT&T and MCI and none have been treated as exogenous in price cap regulation. That incumbent LECs' legal rights to obtain recovery from AT&T for a subset of past equal access costs has expired does not signal that ongoing equal access costs are reduced or eliminated.

These facts demonstrate that exogenous treatment of the expiration of the specific equal access amortization would be an arbitrary adjustment for certain equal access costs but not to other equal access costs. Price cap regulation, historically has treated these costs (and investments in general) as endogenous and should continue to do so.

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[106] AT&T at 68.

## VI. CONCLUSION.

USTA urges the Commission to adopt the market-based approach described here. The market-based approach will preserve the incentives to provide an advanced telecommunications infrastructure to all consumers. Incumbent LECs should be permitted to adjust prices to respond to market forces. Regulation should sunset as competition grows. Competitors should not be allowed to avoid paying a reasonable share of joint and common costs through TELRIC pricing. Full cost recovery must be permitted.

Respectively submitted,

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February 14, 1997

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# ATTACHMENT 1

## Statement of Alfred E. Kahn
## on
## FCC's Proposed Reforms of Carrier Access Charges

**USTA Reply Comments**
**CC Docket No. 96-262**
**February 14, 1997**

# STATEMENT OF ALFRED E. KAHN ON FCC'S PROPOSED REFORMS OF CARRIER ACCESS CHARGES

## I. INTRODUCTION AND SUMMARY

My name is Alfred E. Kahn. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, Cornell University and Special Consultant with National Economic Research Associates, Inc. (NERA). I have been Chairman of the New York State Public Service Commission and of the Civil Aeronautics Board; and in my capacity as Advisor to President Carter on Inflation, I participated actively in the successful efforts of his Administration to deregulate both the trucking industry and the railroads. I am the author of the two-volume *The Economics of Regulation*, reprinted in 1988 by MIT Press, and have written and testified extensively in the area of direct economic regulation, and particularly of the telecommunications, railroad, trucking, airline and electric power industries. Of particular relevance to my statement here, I was for six years a member of AT&T's Economic Advisory Council. I have also been a member of the Attorney General's National Committee to Study the Antitrust Laws (1954-56) and the National Commission on Antitrust Laws and Procedures (1978-80); I am the co-author of *Fair Competition. The Law and Economics of Antitrust Policy* and have published numerous articles in that area. I attach a copy of my full resume as Appendix A.

The FCC's suggested prescriptive approach to the reform of carrier access charges, as described in its proposed Order in Docket 96-488, taken in conjunction with its previous Order

on local interconnection policy (FCC Order[1]), would, in my judgment, jeopardize achievement of the ultimate goal of the Telecommunications Act—namely, accelerated development and investment in an advanced telecommunications infrastructure, under conditions of efficient, dynamic competition. It would do so by reducing carrier access charges rapidly in the direction of total service long-run incremental cost, not of the companies themselves but of a hypothetical entrant. The prescriptive approach ignores the costs of the incumbent local exchange companies, both historical and current, including the costs of the continuing regulatorily-required underpricing of basic residential service. By so doing, it undermines both the incentives and the ability of the ILECs to engage in the necessary large investments in the public network, on which we will continue to be heavily dependent in the years immediately ahead, while at the same time diluting the incentive of new competitors to enter on a facilities basis. The prescriptive approach would also have particularly damaging effects on the incentive of the ILECs and potential challengers to engage in creative innovation.

It will do these things, evidently, in the belief that the markups above incremental costs contained in the current capped access rates constitute a barrier to efficient competition at both local and interLATA levels. That belief is erroneous.

To the extent that the consequent diminution in the flow of contribution to the ILECs from the present carrier access charges is accompanied by a truly equivalent increase in contributions from a universal service fund, competitively-neutrally financed, these harmful

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[1] Implementation of the Local Competition Provisions of The Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996), petition for review pending and partial stay granted, sub nom. Iowa Utilities Board et.al. v. FCC, No. 96-3321 and consolidated cases (8th Cir., October 15, 1996).

consequences will be averted. There is very little reason to doubt, however, that any steps to provide such equivalent compensation will be strenuously resisted and be frustrated by a combination of the very political forces that, by insisting on the continued suppression of basic residential service rates, have continued to render the present flow of contribution from access charges necessary in the first place.

## II. THE BEGINNING POINT: THE LEGACY OF PAST REGULATION

The process of deregulation—of, so to speak, getting from "here" to "there"[2]—cannot be conducted rationally without a full consideration of the state of affairs at its beginning point. In the U.S. telecommunications industry, economic efficiency alone requires that the process of deregulation begin with a clear conception of the huge legacy of the preceding era of comprehensive regulation.[3] To take the simplest example, that continuing heritage includes a structure of regulatorily-imposed rates, some markedly below and others markedly above incremental costs. In these circumstances a simple removal of barriers invites inefficient as well as efficient entry: the competitive process itself is therefore distorted by that legacy.

The heritage of the local telephone companies incorporated—and continues to incorporate—two closely interrelated regulatory phenomena. First, an historical and continuing obligation to extend service ubiquitously and a continuing entitlement to a reasonable

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[2] See, e.g., Kahn, Alfred E., "Deregulation of Air Transportation: Getting From Here to There," *Regulating Business: The Search for an Optimum*, Institute for Contemporary Studies, San Francisco, California, 1978, pp. 37-68.

[3] In this critical respect the situation in telecommunications differs fundamentally from the cases of trucking and the airlines, where it proved possible simply to wipe the slate clean—simply to abolish the entire structure of accumulated regulatory restraints.

opportunity to recover the costs, both past (to the extent they have been capitalized) and current, of fulfilling that obligation. And, second, a rate structure reflecting the residual pricing of basic residential telephone service, with rates in large areas of the country clearly below incremental cost and in most areas below economically efficient levels, and rates for other services—notably toll, vertical services and switched access services to long-distance carriers—equivalently above both incremental costs and efficient levels.

The question of whether the still-regulated LECs are or should be entitled to continuing recovery of those historically-incurred costs is of course intensely contested. It seems incontestable, however, that under the historical—and still continuing in most jurisdictions—regulatory system, they have been entitled to a fair opportunity to recover their prudently incurred costs—that is, the costs that regulators have not found to have been imprudently incurred. This continues obviously to be the essence of continuing rate base/rate of return regulation practiced in a large minority of states. It is, however, true also under the price cap form of regulation adopted by the FCC in 1990 for the largest LECs and now in one form or another in the majority of states: typically the capped or frozen rates were inherited from traditional rate case determinations finding them "just and reasonable," and the controversies over the indexation formulas and productivity offsets have been essentially controversies over the level of rates that would be sufficient for a well-managed company to recover its costs and a fair return on invested capital. As the FCC itself has observed, "the cost showing contemplated