

Your complaint that AT&T did not provide certain modules used with the Hatfield Model is disingenuous. No party has a greater interest than AT&T in a fair and expeditious resolution of the pricing issues in this proceeding. Accordingly, AT&T filed all of the modules needed to run the Hatfield Model that it could without permission of other parties. The remaining modules are all subject to copyrights owned by other parties, including what you describe as the data and loop modules (which are part of the BCM model, of which U S WEST is a co-owner), and the LERG data (owned by Bellcore, of which U S WEST is a co-owner). Because U S WEST or its affiliates owns all of these data, the fact that they were not filed by AT&T could not have hindered U S WEST's ability to run or analyze the results of the Hatfield Model -- as your letter concedes.

The assertions in your letter that AT&T, MCI or Hatfield have improperly adjusted or failed to disclose adjustments to the data modules used in the Hatfield Model, to the detriment of U S WEST, are likewise meritless. For example, the ARMIS data used in the model was obtained from the Commission (which collects it in turn from U S WEST), and was not altered in any way.

Further, contrary to the suggestion in your letter, all of the material adjustments that were made have been disclosed. Thus, AT&T disclosed all of the adjustments made to the "User Adjustable Inputs" to the BCM Model. In addition, AT&T's May 16 filing (Appendix E, p. 14) disclosed that because the BCM Model upon which the Hatfield Model relies "appears to understate" the structure cost of loop distribution in sparsely populated areas, Hatfield made upward adjustments to those costs. Ironically, the effect of these adjustments was to increase the loop cost estimates, to the benefit of U S WEST and other incumbent LECs.

The remaining adjustments made by Hatfield were intended to correct minor and obvious errors and omissions in the modules taken from the BCM Model, and did not have a material effect on the results produced by the Hatfield Model. For example, the most common adjustment was necessary to correct misformatting of the codes (e.g., omitting one of the characters comprising the code) indicating the soil type of particular census block groups (soil type being one of the variables affecting calculation of loop costs). As a co-owner of the BCM Model, U S WEST presumably became aware of these errors in attempting to run BCM itself.

In sum, AT&T believes that it has made all necessary disclosures with respect to the Hatfield Model, and that U S WEST's claims that it needs further information to run the Model are baseless.

Sincerely



Roy E. Hoffinger

cc: Regina Keeney (FCC)
Leonard Sawicki (MCI)
Don Sussman (MCI)

EXHIBIT 3



**MCI Telecommunications
Corporation**

**1801 Pennsylvania Avenue, NW
Washington, DC 20006
202 887 2048**

**Leonard S. Sawicki
Director
FCC Affairs**

July 9, 1996

**Jeffrey S. Bork
Corporate Counsel
U S West, Inc.
1801 California Street, Suite 5100
Denver, CO 80202**

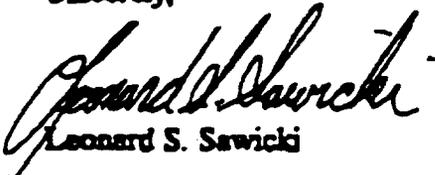
Dear Mr. Bork:

This letter is in reference to your letter of July 1, 1996 addressed to AT&T and MCI, and AT&T's response of July 5, 1996 addressed to you from Mr. Roy Hoffinger.

As I advised in my recent telephone conversation with you, MCI concurs in AT&T's response. MCI has nothing to add to the AT&T letter and will not be providing any reply to the July 1, 1996 letter beyond this note.

If U S West decides to take further action or send additional correspondence on this matter, please continue to address these to both MCI and AT&T. Thank you.

Sincerely,


Leonard S. Sawicki

**cc: Regina Koeney (FCC)
Robert McKenna (U S West)
Roy Hoffinger (AT&T)**



EXHIBIT 4

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

In the Matter of)
)
Implementation of the Local) CC Docket No. 96-98
Competition Provisions in the)
Telecommunications Act of 1996)

FURTHER AFFIDAVIT OF PETER B. COPELAND

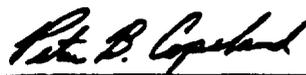
I, Peter B. Copeland, hereby state that the following information is true and correct to the best of my knowledge, information and belief.

1. I am the same Peter B. Copeland who submitted an affidavit in support of U S WEST's Reply To Comments On Its Petition For Order Directing That Discovery Be Permitted, filed June 25, 1996.
2. I have read the letter from Roy E. Hoffinger, dated July 5, 1996, in which Mr. Hoffinger asserts that U S WEST has received sufficient information about the Hatfield Model to permit reasonable examination of the Model and whether it can be trusted to produce accurate results as to loop, switch, and interoffice investment associated with local services. His assertion is not correct.
3. AT&T has still not given U S WEST the line multipliers used by state which adjust households to a total state line count. This information is the very basic input necessary to making the Hatfield Model function.
4. The information cannot be replicated by U S WEST, and the Model cannot be run in a manner which duplicates the Model's results without the information. In fact, AT&T has not given U S WEST any of the input data used to run the Model. Without this input data, it would be extremely difficult and time consuming to conduct an analysis of the Model, even if the line multiplier information were made available.
5. The information which AT&T is withholding is critical for rational analysis. For example, in the Utah proceeding, the Hatfield Model claimed an average loop investment of \$361 (a previous version of the Model). This compared with average loop investment demonstrated by the recently filed BCM2 of \$917. U S WEST's TSLRIC studies, filed with the Utah State Commission,

show an average loop investment of \$858 for the State of Utah. Corrections to the original BCM model, as discussed in U S WEST's and Sprint Corporation's, July 3, 1996 filing of the BCM2 in the Universal Service Docket (CC Docket No. 96-45), included:

- Provision of a more accurate determination of the cost of serving sparsely populated rural areas;
 - More accurate reflection of the cost elements of providing service in dense urban environments, including equipment costs which are necessary in the provision of telephone service which were not included in the original BCM; and
 - Provision of enhancements in the development of costs and provision of additional user options.
6. The new Hatfield Model appears to continue a loop investment in the neighborhood of \$361 in Utah (monthly loop costs were reduced in the most recent Hatfield filing from over \$10.00 per month to \$9.61 per month).
7. We know in general terms why the Hatfield Model reaches such strange results: 1) use of the earlier version of the BCM which, due to simplifying methodologies, significantly understated loop costs (the BCM2, which corrects shortcomings in the original BCM model was filed with the Commission on July 3, 1996, in the Universal Service Docket); 2) unrealistic depreciation lives; and 3) unrealistic fill factors and digital loop carrier costs. A detailed analysis of exactly how these errors acted together to produce incorrect results cannot be conducted without the line multiplier information which AT&T has withheld. Timely analysis cannot be conducted without access to the other input data.

I hereby certify under penalty of perjury that the foregoing is correct.

 7/10/96

Peter B. Copeland Date

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

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FEB 18 1997

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of)

The Use Of Computer Models)
For Estimating Forward-Looking)
Economic Costs)

A Staff Analysis)
_____)

CCB/CPD Docket No. 97-2

COMMENTS OF THE
UNITED STATES TELEPHONE ASSOCIATION

UNITED STATES TELEPHONE ASSOCIATION

By Its Attorneys:

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February 18, 1997

SUMMARY

While the interest of the Staff Analysis in forward-looking cost proxy models is understandable, a broader view of the telecommunications environment based on competition would better serve the public interest. Thus, cost proxy models should not be viewed as a regulatory panacea. Indeed, the Commission wisely has viewed the utility of cost proxy models with caution in a variety of proceedings, and has consistently acknowledged the insufficiencies of existing models.

USTA believes that properly-designed cost proxy models are usable, at best, to assist in identifying high cost areas for purposes of distributing universal service funds. These models should not be a regulatory means of determining the cost of providing service, since their results are hypothetical and disregard costs imposed by the LECs' regulatory obligations. Instead, LECs' actual, company-specific, costs should be used in determining universal service support and in pricing unbundled network elements and other services.

Cost proxy models have difficulty modeling company-specific or geographic costs, particularly those for LECs serving low-density areas. Thus, the Commission staff should consider the special circumstances that rural LECs face in providing services. If a model is used for the limited purpose of identifying high cost areas, the different characteristics and needs of small, medium, and large LECs should be recognized. Any such model should first be applied to non-rural LECs; only after the model's structure, inputs, and outputs have been validated should the Commission consider applying it to rural LECs. To that end, the Commission should establish a task force to evaluate any such models.

As the attached study by Christensen Associates demonstrates, the cost proxy models that have been proposed to date do not properly reflect the economic costs of access services or unbundled elements. The definition in the Staff Analysis of forward-looking costs for purposes of cost proxy models is an incorrect basis for regulatory costing, and thus pricing, decisions. The appropriate basis for determining such costs should be the expected costs of an actual firm in the market, not those of a hypothetical entrant that would instantaneously supply the entire market.

In light of the many difficulties with cost proxy models, the Commission should not compound potential errors or inaccuracies by endorsing or developing a purportedly all-purpose model.

Although new cost proxy models have been submitted since the Staff Analysis was released, USTA has not had the opportunity to analyze them in detail. However, Hatfield model version 2.2.2 is a case study of the flaws of a model that attempts to serve multiple purposes while failing to reflect reality. To the extent that the most recent version of the Hatfield model purportedly corrects the previous version's many flaws, the rapid succession of alleged "fixes" over the past year indicates that any version currently under consideration should not be trusted with the important regulatory role that it could play under the assumptions of the Staff Analysis.

In speculating about the possible causes for the differences between the results of various models, on the one hand, and the ARMIS information reported to the Commission, on the other, the Staff Analysis largely ignores the role of regulation in explaining such differences. The regulation to which incumbent LECs historically have been subject, accounts for any perceived under-depreciation or "overinvestment" that would affect such results.

The Staff Analysis apparently assumes that it would be a simple process to substitute cost proxy models for cost studies by incumbent LECs. In fact, properly gathering, organizing, and validating data -- which would be essential in using a cost proxy model -- would pose a monumental task for both the Commission and incumbent LECs.

Any regulatory costing methodology must be consistent with certain general principles. For example, actual, company-specific cost data, derived from LEC cost studies, are essential. In addition, any costing methodology must be validated. In particular, values for inputs are likely to vary from company to company and region to region. Any costing methodology must also be validated with an engineering assessment to determine its accuracy in describing an efficient, actual network.

The existing wire center approach is an appropriate basis for costing methodologies. This approach helps ensure a realistic analysis of LEC network design. In addition, the geographic unit of analysis for costing purposes other than universal service should be determined by each LEC. Any costing methodology must contemplate embedded costs and must reflect the mix of state-of-the-art and mature technologies that is present in each incumbent LEC's existing networks.

The capital costs used in any costing methodology should reflect the realities of competition as it develops. Cost-of-capital estimates should account for the higher risks inherent in a competitive environment.

The treatment of operating expenses differs between small and large LECs. While small companies may have to adjust book or accounting expenses to reflect inflation and productivity, larger LECs may more reasonably estimate forward-looking expenses based on the historical relationship between expenses and investment.

Finally, joint and common costs must be recovered by LECs under any form of regulation. However, competition, not modeling, is the most efficient mechanism for recovering these costs.

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

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The Use Of Computer Models)	CCB/CPD Docket No. 97-2
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Economic Costs)	
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A Staff Analysis)	
_____)	

**COMMENTS OF THE
UNITED STATES TELEPHONE ASSOCIATION**

I. INTRODUCTION

The United States Telephone Association ("USTA") respectfully submits comments on the above-referenced analysis of forward-looking cost models (so-called "cost proxy models") prepared by members of the Commission's staff (the "Staff Analysis").^{1/} USTA is the principal trade association of the incumbent local exchange carrier ("LEC") industry. Its member telephone companies provide over 95 percent of the access lines offered by incumbent LECs in the United States. USTA has been active in proceedings regarding the use of various

^{1/} See J. Atkinson, C. Barnekov, D. Konuch, W. Sharkey, and B. Wimmer, *The Use of Computer Models For Estimating Forward-Looking Economic Costs: A Staff Analysis* (rel. Jan. 9, 1997); FCC Public Notice, *Commission Staff Releases Analysis of Forward-Looking Economic Cost Proxy Models*, DA 97-56 (Com. Car. Bur. rel. Jan. 9, 1997).

types of cost proxy models in implementing the Telecommunications Act of 1996 (the "Telecommunications Act").^{2/}

USTA welcomes the opportunity provided by the Common Carrier Bureau to comment on the Staff Analysis. In these comments, USTA addresses the conceptual framework of the Staff Analysis, and seeks to correct several of the assumptions on which it is based. USTA also provides some general principles that should be followed in any costing methodology used for regulatory purposes. Because new versions of some of the cost proxy models currently under discussion were filed with the Commission quite recently,^{3/} these comments do not address the details of those new versions except as specifically stated herein.

II. COST PROXY MODELS AS CONCEIVED IN THE STAFF ANALYSIS HAVE VERY LIMITED USES

A. Cost Proxy Models Should Not Be Used For Determining The Cost Of Providing Universal Service Or Rate Levels For Access Services Or Unbundled Network Elements

USTA believes that properly-designed cost proxy models are usable, at best, to assist in identifying high cost areas for purposes of distributing universal service funds.

However, regulators should not rely on them to develop the level of universal service support

² Pub. L. No. 104-104, 110 Stat. 56 (1996), *to be codified at* 47 U.S.C. §§ 151 *et seq.* All citations to the Telecommunications Act herein will be to the relevant sections of the United States Code unless otherwise noted.

³ See FCC Public Notice, *Further Extension Of Time Granted For Parties To Submit Comments In Response To Commission Staff's Analysis Of Cost Proxy Models*, DA 97-333 (rel. Feb. 12, 1997); FCC Public Notice, *Extension of Time Granted For Parties To Submit Comments In Response To Commission Staff's Analysis Of Cost Proxy Models*, DA 97-239 (rel. Jan. 31, 1997).

or the prices for access services, unbundled network elements, or interconnection arrangements. USTA thus respectfully disagrees with the general assumptions of the Staff Analysis that contemplate a broad role for these models. Indeed, the Staff Analysis begins by enumerating the possible uses of forward-looking cost proxy models, stating that:

[such models] could enable regulatory authorities to estimate the forward-looking cost of network facilities and services without having to rely on detailed cost studies, prepared by incumbent local exchange carriers, that otherwise would be necessary. In addition, a publicly available cost proxy model could be useful to regulators by providing an independent check on the accuracy of incumbent LEC cost studies.^{4/}

The Staff Analysis notes that the Commission has received a number of cost proxy models. It acknowledges that these models originally were developed for universal service purposes -- "to determine high cost service areas and calculate universal service support payments" -- but states that they also may be used "in setting interconnection, unbundled network elements, and transport and termination prices."^{5/} However, the Commission itself and the Federal-State Joint Board on Universal Service have been more temperate regarding such models.

1. The Commission Wisely Has Viewed The Utility Of Cost Proxy Models With Caution In A Variety Of Proceedings

In three major proceedings to implement the Telecommunications Act -- regarding access reform, interconnection, and universal service -- the full Commission and the Federal-State Joint Board have acted with notable caution regarding cost proxy models. While

^{4/} Staff Analysis at para. 2.

^{5/} *Id.* at para. 6.

exploring the use of such models, the Commission has consistently acknowledged the insufficiencies of existing models and recognized that cost studies continue to have merit as a means of determining costs.

In the Access Reform Notice,^{6/} the Commission observed that the allocation of common costs using forward-looking cost methodologies is particularly problematic in the pricing of "conventional" services such as interstate access because such services are provided over shared facilities.^{7/} The Access Reform Notice suggests that cost studies will continue to be important for estimating the economic costs of access services.^{8/}

In the Federal-State Joint Board's Recommended Decision on universal service (the "Recommended Decision"),^{9/} the Joint Board declined to recommend a particular cost proxy model for use in determining universal service support levels. Although the Recommended Decision suggested generally that cost proxy models may be an effective means of determining the "competitively neutral" cost of providing supported services,^{10/} it acknowledged that problems exist with all of the models currently under consideration. Indeed, the Recommended Decision extensively reviewed the then-existing record on the various models, only to determine that too many questions remain about the validity of all the models to

^{6/} *Access Charge Reform*, Notice of Proposed Rulemaking, CC Docket No. 96-262, FCC 96-488 (rel. Dec. 24, 1996) ("Access Reform Notice").

^{7/} *See* Access Reform Notice at para. 237.

^{8/} *See id.* at paras. 237-38.

^{9/} *Federal-State Joint Board on Universal Service*, Recommended Decision, CC Docket No. 96-45, FCC 96J-3 (rel. Nov. 8, 1996).

^{10/} *See* Recommended Decision at para. 276.

consider adopting one of them.^{11/} The Recommended Decision acknowledged that the use of proxy models may adversely affect rural carriers, concluding that existing mechanisms for determining support levels should be retained for three years.^{12/}

In the Interconnection Order,^{13/} the Commission also discussed the shortcomings of existing cost proxy models, recognizing that "criticism of [the models] may have merit."^{14/} In developing its own hybrid proxy ceiling for local loops, for example, the Commission combined data from two existing proxy models and the results of six state cost studies, and made numerous other adjustments.^{15/} The Commission noted in doing so, however, that "[w]e do not believe... that these model outputs by themselves necessarily represent accurate estimates of the absolute magnitude of loop costs."^{16/}

Regulatory caution regarding the use of cost proxy models is justified. USTA has demonstrated repeatedly before the Commission that cost proxy models should not be used for determining universal service support levels or actual rate levels for services offered by individual LECs.

¹¹ See *id.* at para. 268.

¹² See Recommended Decision at para. 184.

¹³ *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98, FCC 96-325 (rel. Aug. 8, 1996).

¹⁴ *Id.* at para. 795.

¹⁵ Of course, most of the pricing provisions of the Interconnection Order are currently subject to a stay issued by the U.S. Court of Appeals for the Eighth Circuit. See *Iowa Utilities Board v. FCC*, No. 96-3321, slip op. (8th Cir. Oct. 15, 1996).

¹⁶ *Id.* at para. 794.

2. Cost Proxy Models Should Not Be Used For Determining The Cost Of Providing Universal Service

In commenting on the Recommended Decision, USTA stated that while a cost proxy model can be useful for identifying high cost areas, its outputs should not serve as the regulatory means of determining the cost of providing service, since those outputs are hypothetical and disregard costs imposed by the LECs' regulatory obligations.^{17/} Instead, the costs of providing universal service must include incumbent LECs' actual costs. These costs include embedded costs previously incurred under regulation.

In its reply comments on the Recommended Decision USTA, also demonstrated that cost proxy models should be used only to geographically disaggregate actual costs for universal service purposes.^{18/} USTA emphasized that no rural telephone company should be required to use a proxy model that does not reflect its actual costs.^{19/}

Indeed, the special circumstances that rural LECs face in providing services must be considered by the Commission staff, since these LECs in particular have widely differing cost structures and customer bases. The attached paper prepared by Christensen Associates (the "Christensen Attachment") demonstrates that, as a general matter, proxy models have difficulty modeling company-specific or geographic costs, especially for, *e.g.*, LECs serving

¹⁷ See Comments of USTA, CC Docket No. 96-45 (filed Dec. 19, 1996) ("USTA Recommended Decision Comments") at 12-13.

¹⁸ See Reply Comments of USTA, CC Docket No. 96-45 (filed Jan. 10, 1997) ("USTA Recommended Decision Reply Comments") at 13-14.

¹⁹ See *id.* at 9.

low-density areas.^{20/} This is particularly true for such service areas that are smaller than a state.^{21/} As a result, proxy models are very limited in their ability to model the service costs of rural LECs, many of which serve low-density areas within their states. Such costs are critical for determining universal service support. The Christensen Attachment and the record compiled in response to the Recommended Decision establish that no model currently exists that can accurately predict the costs incurred by rural LECs, and those costs vary widely among such LECs.^{22/}

In order to account for these differences, USTA recommends that if a model is used for the limited purpose of identifying high cost areas, the different characteristics and needs of small, medium, and large LECs should be recognized.^{23/} Any such model should first be applied to non-rural LECs. Only after the model's structure, inputs, and outputs have been validated should the Commission consider applying it to rural LECs. As the Joint Board itself recognized, there must be an opportunity to "tailor the model for rural companies" in order to "take into consideration the unique situation of rural carriers."^{24/} USTA recommends that the Commission establish a task force under Joint Board auspices^{25/} to evaluate the appropriateness

²⁰ See *Appropriate Standards For Cost Models and Methodologies* (Christensen Associates, Feb. 1997), Attachment A hereto, at 11, n. 14, 14-15.

²¹ See *id.* at 14-15.

²² See *id.*

²³ See, e.g., Competition Policy Institute, *An Integrated Universal Service Plan*, (Oct. 1996) at 5-6 (recommending a three-tier approach to the implementation of any TSLRIC based model, differentiated to recognize small, mid-size (2%) and large incumbent LECs).

²⁴ Recommended Decision, at para. 272, 283.

²⁵ See Recommended Decision at para. 282 ("The Commission and state members should
(continued...)

of any such model for rural carriers and to make recommendations concerning whether the model chosen for non-rural companies (or any other model) can be used for rural companies. The efforts of the task force could be completed during the three-year transition period recommended by the Joint Board.^{26/}

3. Cost Proxy Models Should Not Be Used For Determining Actual Rates For Unbundled Rate Elements, Access Services, Or Interconnection Arrangements

In the Commission's interconnection proceeding, USTA stated that a pricing formula based on forward-looking costs (in that case, TSLRIC), together with joint and common costs, at most can serve as a pricing guideline, and not an actual rate level, for individual network elements.^{27/} In commenting on the Access Reform Notice, USTA demonstrated that cost proxy models that have been proposed to date do not properly reflect the economic costs of access services or unbundled network elements.^{28/} USTA amplifies on this important point below:

²⁵ (...continued)

continue to work cooperatively and remain integrally involved in the development of an acceptable proxy model.").

²⁶ See Comments of Pacific Telecom, Inc., In Response to Questions Relating to Proxy Cost Models, CC Docket No. 96-45 (filed Jan. 7, 1997).

²⁷ See Reply Comments of USTA, CC Docket No. 96-98 (filed May 30, 1996) ("USTA Interconnection Reply Comments") at 28-29. See also *id.* at 19.

²⁸ See Comments of USTA, CC Docket No. 96-262 (filed Jan. 29, 1997) ("USTA Access Reform Comments") at 13-16, and the following attachments to those comments: R. Schmalensee and W. Taylor, *Economic Aspects of Access Reform*, Attachment 1 (the Schmalensee/Taylor Access Paper") at 17-22; *Affidavit of J. Gregory Sidak and Daniel F. Spulber*, Attachment 3 (the "Sidak/Spulber Access Affidavit") at 19-33.

B. The Forward-Looking Costs Defined In The Staff Analysis Are An Inappropriate Basis For Making Cost Or Pricing Decisions

The Christensen Attachment demonstrates that the definition in the Staff Analysis of forward-looking costs for purposes of cost proxy models is an incorrect basis for regulatory costing, and thus pricing, decisions.^{29/} The appropriate basis for determining forward-looking economic costs, and prices based on those costs, is the expected cost of an *actual firm* in the market and not a hypothetical entrant that would instantaneously supply the entire market.^{30/} Indeed, an actual market participant, whether it is an incumbent or new entrant, may be efficient in a dynamic sense but not in the idealized "static" sense assumed in the Staff Analysis.^{31/} Moreover, incumbent LECs, as participants in a technologically changing industry, provide services using both state-of-the-art and mature technologies. The definition of forward-looking costs in the Staff Analysis fails to take into account these important factors, and as the Christensen Attachment notes, this failure poses significant cost recovery risks for incumbent firms, even if they are operating efficiently.

The Staff Analysis also does not recognize the need for incumbent LECs to recover their embedded costs, incurred under prior regulatory regimes that were based on the concept of franchised monopolies with a broad obligation to serve.^{32/} As the Schmalensee/Taylor

^{29/} See Staff Analysis at paras. 9, 47.

^{30/} See Christensen Attachment at 1, 4-10.

^{31/} See *id.* at 5-6.

^{32/} See Staff Analysis at paras. 9, 47.

Access Paper, filed in response to the Access Reform Notice, demonstrates, incumbent LECs must have an opportunity to recover embedded costs.^{33/} That analysis shows that the failure of regulators to stand by commitments made in prior regulatory regimes results in several types of explicit economic costs, including (i) diminution of investor faith in the institutional framework, with a likely increase in the capital costs of incumbents relative to entrants; (ii) reduction of a firm's incentive to invest, especially in areas or for classes of customers that are unremunerative; and (iii) distortion of entrants' incentives.^{34/} Moreover, because past regulatory depreciation has been inadequate to reflect the decline in economic value of embedded plant, embedded plant is carried on the books at far above economic value.^{35/}

The Schmalensee/Taylor Access Paper notes that in the electricity industry, the Federal Energy Regulatory Commission and most state regulators have recognized the legitimacy of allowing a reasonable opportunity for the recovery of potentially "stranded" costs.^{36/} The 1996 Economic Report of the President, prepared by the Council of Economic Advisers, reaches a similar conclusion:

Nor should competition be a cover for unreasonably shifting costs from customers to utility investors. To meet their obligation to serve all customers in their monopoly franchise areas, electric utilities have made costly investments in long-lived generating plant and other assets - with the regulators' implicit

³³ See Schmalensee/Taylor Access Paper at 11-15.

³⁴ See *id.* at 11-12.

³⁵ See USTA Access Reform Comments, J. Rohlfs, C. Jackson and R. Richardson, *The Depreciation Shortfall*, Attachment 15 ("Strategic Policy Research Paper") at 10.

³⁶ See Schmalensee/Taylor Access Paper at 13-14. Indeed, failure to permit an incumbent LEC a reasonable opportunity to recover its total costs would be an unconstitutional taking of property. See USTA Access Reform Comments at 72, *citing* Sidak/Spulber Access Affidavit at 76-107.

promise of a guaranteed return. Opening up utilities' traditional monopoly franchises to competition at a time when they have significant excess capacity would greatly reduce the value of such investments, and subject utilities to so called "stranded costs." ...[I]t is important to ensure that, in the transition to competition, utilities are not saddled with these stranded costs.^{27/}

Cost proxy models or any other costing methodology that do not account for or recognize these costs should not be used for pricing services.

C. The Commission Should Rely On Competition, Not Regulation, To Ensure Efficient Pricing

A fundamental conceptual problem with the use of cost proxy models for regulatory pricing purposes is that the detailed governmental oversight entailed in such modeling is antithetical to reliance on competition as the best means of maximizing efficiency and consumer welfare. As the Staff Analysis mentions in its first paragraph,^{28/} the intent of the Telecommunications Act is to "establish a pro-competitive, de-regulatory national policy framework" for the U.S. telecommunications industry. However, the Staff Analysis focuses on creating a regulatory mechanism to control prices through the use of cost proxy models. This displays a singular lack of confidence in the ability of competition to achieve efficient pricing.²⁹ In light of the Telecommunications Act's broad removal of regulatory entry

²⁷ *Economic Report of the President* (Feb. 1996) at 165-66.

²⁸ See S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 1 (1996), *quoted in* Staff Analysis at para. 1.

²⁹ As the Schmalensee/Taylor Access Paper shows, in the access reform context, efficient input prices are not a precondition for efficient entry into either the inter- or intra-LATA toll markets. *See id.* at 21-22.