SUMMARY

U S WEST, Inc. ("U.S WEST") hereby submits its reply comments in the above-captioned proceeding. In its analysis of proxy cost models, the Federal Communications Commission ("FCC" or "Commission") should carefully scrutinize proxy models which produce results that bear no relationship to reality. The Hatfield Model 3.0 cannot withstand such scrutiny and should be rejected by the FCC. While U S WEST has only begun to delve into the mass of changes between Hatfield 2.2.2 to Hatfield 3.0, it is apparent that many of the flaws and illogical assumptions present in Hatfield 2.2.2 continue to be present in Hatfield 3.0, and in fact, some of those flaws are exacerbated in Hatfield 3.0.

There can be little doubt that the Hatfield modelers took a results-oriented approach in their attempts to correct or update Hatfield 2.2.2. and that such a results-oriented approach flies in the face of the FCC's attempts to facilitate the development of appropriate proxy cost models. Because the Hatfield model 3.0 is replete with errors, faulty assumptions and basic modeling flaws, it should be rejected in its totality.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
The Use of Computer Models for Estimating Forward-Looking Economic Costs	)	CCB/CPD Docket No. 97-2

REPLY COMMENTS OF U S WEST, INC.

U S WEST, Inc. ("U S WEST") hereby submits its reply comments in the above captioned proceeding.

I. INTRODUCTION

In this proceeding the Commission seeks information on how to evaluate and utilize so-called proxy cost models — computer programs which estimate the forward-looking cost of providing telephone service. U S WEST, as one of the original developers of what has become the Benchmark Cost Proxy Model (BCPM), has been wrestling with this issue for almost four years. While the BCPM and its predecessors were developed for the specific purpose of estimating costs for universal service fund eligibility analysis, proxy cost models have recently taken on a life of their own in other dockets, most significantly federal and state proceedings involving interconnection prices and the federal access charge reform docket.[1] In

[1] See, e.g., "The Use of Computer Models for Estimating Forward-Looking Economic Costs, A Staff Analysis," dated Jan. 9, 1997, at ¶¶ 1, 2, 4, 6-7, 9-16, wherein the

these proceedings, U S WEST has been repeatedly faced with something called the Hatfield Model ("Hatfield"), which is put forth by AT&T and MCI to justify that they be permitted to purchase services from U S WEST at prices which represent approximately half of what U S WEST estimates are U S WEST's own reasonable costs of providing service or facilities to AT&T and MCI. U S WEST intuitively knew that half of its costs and investment were not based on waste, duplication and inefficiency — which is what Hatfield claimed — but evaluation of Hatfield proved a tricky proposition indeed. To a very large extent, methodological and input flaws and distortions in the Hatfield Model can be identified with sufficient precision to permit (actually, to require) that Hatfield be discarded entirely. U S WEST's initial comments in this docket (and these reply comments) add to what is, by now, a mountain of evidence and analysis to this effect.

However, in reviewing some of the thoughtful initial comments in this proceeding, several additional observations on proxy cost models and their uses can be made. Many entities involved in the development of proxy cost models address the models as if they have an animus or force independent of the underlying data or facts, i.e., as if the mere fact that they are "proxy models" gives them some type of inherent validity. Thus, if Hatfield erroneously calculates U S WEST's costs to be half of what they really are, it has all too often been assumed that the next step in the process was to construct another iterative, superior and more accurate cost

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authors discuss the evolution of the use of cost models as a multi-purpose regulatory tool in state and federal proceedings.

model. Thus, warring theoretical computer models of hypothetical telecommunications costs were developed.

GTE's comments in this proceeding reverse the assumptions and the logic in a way which is extremely beneficial. GTE posits that a company such as GTE (and U S WEST) should not have huge differentials between its existing costs (represented by ARMIS data) and its properly calculated forward-looking costs.[2] A company's actual costs ought to, at least presumptively, come pretty close to its forward-looking costs. Thus, when a computer proxy model, such as Hatfield, calculates a company's forward-looking costs at a level of half the company's actual costs, an extraordinarily powerful and documented reason for the disparity must be shown or the proxy model simply must be discarded altogether as untrustworthy.[3] This sentiment was echoed by Strategic Policy Research, Inc. ("SPRI"), which summarized this matter somewhat colorfully: "When cost estimates diverge so far from actual average costs with no convincing explanation, there is a real possibility that the cost model has run amok."[4]

GTE's analysis compares Hatfield's assumptions about network deployment, fill factors capital costs, switching costs and other critical elements of cost in a telephone network, with GTE's own experience in providing telephone service. The bottom line is that Hatfield's theoretical "let's pretend" network in no way resembles GTE's. Similarly, it in no way resembles U S WEST's network. Valid

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[2] See, e.g., GTE at 23.

[3] See, e.g., id. at 19-20, 23-28.

[4] SPRI at 49.

computer cost models can accurately predict forward-looking costs, and can provide a value in regulating some aspects of the transition of the telecommunications industry to a fully competitive marketplace. But, as GTE points out forcefully, when models begin to diverge dramatically from reality, the assumption must be that reality continues and that there is something wrong with the computer model.[5]

This divergence between modeled predictions of what reality should be and experience with what reality really is must play a larger part in any FCC use of computer models. If a computer model demonstrates a palpably implausible result, as is the case with Hatfield, the proper response is to demand a detailed and fact-based explanation for how the result differs from what is actually occurring in the real world. Another more accurate computer model can do much to discredit seriously flawed models, as can detailed analysis of the Hatfield's defects, but a model which predicts a telephone network which is completely different from what actually exists can be discarded from the beginning.

GTE also applies this reality principle to explain the dangers inherent in using a proxy cost model to set local exchange carrier prices. While U S WEST has had numerous occasions to comment on the fallacy of equating the tendency of market forces to drive prices toward economic costs with the assumption that

[5] Throughout history, theoreticians have been confounded by reality which diverged from what their theory predicted. A very large part of the tragedy which Marxism/Communism wreaked upon mankind in the Twentieth Century was based on unsuccessful efforts of people in power to bend reality to fit their theories (to a large extent theories of Marx, Engels and Lenin).

economic costs will equal prices in a competitive market,[6] GTE describes a principle called a "dynamic cost minimization problem,"[7] which describes why an efficient market participant will never price its services at economic costs as those costs are stated in theory. While GTE's analysis is sophisticated, its basic premise is the same as its first argument described above — real regulators in real industries must base their decisions on what is real, not what is theoretically most attractive. In point of fact, using any computer proxy cost model to set prices — especially if the additional assumption is made that some kind of economic cost, such as total element long-run incremental costs ("TELRIC"), is used as a price ceiling, would be dangerous, destructive of infrastructure and anticompetitive.

II. HATFIELD 3.0 IS FATALLY FLAWED

U S WEST has reviewed the thoughtful and thorough analyses that INDETEC International and NERA provided for GTE on the Hatfield Models 2.2 and 3.0 and agrees with the conclusions reached by these independent examiners. While it would be impossible to list every flaw contained in Hatfield 3.0, INDETEC points out many of the major flaws, including: loop lengths 17 times higher than Hatfield 2.2, with no expected corresponding increase in overall costs; continued reliance on unrealistic sharing assumptions; unrealistic drop and network interface device ("NID") costs; an increase in the already absurd assumption regarding increased network efficiency; faulty assumptions regarding the mix of facilities;

[6] U S WEST at 6-11.

inappropriate fill factors; inappropriate depreciation lives and cost of capital inputs, etc. U S WEST has reached similar conclusions regarding these and other flaws in Hatfield 3.0 and concurs wholeheartedly that Hatfield should be rejected in its entirety. Hatfield produces results that are purposefully low and have no relationship to the reality of costs incurred by U S WEST.

III. U S WEST OBSERVATIONS ON HATFIELD 3.0

In addition to its concurrence with the analyses provided with the GTE comments, U S WEST adds the following observations about Hatfield 3.0 When analyzing the Hatfield Model it is again critical to remember the purpose for which these models have been developed. These models are theoretical estimates of a company's cost of providing service assuming the use of current technology. Nowhere in the Telecommunications Act did Congress rule that the costs should ignore the actual environment in which companies operate. Nowhere in the Act did Congress rule that cost should be calculated assuming a hypothetical world that never will exist but if it did exist might result in vastly reduced costs. If the objective is to determine the most efficient forward-looking cost of developing a network, those costs should be based at least in the context of the world as it currently exists and not make assumptions that no reasonable businessman would ever consider in developing such a network. A costing methodology that would have

[7] GTE at 10-20.

no relevance in a normal competitive business environment should also have no relevance in an industry that is seeking to become competitive.

There are numerous costing techniques used by competitive firms depending on the issue that is being addressed. Some include only looking at shortrun variable or marginal costs. These approaches for the most part ignore fixed or sunk investment and are used primarily to make short run operating decisions on such issues as product mix and when to exit markets when firms are unable to continue recovering all their capital related costs. These costs could never be used to determine the amount a company must recover in prices to remain a viable participant in an industry since a large portion of the ongoing costs of maintaining a business (i.e. capital investment) are ignored. A pricing strategy that assumes these costs never need to be recovered would quickly eliminate any ability a firm has to continue operating and growing. Therefore, as the Commission has recognized, only long term costs including the capital required to build and operate the network should be considered in determining prices for a company's critical or primary services.

What are the critical variables that should be considered in determining these costs? There should be no question that if the costs that are ultimately developed are based on assumptions no competitive firm would ever use in making actual business decisions, then they would also be irrelevant in an industry moving toward competition. Competitive firms will use long run or total costs to answer the following questions:

1. Am I recovering my actual incurred or historic costs;

2. Will I be able to recover the costs I will incur for adding to or expanding the network;

3. Will I be able to recover the costs I will incur in replacing the network as it becomes either physically or technologically obsolete; and

4. Over the long run will I be able to compete with other firms that enter the market using current technology or can I compete in a new market.

Actual or embedded costs are used in the first analysis. The costs of potential additions to the network or planned construction expenditures are used in the second. The forward-looking cost of building or rebuilding the total network or a major segment of the network would be used in the third and fourth. There are no other long run costs that would be considered by firms in a competitive market and costing procedures that do not reflect one of these objectives should be ignored in developing prices for emerging competitive firms. Clearly if a costing procedure would have no validity in a normal business environment, it would have no relevance in a regulatory environment trying to simulate competition.

A. Sharing

Hatfield is full of assumptions no sane businessman would ever make in developing costs for an ongoing business. Mr. Donovan stated in a discussion before the Washington Public Service Commission that the sharing assumptions in the Hatfield Model are based on the premise that all utilities are scorched, and therefore three companies would be available to share in virtually all the cost of placing cable facilities. Hatfield is modeling a world of let's pretend: Let's pretend

all the facilities that currently exist disappear, allowing all utilities to come in and jointly design and build a network to provide all utility services to all existing residences. Let's ignore the actual sharing that has occurred in the past, is occurring in the present, and will occur in the future, and base the model assumptions on an optimal business environment that will never exist.

The critical question is whether such a model would have any use in a normal competitive environment. The answer clearly is no. TELRIC principles were never designed to answer the question of how much it actually costs companies to build their current networks or add to the existing network since TELRIC is forward-looking and includes the cost for all existing facilities. TELRIC only addresses how much the existing provider will incur over time as he replaces the existing network or the cost a competitor will incur as he enters the market. If a model makes assumptions that render it useless in answering both of these questions, then it is fatally flawed and would never have any applicability to any actual or business environment.

U S WEST could never assume that all other utilities will need to replace all their facilities at the same instance that U S WEST's become either physically or technologically obsolete. U S WEST cannot delay replacements or repairs to its network until such time as two other companies desire to share the cost of placing those facilities. U S WEST's competitors cannot assume all utilities will wish to participate in building their networks if they determine to enter into competition with U S WEST. Electric and cable companies already have networks in place. Those networks aren't going to disappear. No competitor would base a market

entry decision on an assumption that these networks didn't exist. Similarly, no incumbent can forestall replacing its facilities until the point that all other utilities need to replace their existing networks. Suppose U S WEST, or any other company, were to approach the investment community with a plan that it was going to build a ubiquitous telecommunications network. Suppose also that the most critical assumption in the plan was that no one in the United States currently has either electric power or cable TV. Now suppose this company can find investors to finance this project. It would be impossible to sell such an outlandish proposal. Yet the Hatfield sponsors are asking that the FCC accept this fiction.

B. Placement Costs

The placement costs for buried cable that are used in the Hatfield Model suffer from a similar reliance on unreal assumptions. In this instance, the Hatfield Model appears to make no adjustment for the fact that building or rebuilding the current network would require negotiating around, under or through all of the impediments that exist in normal city neighborhoods. One only needs to drive through a normal residential neighborhood to realize that most residences have fences, rock gardens, sprinklers systems, trees, lawns or other obstacles that require special construction techniques to negotiate around or replacement once the construction is completed. These landscaping obstacles have a significant impact on the cost of placing buried cable in existing neighborhoods. Special construction techniques such as cut and restore asphalt, boring, hand trenching and sod replacement are required when such a project is undertaken.

C. Aerial Cable

The Hatfield Model assumes the use of aerial placement techniques for 25% to 85% of the cable placed by the program. Again this assumption does not withstand even minor scrutiny. Aerial cable represents only 13% of the cable U S WEST currently has to serve its existing customers. This percentage has been going down over time. In fact, most cities have covenants that limit the ability to use aerial cable. Many are requesting that the company bury facilities which are aerial. People don't like poles and cities are recognizing this fact through ordinances and restrictions on right of ways. Although many years ago aerial placement was the preferred method of laying cable, new covenants and laws are making this practice obsolete. However, the Hatfield Model assumes that this placement technique will replace the current plant that is buried over time. Again, AT&T and MCI appear to have determined that the past is a better environment to build a forward-looking network than the present. Would a normal business person make this same assumption when designing his forward-looking network? If not, Hatfield should be rejected.

IV. ERRORS AND OMISSIONS

A. General

U S WEST continues its review of Hatfield 3.0. In the review that U S WEST has completed, numerous deficiencies in the calculations employed by the Hatfield Model have been identified. These include:

1. Basing the expense calculations on plant balances that have been grossly understated by erroneous assumptions;

2. Making arbitrary adjustments to the factors used to calculate the expense, all of which decrease the resultant cost of elements;

3. Using factors that are lower than those actually experienced by the company with no explanation of their source;

4. Ignoring costs that Hatfield sponsors admit the company must incur when unbundling the network; and

5. Including special access lines on a per channel basis in determining line counts in a serving area.

In addition, there appear to be numerous instances in Hatfield where the actual calculations vary from the documentation provided. For example, the documentation claims that line counts included in Hatfield match the ARMIS report. However, in our review of the Hatfield results for the two states provided, Washington and Colorado, there was no match to ARMIS. Similarly, the documentation claims that some expense factors are based on 1995 actual ARMIS data. Again our review found this not to be the case. The Commission should not adopt a model in which the base information used in the calculations do not reconcile to the source information the model documentation claims to use.

B. Expense Calculation

In addition to the foregoing, Hatfield uses numerous approaches to minimize operating expenses calculated by its model. As stated in our original comments, the method of calculating expenses in Hatfield is based on the level of investment derived in its model. If the model calculates a forward-looking 50% decrease in the cost of placing cable, the model would calculate a similar decrease in all the expenses associated with that investment. Factors are derived using the actual costs of the company or an alternative factor that is, in every case, less than the one that would be calculated using the company's actual expenses. These expenses are turned into factors by dividing by the actual investment on the company's books and records. The factors are then applied to the investment produced by the model, which conveniently is always less than the amounts of those investments on the company's books. This approach automatically reduces the cost of maintaining the network based on the forecasted reduction in the cost of building the facilities. It assumes that if the cost of buying switches decreases, so does the cost of maintaining them. There is no expense in its model that is not impacted by the estimated cost of placing the facilities. Hatfield first makes numerous unjustified adjustments to expenses (see below) to reflect assumed efficiencies and then uses this hidden adjustment to ratchet up there impact.

The above adjustment to expenses is compounded by the hidden or implicit direct adjustments to the expense factors contained in Hatfield. As an example, one only needs to review the calculation of the cost of maintaining buried and underground cable facilities. Hatfield calculates the maintenance factor for these facilities by dividing the actual maintenance expense the company incurred by the

embedded investment in those facilities. These factors are then multiplied by the total investment less all placement costs as calculated by Hatfield to determine the maintenance expense. In other words, placement costs are used in the denominator to make the factor smaller, but the factor is then applied only to the materials costs developed by Hatfield. By applying the factor only to the forward-looking costs of the capitalized material, Hatfield significantly reduces these expenses. Maintenance expenses are thus adjusted twice, once by applying them to reduced forward-looking investment costs, and again by only applying the factor to the materials' cost even though it was calculated using the total account balance. Neither of these adjustments is discussed in the documentation of Hatfield, therefore, no justification for such faulty calculations is provided.

Similarly, virtually all other expenses in Hatfield have been reduced by multiple adjustments, sometimes explicit but commonly hidden. Following is a list of some of these adjustments:

1. The maintenance factor applied to the serving area interface equipment in the model is the underground cable maintenance factor. This factor .018 is significantly lower than the factors that should be applied, 2-5%. It appears in this case Hatfield subscribes to the loose methodology of pick a factor, any factor, just make sure its small.

2. For circuit equipment and central office equipment, a surrogate maintenance factor is applied. These factors are lower than the expenses actually experienced by the company. Again the resulting expense amount is further reduced by applying these forward-looking expense factors to the reduced forward-looking cost of the facilities.

3. Network support expenses are reduced by 50% and then reduced again by applying them to the reduced costs produced by the model.

The preceding are examples from Hatfield where the expense development always includes two adjustments to reduce the amount of costs produced by its model. One adjustment is always hidden, the other is sometimes explicit and other times hidden. All of the adjustments decrease expenses. U S WEST has concerns that there are other hidden adjustments in the expense and investment calculations in Hatfield. However, based on our preliminary review it is obvious that Hatfield makes numerous adjustments to virtually all expenses in its efforts to minimize costs. The question is how did the modelers determine that multiple adjustments were required and why are they so secretive regarding their existence. The FCC should not accept a model that is so obviously contrived to produce a low answer.

C. Line Count

As previously mentioned, there appear to be two major problems with the line counts used to develop unit costs in the Hatfield Model:

1. The line counts do not reconcile to the ARMIS data which AT&T and MCI reference as the source of the data; and
2. The line counts include special access lines on a per equivalent channel basis.

The first issue is just another example showing how the actual construction of Hatfield deviates from the provided documentation. The second is a major flaw in the Hatfield design. The FCC has always set special access rates based on the costing assumption that digital switch services ("high capacity services") are generally four wire loops with the associated electronics. The Hatfield Model

assumes that special access lines are individual loops based on the per channel equivalent capacity. In other words, a DS1 is treated as 24 equivalent lines or loops. This is a major departure from FCC costing practices for this service and would have a significant impact on special access rates. By artificially inflating the number of lines in the model in this way, Hatfield is able to significantly reduce the cost of a normal loop by significantly increasing the number of lines in high dense urban areas.

There is no logical costing principle that supports this assumption. High capacity services such as DS1 are generally one four-wire loop which uses electronics to derive 24 or more voice grade channels. The costs should reflect this architecture. Hatfield does not. It treats a DS1 as 24 separate business loops with no electronics. This assumption increases the density of loops in the low cost business districts, significantly reducing the overall loop cost. In those states that have been analyzed, the impact is generally in the range of $2 a loop. The FCC has always adopted the more appropriate method of costing high capacity services based on their actual architecture and not as treating each channel as a separate loop. AT&T has provided no justification for this approach other than it just used the ARMIS reports.

The bigger issue, however, is whether the FCC wants to change the prices for these services to reflect this new costing methodology. If U S WEST priced special access based on equivalent channels, the price of the service would more than triple in most of the region. This increase in prices would lead to a significant windfall for the company over the shortrun while access providers struggled to place their own

networks. In the long run it would eliminate the company's ability to compete in the market since the costing approach used by Hatfield would have no relationship to the actual cost incurred to provide the service. Neither of these outcomes is desirable or justifiable. Regulators need to insure that they do not adopt models in their effort to minimize costs which create illogical prices that neither reflect the actual cost of providing services nor allow companies to compete on an equitable basis.

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February 24, 1997

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 24th day of February, 1997, I have caused a copy of the foregoing **REPLY COMMENTS OF U S WEST, INC.** to be served via first-class United States Mail, postage prepaid, upon the persons listed on the attached service list.

Kelseau Powe, Jr.

***Via Hand-Delivery**

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

In the Matter of	)	
The Use Of Computer Models For Estimating Forward-Looking Economic Costs	)	CCB/CPD Docket No. 97-2
A Staff Analysis	)	

REPLY COMMENTS OF THE UNITED STATES TELEPHONE ASSOCIATION

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SUMMARY

Because the definition of forward-looking costs in the Staff Analysis ignores the actual costs incurred by LECs pursuant to regulatory obligations, it is an inappropriate basis for cost or pricing decisions. Indeed, failing to recognize the need for incumbent LECs to recover their embedded costs is at odds with Administration policy, which recognizes that costs incurred pursuant to regulatory obligations should be recovered. The report of Christensen Associates submitted by USTA in its initial comments demonstrates that the costs that are expected to be incurred by incumbent LECs would provide a good benchmark to assess the forward-looking economic costs of telecommunications providers.

WorldCom's claimed "improvements" to the models would amount to a biased "wish list" of ways to benefit competitors of LECs. Similarly, MCI/AT&T, in claiming that "any cost model should minimize cost," pleads for the Commission to require LECs to subsidize the services of their competitors while continuing to provide universal service.

WorldCom's emphasis on ways to make on-going adjustments to cost models, and MCI/AT&T's argument that *any* proprietary data used in cost models "should be made available on the public record without proprietary protections," are antithetical to the competitive process.

The recently-released Hatfield Model Release 3.0 ("Hatfield 3") appears to persist in inaccurately estimating forward-looking economic costs. Analyses submitted in initial comments indicate that because the basic model structure has not changed, Hatfield 3 retains problematic features virtually designed to underestimate costs. Moreover, these analyses indicate that the results produced by Hatfield 3 for several non-BOC LECs did not differ in