MCI Telecommunications Corporation

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Federal Communications Commission
Office of Secretary

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April 18, 1997

William F. Caton
Acting Secretary
Federal Communications Commission
Washington, D.C. 20554

Re: Ex Parte Submission
CC Docket No. 94-1 and 96-262

Dear Mr. Caton:

In response to a staff request, MCI submits the attached material, which computes the LECs' projected and achieved productivity based on their performance under the interim price cap plan. Please associate it with the record in the above captioned dockets.

Respectfully submitted,

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CC: Anthony Bush, James Casserly, James Coltharp, Tom Boasberg, Dan Gonzales, John Nakahata, Greg Rosston

In Attachment 7 of its comments in CC Docket 96-262, filed January 29, 1997, USTA purports to correct an analysis of local exchange carrier (LEC) productivity previously filed by MCI. These "corrections," claims USTA, prove that the LECs' productivity was only 2.85%. However, USTA's analysis is flawed. As described below and in the attached tables, the LECs' choice of productivity factor under the interim price cap plan and their achieved earnings since 1995 indicate that their own assessment of prospective productivity has been between 7.95% and 10.63%. MCI urges the Commission to set the LECs' productivity factor within that range.

MCI's initial analysis examined the LECs' choice of productivity factor at two times. First, it examined the choice of 5.3% in 1995, when the interim price cap plan was adopted. The LECs' choice of 5.3% at that time implied that the LECs expected to achieve productivity of at least 8.54%. Second, the analysis examined the LECs' choice of 3.3% as their productivity factor under the original LEC price cap plan, and found that they would have chosen this productivity factor so long as their expected productivity were no more than 10.86%.

USTA claims that this analysis by MCI is in error because it assumes that the LECs were earning 11.25% when they made their productivity election in 1995. Since the LECs' earnings were in fact 13.78% in 1994, USTA claims, the LECs could have been expecting lower productivity than MCI's analysis shows, and still have chosen an X of 5.3%. In fact, USTA states, duplicating MCI's original analysis but starting from a rate of return of 13.78% results in a break-even X factor of only 2.85%.

USTA's criticism, while making a valid point, is flawed. First, USTA's criticism does not apply to the analysis of the original price cap plan, since the starting point rates under price caps were adjusted to target an 11.25% rate of return. Thus, the LECs' choice of 3.3% in the initial price cap filing indicates that the LECs' expected productivity was no more than 10.86%, as MCI's original analysis showed. Second, while the LECs' rate of return in 1994 is relevant to what their expected productivity level was, USTA has misapplied their earnings in its analysis.

The 13.78% rate of return that the LECs achieved in 1994 is not the correct starting point for the analysis. The Commission required the LECs to take two exogenous adjustments to their price caps, which lowered their revenues without changing their costs. These two changes, removal of Other Post-Employment Benefits and adjusting the cap by 0.7 percentage points for each year the LECs chose a productivity factor of 3.3% under the original price cap plan, lowered the LECs "starting-point" earnings to 11.64%. Given these earnings, the LECs' projected X factor in 1995 would have to have been at least 7.95%, as shown in Table 1. In fact, since the LECs achieved earnings of 13.88% in 1995, their achieved productivity was 10.63%, as shown in Table 1.

This productivity continued into 1996 when the LECs earned 14.98%. Given their 1995 and 1996 earnings, the LECs must have achieved productivity of 7.93% in 1996, as shown in Table 2. Clearly, the LECs' achieved productivity under the interim price cap plan when they have had the greatest incentive to control their costs, has been between 8% and 10%. This is consistent with their election of productivity factor under the original price cap plan, as discussed above. MCI urges the Commission to set the X factor at a level which will reflect the achieved productivity levels of the LECs.

TABLE 1

1994 Price Cap Revenue ($000)	$ 21,618,490	
Net Investment ($000)	$ 30,828,507	
Composite Income Tax Rate	40.00%	
1994 Reported ROR	13.78%	
1994 Reported ROR, adj for OPEB, X-factor adjustment	11.64%	
50/50 Sharing @	12.25%	12.25%
100% Sharing @	13.25%	16.25%

Implicit X	ROR at X = 4%, no sharing	ROR at X = 4%, after sharing	ROR at X = 4.7%, after sharing	ROR at X = 5.3%
3.08%	11.25%	11.25%	10.96%	10.70%
4.26%	11.75%	11.75%	11.46%	11.20%
5.45%	12.25%	12.25%	11.96%	11.70%
6.64%	12.75%	12.50%	12.35%	12.20%
7.83%	13.25%	12.75%	12.60%	12.70%
7.95%	**13.30%**	**12.75%**	**12.63%**	**12.75%**
9.02%	13.75%	12.75%	12.85%	13.20%
10.21%	14.25%	12.75%	13.10%	13.70%
10.63%	**14.43%**	**12.75%**	**13.19%**	**13.88%**
11.39%	14.75%	12.75%	13.35%	14.20%
12.58%	15.25%	12.75%	13.60%	14.70%
13.77%	15.75%	12.75%	13.85%	15.20%
14.96%	16.25%	12.75%	14.10%	15.70%
16.15%	16.75%	12.75%	14.25%	16.20%
17.34%	17.25%	12.75%	14.25%	16.70%

TABLE 2

1995 Price Cap Revenue ($000)	$ 22,110,717	
Net Investment ($000)	$ 32,046,559	
Composite Income Tax Rate	40.00%	
1995 Reported ROR	13.88%	
1995 Reported ROR	13.88%	
50/50 Sharing @	12.25%	12.25%
100% Sharing @	13.25%	16.25%

Implicit X	ROR at X = 4%, no sharing	ROR at X = 4%, after sharing	ROR at X = 4.7%, after sharing	ROR at X = 5.3%
-2.35%	11.25%	11.25%	10.96%	10.71%
-1.15%	11.75%	11.75%	11.46%	11.21%
0.06%	12.25%	12.25%	11.96%	11.71%
1.27%	12.75%	12.50%	12.36%	12.21%
2.48%	13.25%	12.75%	12.61%	12.71%
2.60%	**13.30%**	**12.75%**	**12.63%**	**12.76%**
3.69%	13.75%	12.75%	12.86%	13.21%
4.89%	14.25%	12.75%	13.11%	13.71%
6.10%	14.75%	12.75%	13.36%	14.21%
7.31%	15.25%	12.75%	13.61%	14.71%
7.96%	**15.52%**	**12.75%**	**13.74%**	**14.98%**
8.52%	15.75%	12.75%	13.86%	15.21%
9.73%	16.25%	12.75%	14.11%	15.71%
10.93%	16.75%	12.75%	14.25%	16.21%
12.14%	17.25%	12.75%	14.25%	16.71%