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**EX PARTE**

April 23, 1997

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Federal Communications Commission
Office of Secretary

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

Re: Written Ex Parte
CC Docket No.96-262

Dear Mr. Caton:

A copy of the attached written USTA ex parte and attachments (filed with the Secretary on April 22, 1997) was sent today to the following FCC Common Carrier Bureau staff members: Jay Atkinson, Alexander Belinfante, Dr. Anthony Bush, Raj Kannan, Jane Jackson, Rich Lerner, Richard Metzger, Jim Schlichting, Steve Spaeth and Mark Uretsky.

The original and a copy of this written ex parte are being filed in the Office of the Secretary on April 23, 1997. Please include it in the record of the above-referenced proceeding.

Respectfully submitted,

Frank McKennedy
Director - Legal and Regulatory Affairs

Attachment
cc: Jay Atkinson
Alexander Belinfante
Dr. Anthony Bush
Raj Kannan
Jane Jackson
Rich Lerner
Richard Metzger
Jim Schlichting
Steve Spaeth
Mark Uretsky

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USTA 100 Years 1897-1997

April 22, 1997

The Honorable Reed E. Hundt, Chairman
The Honorable James H. Quello, Commissioner
The Honorable Susan Ness, Commissioner
The Honorable Rachelle B. Chong, Commissioner

Re: CC Docket No. 96-262
Productivity Factor

Dear Commissioners:

The single most critical financial aspect of the regulatory environment for price cap LECs is the productivity offset. Any change to the current productivity offset should reflect the deregulatory, competitive environment envisioned by the Telecommunications Act of 1996. In such an environment, raising the productivity factor is inappropriate and damaging. As intended by the Act, efficient competitive dynamics will discipline pricing. Initially, competitive pricing pressure will be intense for high margin business services in the densest geographies. As competition grows, more services will be subject to competitive influences. Consequently, price cap regulation should apply to an ever-decreasing number of services. In addition, the availability of unbundled network elements will drive all access prices down, for all services and customers.

The record established to date in both the price cap and access reform proceedings supports the adoption of a productivity offset based on the total factor productivity (TFP) results filed by USTA in those dockets. The TFP approach is verifiable and relies on publicly available data. No other method meets the Commission's criteria. No other party has updated the record to provide results for the most recent five year period. In addition, the effect of rate restructuring, from a per minute basis to a flat rate basis, must also be reflected in a productivity factor which is appropriate for that structure.

Of particular concern to USTA is the impact of any increase in productivity measurement in this period of change, uncertainty and increasing competition. In previous proceedings, the



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Commission has recognized that there are differences among companies as to the size and scope of their operations, the efficiency gains they can reasonably be expected to achieve, the geographic areas served and the level of competition which currently exists. Therefore, it is imperative that the price cap plan continue to contain options.

Attached hereto is a brief listing of the issues raised by USTA and other LECs in the access charge proceeding regarding an appropriate productivity factor. I urge you to adopt the TFP Review Plan Model as discussed by USTA in its comments and replies.

Cordially,

Roy M. Neel
President and CEO

Attachment

cc: Mr. Thomas Boasberg
Mr. James L. Casserly
Mr. James R. Coltharp
Mr. Daniel Gonzalez

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4/16/97

# USTA ANALYSIS OF PRODUCTIVITY ISSUES

## The Record in 96-262 Does Not Support Any Increase in the Productivity Offset

- The Christensen Update (USTA Comments at Attachment 5) provides updated total factor productivity (TFP) results through 1995 showing that, historically, LEC productivity growth has exceeded U.S. economy productivity growth by 2.7% per year. TFP is the appropriate method to reflect the impact of rate restructuring.

- The Critique of AT&T (USTA Comments at Attachment 6) by Christensen Associates demonstrates that the AT&T analysis is replete with errors and is based on a series of fundamentally incorrect methods. It incorrectly measures every component of productivity (i.e., capital input, labor input and materials, rents and services input and output). If corrected, AT&T's estimate of productivity yields 2.9%, close to the Christensen results.

- The Response to MCI Productivity Analysis (USTA Comments at Attachment 7) demonstrates that MCI's methods are both conceptually and quantifiably incorrect and contrary to the incentives of price cap regulation. MCI does not measure productivity. Instead, it seeks to eliminate all the incentives for increased efficiencies which the price cap LECs have earned in the past five years. Correcting the mathematical errors of the MCI Analysis yields a productivity factor of approximately 2.85%, close to the Christensen results.

- The Affidavit of Dr. James Vander Weide (USTA Comments at Attachment 4) demonstrates that the accounting earnings results of the price cap LECs cannot serve as the basis to increase the productivity offset particularly since the economic rates of return are significantly less that 11.25%. The achieved economic rate of return was 8.75% over 1991-1995. (This figure is computed using the same methodology the Commission used to set the 11.25% return). Comparing the FCC's accounting ROR results to the 11.25% is comparing "apples and oranges". The sharing mechanism serves no useful purpose and is counterproductive to incentive regulation. Elimination of sharing will provide safeguards against cross subsidization concerns.

## Total Factor Productivity is the Proper Measure of Historical Productivity.

- TFP measures the growth in the demand actually experienced (output) minus the growth in resources actually used (inputs).

- The LEC TFP results are stable.



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- After detailed review of the record in CC Docket No. 94-1, the Commission supported TFP.

- No party has contradicted the Christensen finding that LEC TFP growth differential is 2.7% (five-year average ending in 1995).

- The TFP Review Plan Model conforms to Commission standards and relies on data which are publicly available and verifiable. No other model meets those criteria.

**LEC TFP Growth for the Most Recent Five Years.**

- LEC TFP Differential, 1990-95, is 2.7% (3.1% LEC TFP less 0.4% U.S. TFP).

- Effect of Rate Restructuring is 0.4% (Proposed CCL and TIC rate restructuring).

- LEC Differential Adjusted for Restructuring is 2.3% (Differential less restructuring effects). [USTA Comments, Attachment 5, and Reply Comments, Attachment 10].

**The X-Factor Should Be Based on Total Company Results.**

- There is no economically valid procedure for measuring interstate TFP.

- The existence of joint and common costs means that interstate TFP cannot be measured or defined.

- Inputs/input growth cannot meaningfully be attributed to interstate only.

**An Input Inflation Adjustment Factor Should <u>Not</u> be Added to X.**

- The inclusion of an input inflation adjustment factor does not change the long-term trend of price cap indexes since the average input inflation differential is zero.

- An input inflation adjustment will only serve to reduce the accuracy and reliability of the productivity factor.

- Any analysis of input inflation differences must utilize data that are consistent for LECs and the U.S. and must use consistent methods. AT&T and Ad Hoc do not utilize consistent data.

**The X-Factor Should Recognize that Rate Restructuring and Competition Will Reduce Productivity Growth in the Future.**

- The effects of competition and rate restructuring are not typically reflected in the historical productivity studies. These effects should be considered in an increasingly competitive market.

- For the Commission, rate restructuring will be known and measurable.

- Flat rate recovery of CCL and TIC will reduce measured TFP by approximately 0.4% per year and interstate revenue growth by approximately 1.4% per year.

- Competitive losses will affect output growth before services are removed from price caps.

- A 10% loss in output over 5 years reduces revenue growth by an average of 2% per year. This reduces TFP by between 0.6% and 1.0% per year. A 20% loss over 5 years reduces TFP growth by 1.2% to 2.0% per year.

**Other Methods Incorrectly Attempt to Replicate ROR Regulation.**

- MCI attempts to use the productivity factor to target ROR. This method only seeks to regulate earnings, not prices, and to provide disincentives for investment, not incentives.

- AT&T's Norsworthy analysis closes back to revenues, attempting to use earned returns as a measure of productivity contrary to price cap regulation.

- Norsworthy incorrectly defines Total Cost as equal to the Total Revenue observed in each time period.

- Norsworthy uses the fastest output growth with overall input growth, inflating the estimate of TFP.

- Other Norsworthy errors: Local output and toll output are measured incorrectly; interstate access are measured incorrectly due to confusion about EUCL; costs are incorrectly split among Labor, Capital and Materials; materials price index are entirely inaccurate, especially for LECs (counts access as materials); capital quantity index has computational and conceptual errors; and, numerous data items were arbitrarily extrapolated when actual data were available.

- Neither of these methods are economically meaningful or appropriate productivity methods.

**The Price Cap Formula Should Reflect the Deregulatory, Competitive Telecommunications Market Established by the Telecommunications Act of 1996.**

- The productivity offset is the single most critical financial aspect of the regulatory environment.

- The competitive environment make the setting of high productivity factor unnecessary and inappropriate.

- Other telecommunications providers are not burdened by an excessive productivity factor:

(0% productivity factor for cable and the previous 3% productivity factor for AT&T).

- State productivity factors average about 2.8%.

- Demand stimulation in the future will be a much different issue than demand stimulation in the past. Fighting for retention of market share with facilities-based competitors (for access, the services relevant to setting the productivity factor) is very different from an environment where access was a monopoly and AT&T was required by regulation to reduce toll prices when access prices declined.

**Accounting Rates of Return Send Incorrect Signals Regarding LEC Productivity.**

- Changes in LEC accounting earnings and LEC productivity are unrelated.

- Accounting earnings cannot be used to gauge productivity performance.

- The 5.3% productivity offset selections are not a measure of achieved productivity growth.

- The choice between 4.0% and 5.3% is as much about initial accounting earnings levels relative to the sharing range thresholds <u>and</u> the distance between the options as anything else.

- The economic earnings of price cap LECs (8.75%) are much lower than those of the IXCs.