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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Access Charge Reform	)	CC Docket No. 96-262

OPPOSITION OF THE UNITED STATES TELEPHONE ASSOCIATION TO PETITIONS FOR RECONSIDERATION FILED BY AT&T AND AD HOC

The United States Telephone Association (USTA) respectfully submits its Opposition to the Petitions for Reconsideration filed July 11, 1997 by AT&T Corp. (AT&T) and the Ad Hoc Telecommunications Users Committee (Ad Hoc) in the above-referenced proceeding.[1] As will be discussed below, the issues raised in these petitions do not merit reconsideration by the Commission.

I. THE RECORD DOES NOT SUPPORT AT&T'S RECOMMENDATION THAT INTERSTATE-ONLY DATA BE USED TO DETERMINE LEC PRODUCTIVITY.

AT&T recommends that the Commission reconsider its decision to rely on total company data rather than interstate-only data as the basis for measuring LEC productivity.[2] AT&T's recommendation is based on unsupported statements regarding input characteristics and the ability to reliably estimate interstate productivity growth and is not supported by the record.

[1] Price Cap Performance Review for Local Exchange Carriers, Access Charge Reform, *Fourth Report and Order* in CC Docket No. 94-1 and *Second Report and Order* in CC Docket No. 96-262, 62 Fed. Reg. 31939 (June 11, 1997) (Price Cap Order).

[2] AT&T at 3-12. *See*, also Ad Hoc at 12-13.

As the Commission explains[3], no party, including AT&T, supported the Historical Price Method originally developed in the first LEC Price Cap Order which included an ad hoc, interstate adjustment.[4] The Commission itself rejected such an approach in the LEC Price Cap Performance Review[5] and concluded in this proceeding that the "record before us does not allow us to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth...Accordingly, we find no basis in the record for making an adjustment to the X-Factor to account for any differences between interstate and total company productivity."[6] AT&T now suggests that the Commission adopt the interstate adjustment from the Historical Price Method. Such an approach is illogical and should be rejected for the same reasons the Commission first rejected it over two years ago: AT&T's assertions are unsupportable and have not been substantiated in the record.

In the LEC Price Cap Performance Review the Commission considered whether to calculate total factor productivity (TFP) using total company data, both interstate and intrastate, or on an interstate basis. The Commission stated that "[n]o party has argued that the production functions (the technological relationship between inputs and outputs) significantly differ for intrastate and interstate services in ways that can be readily measured or separated. Indeed, intrastate and

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[3]Price Cap Order at ¶ 23.

[4]Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990).

[5]Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, *First Report and Order*, 10 FCC Rcd 8961 (1995) at ¶ 155.

[6]Price Cap Order at ¶ 110.

interstate services are largely provided over common facilities."[7] The Commission noted that traffic growth differential alone would not establish that it is meaningful to distinguish two different measures of productivity.

This issue was raised again in the *Fourth Further Notice*.[8] USTA provided extensive comments regarding this issue. Dr. Laurits Christensen explained that there is no valid distinction between intrastate and interstate productivity or between intrastate and interstate input prices. "This is because there is no economically valid distinction between intrastate and interstate inputs. Intrastate and interstate services have joint and common inputs and there is no economically meaningful allocation of these inputs between jurisdictions: any allocation of these inputs between intrastate and interstate services is arbitrary."[9]

In his reply affidavit, Dr. Christensen demonstrated the inappropriateness of using differences in output growth rates among the products of a multi product firm to craft an interstate adjustment factor.[10] He presented an example of a firm that produces red and blue paper clips. In his example, except for the pigment, the same joint and common inputs were used to produce the paper clips. The red paper clips experience a 5 percent growth in sales and the blue paper clips

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[7]*Id.* at ¶ 159.

[8]Price Cap Performance Review for Local Exchange Carriers, *Fourth Further Notice of Proposed Rulemaking*, CC Docket No. 94-1, 10 FCC Rcd 13659 (1995).

[9]Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen, "Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans Including Response to Appendix F: The Appropriate Data Set to Use in Analyzing Telephone Industry Input Price", USTA Comments, January 16, 1996, at Attachment A.

[10]Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen, "Total Factor Productivity Methods for Local Exchange Carrier Price Cap Plans: Reply Comments", USTA Reply Comments, March 1, 1996 at Attachment A.

experience a 3 percent growth in sales. The arbitrary assumption of AT&T that the inputs for red and blue paper clips grow at the same rate led to the economically meaningless conclusion that the productivity growth of one color paper clip was different from the productivity growth of another color paper clip.

These points were underscored by Dr. William E. Taylor. He observed that economic theory shows clearly that TFP growth for subsets of services in a multi product firm can be defined only in very restrictive circumstances that certainly do not hold for telecommunications firms. "The known presence of economies of scope among interstate and intrastate services means that the cost function cannot be separable, and TFP growth cannot be measured independently for interstate and intrastate services."[11]

> Interstate and intrastate usage services are produced using the same facilities and expenses. An increase in demand for interstate carrier access leads to precisely the same changes in investment and expenses as an increase in the demand for intrastate carrier access or, indeed, for local usage. In these circumstances, it is impossible to distinguish between productivity growth rates of intrastate and interstate services. If each additional minute of interstate service requires the same increase in inputs as an additional minute of interstate service, then productivity growth in the two sectors will be the same.
>
> Note that this result holds irrespective of the output growth rates of the two services. Even if intrastate output is constant, if the identical technology is used to produce intrastate and interstate services, interstate and intrastate services would experience the same growth in total factor productivity, in the sense that the change over time in the amount of output produced per unit of input would be the same. An addition to the rate of growth of interstate output would lead to higher total factor productivity growth for intrastate as well as interstate services.[12]

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[11]William E. Taylor and Charles Zarkadas, National Economic Research Associates, Inc., "Economic Evaluation of Selected Issues from the Fourth Further Notice of Proposed Rulemaking in the LEC Price Cap Performance Review", USTA Comments, January 16, 1996 at Attachment C.

[12]*Id.* at 17.

Dr. Taylor also pointed out that productivity growth measures which are based on separated costs would be distorted by changes in the separations formulas and factors and would provide no meaningful information about productivity growth. "Obviously a change in a separations formula that shifts investment or costs towards the interstate jurisdiction does not represent a reduction in interstate productivity growth in any meaningful sense of the word."[13] The Part 36 rules do not separate costs for the purpose of setting prices. These rules represent arbitrary regulatory boundaries that have no economic meaning or basis for determining the input or output components of production. The inputs of telecommunications firms are not deployed by jurisdiction. Any attempt to reach conclusions regarding the effects on overall productivity of single sources of output produced from joint and/or common inputs requires arbitrary assumptions about inputs. These arbitrary assumptions have been exposed in the record and the Commission was correct not to include an adjustment for interstate only productivity.

USTA also provided a critique of AT&T's Performance-Based model which describes the fundamental errors in that model, including the unsupported claim that it provides a meaningful estimate of interstate only productivity.[14] Because that model is based on the same arbitrary

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[13] *Id.* at 19.

[14] Christensen Associates, "Critique of the AT&T Performance-Based Model", USTA Comments, CC Docket No. 96-262, January 29, 1997 at Attachment 6. *See,* also Bell Atlantic Ex Parte Presentation of Dr. Melvyn Fuss, April 8, 1997, CC Docket No. 96-262. Dr. Fuss corroborated the findings of Dr. Christensen and Dr. Taylor in that he has found no economically valid method for measuring interstate-only TFP because significant amounts of inputs are used jointly with intrastate services to create joint and common costs. He also stated that it would be impossible to write down a formula to calculate interstate TFP; that joint and common costs cannot be allocated to separate services in an economically meaningful manner; and that AT&T's assumptions that inputs used by all services grow at the same rate is a particularly simplistic form of fully distributed cost allocation which has not been justified in AT&T's various

assumption which Dr. Christensen invalidated with a simple paper clip example, the Commission properly rejected it.

In fact, no party has presented an economically meaningful method of measuring interstate inputs. This fact is clearly demonstrated in the record by the illogical leaps in reasoning which AT&T and Ad Hoc make in order to attempt to develop an interstate only productivity factor. As Dr. Taylor aptly concludes, measuring interstate TFP growth is "like trying to find a black cat in a dark room where there is no cat. It is not merely very difficult; it can't be done."[15]

The Commission has found that interstate and intrastate services are largely provided over common facilities and the record contains no evidence that an economically meaningful way to measure productivity other than on a total company basis even exists. TFP on a total company basis meets the Commission's stated criteria that the productivity offset should be "economically meaningful". Comparison of any differences in outputs to any jurisdictionally separated inputs will not yield economically meaningful differences in productivity. The Commission need not reconsider this issue.

II. THE COMMISSION WAS CORRECT IN ELIMINATING SHARING.

AT&T suggests that the Commission also reevaluate its decision to remove the sharing obligation.[16] The Commission has correctly found that the sharing obligations imposed in the past have served their purpose and must be eliminated. As stated by the Commission, sharing is

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submissions, either analytically or empirically.

[15]Taylor at 19.

[16]AT&T at 12-16.

inapposite with price cap regulation in that it only serves to eliminate the efficiency incentives that are the goals of price cap regulation by blunting incentives to reduce costs, invest in the infrastructure and introduce new services.[17] The Commission also correctly points out that sharing is inconsistent with the pro-competitive objective of the Telecommunications Act of 1996.[18] It perpetuates expensive and burdensome cost allocations procedures which are not required under price cap regulation.[19] The Commission notes that parties seeking to retain sharing did not make a persuasive case and AT&T does not alter that perception in its petition. The Commission need not reconsider its decision to eliminate sharing.

AT&T also recommends eliminating the low-end formula adjustment. AT&T incorrectly states that smaller LECs may "opt out" of price caps inferring that the low-end formula adjustment is not necessary. This statement is incorrect. The Commission's rules specifically prohibit LECs from opting out of price cap regulation. *See*, Section 61.41(d). AT&T also states that the low-end formula adjustment rewards inefficient LECs. Given that the Commission adopted a productivity offset of 6.5 percent, which forces LECs each year to outperform the U.S. economy average by 6.5 percent, the low-end formula adjustment is their only protection against confiscation.

The lower formula adjustment does not interfere with the incentives of price cap regulation since a company must endure over a year and a half of low earnings which may never be recouped in order to qualify for the adjustment. This adjustment is a vital safety net which must be retained.

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[17]Price Cap Order at ¶ 148.

[18]*Id.* at ¶ 150.

[19]*See*, Robert G. Harris, "Economic Benefits of LEC Price Cap Reform", USTA Comments, CC Docket No. 94-1, May 9, 1994 at Attachment 2.

III. THE COMMISSION SHOULD NOT APPLY THE X FACTOR TO 1995.

The Price Cap Order requires price cap LECs to adjust their price cap indices to levels that would have been in effect had the 6.5 percent productivity factor become effective with the 1996 annual tariff filings. AT&T suggests that the Commission should have applied the new productivity factor as if it had been in effect with the 1995 annual tariff filings.[20] Such adjustments significantly alter the business decisions made by LECs who must rely on Commission decisions in order to operate.

AT&T argues that this adjustment will benefit long distance customers. Of course, AT&T typically does not share the reductions in access prices which result from the application of the price cap formula with its long distance customers so it is unlikely that its customers would receive any benefit. AT&T's real objective is to line its own pockets at the expense of the LECs. However, the Commission properly recognized that LEC shareholder and investor interests must be considered and AT&T's self-serving proposal ignores such considerations.

IV. THE COMMISSION CORRECTLY REJECTED THE PRODUCTIVITY ESTIMATES OF AD HOC.

The Commission correctly rejected the productivity estimates of Ad Hoc. As explained by the Commission, the Ad Hoc estimates were not publicly available, relied on the original USTA/Christensen model which was subsequently revised by USTA and created volatile results which could not be adopted. USTA refuted Ad Hoc's productivity estimates in its reply comments in CC Docket No. 94-1.

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[20] AT&T at 16-19.

The Commission clearly stated that it would give little weight to undocumented TFP calculations. In the *Fourth Further Notice* the Commission stated that "[a]ny party submitting studies, proposed methods for calculating a X factor or other empirical information must furnish promptly upon request by Commission staff or any party to this proceeding work papers and any other data necessary to replicate the results submitted in the proceeding. If any party fails to do so, we will accord no weight to those studies, methods, or empirical information in our deliberations."[21] In addition, the Commission stated that calculation of the productivity offset should be reasonably simple and "based on accessible and verifiable data."[22] Finally, the Commission stated that it was "concerned that certain proposals to compute the X factor may rely on proprietary information. In such cases, it is possible that data which are critical to the calculation of the X-Factor would not be accessible to public scrutiny."[23] At the very least, Ad Hoc should have been on notice that it should have provided estimates that were publicly available. Ad Hoc did not meet the standards for accessibility established by the Commission.

The record clearly shows that Ad Hoc's estimates of input prices are the most volatile estimates presented by any party in this proceeding.[24] The unsupported hedonic adjustments made

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[21]*Fourth Further Notice of Proposed Rulemaking* at ¶ 15.

[22]*Id.* at ¶ 16.

[23]*Id.* at ¶ 18.

[24]*See*, *Ex Parte* Presentation of Sprint Corporation, March 13, 1996, CC Docket No. 94-1, at 11 (demonstrating the volatility of input price data). Ad Hoc itself made public little actual evidence regarding its annual input inflation estimates. The Commission was only provided Ad Hoc's annual estimates of LEC input inflation, which were approximately three times more volatile that the Commission's estimates of LEC input inflation, as measured by the range of actual estimates. Price Cap Order at ¶¶ 37-38.

by Ad Hoc significantly increased the volatility of its estimates. Ad Hoc presented no justification for a specific hedonic adjustment. It cited academic articles that discussed the concept, but provided no empirical evidence of any specific hedonic adjustments that it claimed should be applicable to the telecommunications industry or to price cap LECs. Neither the Commission nor any party, could confirm or validate how the hedonic adjustments were made or whether Ad Hoc made hedonic adjustments on top of the existing hedonic adjustments already computed in the U.S. price indexes. The Commission had no choice but to summarily reject Ad Hoc's unsubstantiated recommendations on input inflation based on the erratic fluctuations and that a hedonic adjustment was appropriate for certain price indices applicable to price cap LECs.

V. CONCLUSION.

For the reasons set forth above, the Petitions for Reconsideration filed by AT&T and Ad Hoc should be rejected.

Respectfully submitted,

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August 18, 1997

CERTIFICATE OF SERVICE

I, Robyn L.J. Davis, do certify that on August 18, 1997 Opposition to Petitions for Reconsideration of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.

Robyn L.J. Davis