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AT&T

Peter H. Jacoby
General Attorney

Room 3245H1
295 North Maple Avenue
Basking Ridge, NJ 07920
908 221-4243
FAX 908 953-8360
STARMAIL law295b!pjacoby

September 4, 1997

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: Price Cap Performance Review for Local Exchange Carriers/Access Charge Reform, CC Docket Nos. 94-1 and 96-262 (Written **Ex Parte** Presentation)

Dear Mr. Caton:

Yesterday AT&T Corp. served and filed with the Commission its Reply to Oppositions to its Petition for Partial Reconsideration in the above-referenced docket. AT&T has since identified a number of typographical errors in the filed Reply. In accordance with Section 1.1206 of the Commission's rules, AT&T is submitting to the Commission two copies of this letter with copies of a corrected version of the Reply and a blacklined version showing the corrected portions of that pleading.

Very truly yours,

Peter H. Jacoby /ha

Enclosures

No. of Copies rec'd 0+2
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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

AT&T REPLY TO OPPOSITIONS TO ITS PETITION FOR PARTIAL RECONSIDERATION

Pursuant to Section 1.429(g) of the Commission's Rules, 47 C.F.R. § 1.429(g), AT&T Corp. ("AT&T") hereby replies to the oppositions and comments concerning AT&T's Petition for Partial Reconsideration of the Commission's Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, released May 21, 1997, FCC 97-159 (hereinafter "Order" or X-Factor Order").[1]

As AT&T pointed out in its Petition for Partial Reconsideration, the Commission's X-Factor Order made laudable advances in improving the effectiveness and reliability of the LEC price cap system. But in three particular areas the Order should be reconsidered and revised in order to provide more accurate measurements of the LECs' productivity and better ensure the reliability of LEC price cap regulation. Specifically, the Order needs revision (1) to measure the productivity of the LECs' interstate access services on the basis of interstate-only data (rather than "total company" data), (2) to eliminate the low-end adjustment mechanism, and (3) to require that the price cap LECs adjust their price cap indices to reflect the newly determined X-Factor for the 1995 tariff year, as well as for the 1996 tariff year.

The existing deficiencies in the X-Factor Order, if not corrected, produce substantial and unjustified benefits for the price cap LECs, and thus adversely affect the interexchange carriers

[1] Appendix A identifies the parties that filed Oppositions or Comments. This Reply is directed to the Oppositions or Comments filed herein by the parties representing the interests of the incumbent local exchange carriers ("LECs").

and their long-distance customers. The X-Factor determined in the Order is understated by some two to three percentage points; the currently required LEC access rate reductions are at least $360 million too low; and the Order's retention of the low-end adjustment improperly rewards the less efficient LECs.

Quite predictably, the oppositions filed herein on behalf of the LEC interests take exception to the points raised in AT&T's petition (as well as to the Petition of the Ad Hoc Telecommunications Users Committee ("Ad Hoc"), which also particularized the Order's understatement of the LEC X-Factor). The LEC oppositions argue against AT&T's fully supported recommendations that would improve the accuracy of measuring LEC productivity through the use of relevant interstate data, would properly determine the amount of the access rate reductions through application of the new X-Factor to the entire two-year period in which the former, understated "interim" X-Factors were in effect, and would terminate the ill-conceived low-end adjustment mechanism which subverts the objectives of incentive regulation. As shown herein, there is no sound basis for the LEC oppositions, and they should be denied.

ARGUMENT

I. THE ORDER SHOULD BE REVISED TO CURE THE UNDERSTATEMENT OF THE X-FACTOR ARISING FROM EXCLUSIVE RELIANCE ON "TOTAL COMPANY" DATA TO MEASURE LEC INTERSTATE PRODUCTIVITY.

The LEC oppositions attempt to minimize AT&T's demonstration, based on substantial record data and past Commission decisions, documenting that the Commission-adopted productivity measures produce a significant understatement in the LECs' interstate X-Factor by relying exclusively on "total company" (combining local, intrastate and interstate) data. See AT&T Petition at 3-12. Rather than dealing explicitly with the substantive showings of AT&T (supported by Ad Hoc), the LECs simply brand the AT&T demonstration as an "unsupported presumption" or complain about the difficulties of separating interstate and intrastate costs.[2]

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[2] See, e.g., Bell Atlantic at 2; GTE at 10; Sprint at 3; U S WEST at 2.

In order to support their claim that "total company" data should be used as the standard to determine the LECs' interstate X-Factor, the LECs must establish that productivity growth on a total company basis (which is heavily weighted with local and intrastate services) is the equivalent of productivity growth determined on an interstate-only basis. Nowhere in the LEC oppositions do the LECs make this essential showing.

Indeed, the record evidence and past Commission decisions demonstrate precisely the opposite -- that is, interstate total factor productivity ("TFP") growth far exceeds TFP growth with respect to the LECs' local and intrastate services. On the output side, the evidence is overwhelming that LEC interstate demand growth substantially exceeds LEC local and intrastate growth. See AT&T Petition at 5. Thus, according to the LEC data reported to the FCC, during the post-divestiture period (1985-94), the demand for LEC interstate access services grew at annual rate of 6.8 percent -- far greater than the 4.2 percent annual growth rate in demand for LEC local and intrastate services. Id. Other evidence of record provided by AT&T and Ad Hoc further confirm the same magnitude of the differentials between LEC interstate output growth and LEC local/intrastate growth. Id.

The Commission has recognized the significance of the data establishing greater demand growth for the LECs' interstate services vis-a-vis the lower demand growth for their local/intrastate services. As the Commission determined, "the more rapid growth in [LEC] interstate usage results in higher apparent interstate productivity growth."[3] Accordingly, it was found that productivity measured on a "total company" basis must be adjusted upward to reflect greater interstate productivity growth.[4]

Significantly, the LEC oppositions do not produce any data -- or furnish any specific reference to the record -- to refute AT&T's showing that the LECs' interstate demand growth

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[3] LEC Price Cap Order, 5 FCC Rcd. 6786, 6798 (¶ 92)(1990)(emphasis added).

[4] Id. at 6935-37 (App. D).

outstrips their local/intrastate demand growth. By their silence, the LECs effectively concede the correctness of AT&T's position.

It is also noteworthy that two of the major price cap LECs (NYNEX and Ameritech), who did not file any opposition to AT&T's Petition, recognized in their prior submissions in this proceeding that the LECs' higher interstate output growth would likely require an upward adjustment to the LECs' X-Factor determined on a "total company" basis. As NYNEX stated, "intuitively the higher output growth rates for interstate indicate a potential need for an adjustment to the TFP result. . . . Basing the productivity offset only on a total company TFP and not accounting for the higher revenue generation (output growth) in interstate may result" in a misalignment between interstate revenues and interstate costs.[5] Besides, it is important to note that USTA, the leading advocate for the price cap LECs in this proceeding, made it abundantly clear that greater demand growth produces greater productivity growth. As USTA observed in its earlier comments herein: "[I]ncreased [demand] growth generates productivity gains. Thus, as more units of demand are carried on a LEC's network, an increase in productivity will be realized for all services. . ."[6]

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[5] NYNEX Comments at 20 (emphasis added). (Reference herein to "Comments" and "Reply" are to the parties' submissions in CC Docket No. 94-1 (Fourth Further NPRM), filed January 1996 and March 1996, respectively.) In its Comments, NYNEX pointed out the greater interstate growth rate compared to the "slower" intrastate growth: "[T]he interstate market [of the LECs] is based on output growth that reflects revenues primarily generated by MOU growth as compared to intrastate, which reflects a significant portion of output growth generated by a slower line growth." Id. See also Ameritech Comments at 7 (Ameritech is "willing to consider modifications" to the USTA model if the "Commission . . . believe[s] it is appropriate to have an adjustment (e.g., interstate output growth factor)" to determine TFP.)

[6] USTA Comments at 45 (emphasis added). Moreover, this same position was clearly supported by Dr. Laurits Christensen, the principal consultant to USTA and the LECs. While USTA relies on Dr. Christensen's "paper clip" example to cast doubt on using greater LEC output growth to indicate greater productivity growth (see USTA Opposition at 3-4), it so happens that Dr. Christensen endorsed that very principle in testifying before a state regulatory agency. In his recent appearance before the California commission, Dr. Christensen emphasized the direct relationship between the LECs' output growth and their TFP growth, pointing out that a change in the demand (output) growth rate for a LEC leads to a proportional change in the LEC's TFP growth rate. See Testimony of Dr. L.R. Christensen on behalf of Pacific Bell, No. 95-05-047,

(footnote continued on following page)

Given the much higher growth rate for the LECs' interstate output -- and given the recognized principle that higher output growth generates higher productivity growth -- it is quite evident why the LEC oppositions choose to divert attention from the output data and focus instead on inputs. As the LECs argue, because of the difficulties of making a "meaningful" separation between interstate and intrastate inputs, the "total company" approach should be used to calculate LEC interstate productivity growth.[7]

This argument, however, provides no basis for adopting a procedure that is bound to give the wrong answer and produce a pronounced downward bias in the LECs' interstate X-Factor. There is no justification for the LECs ignoring the actual demand data showing a significant differential between the LECs' interstate and intrastate output growth rates. And the LECs have supplied no theoretical support for casting aside the well-established economic principle that there is a direct relationship between output growth and productivity growth.

Under these circumstances, the conceptually sound procedure is that followed in the AT&T Performance-Based Model, developed with Dr. John R. Norsworthy and strongly endorsed by Dr. Ernst Berndt of MIT and Dr. M. Ishaq Nadiri of NYU. This procedure utilizes actual LEC demand data to determine interstate and intrastate output growth rates separately, but treats input growth the same for both interstate and intrastate. This approach obviates the need to allocate input costs between the jurisdictions, and, if anything, works to the advantage of the LECs. See AT&T Petition at 9-11. Results of this more valid procedure show that the Order has underestimated the X-Factor by 1.9 to 2.8 percentage points. Id. at 10-11.

(footnote continued from previous page)

Calif. P. Utils. Comm'n (Sep. 8, 1995), App. 2 at 7-8, 10, 12, 14-16; see also AT&T Reply at 24-25, n.53.

[7] E.g., Bell Atlantic at 2-3; GTE at 12; U S WEST at 2.

II. THE LOW-END ADJUSTMENT MECHANISM SHOULD BE ELIMINATED.

The LEC oppositions further dispute AT&T's showing (Petition at 12-16) that, with the elimination of sharing, the Order errs in not also discontinuing the low-end adjustment mechanism. The LECs argue that, even though sharing no longer exists, the low-end adjustment should be retained as a "safety net" and as a "protection" for the less productive price cap LECs.[8]

These arguments represent a manifest reversal of position for many of these same LEC representatives. In previous submissions to the FCC, the LECs themselves freely admitted that the low-end adjustment is unnecessary, that it improperly protects the least efficient LECs, and that it contravenes the objectives of incentive regulation. As Bell Atlantic told the Commission, the "lower-bound adjustments . . . reward the least efficient [LECs] by providing a safety net to protect against their own performance."[9] And USTA, the chief proponent for the price cap LECs herein, emphasized:

> "[T]he low-end adjustment is another relic of rate-of-return regulation that has no role in the Commission's long-term price cap plan. . . . With the elimination of sharing . . . LECs should not be afforded an automatic upward adjustment for underearnings."[10]

This same position, arguing against continuing the low-end adjustment if sharing were eliminated, was forcefully urged by several other major price cap LECs."[11]

Now that the sharing requirement has been withdrawn, those LECs who previously conditioned their support for the termination of the low-end adjustment on the concurrent elimination

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[8] See, e.g., Bell Atlantic at 5-6; GTE at 13-14; SNET at 1-3; USTA at 7; U S WEST at 5-6.

[9] Bell Atlantic Comments at 6-7.

[10] USTA Comments at 43.

[11] See, e.g., BellSouth Comments at 41 ("Coincident with the elimination of sharing, the Commission should eliminate the low-end adjustment mechanism . . . the low-end adjustment is also an inappropriate rate of return construct that has no place in a price cap regime. For price caps to truly function as they are intended, the Commission must sever all conceptual links between prices and earnings."); Southwestern Bell Comments at 34 ("All ties to ROR [rate of return] regulation should be eliminated. This includes . . . the low-end adjustment. . . ."); U S WEST Comments at 25; U S WEST Reply at 33-34 ("low-end adjustments are inappropriate and unnecessary remnants of rate-of-return regulation").

of sharing do not have any ground left to argue for retention of the low-end adjustment.[12] Just as sharing was allegedly a last "vestige" of rate-of-return regulation, so is the low-end adjustment. Notably, when the Commission's previous order in this proceeding eliminated the sharing requirements for those LECs selecting the highest X-Factor option, it also terminated the low-end adjustment for those LECs not subject to sharing.[13] No LEC objected to this at the time. In short, there is no longer any basis to continue the ill-advised low-end adjustment mechanism now that sharing has been eliminated.[14] But in the event the Commission should decide to retain the low-end adjustment, it would then be just as appropriate to reinstate the FCC's former sharing obligations.

III. THE COMMISSION'S NEWLY DETERMINED X-FACTOR SHOULD BE APPLIED AS WELL TO THE 1995 TARIFF YEAR.

As AT&T pointed out in its Petition (at 16-19), the Commission's rationale for incorporating its newly determined X-Factor in the LECs' price cap indices ("PCIs") for the 1996 tariff year is equally applicable to the 1995 tariff year. During both years, as the Commission recognized, the price cap LECs were allowed to use the "interim" X-Factors, which were subject to revision at the conclusion of this proceeding. As it turned out, these "interim" X-Factors were substantially understated. See Order at ¶¶ 178-79. Accordingly, AT&T has urged the Commission to apply its new X-Factor not only to the LECs' PCIs for the 1996 tariff year but also to those for the 1995 tariff year.

The LEC oppositions generally do not quarrel with the application of the Commission's revised X-Factor to the previous 1996-97 tariff year, but they complain about its

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[12] See, e.g., NYNEX Comments at 4 n.9; Southwestern Bell Comments at 34.

[13] LEC Price Cap Performance Review, 10 FCC Rcd. 8961, 8971 (¶ 20)(1995).

[14] Furthermore, there is no merit whatever to GTE's contention (at 13) that curtailment of the low-end adjustment would be an unconstitutional "taking." No evidence exists that a 10.25 percent return level sets the dividing line for "confiscatory" returns. And even without the low-end adjustment, there are other viable alternatives (e.g., above-cap filings) to provide relief to a price cap LEC whose earnings have fallen to unreasonably low levels.

application to the 1995-96 year Such a course, they contend, would be "unreasonable," "disruptive," "harmful," and unlawfully retroactive."[15]

Significantly, the LECs do not deny that they were on full notice that (1) the earlier X-Factors were "expressly and repeatedly" denominated as "interim" numbers, subject to later adjustment "beginning with the 1995 tariff year," (2) such "interim" X-Factors were likely to be revised with the development of "more accurate" productivity measures at the conclusion of this proceeding, and (3) the Commission had established a valid precedent (affirmed by the Court of Appeals for the D.C. Circuit) applying its newly determined (and increased) X-Factor to the LECs' PCIs in effect during previous tariff filing periods. See Order, ¶¶ 177-179; Bell Atlantic v. FCC, 79 F.3d 1195 (D.C. Cir. 1996).

The arguments contained in the LEC oppositions here amount to nothing more than pleas for equitable relief, which are lacking in substantive support. Other than reciting vague generalities, the LECs offer no concrete evidence demonstrating their detrimental reliance during the pendency of this X-Factor proceeding. Indeed, it is abundantly clear that the price cap LECs benefited enormously with the lower X-Factors in effect since 1995.[16] Moreover, there is no sound justification for "allowing all of the past two years of understated productivity to become permanently ingrained in LEC PCIs" by neglecting to apply the recently revised X-Factor to the PCIs for the 1995 tariff year. See Order, ¶ 179 (emphasis added). It follows, therefore, that the

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[15] See Bell Atlantic at 6-7; GTE at 14-18; SNET at 4-5; Sprint at 5-6; USTA at 8. While U S WEST claims that the Commission was also in "error" by "looking back" to 1996 as well, it attempts to distinguish past Commission precedent on the ground that the Order's revised X-Factor here was determined on the basis of a "new study." U S WEST at 3-4. That is a distinction without a difference, because, as U S WEST was well aware, the X-Factors in effect in 1995 and 1996 were "interim," subject to revision pending the completion of new and "more accurate" studies, and, as it developed, grossly understated.

[16] For example, during the past year the price cap LECs earned, on average, an interstate return exceeding 14.8 percent, some 350 basis points above the Commission-prescribed rate of return. See AT&T Petition at 16 n.22.

Order should be modified to require the new X-Factor to be reflected in the PCIs for all of the past two years.

IV. ITTA'S REQUEST FOR SPECIAL X-FACTOR TREATMENT FOR THE MID-SIZE LECS SHOULD BE REJECTED.

In a pleading, plainly violating the Commission's Rules, ITTA has submitted what amounts to be a late-filed (and unauthorized) petition for reconsideration.[17] ITTA's submission champions the cause of the mid-size LECs, requesting that the Commission (1) "immediately suspend" application of the newly revised X-Factor to the mid-size carriers, (2) initiate a new rulemaking proceeding to "study" productivity for the mid-size LECs, (3) allow, in the interim, the mid-size LECs to apply a 5.3 percent X-Factor without sharing, and (4) adopt a new X-Factor "appropriate" for the mid-size LECs. See ITTA at 1, 20.[18]

The relief requested by ITTA should be denied forthwith. Many of these same matters were thoroughly discussed in AT&T's Opposition, filed August 18. As shown therein, the Commission has repeatedly refused to adopt a policy approving special X-Factor treatment tailored to the individual needs of the mid-size LECs. And the Commission has found that uniform determination and application of the same X-Factor for all price cap LECs is the most administratively feasible and most consistent with the objectives of the price cap plan. The small and mid-size LECs are given the option of electing price cap regulation in the first place, but there is

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[17] The bulk of ITTA's "Comments" (pp. 1-14, 20) requests reconsideration and revision of the X-Factor Order, and essentially seeks affirmative relief from the Commission that goes beyond that sought in previously filed petitions for reconsideration. As such, it represents an untimely petition for reconsideration, not meeting the timeliness requirements of the FCC Rules and the Communications Act. See 47 C.F.R. § 1.429(d); 47 U.S.C. § 405(a). Further, Section 1.429(f) of the Rules, 47 C.F.R. § 1.429(f), requires that responses to petitions for reconsideration be "Oppositions" -- not just friendly commentary supporting existing petitions, as ITTA has done in the case of its endorsement of the petitions of Cincinnati Bell Telephone Company and Citizens Utilities Company. See ITTA at 2-8, 11.

[18] Somewhat similar relief was sought in the Citizens' petition, but that request was explicitly confined to the "rural price cap LECs" and by definition did not apply to the "mid-size LECs."

no reason, as ITTA suggests (at 1, 20), for creating a lower X-Factor so as to entice mid-size LECs to elect price caps.

WHEREFORE, for the reasons stated herein and in AT&T's Petition for Partial Reconsideration, the Commission should reconsider and revise its Order as requested in AT&T's Petition.

Respectfully submitted,

By /s/ Peter H. Jacoby

Mark C.Rosenblum
Peter H. Jacoby

295 N. Maple Avenue
Room 3250J1
Basking Ridge, New Jersey 07920
(908) 221-4243

Jules M. Perlberg

One First National Plaza
Chicago, Illinois 60603
(312) 853-7439

Attorneys for AT&T Corp.

September 3, 1997

APPENDIX A

PARTIES FILING OPPOSIITONS OR COMMENTS

American Petroleum Institute ("API")

Bell Atlantic Telephone Companies ("Bell Atlantic")

GTE Service Corporation ("GTE")

Independent Telephone & Telecommunications Alliance ("ITTA")

Southern New England Telephone Company ("SNET")

Sprint Corporation ("Sprint")

United States Telephone Association ("USTA")

U S WEST, Inc. ("U S WEST")

CERTIFICATE OF SERVICE

I, Ann Marie Abrahamson, do hereby certify that on this 3rd day of September. 1997, a copy of the foregoing "AT&T Reply To Oppositions To Its Petition For Partial Reconsideration" was served by U.S. first class mail, postage prepaid, to the parties listed below.

Wayne V. Black
C. Douglas Jarrett
Susan M. Hafelo
Keller and Heckman LLP
1001 G St., NW, Suite 500 West
Washington, DC 20001
Attorneys for American Petroleum Institute

Edward Shakin
Edward D. Young III
Michael E. Glover
Betsy L. Roe
Bell Atlantic Telephone Companies
1320 North Court House Rd., 8th Floor
Arlington, VA 22201

Christopher J. Wilson
Frost & Jacobs LLP
2500 PNC Center
201 East Fifth Street
Cincinnati, OH 45202
Attorneys for Cincinnati Bell Telephone Company

Thomas E. Taylor
Sr. Vice President-General Counsel
Cincinnati Bell Telephone Company
201 East Fourth St., 6th Floor
Cincinnati, OH 45202

Richard M. Tettelbaum
Associate General Counsel
Citizens Utilities Company
1400 16th St., NW, Suite 500
Washington, D.C. 20036

Ward W. Wueste
Gail L. Polivy
GTE Service Corporation
1850 M St., NW, Suite 1200
Washington, D.C. 20036

R. Michael Senkowski
Robert J. Butler
Gregory J. Vogt
Todd D. Daubert
Wiley, Rein & Fielding
1776 K St., NW
Washington, D.C. 20006
Attorneys for GTE Service Corporation

David W. Zesiger
Independent Telephone and Telecommunications Alliance
1300 Connecticut Ave., NW
Washington, D.C. 20036

Gregory J. Vogt
Suzanne Yelen
Davida M. Grant
Wiley, Rein & Fielding
1776 K St., NW
Washington, D.C. 20006
Attorneys for Independent Telephone and Telecommunications Alliance

Wendy Bluemling
Director - Regulatory Affairs
The Southern New England Telephone Co.
227 Church Street
New Haven, CT 06510

Jay C. Keithley
Sprint Corporation
1850 M St., NW, Suite 1110
Washington, D.C. 20036

Joseph P.Cowin
Sprint Corporation
PO Box 11315
Kansas City, MO 64112

Mary McDermott
Linda Kent
Keith Townsend
Hance Haney
United States Telephone Association
1401 H St., NW, Suite 600
Washington, D.C. 20005

Richard A. Karre
Dan L. Poole
U S WEST, Inc.
1020 19th St., NW, Suite 700
Washington, D.C. 20036

/s/ Ann Marie Abrahamson
Ann Marie Abrahamson