DOCKET FILE COPY ORIGINAL

EX PARTE OR LATE FILED

AT&T

Robert W. Quinn, Jr.
Director - Federal Government Affairs

Suite 1000
1120 20th St., NW
Washington, DC 20036
202 457-3851
FAX 202 457-2545

RECEIVED
JAN 1 8 1998
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

January 13, 1998

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, D.C. 20554

RE: Ex Parte
Proxy Cost Models 96-45

Dear Ms. Roman Salas:

On Monday January 12, 1998, Joel Lubin,, Steve Levinson and I of AT&T and Dr. Janusz Ordover and Dr. Robert Willig of Consultants in Industry Economics, L.L.C met with Mike Riordan, Patrick DeGraba, Brad Wimmer, Michael Kende, Jay Atkinson, Chris Barnekov, Evan Kwerel, Gary Biglaiser, and Don Stockdale of the Commission Staff. The purpose of this meeting was to discuss the cost methodology issues raised in AT&T's Complaint in the docket captioned AT&T Corp. v. Bell Atlantic, CC Docket No. E 98-05, and which were specifically addressed in the affidavit filed by Profs. Willig and Ordover in that proceeding. During the discussion, some reference was made to the Hatfield cost methodology which is under consideration by the FCC for modeling universal service costs in this proceeding. Attached are documents used and distributed during the presentation, including pp. 6 and 7 from the aforementioned affidavit.

No. of Copies rec'd 0+2
List A B C D E

Two copies of this Notice are being submitted on the following business day to the secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Robert W. [illegible]

Attachments

cc: M. Riordan
P. DeGraba
B. Wimmer
G. Biglaiser
E. Kwerel
M. Kende
C. Barnekov
J. Atkinson
D. Stockdale

AMERITECH TELRIC COST STUDIES
DEVIATIONS FROM FORWARD-LOOKING ECONOMIC COST PRINCIPLES

- Ameritech overestimated the cost of capital by attempting to capture the purported additional risks inherent in the UNE portion of the business

- Ameritech judgmentally set inappropriately short economic lives based on alleged "increased demand for state-of-the-art network elements that is already developing and is expected to escalate as competition heightens."

- Ameritech inappropriately lowered fill factors from those traditionally used purportedly to account for "increased churning" and a corresponding increase in the network capacity required for maintenance, testing and administrative purposes.

- Ameritech proposed different assumptions for cost of money, economic lives and fill factors in different states.

- In some of the states in its serving area, Ameritech proposed different assumptions for cost of money and economic lives between UNEs and retail services

- Ameritech inconsistently applied switch vendor discounts in the SCIS model. In particular, for one manufacturer, Ameritech used only the discount applicable to switch upgrades, not the larger discount applicable to switch replacements

- Ameritech's unbundled local switching study incorrectly included costs for end office switching and SS7 in *two* end offices, which is incorrect because ULS charges are paid in each office

- Ameritech made a series of speculative predictions with respect to report generation, computer programming, maintenance cost increases and various sorts of "other" costs. Often these costs are nonrecurring in nature and amortized over a three year period. Ameritech's proposed pricing recovers these costs in perpetuity, even though they will be fully recovered after year three.

- Nonrecurring charges were established based on existing processes, not forward-looking processes that reflect minimal manual intervention (non-EDI interfaces were assumed)

- Ameritech's study of shared and common costs did not reflect, forward-looking, efficient operations. Rather, it was based on 1997 *accounting* costs, which include massive one time implementation activities including "public policy" and legal costs. It also inappropriately included retail costs such as sky boxes, golf tournaments, etc. It allocated shared and common costs to loops in a manner that attributed

proportionately higher costs in the access areas where competition is most likely to originate

- Ameritech included "non volume-sensitive costs primarily involved with upfront network planning for the deployment of certain UNEs ..." These costs were amortized over three years, but used to develop rates intended to exist in perpetuity. A more correct approach for such costs would be a competitively neutral recovery mechanism.

- Ameritech's unbundled local switching study contained an ill-defined cost for "line class code maintenance" – a cost that it abandoned later in the TELRIC cases. This cost was apparently related to its version of "shared transport" (a version of dedicated transport shared by one or more new entrants)

- Ameritech's collocation studies excessively loaded collocation floor space with costs related to supporting functions such as HVAC, aisle space, etc.

- Ameritech's outside plant cost model failed to account for future demand in its calculation and was incapable of optimizing either feeder length and location or the length of the distribution portion of the loop

- Ameritech's "service coordination fee" cost study was inappropriately based on an analysis of the retail environment, including costs for items such as customer payment centers and bill inserts which are not relevant in a wholesale environment

- The "service coordination fee" double counted costs for billing activities that are also accounted for in the unbundled loop and port studies

- The unbundled port studies in three states inappropriately included an excess capacity adjustment which, as it turns out, is simply the difference between an "average" SCIS run and a "marginal" SCIS run

December 12, 1997

1. SWBT employs depreciation rates that are based on network asset lives that are far shorter than the lives most recently approved by the FCC. In many instances, the lives fall far below the FCC range. SWBT, in Texas, also proposed significant misuse of the CAPCOST program, basing depreciation, return and tax factors on only a 3-year planning period – the Texas Commission ordered a 99 year planning period.

2. SWBT's cost studies use their existing utilization rates or fill factors. For distribution, SWBT assumes less than one third capacity utilization. SWBT has used fill factors of 6% and 10% for a variety of equipment. It is not reasonable to believe that SWBT would purchase and use equipment at 6 or 10% capacity in a competitive marketplace.

3. SWBT's Common Cost factor computation is conceptually flawed. It is based on booked 1995 regulated plus unregulated expenses without forward-looking adjustments. The factor is inappropriately determined as a proportion of expenses excluding profits and then applied to "forward looking" TELRICs which include profit. The Common Cost factor also double counts marketing, customer service, and operator services costs which are recoverable as separately charged elements.

4. SWBT's non-recurring cost estimates recover costs multiple times. For example, SWBT's loop NRC includes costs for 1) service order activity, 2) circuit design, 3) installation and maintenance (I&M). However, service order activity is covered in a separate service order charge. Circuit design is totally inappropriate for POTS loops and SWBT does not do design work on its own customer's POTS loops. In many instances, no I&M work will be necessary when an existing SWBT customer is migrated to an LSP using network elements. No installation, cross connect, or testing should be required. Yet SWBT's study assumes that a uniform NRC will be applied as though every customer going to an LSP will require all activities of a new installation.

5. SWBT's non-recurring rates assume manual processes and double count expenses embedded in recurring cost studies. SWBT's proposed NRCs are not based upon electronic, efficient, forward-looking, least cost technology.

6. SWBT's cost studies use its existing network configuration and, thereby, use embedded cost. For example, SWBT uses all of the existing equipment in its network today with the exception of analog switches. The costs of equipment purchased ten to fifteen years ago are included in the cost studies. Much of this equipment was purchased during years of rate-of-return regulation. Consequently, one cannot assume that this type of equipment or the quantity thereof would be purchased or provisioned in a competitive industry. SWBT has made no attempt to determine the type of equipment or the quantity of equipment that would be provisioned in a competitive marketplace.

7. SWBT's maintenance factors are based on 1995 booked costs, which include all embedded non-recurring costs and are not adjusted for avoided retail costs.

8. SWBT includes average overtime and premium time in all basic loaded labor rate computations yet demands higher overtime and premium time charges in "Maintenance of Service," "Time and Materials," and "Nonproductive Dispatch" rates.

9. SWBT building factor development methods are inconsistent from state to state. The MOKA method inappropriately excludes radio equipment from computation of denominator and inappropriately includes administrative building space in numerator.

10. SWBT frequently employs the wrong labor rate factor, resulting in overstated labor rates.

11. SWBT's LPVST program for determination of loop investment uses flawed loop length averaging which results in overstated costs on shorter loops.

12. SWBT makes no adjustment for prospective sharing of pole and conduit investment in the in the non-Texas studies.

13. SWBT's costs for cross connects inappropriately include test points not requested by new entrants.

14. SWBT's present "TELRIC" levels far exceed numerous current tariffed loop rates for business (e.g., Centrex, private line, and others) which were claimed to be compensatory when established.

15. SWBT has consistently proposed switching equipment discounts that are far below the replacement discounts that are appropriately used in TELRIC studies.

16. SWBT improperly includes non-traffic sensitive costs in traffic sensitive, minute-of-use costs and rate elements for local switching.

17. SWBT inappropriately uses default settings in SCIS related to spare and test equipment thereby ignoring its own internal efficient practices of centralized sparing.

18. SWBT's transport costs are overstated because they fail to reflect efficient existing network topology and demand. SWBT studies only retail private line

circuits and excludes special access and all circuits used to transport SWBT's own traffic and traffic to IXC POPs.

19. SWBT's common transport fails to reflect total demand by determining rates based on weekday usage only.

20. SWBT's transport terminal equipment fill factors are inappropriately applied to both hard wired equipment and to plug ins and are far below the typical industry engineered fill of 80%.

21. SWBT's studies fail to reflect that multiplexing equipment is rented in toto so the investment fill factor should be 100% for cost study purposes.

13. In Section IV of this affidavit, we identify several major ways in which Bell Atlantic's cost studies have deviated from the principles of forward-looking costing, and thus are in violation of the merger conditions imposed by the Commission. As an initial matter, the fundamental pricing methodology employed by Bell Atlantic in its cost models is inconsistent with both the Commission's forward-looking pricing standard and sound economic theory. Rather than attempt to measure forward-looking costs, Bell Atlantic's own statements confirm that its cost studies, in fact, measure embedded costs. Moreover, this fundamental flaw is reflected in the inputs used in Bell Atlantic's cost studies. The following list summarizes some specific deviations between the principles of forward-looking costs and the pricing proposals of Bell Atlantic based on its cost studies:[2]

- Bell Atlantic has overestimated the cost of capital by estimating the risks of a diversified group of industrial companies rather than the lower risk of the "wholesale" business of providing unbundled network elements.

- Bell Atlantic's depreciation analysis has also failed to focus on the forward-looking risks, and depreciation lives pertinent to the provision of unbundled network elements.

- Bell Atlantic's proposed fill factors would force purchasers of unbundled network elements to pay for even more spare capacity than exists in Bell Atlantic's embedded network, and even more spare capacity than we understand Bell Atlantic's own engineering guidelines articulate as the efficient level. Bell Atlantic cannot validly assume that its embedded fill factors indicate what is efficient on a forward-looking basis. Bell Atlantic also cannot validly neglect the projected increase in demand when calculating network element prices sufficient to cover costs that include spare capacity to serve the same demand increase.

- Bell Atlantic has inflated the cost of the narrowband network loop by improperly including costs that are attributable to broadband services, not narrowband services.

---

[2] We have not reviewed, and therefore do not discuss, Bell Atlantic's common cost markup. We do note, however, the Commission in its *Local Competition Order* made clear that this markup should not be a bar to competition or a means of collecting costs -- like embedded or opportunity costs -- that otherwise could not be collected. *Id.* ¶¶ 694-98. Rather, only forward-looking common costs should be recovered and the amount of this additive should be small because network elements are defined "at a relatively high level of aggregation." *Id.* ¶ 695.

- Bell Atlantic has overstated the cost per unit of output of next generation digital loop carrier by ignoring its greater productivity compared with prior technologies.

- Bell Atlantic has overstated the cost of switching equipment by assuming that an efficient supplier would receive, over the long run, only the limited discounts that Bell Atlantic expects to receive on the "add-on" purchases it expects to make in the next few years, rather than the larger discounts that are pertinent to average long-run purchases, due to the aggressive discounts that apply to new equipment purchases.

- Bell Atlantic has inflated the incremental costs of vertical features by assuming that an unrealistically large array of vertical features will be used simultaneously on every call.

- Bell Atlantic has proposed to recover from new entrants most of the development and investment costs of a Specialized Routing Node ("SRN") – a specialized switch used to route certain operator calls to new entrants' operator services/directory assistance ("OS/DA") platforms – even though less expensive means of handling this traffic are available. We understand that Bell Atlantic, when it incurred the software and hardware costs of developing the SRN, anticipated that the bulk of the traffic handled by the SRN would be Bell Atlantic's own calls, but now a different technique has been found for this traffic. As such, from the most recent perspective, the forward-looking efficient incremental costs of handling the few types of calls for which the SRN was developed for do not reflect the development and investment costs of the SRN. We further understand that Bell Atlantic adopted the SRN approach because its existing analog switches cannot perform customized routing and that it planned to use the SRN to provide intraLATA toll dialing parity. Hence, inclusion of SRN costs is inconsistent with forward-looking switching costs that are based on digital equipment, rather than on outdated used analog equipment. In addition, to the extent that the SRN is being used by Bell Atlantic for its own business purposes, new entrants have not caused the costs associated with that usage, and Bell Atlantic should therefore not be permitted to recover those costs from new entrants.

III. DEFINITION OF "FORWARD-LOOKING ECONOMIC COST"

14. In its *Local Competition Order*, the Commission adopted the total element long run incremental cost ("TELRIC") methodology for setting rates for unbundled network elements. As the Commission recognized, setting rates on the basis of forward-looking costs "best replicates . . . the conditions of a competitive market." *Local Competition Order* ¶ 679. Thus, if properly applied, the