



**MCI Communications
Corporation**

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JUL - 9 1998

**FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY**

July 9, 1998

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

Re: **CC Docket No. 96-45 - Federal-State Joint Board on Universal Service**
CC Docket No. 97-160 - Forward-Looking Mechanism for High Cost
Support for Non-Rural LECs; APD No. 98-1; DA 98-1055

Dear Ms. Salas:

Enclosed herewith for filing are the original and five (5) copies of MCI Telecommunications Corporation's Reply Comments in the above-captioned proceeding.

Please acknowledge receipt by affixing an appropriate notation on the copy of the Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

A handwritten signature in cursive script that reads "Chris Frentrop". The signature is written in black ink and is positioned above the typed name and title.

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MCI Telecommunications Corporation

Enclosure

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JUL - 9 1998

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)	
)	
Federal-State Joint Board on)	CC Docket No. 96-45
Universal Service)	CC Docket No. 97-160
)	
Forward-Looking Mechanism)	APD No. 98-1
for High Cost Support for)	DA 98-1055
Non-Rural LECs)	

REPLY COMMENTS OF
MCI TELECOMMUNICATIONS CORPORATION

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MCI Telecommunications Corporation

July 9, 1998

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SUMMARY

The LECs argue for several modifications to the states' submitted models that would have the effect of raising both the cost of local service and the required universal service subsidy. The Commission should reject these LECs' arguments. First, the LECs' arguments that the cost model selected should reflect their specific costs misunderstands what a forward-looking cost model is intended to measure. Second, no state model should use a cost of capital greater than the currently authorized 11.25%. Indeed, if anything, this rate of return is too high, because the current best estimate of the forward-looking cost of capital is approximately 10%. Third, the Commission should not revisit the determination of depreciation lives it has already made in the triennial reviews. These reviews are made with input from the states and the LEC, and are based on the LECs' actual and planned retirement practices. The Commission should reject any move to unilaterally revisit and revise those decisions. Finally, the HAI model's customer location algorithm, which uses geocode data to determine those locations and the amount of distribution plant, is accurate and should be adopted.

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**REPLY COMMENTS OF
MCI TELECOMMUNICATIONS CORPORATION**

MCI Telecommunications Corporation (MCI) hereby submits its reply comments regarding state forward-looking cost studies for universal service support.

I. INTRODUCTION

In the Universal Service Order,¹ the Commission allowed states to submit their own forward-looking economic cost studies as the basis for calculating universal service support, specifying ten criteria that any state-sponsored cost model would have to meet.² In addition, the Commission required that any state-sponsored cost model must also be used to determine the level of support in any

¹ Federal-State Joint Board on Universal Service, Report & Order, 12 FCC Rcd 8776 (1977) (Universal Service Order).

² Universal Service Order at para. 250.

intrastate universal service support mechanism, and encouraged the states, to the extent possible, to use their ongoing proceedings for developing permanent unbundled network element (UNE) prices as the basis for their universal service cost model.³

Numerous states filed cost models, using either the Benchmark Cost Proxy Model (BCPM), the HAI Model, or some other company-specific model. Several of the local exchange carriers (LECs) have filed comments on these submissions that evidence a misunderstanding of the purpose of cost models. MCI responds *infra* to these errors.

II. THE LECs' EMBEDDED COSTS ARE IRRELEVANT TO A DETERMINATION OF COSTS IN A FORWARD-LOOKING MODEL

In their comments on the cost model submissions, several LECs contend that the states erred in selecting inputs for the models because they either failed to consider company-specific inputs,⁴ ignored the LECs' embedded mix of aerial, buried, and underground plant,⁵ or did not create a subsidy that equals the difference between unbundled network element (UNE) rates and existing LEC local service revenues.⁶

Each of these arguments is incorrect, because each ignores the fact that, in

³ Ibid. at para. 251.

⁴ See, e.g., Aliant Comments at 3, 6.

⁵ See GTE at 20.

⁶ See GTE at 35.

a forward-looking model, an individual LEC's historic cost experience is irrelevant. The manner in which the LECs have historically placed plant and otherwise structured their expenses is not necessarily the same manner that an efficient provider would have used. Indeed, since the LECs have not faced any competitive discipline in the past, it is unlikely that they are providing service at an efficient cost. Thus, that the cost model is showing a cost below the embedded level of the incumbent LEC is hardly surprising.

In addition, it is unnecessary to adjust the cost model to reflect an individual incumbent LEC's alleged lack of economies of scale. Aliant claims that, as a smaller LEC, it is incapable of achieving the same economies of scale as GTE or U S West, and thus that the equipment costs used in the model for its territory should be adjusted upward to reflect its cost of equipment. This is incorrect. A forward-looking cost model is based on the costs that an efficient provider would face. If Aliant is operating at a scale that does not allow it to achieve the same economies as an efficient provider, the universal service fund should not be increased merely so that Aliant can continue to operate at an inefficient scale.

Similarly, the embedded structure mix of the incumbent LEC is unlikely to be the forward-looking mix. The mix reflected in the LEC's embedded network is the result of a number of decisions over time that do not necessarily reflect the efficient forward-looking mix. The default mix in the HAI model already reflects the fact that, e.g., more buried cable is being placed today than in the past, because water blocking compounds for use in cable have improved, making its use more

economical.

Finally, there is no reason why the universal service cost model should ensure the LEC's current local revenue stream against the inroads of the competition which will be made possible by implementation of the pro-competition provisions of the 1996 Telecommunications Act, including non-discriminatory access to UNEs at rates based on forward-looking costs. Indeed, to do so would be to prevent any gains from competition from accruing to the benefits of customers. Thus, the Commission should reject pleas by the LECs that the cost model must make up this difference in rates.

III. THE LECs' COST OF CAPITAL WILL NOT BE RAISED ABOVE 10% BY COMPETITION

Several LECs claim that the states erred in selecting the current federal rate of return of 11.25% for use in their models, because expected increased competition in the provision of local service will increase their business risk and require a higher cost of capital.⁷ As MCI and others have previously shown in this and other proceedings before the Commission, the current federal 11.25% rate of return is well in excess of the LECs' actual current cost of capital of 10%.⁸ Thus, even if competition were to raise the LECs' cost of capital, that would not

⁷ See, e.g., Aliant at 7; GTE at 43.

⁸ See, e.g., Statement of Matthew I. Kahal Concerning Cost of Capital," In the Matter of Rate of Return Prescription for Local Exchange Carriers, AAD 95-17, March 11, 1996; Estimating the Cost of Capital of Local Telephone Companies for the Provision of Network Elements, AT&T ex parte, February 12, 1997.

necessarily imply that the cost of capital would be higher than 11.25%.

In fact, when the Commission initially set the current rate of return in 1990, it selected a rate of return at the upper end of its computed range of reasonableness, because of a desire to encourage infrastructure investment.⁹ The Commission did this in part because the LECs claimed at the time that infrastructure investment would be more risky due to increased competition.¹⁰ Thus, the federal rate of return was and always has been set to reflect a premium for competition.

Since the Commission set the rate of return in 1990, interest rates have fallen substantially, lowering the overall cost of capital. Using the same methodology used by the Commission in 1990, MCI has shown that the LECs' cost of capital is now about 10%. This rate of return computation includes the markets' assessment of the effect of currently expected competition. Thus, using the Commission's prescribed rate of return of 11.25% is, if anything, too generous.

Aliant claims to have performed an analysis of the change in the rate of return of airline companies after deregulation, and found that the rate of return increased for those companies by about 1.4% after deregulation. As an initial matter, Aliant has not explained why the change in the cost of capital for the airline industry is a relevant comparison for the local exchange industry. There are a number of significant differences between the two industries, and in the manner in

⁹ See Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, 5 FCC Rcd 7507,7530 (1990) at para. 203.

¹⁰ Ibid. at para 197.

which competition was introduced in the airline industry and will be introduced to the local exchange industry. First, the airline industry was effectively deregulated in a very short time period, with free entry allowed and the carriers allowed to vary their tariffs as they saw fit. This is clearly not how "deregulation" of the local exchange industry is occurring.

Second, the airline industry is much less costly to enter (and exit) than is the local exchange business. For example, the airplanes used to provide service can be relatively cheaply re-deployed to other routes, if service on a given route proves to be unprofitable. On the other hand, a new entrant in the local exchange business will either have to invest in its own facilities, which cannot be easily re-deployed to serve new areas if business turns out to be unprofitable, or it will have to purchase the LECs' facilities through either UNEs or resale, placing it at the mercy of the LEC and the regulator for pricing of these facilities.

Given these differences, it is clear that the airline industry was exposed to much greater competitive risk than the local exchange industry will be. Thus, Aliant's claim that the LECs' rate of return needs to be adjusted by the differential it found for the airline industry is unfounded.

In any case, even if such an adjustment were appropriate, Aliant has provided neither the data used in its analysis nor the regression statistics of its analysis to make it possible to comment on the specifics of what they found. In fact, Aliant does not even indicate what time period its analysis examines. It should be noted, however, that the airlines were deregulated in the mid to late 1970s, a time

of generally rising interest rates. Aliant has not indicated how, if at all, its analysis takes this into account. Thus, even if the analogy between the two industries were apt, Aliant has failed to make it clear that it has correctly performed the analysis. The Commission should place no reliance on such a poorly documented analysis.

IV. DEPRECIATION LIVES SHOULD NOT BE SHORTER THAN THE COMMISSION'S PRESCRIBED RANGES

Several LECs support the use of shorter depreciation lives than those within the Commission's prescribed ranges.¹¹ These parties instead urge the Commission to allow the state models to use either the state prescribed depreciation lives, or the depreciation lives that the LECs use for their financial books.

As MCI explained in its comments in this proceeding, the Commission's prescribed ranges for depreciation lives are based on a triennial review of the LECs' actual practices in depreciating and retiring plant. These reviews are performed with input from the Commission, the state utility commission, and the LEC itself. The results of this review reflect LEC practice and LEC plans for future modifications. There is no reason for the Commission to revisit, as one part of a cost model proceeding, decisions it has already made in a proceeding expressly devoted to depreciation lives.

There is especially no reason for the Commission to allow one party to change the depreciation decisions made in these three-way reviews that the Commission currently uses to set interstate depreciation ranges. Ameritech-

¹¹ See Aliant at 8-9; BellSouth at 4; GTE at 42.

Michigan's petition to use shorter depreciation lives was not even supported by the Michigan PSC. Thus, the Commission should reject Ameritech-Michigan's attempt to unilaterally shorten its depreciation lives and thereby raise the universal service support it receives.

V. THE HAI MODEL'S USE OF GEOCODE DATA TO DETERMINE THE AMOUNT OF DISTRIBUTION PLANT IS SUPERIOR, AND BUILDS SUFFICIENT PLANT

GTE and Sprint claim that the HAI model fails to build sufficient distribution plant to reach all the customers located using the HAI model's geocoded customer locations.¹² In addition, GTE claims that the HAI model's geocode data should not be used, because the success rate for geocoding customer locations is lower in the rural areas that receive universal service support.¹³ Both these claims are incorrect.

GTE's and Sprint claim that the backbone and branch cable placed by the HAI Model's clustering algorithm is far below the amount of cable required by a minimum spanning tree ("MST") analysis. MCI has already addressed this issue, in conjunction with AT&T, in numerous ex partes, and in our initial comments in this proceeding. First, the MST does not constitute the minimum distance required to connect a series of customers in a distribution area. Second, many of the HAI Model customer locations have been established by placing non-geocoded points

¹² See GTE at 11-12; Sprint at 2-3.

¹³ See GTE at 5-6.

on the boundaries of the CB in which they lie. Because this approach overstates the dispersion of customers, the resulting MST distances would be larger than required to connect actual customer locations. Third, although the BCPM proponents claim that certain features of the HAI Model clustering process lead to significant understatements of backbone and branch cable, results in those states that have compared HAI Model route miles to actual route miles demonstrate the opposite. In Nevada, for example, total loop lengths of cable produced by the HAI Model were higher than those Nevada Bell identified for the state as a whole. And in Texas, analyses conducted by MCI and AT&T for two sample groups of wire centers selected by the Public Utility Commission staff (including very rural wire centers) revealed that the HAI Model provided 20 to 30 percent *more* backbone and branch cable than did the BCPM. Because it is backbone and branch cable that “connects the dots” of customers in each model’s distribution areas, this is solid evidence that the HAI Model does not understate the amount of distribution cable in the vast majority of cases. Indeed, it suggests that the BCPM is the model deficient in this regard.

The HAI model uses geocode data where it is available to locate customers, and then places the customers for whom it does not have geocodes along the perimeter of the Census Block in which they are located. As discussed supra, this approach is conservative in that it likely overstates the dispersion of customers. The use of geocoded locations in conjunction with a surrogate method for placing customers for whom no good geocodes are available will give a more accurate

picture of the network needed than will a model, such as the BCPM, which relies solely on a surrogate method. Thus, GTE is incorrect in arguing that the geocode data should not be used because it is less prevalent in the more rural areas.

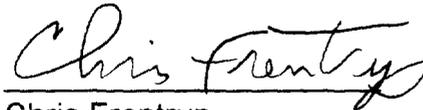
VI. CONCLUSION

The LECs argue for several modifications to the states' submitted models that would have the effect of raising both the cost of local service and the required universal service subsidy. The Commission should reject these LECs' arguments. First, the LECs' arguments that the cost model selected should reflect their specific costs misunderstands what a forward-looking cost model is intended to measure. Second, no state model should use a cost of capital greater than the currently authorized 11.25%. Indeed, if anything, this rate of return is too high, because the current best estimate of the forward-looking cost of capital is approximately 10%. Third, the Commission should not revisit the determination of depreciation lives it has already made in the triennial reviews. These reviews are made with input from

the states and the LEC, and are based on the LECs' actual and planned retirement practices. The Commission should reject any move to unilaterally revisit and revise those decisions. Finally, the HAI model's customer location algorithm, which uses geocode data to determine those locations and the amount of distribution plant, is accurate and should be adopted.

Respectfully submitted,

MCI Telecommunications Corporation

A handwritten signature in cursive script that reads "Chris Frentrop".

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July 9, 1998

STATEMENT OF VERIFICATION

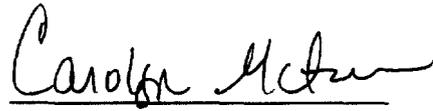
I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on July 9, 1998.

A handwritten signature in cursive script that reads "Chris Frentrup". The signature is written in black ink and is positioned above a horizontal line.

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CERTIFICATE OF SERVICE

I, Carolyn McTaw, do hereby certify that on this 9th day of July, 1998, I caused a copy of the foregoing Comments of MCI Telecommunications Corporation to be served upon each of the parties listed on the attached Service List by U.S. First Class mail, postage prepaid.



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