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**EX PARTE**

August 11, 1998

Ms. Kathryn C. Brown
Chief, Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W. — Room 518
Washington, DC 20554

**Re: Written Ex Parte — CC Docket Nos. 91-213, 94-1, 95-72, and 96-262**

Dear Ms. Brown:

Since 1994, the Customers for Access Rate Equity ("CARE")[1] Coalition has worked with the Commission to establish economically rational interstate access prices. On June 2, 1998, the United States Telephone Association ("USTA") filed a written ex parte (USTA letter dated May 29, 1998) claiming that recent AT&T and MCI ex parte communications relied on "the same unsupported arguments as in the past" in "requesting that the Commission increase the productivity offset for incumbent local exchange carriers (ILECs) subject to price cap regulation."

USTA chooses to ignore the record established in these proceedings, particularly, the Commission's analysis and those submitted by other parties. More than sufficient support exists in the filings submitted by AT&T, MCI, and others for increasing the price cap productivity factor. Also, data used in the Commission's own analysis (as documented in Appendix D of their Access Order)[2] supports a higher X-factor.

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[1] CARE's consumer (both residential and business) and long distance company members include: Ad Hoc Telecommunications Users Committee, American Petroleum Institute, International Communications Association, National Retail Federation, Consumer Federation of America, National Association of State Utility Consumer Advocates, America's Carriers Telecommunications Association, AT&T, Excel Communications, LCI International, MCI, and Worldcom.

[2] *First Report and Order*, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges, CC Docket Nos. 92-262, 94-1, 91-213 & 95-72, FCC 97-158 (rel. May 16, 1997), *review*

Although the Commission's LEC price cap plan[3] resulted in some rate reductions for interstate access services, the Commission made two fundamental errors that substantially understated the required reductions, both then and on an ongoing basis. First, the Commission erroneously concluded that the LECs' productivity offset (the "X-factor" in its LEC price cap formula) should be set based on the LECs' total interstate and intrastate productivity, rather than using interstate only performance data. By using combined interstate and intrastate productivity in determining the price of services that are solely interstate, the Commission made a selection that **does not** reflect the markedly higher LEC interstate productivity, both historical and current. Second, the Commission mistakenly concluded, when "reinitializing" the X-factor, that corrections for past understatements should only go back to the LECs' 1996 tariff year, rather than going back to the 1995 tariff year when the previous understated X-factor had actually been established.

As a result of these errors, interstate consumers have been overcharged by billions of dollars since 1995. Had a properly selected X-factor of 8.4 percent to 9.3 percent been in effect since 1995, consumers would have paid $5.4 billion to $7.1 billion less in interstate access charges. [See Attachment A, *Price Cap Analyses*, pages 1-3.]

Understatement of the X-factor. The Commission's Price Cap Order adopted a new economic measure, total factor productivity ("TFP"), to calculate the X-factor. While there is no dispute on using TFP as a productivity measure, the Commission seriously erred in selecting the underlying data. Specifically, the Commission found (Price Cap Order, paras. 107-112) that there was "no basis in the record" to conclude that there is any difference in the TFP measurement results from using the LECs' total company (i.e., combined interstate and intrastate) performance data, as opposed to using interstate only productivity data.

As a threshold matter, this conclusion represents an about-face by the Commission, which had long recognized that interstate productivity is measurably higher than total company productivity. Both the Commission's 1990 decision adopting LEC price caps and the staff study that the Commission relied on found that total company productivity should be adjusted to reflect higher interstate productivity growth.[4]

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*pending sub nom.* Southwestern Bell Tel. Co. V. FCC, Nos. 97-2866/2873/2875/3012 (8th Cir.)("Access Order").

[3] *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, In the Matter of Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform, CC Docket Nos. 94-1 & 96-262, FCC 97-159 (rel. May 21, 1997)("Price Cap Order").

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

The Commission ordered an X-factor of 6.5 percent for regulating price cap carriers' interstate access prices. Underlying the X-factor of 6.5 percent, which includes a consumer productivity dividend of 0.5 percent, is the Commission's finding that total company productivity growth over the period from 1985 to 1995 was 6 percent. Productivity is a measure of the change in outputs relative to the change in inputs. The changes in all (total) outputs of the firm relative to the changes in all inputs is "total company productivity." Because the X-factor is used to regulate the prices of the price cap LECs' interstate access services, it should most certainly reflect the productivity associated with those services. Had the Commission calculated its revised X-factor using more appropriate interstate only productivity data, it would have reached a significantly higher result. CARE estimates that productivity growth associated with interstate only is about 1.9 percent to 2.8 percent higher than total company productivity growth. The 1.9 percent results from simply replacing total company output growth with interstate only output growth; the 2.8 percent results by also replacing changes in total company input factors of production with interstate only input factors of production.[5] In its July 11, 1997 petition for reconsideration, AT&T urged the Commission to increase the X-factor by 1.9 percent to 2.8 percent. Adding this differential to the Commission's selection of 6.5 percent results in an interstate X-factor ranging from 8.4 percent to 9.3 percent.

Anticipating that USTA will likely question the results of AT&T's analysis, CARE urges them to examine the Commission's analysis in Appendix D and make the calculation for themselves. USTA need only replace the measure of total company output growth found in Chart D5 with interstate output growth found in Chart D4 and do the arithmetic; the results would show a productivity range from 9.2 percent to 10.5 percent. Adding the Commission's consumer productivity dividend ("CPD") of 0.5 percent, the range is 9.7 percent to 11.0 percent. Although the price cap LECs are quite capable of achieving X-factors in the range of 9.7 percent to 11.0 percent, some might question whether the impact of recent access reforms has been properly accounted for.[6] The effect of both access reform and the Common Line price cap formula can be reflected by adjusting the revenue weights applied to lines and minutes in calculating productivity growth. Applying these adjustments to the Commission's data yields X-factors ranging from 8.0 percent to 9.3 percent. Adding the 0.5 percent CPD, the X-factor range is 8.5 percent to 9.8 percent. [See Attachment A, pages 4-6.]

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[5] An index of interstate only inputs was calculated by using separations data for 1991-1994 to allocate LEC inputs between interstate and other regulated services. See AT&T Comments in CC Docket No. 94-1 dated January 11, 1996, pp. 29-30 in Appendix A and pp.23-24 in Appendix B.

[6] As a result of the Commission's decision to lower access charges mostly by increasing per-line subscriber line charges ("SLCs") and creating new charges (such as the presubscribed interexchange carrier charge — PICC) instead of prescriptively lowering access to economically rational levels, LEC revenue weights applicable to lines and minutes growth were altered.

The erroneous reinitialization. The Commission has correctly recognized that, when the X-factor is modified to reflect higher past productivity, the past understatements in the productivity offset must also be corrected to reset the LECs' price caps to the proper levels. Otherwise, as the Commission pointed out, the understatement would become "permanently embedded" in the LECs' price cap indices and allow the LECs to retain the resulting higher earnings without having to increase the actual level of their productivity.

The Commission first applied this principle in its 1995 price cap performance review, when it found that the range of X-factors initially prescribed were understated due to certain anomalies in the historical productivity data, and it required the LECs to adjust their then-current price cap indexes ("PCIs") to the levels they would have been had the revised X-factor been in effect since 1991. The Commission's legal authority to require this adjustment and the lawfulness of the modification were both explicitly affirmed on appeal. [Bell Atlantic Telephone Companies v. FCC, 79 F.3d 1195 (D.C. Cir. 1996).]

Similarly in its 1997 Price Cap Order, the Commission recognized that the X-factor range it adopted in 1995 was also significantly understated. (Price Cap Order, para. 178.) It also found that the LECs had been on clear notice since 1995 that the adjustment adopted then was an "interim" measure and that the productivity offset was subject to reinitialization back to the 1995 tariff year. (Id., para. 179.) In addition, the Commission recognized that failure to reinitialize back to the 1995 tariff year would "permanently ingrain" the X-factor understatement in the LECs' PCIs. (Id.) Unfortunately, the Commission required the LECs to reinitialize back to only the 1996 tariff year because of the "relative uncertainty" created by the longer than anticipated duration of the post-1995 interim period, and to "limit harm to LEC productivity incentives." (Id.) This decision was seriously flawed in numerous respects.

First, and most fundamentally, the decision is seriously unfair to customers and long distance carriers because, as the Commission itself recognized, it permanently inflates the LECs' price caps above the levels the Commission had found reflect the appropriate X-factor (which, as shown above, is itself significantly understated). Also, no LEC has shown that it somehow relied on the "interim" productivity offset, and, as the Commission's ruling shows, any such reliance would not have been reasonable. The decision also penalizes access customers for the "regulatory lag" for which they were not responsible.[7] Finally, reinitializing back to 1995 to reflect a prior under-statement of the X-factor would have no effect on future "LEC productivity incentives."

Effect of the Commission's errors. The cumulative combined effect of the Commission's failure to adopt an interstate only X-factor and to require reinitialization back to the 1995 tariff year

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[7] During numerous meetings with the Commission in 1996 prior to the beginning of the 1996 tariff year and in its April 16, 1996 Ex Parte Comments in CC Docket No. 94-1, the CARE Coalition repeatedly urged the Commission to act expeditiously to complete its price cap performance review in advance of 1996 tariff year.

has been to enormously inflate the LECs' interstate access revenues and earnings. The impact of alternative X-factors on LEC access revenues for the 1995 to 1998 period is shown on page 3 of Attachment A. Had the X-factor been set at 6.5 percent, 8.4 percent, or 9.3 percent for the entire period, consumers would have paid $1.8 billion, $5.4 billion, or $7.1 billion less, respectively, in interstate access charges. In order to correct the errors in the Commission's Price Cap Order on a going-forward basis, the X-factor should be increased to a range of 8.4 percent to 9.3 percent, and the LECs' price cap indexes should be adjusted to the levels they would have been at had the revised X-factor been in effect since mid-1995. Had these measures been implemented in time to become effective as part of the 1998 annual interstate access tariffs on July 1st, the total price cap reduction associated with a 9.3 percent X-factor would have been about $2.9 billion more than the $700 million reduction that occurred on July 1st. [See Attachment A, page 7.]

Attachment B displays the price cap LECs' 1990 to 1997 interstate earnings that they reported to the Commission. Despite the Commission's changes to its price cap plan, LECs reported rates of return are significantly higher than any incentive plan would have imagined, with an average return of 15.64 percent and total earnings of almost $2.4 billion in excess of an 11.25 percent rate of return (the outdated "authorized rate of return" set prior to the commencement of incentive regulation). Such inflated earnings, which have increased steadily from 11.81 percent in 1991 to 15.64 percent in 1997, are, in themselves, compelling evidence that the Commission's productivity offset has been set far too low.

It comes as no surprise that USTA would attempt to manipulate the data on LEC earnings[8] to show a different result. The USTA data used to show that LECs are not particularly profitable is misleading in several respects. First, USTA claims that growth in LEC earnings since 1991 has been substantially less than those of U.S. corporations in general. However, the high growth in U.S. corporate earnings since 1991 reflects the fact that earnings were at depressed levels in 1991 due to recession and subsequently recovered. LEC earnings, on the other hand, were not significantly affected by the 1990-91 recession. It is also misleading to compare LEC earnings growth with those of U.S. corporations as a whole, without accounting for differences in dividend yields. Companies that pay high dividends, like the LECs, tend to have less growth in earnings, since there are relatively fewer retained earnings available to finance growth. When higher shareholder dividends and earnings growth are viewed together, the LECs performed considerably better than most U.S. corporations.[9]

Despite USTA's claims, it is clear that the arguments for setting the X-factor in an appropriate range of at least 8.4 percent to 9.3 percent are amply supported by the analytical record. Since it is

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[8] See Attachment B for an accurate description of price cap LEC earnings extracted from their own ARMIS filings with the Commission.

[9] For a more detailed discussion of the errors regarding USTA LEC earnings claims, see *Note on LEC Earnings*, Attachment A, page 8.

clear that meaningful levels of local telephone service competition do not exist today and will not develop within the foreseeable future, residential and business customers, as well as long distance companies, should not be forced to continue paying **inflated** interstate access charges. Therefore, common sense dictates that the Commission should act swiftly to ensure that customers pay economically rational charges.

Sincerely,

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and

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# ATTACHMENT A

# *Price Cap Analyses*

## *Customer Overpayment of Access*
## *Impact of Alternative X-Factors on LEC Revenues*

The table labeled "Impact of Alternative X-Factors on LEC Interstate Revenues" estimates LEC revenues for the 1995-98 period if the X-Factor had been set at either 6.5%, 8.4%, or 9.3% for the entire period.[1] At a 6.5% X-Factor, access revenues over the 4 year period would have been about $1.78 billion less. At 8.4%, access revenues would have been $5.45 billion less and at 9.3%, $7.14 billion less. These figures represent the amount by which customers have overpaid and will continue to overpay for access.

To estimate the amount of overpayment, price indexes (PCIs) are calculated that reflect the impact of alternative X-Factors on the overall price level of interstate access. These price indexes are then used to adjust the LECs' historical interstate revenues and determine the revenue impact of alternative X-Factors.

The upper portion of the table, labeled "Historical Data for Price Cap LECs", shows total interstate access revenues (Column A) for the price cap LECs from Form 492, with the amount for 1998 projected to be $25 billion. The remaining columns calculate an aggregate price index for each year that reflects operation of the price cap formula. The price index is initialized at 1.0 at the beginning of 1995, as shown in Column B under the heading "Old PCI". The first price cap adjustment occurs in July 1995, when the price index is increased by the 2.92% increase in the GDP-PI (Gross Domestic Product Price Index) and reduced by the 4.87% X-Factor to obtain the new price index shown in Column E under the heading "New PCI". Column F shows the average PCI for the entire year, calculated as a simple average of the "Old PCI", which is in effect for the first 6 months, and the "New PCI" in effect for the last 6 months of the year. The 4.87% X-Factor shown for 1995 and 1996 is a weighted average of the 4.0%, 4.7%, and 5.3% X-Factors selected by individual LECs for those years. Calculation of the new PCI for 1997 includes the FCC's "reinitialization" back to 1996.[2]

The remaining portions of the table repeat the same price index calculations for alternative X-Factors. The higher X-Factors result in lower price indexes, which are then used to adjust the LECs' historical revenues proportionately. The annual price indexes calculated for each X-Factor (shown in Column G) are compared with those calculated for the baseline case (Column F) to form the ratios in Column H. These ratios are then applied to historical revenues to obtain the adjusted revenues in Column I. The "Revenue Delta" in Column J represents the amount customers would have saved if the X-Factor had been set at the higher level.

This analysis is based on several underlying assumptions, which should be noted:

- The starting point for this analysis is 1995, rather than 1991 when price cap regulation was first initiated for the LECs. When the FCC raised the X-Factors in 1995, it made a special adjustment to the PCIs to reflect the fact that the X-Factors had been too low prior to 1995, and thus reduced the PCIs by an extra 0.7% per year for each year a 3.3% was chosen.[3] The alternative X-Factors considered in this analysis are assumed <u>not</u> to have any effect on this special adjustment.
- The price index calculations do not reflect the impact of exogenous cost ("Z") or volume growth ("G") adjustments on the LECs' PCIs. The implicit assumption here is that the dollar impact of these adjustments is not affected by the X-Factor.

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[1] In its July 11, 1997 petition for partial reconsideration of the X-Factor order, AT&T argued that the X-Factor should be increased from 6.5% to the 8.4%-9.3% range to account for higher productivity growth of the LECs' interstate access services (pp. 3-12).

[2] When the FCC raised the X-factor to 6.5% in 1997, the new PCI for 1997 was calculated on the basis of the 6.5% X being in effect for both the 1996 and 1997 price cap adjustments.

[3] Prior to 1995, LECs had the option of choosing between X-Factors of 3.3% and 4.3%. Choosing the higher X-Factor meant lower rates, but enabled the LEC to retain a larger portion of any excess earnings.

- The analysis does not deal with LECs pricing below their price caps. The implicit assumption here is that the extent of below-cap pricing is not affected by alternative X-Factors.

## IMPACT OF ALTERNATIVE X-FACTORS ON LEC INTERSTATE REVENUES
**(Revenues expressed in thousands)**

### HISTORICAL DATA FOR PRICE CAP LECs

| *YEAR* | *Revenue* | *Old PCI* | *GDP-PI* | *X-Factor* | *New PCI* | *Avg. PCI* |
|---|---|---|---|---|---|---|
| | **A** | **B = E(-1)** | **C** | **D** | **E=B(1+C-D)** | **F=(B+E)/2** |
| **1995** | $22,233,735 | 1.00000 | 2.92% | 4.87% | 0.98050 | 0.99025 |
| **1996** | $23,366,177 | 0.98050 | 2.65% | 4.87% | 0.95873 | 0.96962 |
| **1997** | $24,054,772 | 0.94275 | 2.11% | 6.50% | 0.90138 | 0.93006 |
| **1998** | $25,000,000 | 0.90138 | 2.14% | 6.50% | 0.86211 | 0.88175 |

### CALCULATION OF REVENUES AT 6.5% X-FACTOR

| *YEAR* | *Actual Revenue* | *Old PCI* | *GDP-PI* | *X-Factor* | *New PCI* | *Average PCI* | *Adjustment Factor* | *Adjusted Revenue* | *Revenue Delta* |
|---|---|---|---|---|---|---|---|---|---|
| | **A** | **B = E(-1)** | **C** | **D** | **E=B(1+C-D)** | **G=(B+E)/2** | **H = G/F** | **I = H*A** | **J = I - A** |
| **1995** | $22,233,735 | 1.00000 | 2.92% | 6.50% | 0.96420 | 0.98210 | 0.99177 | $22,050,746 | -$182,989 |
| **1996** | $23,366,177 | 0.96420 | 2.65% | 6.50% | 0.92708 | 0.94564 | 0.97527 | $22,788,363 | -$577,814 |
| **1997** | $24,054,772 | 0.92708 | 2.11% | 6.50% | 0.88640 | 0.90674 | 0.97493 | $23,451,638 | -$603,134 |
| **1998** | $25,000,000 | 0.88640 | 2.14% | 6.50% | 0.84778 | 0.86709 | 0.98338 | $24,548,396 | -$415,604 |
| | | | | | | | | **Total** | -$1,779,541 |

### CALCULATION OF REVENUES AT 8.4% X-FACTOR

| *YEAR* | *Actual Revenue* | *Old PCI* | *GDP-PI* | *X-Factor* | *New PCI* | *Average PCI* | *Adjustment Factor* | *Adjusted Revenue* | *Revenue Delta* |
|---|---|---|---|---|---|---|---|---|---|
| | **A** | **B = E(-1)** | **C** | **D** | **E=B(1+C-D)** | **G=(B+E)/2** | **H = G/F** | **I = H*A** | **J = I - A** |
| **1995** | $22,233,735 | 1.00000 | 2.92% | 8.40% | 0.94520 | 0.97260 | 0.98218 | $21,837,446 | -$396,289 |
| **1996** | $23,366,177 | 0.94520 | 2.65% | 8.40% | 0.89085 | 0.91803 | 0.94679 | $22,122,919 | -$1,243,258 |
| **1997** | $24,054,772 | 0.89085 | 2.11% | 8.40% | 0.83483 | 0.86284 | 0.92773 | $22,316,335 | -$1,738,437 |
| **1998** | $25,000,000 | 0.83483 | 2.14% | 8.40% | 0.78260 | 0.80872 | 0.91718 | $22,929,401 | -$2,070,599 |
| | | | | | | | | **Total** | -$5,448,583 |

### CALCULATION OF REVENUES AT 9.3%X-FACTOR

| *YEAR* | *Actual Revenue* | *Old PCI* | *GDP-PI* | *X-Factor* | *New PCI* | *Average PCI* | *Adjustment Factor* | *Adjusted Revenue* | *Revenue Delta* |
|---|---|---|---|---|---|---|---|---|---|
| | **A** | **B = E(-1)** | **C** | **D** | **E=B(1+C-D)** | **G=(B+E)/2** | **H = G/F** | **I = H*A** | **J = I - A** |
| **1995** | $22,233,735 | 1.00000 | 2.92% | 9.30% | 0.93620 | 0.96810 | 0.97763 | $21,736,409 | -$497,326 |
| **1996** | $23,366,177 | 0.93620 | 2.65% | 9.30% | 0.87394 | 0.90507 | 0.93343 | $21,810,745 | -$1,555,432 |
| **1997** | $24,054,772 | 0.87394 | 2.11% | 9.30% | 0.81112 | 0.84253 | 0.90589 | $21,791,057 | -$2,263,715 |
| **1998** | $25,000,000 | 0.81112 | 2.14% | 9.30% | 0.75307 | 0.78210 | 0.88699 | $22,174,681 | -$2,825,319 |
| | | | | | | | | **Total** | -$7,141,793 |

NOTES:

Calculation of the "Old PCI" for 1997 under "Historical Data" reflects reinitialization back to 1996. As a result, the "Old PCI" for 1997 is less than the "New PCI" for 1996.

Actual revenue for 1998 is projected.

The 4.87% X-factor for 1995 and 1996 is a weighted average for all LECs.

## *Modifications to the FCC's X-Factor*

The FCC's LEC productivity analysis contained in Appendix D of its 5/21/97 price cap order (Dockets 94-1 and 96-262) was modified to calculate an X-Factor based on growth in interstate output instead of total company (interstate and intrastate) output. In addition, to address other technical points that have been raised, the impact of access reform and the FCC's "50-50" Common Line price cap formula on the X-Factor was quantified.

Interstate only X:

In contrast to the FCC's previous X-Factor determinations, the recently adopted X-Factor of 6.5% is based on LEC total company output rather than interstate only output. The X-Factor should be developed on the basis of interstate only output because of the high growth in usage and different characteristics of the LECs' interstate services.[4]

*X-Factors*

| *Averages* | *FCC Staff Estimates Total Company Outputs* | *Based on FCC Data Interstate Only Outputs* |
|---|---|---|
| (1986-94) | 5.1% | 9.2% |
| (1986-95) | 5.2% | 9.4% |
| (1987-95) | 5.9% | 10.3% |
| (1988-95) | 6.0% | 10.5% |
| (1989-95) | 6.1% | 10.1% |
| (1990-95) | 5.8% | 10.4% |
| (1991-95) | 5.2% | 9.6% |

The interstate X-Factors shown here are calculated in the same manner as the FCC's total company X-Factors, except that interstate output is used instead of total company output. Total factor productivity (TFP) growth is calculated as the growth in interstate output minus the growth in total inputs, using the FCC's data on interstate quantities (subscriber lines, interstate access minutes, and special access lines) and corresponding revenue weights. The FCC's estimated input price differential is then added to TFP growth to obtain the interstate X-Factor. Since the

[4] The Commission recognizes the relationship between the interstate and intrastate productivity. See Policy and Rules Concerning Rates for Dominant Carriers, 5FCC RCD 6786,6798,6935-37(1990) (par. 92) ("The revised study examines intrastate and interstate usage patterns and concludes that the more rapid growth in interstate usage results in higher apparent interstate productivity growth"); See also Dr. William Taylor, testimony before the *North Carolina Utilities Commission*, Docket No. P-7, Sub 825, and P-10, SUB 478 (February 9, 1996), p.38 ("Price caps adopted in the interstate jurisdiction apply principally to interstate access service. It is reasonable to expect that productivity growth experienced historically in this market would be substantially greater than the overall rate of productivity growth by local exchange companies supplying all services"); See also Mr. Fred Gerwing representing Bell South, testimony before the *Kentucky Public Service Commission*, Case No. 94-121, (April 19,1995), p.257 ("There is no comparison between the efficiencies that can be obtained by high volume, very efficient provision of interstate services versus running exchange lines 8, 10,000, 15,000 feet out to reach a residential customer").

annual growth in interstate output has been about 4% to 4.5% greater than that for total output, it should not be surprising to find that the resulting X-Factor is also 4% to 4.5% greater.

An implicit assumption in this analysis is that the growth in "interstate inputs" is the same as that of total inputs. (Since the LECs' inputs are used to provide both interstate and intrastate services, the quantity of interstate inputs can not be measured directly.) This is actually a conservative assumption, since Separations data indicates that growth in interstate costs has been somewhat less than growth in the LECs' total regulated costs.[5]

Access Reform

As a result of the FCC's access reform plan, the LECs will be collecting less revenue from per-minute switched access charges and more revenue from per-line SLC and PICC charges. This alters the appropriate revenue weights applicable to lines and minutes growth in calculating the growth in aggregate output. With more weight applied to lines, which have grown by less than minutes, the growth in total output is reduced. Over the next few years, the portion of switched access revenues obtained from lines will be increasing while the portion obtained from minutes declines.

*X-Factors*

| *Averages* | *FCC Staff Estimates Total Company Outputs* | *Based on FCC Data Interstate Only Outputs* | *Access Reform Interstate Only Outputs* |
|---|---|---|---|
| (1986-94) | 5.1% | 9.2% | 8.1% |
| (1986-95) | 5.2% | 9.4% | 8.2% |
| (1987-95) | 5.9% | 10.3% | 8.9% |
| (1988-95) | 6.0% | 10.5% | 9.2% |
| (1989-95) | 6.1% | 10.1% | 8.9% |
| (1990-95) | 5.8% | 10.4% | 9.3% |
| (1991-95) | 5.2% | 9.6% | 8.7% |

The X-Factor applicable to access reform is calculated here by changing the revenue weights applied to minutes and lines in calculating the index of total interstate output. Instead of using weights based on historical (including end user revenues) revenues, the weights are based on projected revenues for 1999, in which about 61% of switched access revenue is line-based, while 39% is minute-based. This has the effect of reducing the annual growth in interstate output, and hence the X-Factor, by 0.9 to 1.4 percentage points.

[5]As described in AT&T's price cap analysis, the annual growth in interstate costs was 0.9 percentage points less than that of total LEC costs during the 1985-94 period. See Appendix A (pp. 29-30) of AT&T Comments in Docket 94-1, January 11, 1996.

Balanced 50/50 Common Line Formula

An additional adjustment was made to take into account the operation of the FCC's 50/50 price cap formula for the Common Line basket. As a result of this formula, revenue from the CCL charge is effectively a function of both minutes and lines, even though the CCL charge is assessed on minutes. To account for this, the revenue weights associated with access reform are further adjusted, with one half of projected 1999 CCLC revenue assigned to lines and the other half to minutes. This alters the weights to 62.7% on lines and 37.3% on minutes and reduces growth in interstate output by about 0.1 percentage point. Because CCLC revenue is declining, the impact of this adjustment is relatively minor.

*X-Factors*

| *Average* | *FCC Staff Estimates Total Company Outputs* | *Based on FCC Data Interstate Only Output* | *Access Reform Interstate Only Outputs* | *50/50 CL Formula Interstate Only Outputs* |
|---|---|---|---|---|
| (1986-94) | 5.1% | 9.2% | 8.1% | 8.0% |
| (1986-95) | 5.2% | 9.4% | 8.2% | 8.1% |
| (1987-95) | 5.9% | 10.3% | 8.9% | 8.8% |
| (1988-95) | 6.0% | 10.5% | 9.2% | 9.1% |
| (1989-95) | 6.1% | 10.1% | 8.9% | 8.8% |
| (1990-95) | 5.8% | 10.4% | 9.3% | 9.3% |
| (1991-95) | 5.2% | 9.6% | 8.7% | 8.6% |

## *Fixing the Problem Going Forward to Avoid Overpayment of Access Reinitialization of Interstate X-Factors*

**Price Cap Index Reinitialization**

| Tariff Year | Reinitialize to 6.50% | Reinitialize to 8.40% | Reinitialize to 9.30% |
|---|---|---|---|
| 1995 | ($370) | ($709) | ($1,011) |
| 1996 | NA | ($438) | ($643) |
| 1997 | NA | ($440) | ($647) |
| 1998 | NA | ($442) | ($651) |
| Total | ($370) | ($2029) | ($2952) |

(Additional access reductions - $Millions)

1995 X

The amounts shown in the table address reinitialization of the 1995 X Factor. The figures represent the difference between the actual weighted average industry X factor and the proposed industry X factor, expressed as a dollar amount by multiplying the difference times the industry Base Year revenue ($R_{(t-1)}$), e.g., (4.87% - 6.5%) * $22.6B = ($370M). For consistency in the table, a single Base Year, 1996, was used for all of the calculations. This methodology closely approximates that used in the 1995 Annual Filing to reinitialize the first four years of price Cap regulation to an X of 4.0%, and is the methodology used in AT&T's 1997 Petition for Reconsideration of the May, 1997 X-Factor Order.

Subsequent X Factors

Tariff year 1996 has already been reinitialized to an X of 6.5%. Tariff year 1997 initially incorporated an X factor of 6.5% so no further reinitialization to an X of 6.5% is required for those two years, but it would be necessary to approximate the impact of reinitializing to a hypothetical interstate X Factor in the range of 8.4% to 9.3%. The amounts shown in the table address reinitialization of the 1996 and 1997 X Factors to 8.4% or 9.3% and simply represent, as above, the difference between the actual weighted average industry X factor and the proposed industry X factor, expressed as a dollar amount by multiplying the difference times the industry Base Year revenue ($R_{(t-1)}$), e.g., (6.5% - 8.4%) * $22.6B = ($434M). For consistency in the table, a single Base Year, 1996, was used for all of the calculations. Once again, this methodology closely approximates that used in the 1995 Annual Filing to reinitialize the first four years of price Cap regulation to an X of 4.0%, and is the methodology used in AT&T's 1997 Petition for Reconsideration of the May, 1997 X-Factor Order.

1998 Filing

For Year 1998, in addition to total access reductions implicit in the 1998 filing, including GDP-PI – X, plus "g" and exogenous adjustments, reinitialization to an X of 8.4% would represent an additional reduction of $442M and a reduction of $651M at an X of 9.3%.

# *Note on LEC Earnings*

In its May 29, 1998 letter to the FCC, USTA attempts to deny the existence of inflated LEC earnings by manipulating the data. USTA claims that growth in LEC earnings since 1991 has been substantially less than that of U.S. corporations in general. According to the data cited by USTA, the price cap LECs' interstate earnings grew at a 4.8% annual rate, while overall U.S. corporate earnings rose at a 12.2% rate and average earnings per share for the S&P 500 companies increased at a 16.5% rate. These comparisons are misleading in several respects.

- USTA's selection of 1991 as the initial year is highly misleading. It is important to keep in mind that data on earnings growth is highly sensitive to the particular historic period chosen. The high growth in U.S. corporate earnings since 1991 reflects the fact that earnings were at depressed levels in 1991 due to recession and subsequently recovered. LEC earnings, on the other hand, were not significantly affected by the 1990-91 recession. If one selects an initial year prior to the recession, the overall picture is quite different. Since 1988 growth in earnings per share for the 5 largest LECs has averaged 6.33% annually[6], compared to 6.73% for the Value Line "Industrial Composite", which represents approximately 785 of America's largest corporations.[7]

- It is also misleading to compare LEC earnings growth with that of US corporations as a whole without accounting for differences in dividend yields. Companies that pay relatively high dividends, like the LECs, tend to have less growth in earnings, since there are relatively less retained earnings available to finance growth. Shareholders thus receive higher dividends in exchange for less growth in dividends and earnings over time. Current dividend yields among the RBOCs and GTE range from 2.1% to 4.0%, as compared with an average of 1.44% for the Standard and Poors 500 companies.[8] Despite the LECs' above-average yields, their growth in earnings per share over the past decade has been about the same as that of U.S. corporations as a whole. Hence, when LEC earnings growth is viewed in combination with their relatively high shareholder dividends, the LECs performed better than the majority of U.S. corporations.

- It is similarly misleading to focus on earnings growth without considering the amount of investment needed to generate earnings. USTA notes that interstate earnings for the price cap LECs grew by only 4.8% annually from 1991 to 1997, but fails to mention that growth in interstate investment was only 0.6% during this period.[9] That is, the LECs achieved substantial increases in their interstate earnings without much additional investment. This is reflected in the LECs' ever-increasing interstate rates of return – from an average of 11.8% in 1991 to 15.6% in 1997.

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[6] The 6.33% is a simple average of the 1988-97 growth in EPS for Ameritech, Bell Atlantic, BellSouth, SBC, and GTE, as reported in *Value Line Ratings and Reports*, 7/10/98. (US West is not included here, since pre-1994 data is not available due to US West's reorganization.)

[7] *Value Line Selection and Opinion*, 1/16/98. From 1991 to 1997 growth in EPS for the Industrial Composite was 15.9% annually, similar to the 16.5% figure cited by USTA for the Standard and Poors 500. However, a substantial portion of this growth represents recovery from the decline in EPS – from $1.27 in 1989 to $0.95 in 1991 – associated with the 1990-91 recession. The longer term trend in EPS growth is substantially less than 15.9% and closer to that of the LECs.

[8] As of August 3, 1998.

[9] Based on FCC Form 492 reports for the RBOCs, GTE, SNET, and Frontier. According to AT&T's calculations, annual growth in interstate earnings and average net investment for these companies was 5.32% and 0.60%, respectively, during the 1991-97 period.

# ATTACHMENT B

# LEC EARNINGS*

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | Amount to Reset 1997 earnings to 11.25% | Amount to Reset 1997earnings to 10% |
|---|---|---|---|---|---|---|---|---|---|---|
| Ameritech | 12.76% | 13.00% | 12.66% | 14.40% | 13.96% | 16.78% | 18.27% | 18.22% | 330,197 | 389,414 |
| Bell Atlantic | 11.48% | 12.83% | 12.50% | 14.01% | 14.66% | 13.73% | 11.31% | 14.77% | 253,510 | 343,535 |
| Bell South | 12.04% | 12.62% | 13.03% | 13.68% | 15.97% | 15.75% | 16.24% | 17.90% | 527,762 | 626,965 |
| NYNEX | 9.92% | 9.35% | 12.50% | 12.55% | 11.82% | 12.13% | 13.67% | 13.73% | 154,680 | 232,643 |
| Pacific Bell | 12.18% | 11.85% | 12.68% | 12.89% | 15.29% | 15.12% | 17.76% | 11.90% | 29,779 | 87,047 |
| Nevada Bell | 14.28% | 12.98% | 14.51% | 17.44% | 18.22% | 17.26% | 22.84% | 19.46% | 10,176 | 11,726 |
| Southwestern | 10.52% | 10.75% | 11.80% | 12.91% | 13.43% | 13.37% | 11.60% | 10.32% | (53,173) | 18,296 |
| US West | 12.19% | 12.40% | 12.05% | 13.62% | 12.46% | 11.61% | 13.57% | 15.39% | 254,176 | 330,920 |
| GTE | 11.60% | 11.99% | 11.22% | 10.90% | 11.74% | 12.07% | 17.62% | 20.13% | 636,827 | 726,325 |
| United | 12.27% | 12.84% | 13.33% | 12.08% | 16.61% | 18.79% | 19.55% | 18.76% | 218,882 | 255,325 |
| Lincoln | 10.66% | 12.11% | 12.81% | 14.72% | 15.93% | 16.09% | 14.95% | 12.27% | 888 | 1,976 |
| Rochester | 10.80% | 9.72% | 12.11% | 13.46% | 14.27% | 11.87% | 16.44% | 19.84% | 22,336 | 25,587 |
| SNET | 12.00% | 9.68% | 12.69% | 11.52% | 11.34% | 11.58% | 10.29% | 12.70% | 11,949 | 22,249 |
| Citizens | na | na | na | na | na | na | 15.02% | 10.90% | (2,046) | 5,192 |
| Total RBOCs | 11.53% | 11.81% | 12.49% | 13.47% | 13.97% | 13.99% | 14.41% | 14.78% | 1,507,106 | 2,040,546 |
| Total ICOs | 11.77% | 11.94% | 11.79% | 11.57% | 12.84% | 13.47% | 17.08% | 18.76% | 888,837 | 1,036,654 |
| Total Industry | 11.57% | 11.83% | 12.34% | 13.09% | 13.74% | 13.89% | 14.98% | 15.64% | 2,395,943 | 3,077,199 |

* LEC earnings are interstate.