ORIGINAL

UNITED STATES TELEPHONE ASSOCIATION

EX PARTE OR LATE FILED

USTA 100 Years 1897-1997

EX PARTE

September 10, 1998

RECEIVED
SEP 10 1998
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

Re: Written Ex Parte Presentation
CC Docket Nos. 94-1/96-262

Dear Ms. Salas:

The attached letter was sent today to the Chief of the Common Carrier Bureau. The letter discusses USTA's response to an August 11, 1998 ex parte letter sent by the CARE coalition recommending that the Commission increase the productivity offset for incumbent local exchange carriers subject to price cap regulation. USTA explains that nothing in the flawed analysis provided by CARE can substantiate its claims that the productivity offset should be based on interstate only productivity or that the productivity offset should be reinitialized back to the 1995 tariff year.

An original and two copies are being filed in the Office of the Secretary on September 10, 1998. Please include it in the public record of the above-referenced proceedings.

Sincerely,

Linda L. Kent

Linda L. Kent
Associate General Counsel

cc: C. Barnekov, K. Brown, J. Casserly, K. Dixon, P. Gallant, J. Jackson, R. Lerner, K. Martin, J. Nakahata, T. Priest, T. Power, J. Schlichting, J. Scott

No. of Copies rec'd 0+2
List ABCDE

UNITED STATES
TELEPHONE
ASSOCIATION

USTA 100 Years 1897-1997

EX PARTE PRESENTATION

September 10, 1998

Ms. Kathryn C. Brown, Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, NW, Room 518
Washington, D.C. 20554

Re: Written Ex Parte Presentation
CC Docket Nos. 94-1 and 96-262

Dear Ms. Brown:

Repeating arguments which the Commission has already rejected, the so-called Customers for Access Rate Equity (CARE) Coalition has recommended that the Commission increase the productivity offset for incumbent local exchange carriers (ILECs) subject to price cap regulation.[1] Nothing in the flawed analysis provided by CARE supports its claims that the productivity offset should be based on interstate only productivity or that the productivity offset should be reinitialized back to the 1995 tariff year.

Again, it is obvious that the self-interests of the interexchange carrier (IXC) members of CARE, which receive a windfall profit every time the productivity offset is increased, motivate CARE's advocacy. At least one CARE member has confirmed what USTA pointed out months ago, that the IXC members of CARE have refused to pass on to consumers the savings they have received in the form of lower access charges. Consumers Union and the Consumer Federation of America, in an August 13, 1998 letter to Chairman Kennard, found that as much as $2 billion in interexchange price reductions have not been passed through to consumers and businesses in the form of rate reductions for 1998. These groups concluded that the IXCs have overcharged consumers by more than $1 billion. Of course, on the heels of this finding, AT&T also announced that it will raise rates for low-use consumers. USTA has urged the Commission to

[1]Ex Parte Letter from Brian R. Moir to Ms. Kathryn C. Brown August 11, 1998.

1401 H STREET NW SUITE 600 | WASHINGTON DC 20005-2164 | TEL 202.326.7300 | FAX 202.326.7333 | INT www.usta.org

seek data from the major IXCs to determine the magnitude of this problem.[2] Clearly, CARE's IXC members are motivated by economic self-interest and not by the interests of end user customers. USTA will correct the fallacies of CARE's analysis below.

An 'interstate only' productivity factor is not economically meaningful and the record before the Commission substantiates the fact that there is no economically meaningful way to separately measure productivity for a portion of outputs supported by joint and common plant.[3] Traditional jurisdictional distinctions do not provide an economic basis to segregate outputs. ILECs use many common and multi-use inputs, i.e., wires and other facilities, to provide 'local', 'intrastate', 'interstate', 'intraLATA', 'interLATA' and 'international' outputs, i.e., telecommunications services, regardless of whether a call is 1, 10, 100 or 1,000 miles from one end user to another. When joint-use and/or multi-use facilities are used to provide multiple services, there is no economically principled method of apportioning the costs of those facilities among the services.

Even the Commission recognized that it could not calculate an 'interstate only' productivity offset. CARE's 'interstate only' proposal is inconsistent with the basic principle that productivity growth is a ratio of outputs to inputs. CARE's proposal depends upon assumptions about inputs and does not address the complex and dynamic interactions between inputs and outputs. Even if it is true that interstate outputs have been growing, the inputs needed to produce those outputs may have been growing as fast or faster. The Commission correctly concluded that the record did not allow it "to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth" because no party "provide[d] a factual or theoretical explanation" to support claims that there are differences between interstate and intrastate productivity growth.[4]

CARE's 'interstate only' analysis suffers from additional flaws. The fact that telecommunications companies experience economies of scope and scale is fundamental in establishing a productivity offset relative to the general economy. The total company Total Factor Productivity (TFP) reflects these joint economic benefits. The Commission Staff Model recognizes this as well by utilizing total revenues and total costs and incorporating the achieved earnings of the total company. CARE's isolation of the interstate output volume in the numerator of the TFP ratio is inconsistent with the economies of scope and scale already

---

[2]Ex Parte Letter from Roy M. Neel to Chairman William E. Kennard, March 18, 1998.

[3]*See,* Bell Atlantic and NYNEX Joint Reply Comments, Fuss Declaration at 3 and BellSouth Reply Comments, Gollop Statement at 15.

[4]Price Cap Performance Review for Local Exchange Carriers, *Fourth Report and Order*, CC Docket No. 94-1, *Second Report and Order,* CC Docket No. 96-262, 12 FCC Rcd 16642 (1997) at ¶ 110.

reflected in the total company TFP. Achieving productivity gains requires active management of the installation, maintenance, location, amount and configuration of plant investment and labor as the volume, variety and technology of total output activity grows and shifts. TFP improvement expectations must be related to the economies and practicality of providing all of the ILEC's telecommunications services. CARE's ill-conceived 'interstate only' proposal ignores this fact.

The Commission also correctly refused to direct the ILECs to adjust their price cap indices back to 1995.[5] The Commission's adoption of a 6.5 percent productivity offset, which USTA has argued is erroneous, represents a prospective productivity target. There is nothing in the record which indicates that previous productivity estimates for previous years were too low or that 6.5 percent would have been appropriate in earlier years. The Commission utilized a different forward-looking methodology to forecast productivity gains for the industry in the Price Cap Order. This new methodology did not invalidate previous calculations, thus there is no basis to apply it to prior years. As the Commission has explained, each time it requires carriers to adjust future rates based on retrospective changes to the productivity offset, it risks diminishing ILEC confidence in the price cap system, thereby reducing the incentives to improve productivity and to undertake the risks of investing in innovative new technologies and services. If ILECs are forced to view the productivity factor as a bar that is raised every time they achieve productivity gains in excess of the bar, the basic premise of incentive-based regulation is voided.

The productivity factors from 1991 through 1998 have required the ILECs to be about 48 percent more efficient in order for regulated interstate earnings to be higher in 1998 than in 1991.[6] This mandated rate of cost containment and efficiency improvements reflected by the productivity factor has directly benefitted access customers through lower prices. This 48 percent increase is above and beyond the increases in productivity necessary to keep pace with the economy-wide productivity performance of competitive firms in the U.S. ILECs under price cap regulation have been forced to undertake dramatic operational restructuring in order to achieve the modest earnings improvements through 1998. For example, these ILECs have reduced their workforce by 23 percent through the end of 1997. Such stringent efficiency initiatives were required to exceed the cumulative 48 percent price cap efficiency requirement. CARE's suggestions that the productivity offset should be 8.4 percent or 9.3 percent would have required a 91 percent and 104 percent respective efficiency improvement. CARE's proposal would effectively eliminate any opportunity for earnings gains and would, as the Commission feared, completely eviscerate the benefits of incentive regulation.

---

[5]Price Cap Order at ¶ 179.

[6]Cumulative compounded efficiency requirements based on years at productivity factors of 4 percent, 5.3 percent and 6.5 percent through July 1998.

In fact, CARE's proposal has nothing to do with preserving or promoting incentive-based regulation and has everything to do with re-establishing earnings-based regulation. CARE's 9.3 percent productivity offset would be the equivalent of a ten percent or less rate of return. This would result in confiscatory levels for several ILECs, triggering the need for lower formula (LFAM) adjustments. If CARE's productivity offsets had been in effect beginning in 1991, all price cap LECs would have been forced to file under LFAM before 1995.[7] The Commission certainly did not intend to make LFAM adjustments a regular occurrence when it initiated price cap regulation.

Finally, CARE's attacks on the data provided in USTA's May 29, 1998 ex parte are incorrect. USTA's data reflects interstate price cap industry data. CARE consistently uses total RBOC holding company financial data. USTA's use of 1991 as the initial year of price cap regulation can hardly be misleading, as CARE alleges, since 1991 was the first year ILECs operated under price cap regulation. USTA compares earnings growth for other U.S. corporations for the period 1991 through 1997 when price cap regulation has been in effect. CARE uses earnings data from 1988. CARE's conclusion that the LECs have performed better than the majority of U.S. corporations cannot be substantiated by actual market data from 1991 through 1997.

USTA's conclusions regarding earnings levels remain valid. *Earnings levels for price cap ILECs have benefitted from a strong U.S. economy, but have grown at a moderate rate when compared to other U.S. corporations.* As the record in this proceeding demonstrates, the use of accounting returns to measure results under price cap regulation is comparing apples to oranges. CARE's rate of return benchmark provides no incentives for the continuation of the demonstrated efficiency benefits of incentive regulation or of investment in riskier advanced technologies.

The Commission has already rejected the recommendations of the CARE coalition. Nothing in its most recent ex parte justify any change in the Commission's determinations regarding the use of an 'interstate only' productivity offset or the reinitialization of the productivity offset. Nothing in the ex parte justifies any increase in the productivity offset. USTA urges the Commission to continue to reject CARE's self-serving agenda.

Sincerely,

Linda Kent

Linda Kent
Associate General Counsel

---

[7]CARE's 9.3 percent productivity factor would have required an additional 5.3 percent rate reduction each of the first four years when the actual productivity factor was 4 percent. This means rates would have been some 20 percent lower after four years which would have driven earnings below LFAM levels.