

Original

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

RECEIVED

NOV - 9 1998

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
MCI Telecommunications Corp. Emergency Petition for Prescription	)	CC Docket No. 97-250
	)	
Consumer Federation of America Petition for Rulemaking	)	RM-9210
	)	

REPLY COMMENTS OF THE AD HOC  
TELECOMMUNICATIONS USERS COMMITTEE

Economic Consultants:  
Dr. Lee L. Selwyn  
Patricia M. Kravtin  
Scott C. Lundquist  
Sonia N. Jorge  
Economics and Technology, Inc.  
One Washington Mall  
Boston, MA 02108-2617  
617-227-0900

Counsel:  
James S. Blaszak  
Valerie Yates  
Levine, Blaszak, Block & Boothby, LLP  
2001 L St. NW  
Suite 900  
Washington, DC 20036  
202-857-2550

November 9, 1998

No. of Copies rec'd 0+11  
List A B C D E

## SUMMARY

The Regional Bell Operating Companies (RBOCs) attempt to portray their local service markets as rampantly competitive. However, the underlying factual evidence cited by the RBOCs supports the Committee's experience and view that, when CLEC gains are compared to the size of the total local and access services market controlled by the ILECs, the CLEC competitive inroads to date are too limited in scope and scale to constrain the ILECs' pricing or provisioning behavior. Accordingly, the Commission cannot reasonably rely on market forces to bring interstate access service rates to levels closer to those that would exist in an effectively competitive market.

USTA and the price cap LECs also argue that the Commission erred in viewing the X-factors from 1992 to 1995 as constituting an upward trend.<sup>1</sup> They further argue that new data for 1996 and 1997 indicate a downward trend in productivity, which they attribute largely to the growth in competition.<sup>2</sup> They are wrong on both counts. In these reply comments, Ad Hoc presents a more accurate presentation of the trend in productivity for price cap LECs, showing a consistent trend in LEC productivity in the range of 9 percent on an interstate-only basis and 6 percent total company. In contrast to the X-factor estimates presented by USTA, Ad Hoc's estimates are based solely on publicly available data, use consistent estimation procedures, incorporate a more accurate

---

<sup>1</sup> USTA Comments at 22.

measure of local output growth in recent years, and consider interstate-only conditions. Ad Hoc's analysis demonstrates there is no discernible downward trend in productivity, and that the current X Factor is, indeed, set too low.

The Committee also argues that the short-term benefits associated with premature pricing flexibility do not justify the significant threat to the emergence of long-term, sustainable and effective competition that premature, excessive pricing flexibility would raise. The Committee supports MCI Worldcom's (MCIW) position that the presence of substantial competition, as measured by traditional indicators of market power should determine whether the ILECs obtain pricing flexibility. Prior to the emergence of effective competition, however, the Committee supports allowing ILECs to compete for contested customers, provided that the ILEC can justify a single-customer competitive response offering using a modified competitive necessity doctrine and that the ILEC tariffs the approved offering as a contract tariff and makes it generally available to any similarly situated customer.

---

<sup>2</sup> See, e.g., Bell Atlantic Comments at 14.

## Table of Contents

	<u>Page</u>
SUMMARY .....	i
I. DATA SUPPLIED IN THE RBOC'S COMMENTS UNDERScores THE PRESENT LACK OF WIDESPREAD, PRICE-CONSTRAINING COMPETITION IN THE INTERSTATE ACCESS MARKET.....	2
II. CLAIMS BY USTA AND THE PRICE CAP LECs OF A NEW DOWNWARD TREND IN THE X-FACTOR ARE BASED ON DEFICIENT PRODUCTIVITY ANALYSIS, THE RESULTS OF WHICH ARE SIMPLY NOT CREDIBLE IN LIGHT OF LIMITED COMPETITIVE INROADS AND HIGH LEC RATES OF RETURN FOR INTERSTATE SERVICES.....	12
A. The Relatively Low X-Factors For 1996 And 1997 Presented In The USTA/Gollop Analysis Reflect Non-Publicly Available Data And Other Data Anomalies, Including The Effect Of LEC Earning Increases On The Cost Of Capital Input.....	16
1. Adjustment to Labor Compensation Value.....	17
2. Updated data for local calls and number of special access lines.....	18
3. The 1996 X-factor revenue/cost of capital anomaly .....	18
III. AD HOC'S ANALYSIS, BASED ON PUBLICLY-AVAILABLE DATA AND A MORE ACCURATE MEASURE OF LOCAL OUTPUT IN RECENT YEARS, SUPPORTS X-FACTORS SIGNIFICANTLY HIGHER THAN THOSE PRESENTED IN THE USTA/GOLLOP ANALYSIS.....	21
IV. CLAIMS BY USTA AND THE INCUMBENT LECs THAT INTERSTATE-ONLY PRODUCTIVITY IS NOT "ECONOMICALLY MEANINGFUL" IS BELIED BY STATE COMMISSION DECISIONS TO BASE INTRASTATE RATES ON INTRASTATE-ONLY PRODUCTIVITY AND CONDITIONS.....	25

V.	EVEN IF THE COMMISSION ACCEPTS THE USTA/GOLLOP ANALYSIS, WHICH AD HOC MAINTAINS THE COMMISSION SHOULD NOT, THAT ANALYSIS ALSO PRODUCES INTERSTATE-ONLY X-FACTORS IN THE RANGE OF 9%.....	30
VI.	UNLESS AND UNTIL THE COMMISSION ADOPTS AN INTERSTATE-ONLY PRODUCTIVITY MEASURE, THE CPD, WHILE EXTREMELY SMALL, IS A VERY IMPORTANT COMPONENT OF THE PRODUCTIVITY OFFSET.....	33
VII.	PRICING FLEXIBILITY.....	34
	CONCLUSION .....	39

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
MCI Telecommunications Corp. Emergency Petition for Prescription	)	CC Docket No. 97-250
	)	
Consumer Federation of America Petition for Rulemaking	)	RM-9210
	)	

**REPLY COMMENTS OF THE AD HOC  
TELECOMMUNICATIONS USERS COMMITTEE**

The Ad Hoc Telecommunications Users Committee (hereinafter "Ad Hoc" or "the Committee") hereby submits reply comments in response to the Commission's October 5, 1998 Public Notice inviting parties to refresh the record in the above-referenced proceedings and seeking comment on proposals for access charge reform pricing flexibility.

I. DATA SUPPLIED IN THE RBOC'S COMMENTS UNDERSCORES THE PRESENT LACK OF WIDESPREAD, PRICE-CONSTRAINING COMPETITION IN THE INTERSTATE ACCESS MARKET.

The Regional Bell Operating Companies (RBOCs) attempt to portray their local service markets as rampantly competitive.<sup>3</sup> However, the underlying factual evidence cited by the RBOCs supports the Committee's experience and view that, when CLEC gains are compared to the size of the total local and access services market controlled by the ILECs, the CLEC competitive inroads to date are too limited in scope and scale to constrain the ILECs' pricing or provisioning behavior.

Ameritech presents a chart showing that CLECs have deployed 34 switches in its five-state territory.<sup>4</sup> This, however, represents less than one percent of the more than 4,000 central office switches located in that region.<sup>5</sup> CLEC collocation efforts are also placed in a more realistic perspective by noting that the 339 wire centers in which, according to Ameritech,<sup>6</sup> collocation was either in-place or pending by late September 1998, constitute only 8% of the total number of switches in the region.

---

<sup>3</sup> For example, Ameritech contends that local competition in its region is "vibrant," with growth that has "exploded" and been "astounding." Ameritech Comments, at 6. Bell Atlantic claims that it has seen a "dramatic increase in competitive entry" and is beset by a "competitive firestorm." Bell Atlantic Comments, at 8 and 10.

<sup>4</sup> Ameritech Comments, at 6 and Attachment E.

<sup>5</sup> Statistics of Common Carriers, Preliminary 1997, Table 2.4 provides the total number of central office switches for each state, as of December 31, 1997. The total switch count indicated therein for the Ameritech region (Illinois, Indiana, Michigan, Ohio, and Wisconsin) is 4149.

<sup>6</sup> Ameritech Comments, at 6, footnote 11.

Ameritech also points to the fiber facilities installed by CLECs in seven major cities in its region, which it claims totaled about 3,000 miles in 1997.<sup>7</sup> However, Ameritech fails to mention that it owns some 32,000 route miles of fiber in its region, more than ten times as much as all of the competitors combined.<sup>8</sup> In any case, a more useful comparison is to account for total network route miles, including copper facilities, which comprise over 90% of the RBOCs' installed transmission mileage.<sup>9</sup> On this basis, the CLEC fiber deployments cited by Ameritech represent less than one percent of Ameritech's approximately 331,500 miles of installed cable facilities in the state.

The same limited scope of CLEC network deployment, relative to the incumbents' existing facilities, holds true for the other RBOCs as well. In the July 1998 application for license transfer approvals related to the pending SBC-Ameritech merger, the two companies claimed (without documentary support) that CLECs have deployed some 6500 route miles on fiber in SBC's service territory.<sup>10</sup> Even if this figure is taken at face value, it represents only one percent of SBC's total network route mileage of over 657,000 miles.<sup>11</sup> Similarly, in its recent alternative regulation proceeding in

---

<sup>7</sup> Ameritech Comments, Attachment C (CLECs' fiber deployment miles in Ameritech cities).

<sup>8</sup> FCC Common Carrier Bureau, *Statistics of Common Carriers – Preliminary 1997*, Table 2.10. Combining the figures for the Ameritech operating companies' fiber route kilometers and multiplying by the km.-to-miles conversion factor of 0.6214, produces 32,592 miles.

<sup>9</sup> The Commission's Industry Analysis Division has noted that "comparison of relative fiber deployment may overstate the relative size of new local service competitor networks" for just this reason. See *Trends in Telephone Service*, Industry Analysis Division, July 1998, at 30.

<sup>10</sup> Application of Ameritech Corporation and SBC Corporation Inc. for Authority, Pursuant to Part 24 of the Commission's Rules, to Transfer Control of a License Controlled by Ameritech Corporation, (July 24, 1998) ("SBC/Ameritech Merger Filing"): Applicant's Description of the Transaction, Public Interest Showing and Related Demonstrations, attached *Comments Concerning the Proposed SBC-Ameritech Merger*, NERA (R. Schmalensee and W. Taylor), July 21, 1998, at 22.

<sup>11</sup> FCC Common Carrier Bureau, *Statistics of Common Carriers – Preliminary 1997*, Table 2.10. Combining the figures for the SBC operating companies' fiber route kilometers and copper route kilometers, and multiplying by the km.-to-miles conversion factor of 0.6214, produces 657,448 miles.

Colorado, U S West supplied data that demonstrates that the fiber route miles deployed by CLECs in Colorado represent less than one percent of U S West's approximately 80,000 miles of installed cable facilities in that state.<sup>12</sup> The superficially impressive volume of evidence that U S West has supplied in the instant proceeding concerning competition in the Phoenix access services market<sup>13</sup> has already been rebutted by parties in the Commission proceeding addressing U S West's petition for regulatory forbearance in that market.<sup>14</sup>

Additional evidence cited by NERA in support of USTA's Comments confirms that the network facilities currently deployed by all CLECs represent only about two percent of the total network route mileage that the ILECs control. NERA cites a New Paradigm Resources Group, Inc. study estimating the total route mileage deployed by CLECs as 37,403 miles in 1996 and 78,506 miles in 1997.<sup>15</sup> When evaluated against comparable route mileage (converted from kilometers) statistics reported to the Commission, however, it is apparent that the CLECs' total route mileage amounts to only 0.9% of the ILECs' total network route mileage (including fiber and copper facilities) in 1996, and two percent in 1997. These comparisons are shown graphically in Appendix 1 to these Reply Comments.

---

<sup>12</sup> Colorado PUC Docket No. 97A-540-T, Direct Testimony of Kevin Smith (U S West-Colorado), January 30, 1998, at 7-8.

<sup>13</sup> *Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket No. 98-157, Comments of U S West at Exhibit A (filed Aug. 24, 1998).

<sup>14</sup> See *Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket No. 98-157, Reply Comments of the Ad Hoc Telecommunications Users Committee (filed Oct. 28, 1998).

<sup>15</sup> USTA Comments, Attachment A, *Access Reform Again: Market-Based Regulation, Pricing Flexibility, and the Universal Service Fund*, William E. Taylor (NERA Report), at 17. The 1996 value is derived by subtracting the cited figure for CLEC fiber route mileage growth during 1996-1997 (41,103 miles) from the 1997 route mileage figure (78,506).

NERA also cites one financial analyst's positive report on the state of local competition as evidence that "competition for the business market has been quite successful."<sup>16</sup> Other market analysts hold a much more pessimistic view of the progress of local competition to date. A senior partner of the Yankee Group research firm was recently quoted as follows concerning local competition: "This is a big stalemate and there's no end in sight. We are about to reach the third anniversary of the telecom act and we have seen very little benefit to the customers."<sup>17</sup> Ad Hoc certainly concurs that it has not seen a material increase in wide spread competition. On October 28 (after the filing deadline for initial Comments in this proceeding), the Common Carrier Bureau released its second annual survey of local competition.<sup>18</sup> The results, which are summarized in Appendix 2 of these Comments, confirm Ad Hoc's view of the limited extent of local competition. Importantly, the great majority of lines that CLECs are serving continue to rely upon the total service resale mechanism, which does not reduce ILECs' interstate access revenues or market share.

Moreover, the CLEC access line gains that have been achieved via total service resale may not be sustainable. The basis for this concern lies in experience in Illinois, where CLECs' line growth appears to be markedly slowing and even reversing. During the Illinois Commerce Commission's ongoing proceeding addressing the proposed SBC-Ameritech merger, a witness offered the following testimony:

Indeed, Ameritech Illinois has reported an alarming trend: the number of lines and loops provisioned by Ameritech Illinois for CLECs each month has been cut

---

<sup>16</sup> NERA Report, at 15.

<sup>17</sup> Brian Adamik, quoted in "AT&T Chief Exec Slams Bell Atlantic," Boston Herald, November 6, 1998, at 37.

<sup>18</sup> See [http://www.fcc.gov/ccb/local\\_competition/survey/responses](http://www.fcc.gov/ccb/local_competition/survey/responses) (October 28, 1998).

by more than half since May 1997 (26,160 in May 1997, compared to only 11,492 in July 1998). Similarly, the total number of residential resold lines in Illinois has declined during 1998. While the total amount of CLEC activity in Illinois has continued to increase, these indications that segments of the CLEC market are slowing and, indeed, that residential resale has declined should be taken as a warning that the limited success to date must be guarded carefully if it is to survive and grow.<sup>19</sup>

USTA has presented statistics concerning the number of CLEC state certifications for operating authority, based on a survey conducted by *State Telephone Regulation Report (STRR)*. However, as that publisher cautions readers of its survey results (and USTA failed to mention), counts of CLEC certifications tend to greatly overstate the number of actual competitors in place. As *STRR* explains, certificates "represent the number of potential local exchange competitors, not operational companies. For example, Nevada has authorized 65 CLECs but state staffers said that they knew of only 9 that are soliciting customers. Kansas has issued 59 CLEC certificates but only 20 companies are believed operational. Idaho has authorized 20 CLECs, but only 4 actually may be serving customers."<sup>20</sup>

As in past filings, NERA once again trots out the stalking horse of technological alternatives to the ILECs' local exchange and access services.<sup>21</sup> In reality, the new telecommunications technologies cited by NERA, such as wireless PCS (personal communications services) and Internet telephony do not represent viable and economically competitive alternatives to ILEC local services at the present time, nor are they likely to present a realistic competitive alternative for several years hence.

---

<sup>19</sup> Illinois Commerce Commission, Docket No. 98-0555, Direct testimony of Charlotte F. Terkeurst on behalf of the Government and Consumer Intervenors (GCI), October 28, 1998, at 47 (footnote omitted).

<sup>20</sup> STRR, September 4, 1998, at 2.

<sup>21</sup> NERA Report, at 18-19.

As the Commission has already recognized, the deployment of PCS systems represents a significant change in mobile services technology, but the market for mobile services (primarily, cellular telephone services) has remained essentially separate from the market for wireline-based local telephone services.<sup>22</sup> Whether or not PCS “can be” a competitive alternative to wireline local service “in principle,” as NERA would have us focus on,<sup>23</sup> the Commission has correctly concluded that mobile telephone services, including PCS-based systems, are not currently providing a competitive alternative to wireline local service,

Mobile telephone service providers are currently positioned to offer products that largely complement, rather than substitute for, wireline local exchange.<sup>24</sup> These providers utilize spectrum whose carrying capacity is relatively finite. There are economic and technical limits to increasing spectrum reuse through reduction in cell size and use of compression and encoding techniques. Additionally, their installed technology and facilities are specialized for use in mobile communications. These factors limit the ability of wireless carriers to compete on a mass market scale with wireline providers in the local exchange and exchange access services market. Although the Applicants predict that some of these providers will become competitors to wireline providers, the Applicants recognize that, as stated *supra*, such competition is currently precluded as a practical matter by the higher prices that mobile telephone service providers can charge. Thus, only if wireline prices were to increase or other factors caused wireless prices to decline materially, would this class of entrants become viable competitors in the relevant market. Accordingly, we are unpersuaded by the Applicants and CFA that mobile telephone service providers are, at this time, either singularly or as a class, significant market participants; they lack the requisite incentives and access to facilities that would allow them to compete effectively in the relevant market. We are mindful, however, of the possibility that conditions could alter significantly as a result of increased spectrum being made available (either through reallocation or

---

<sup>22</sup> *Second Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, FCC 97-75 (rel. March 25, 1997), at 54-55. The FCC report states that, while wireless services are generally becoming more affordable, consumers at present do not treat them as substitutes to wireline service. (*Id.*) The fact that cellular service prices remain substantially higher than wireline local service prices confirms this conclusion.

<sup>23</sup> USTA Comments, Attachment A, at 19.

<sup>24</sup> *Second Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services*, FCC 97-75, 53 - 55, (rel. Mar. 25, 1997).

through developments in mobile and fixed wireless technologies), major pricing shifts as a result of competition, or the alteration of consumer perceptions as to the substitutability of wireless for wired telephony.<sup>25</sup>

Moreover, the AT&T Wireless, Inc. calling plan that NERA cites as evidence that PCS is competitive with wireline local service proves just the opposite. As NERA has observed, in order to obtain the \$0.11 per minute rate, a Digital One Rate Plan customer must commit to 1400 minutes of use per month, which equates to \$154 of total usage (*i.e.*,  $0.11 \times 1400 = 154$ ). That \$154 payout is more than twice as much as the average household expends per month on telephone service, and therefore is nowhere near being an economically viable service alternative for most residential subscribers.<sup>26</sup> As PCS penetration spreads over the next several years, these services will generally compete against cellular carriers' relatively high (compared to wireline) price levels rather than wireline service directly, and therefore will not constrain the retail local service and access prices of the RBOCs and other wireline carriers.

As for telephony by cable television companies or the Internet, neither technology has been transformed into viable commercial alternatives to the ILECs' local and access services at the present time. Most cable television companies have indefinitely delayed the roll-outs of local telephony that were proclaimed in the 1994-1995 timeframe, due in part to severe technical impediments and higher-than-expected

---

<sup>25</sup> *In the Matter of: Applications of NYNEX Corp., Transferor, and Bell Atlantic Corp., Transferee, For Consent to Transfer Control of NYNEX Corp. and Its Subsidiaries*, Memorandum Opinion and Order, File No. NSD-L-96-10, FCC 97-286 (rel. Aug. 14, 1997), at para. 90 (emphasis supplied).

<sup>26</sup> In 1995 (the latest year for which the Commission has published this data), the average household total expenditure on telephone service (local, toll, and all other charges) was \$62 per month. *Trends in Telephone Service*, Industry Analysis Division, July 1998, at 16, Table 4.1 (Telephone Service Expenditures).

costs. Internet telephony has potential that bears watching, but confronts significant obstacles to widespread commercialization.

Despite the generally glowing ILEC portrayals of the status of local competition, there are some distinct cracks in the façade. Even USTA admits that “[c]ompetition for residence and single line business customers is developing slowly.”<sup>27</sup> While USTA seeks to excuse the low level of competition in the residential and small business market as a typical market outcome, USTA also admits that it takes time for competition to expand outward from the most profitable customers to less lucrative customers, so that “competition may develop in an uneven or sporadic manner”.<sup>28</sup> Unfortunately, USTA ignores the obvious harm of monopolistic pricing that results from reliance on a market-based approach, for those less-lucrative customers for which competitive alternatives have not yet arrived.

In an attempt to defuse criticism of the egregious rates of return that the RBOCs have been reaping on their interstate access services, returns which would not be possible in a competitive market, USTA presents data that purports to show that the earnings growth rates for U.S. firms have increased much faster than those for the ILECs under the price cap regime during 1991-1997.<sup>29</sup> However, USTA’s earnings comparisons are distorted in several significant ways which invalidate USTA’s conclusion. First, USTA is measuring the *aggregate* level of earnings for three categories (price cap ILECs, U.S. industrial firms, and U.S. non-financial corporations), rather than profitability expressed in relation to the resources being used, *i.e.* rates of

---

<sup>27</sup> USTA Comments, at 9.

<sup>28</sup> *Id.*, 14

return or net margins. As MCI has demonstrated, on a net margin basis, the RBOCs (and GTE) are one of the most profitable business categories in the world, surpassed only by the electronics/semiconductor industry, computer services and software, and pharmaceuticals.<sup>30</sup> Measuring aggregate earnings, as USTA has done, masks ILECs' relative profitability by failing to control for changes in each categories' underlying asset base. This is especially true for USTA's category of "all U.S. non-financial corporations," whose higher rate of growth for aggregate earnings reflects growth in the total number of non-financial corporations – and even the addition of entirely new lines of products, services and businesses over 1991-1997 – rather than simply growth in the earnings for a defined set of firms such as the price cap ILECs. Second, while USTA has failed to provide any source data for its earnings calculations, the earnings estimates for the price cap ILECs appear to reflect earnings reported to regulators, rather than financial earnings, given that they are identified as "interstate" (only) earnings. RBOCs' regulatory earnings will generally understate financial earnings because the former does not include the impacts of RBOCs' substantial write-offs of Statement of Financial Accounting Standards (SFAS) No. 71-related assets.<sup>31</sup> Finally, it would be unreasonable, indeed, if price cap ILECs' interstate earnings were allowed to grow as fast as those for non-regulated firms, in light of the continued regulatory protections the ILECs enjoy from financial risk. Non-regulated firms compete for earnings as best they can without protection from low earnings, negative earnings, or even bankruptcy. In contrast, the "low end adjustment" element of the Commission's

---

<sup>29</sup> USTA Comments, at 5 and Attachment C, Chart 1.

<sup>30</sup> MCI Comments, Appendix A, sheet 5.

price cap plan shields ILECs from those financial risks, by allowing ILECs to respond to earnings of below 10.25% by making rate increases that would never be tolerated in competitive markets.

II. CLAIMS BY USTA AND THE PRICE CAP LECs OF A NEW DOWNWARD TREND IN THE X-FACTOR ARE BASED ON DEFICIENT PRODUCTIVITY ANALYSIS, THE RESULTS OF WHICH ARE SIMPLY NOT CREDIBLE IN LIGHT OF LIMITED COMPETITIVE INROADS AND HIGH LEC RATES OF RETURN FOR INTERSTATE SERVICES.

USTA and the price cap LECs argue that the Commission erred in viewing the X-factors from 1992 to 1995 as constituting an upward trend.<sup>32</sup> They further argue that new data for 1996 and 1997 indicate a downward trend in productivity, which they attribute largely to the growth in competition.<sup>33</sup> They are wrong on both counts.

In support of its contention of a new downward trend in productivity for price cap LECs, USTA identifies three sets of five year average X-factors based on an update to the Commission's model ranging from 5.0, 4.2, and 4.4 percent for the periods 1991-1995, 1992-1996, and 1993-1997, respectively. USTA also presents five year averages for the X-factor for these same periods based on an update to USTA's Total Factor Productivity Review Plan (TFPRP) model which range from 2.7 to 3.2 to 3.0 percent<sup>34</sup>

---

<sup>31</sup> See *Patterns of Investment by the Regional Bell Holding Companies*, by Economics and Technology, Inc., December 1997 revision, at 6.

<sup>32</sup> USTA Comments at 22.

<sup>33</sup> See, e.g., Bell Atlantic Comments at 14.

<sup>34</sup> USTA Comments at 23.

Given the Commission's emphatic rejection of the X-factors derived from USTA's TFPRP in the Access Charge Reform Order<sup>35</sup> and USTA's failure to correct the fundamental deficiencies in its TFPRP, the Commission should summarily reject the latter set of figures. While the first set of X-factor figures presented by USTA are based on the Commission's model, as discussed in these reply comments, USTA's application of the Commission's model is subject to a number of deficiencies, which taken together, result in a very misleading portrayal of ILEC total company productivity. These deficiencies include reliance on non-publicly available and non-verifiable data and the use of a local output measure that does not accurately reflect the true extent of growth in recent years. In addition, Ad Hoc points out that the low X-factor result for the year 1996 is an anomaly, resulting from an extremely high level of earnings growth for the LECs, and essentially does not indicate any true decline in productivity. Accordingly, the "peak in 1995" in the total company X-factor data that USTA observes and argues is the basis of what USTA believes to be an improper finding by the Commission of an upward trend in LEC productivity,<sup>36</sup> is itself the result of the anomalous 1996 result, rather than any structural reversal of LEC productivity. Most importantly, however, as argued in Ad Hoc's comments, the true productivity trend applicable to interstate services can only be determined on the basis of interstate-only conditions, and USTA's analysis, not surprisingly, does not quantify an interstate-only X-factor.

---

<sup>35</sup> See Access Charge Reform, CC Docket No. 96-262 *et al.*, First Report and Order, 12 FCC Rcd 15982 (1997) ("Access Charge Reform Order") at para. 267 (emphasis supplied); *aff'd sub nom. Southwestern Bell Tel. Co. v. FCC*, \_\_\_ F.3d \_\_\_ (8<sup>th</sup> Cir., Aug. 19, 1998); Order on Reconsideration, 12 FCC Rcd 10119 (1997), Second Order on Reconsideration and Memorandum Opinion and Order, 12 FCC Rcd 16606 (1997).

<sup>36</sup> USTA Comments at 22.

In these reply comments, Ad Hoc presents a more accurate presentation of the trend in productivity for price cap LECs. Ad Hoc's estimates which, as illustrated in Table 1 below, show a consistent trend in LEC productivity in the range of 9 percent on an interstate-only basis and 6 percent total company. In contrast to the X-factor estimates presented by USTA, Ad Hoc's estimates are based solely on publicly available data, use consistent estimation procedures, incorporate a more accurate measure of local output growth in recent years, and consider interstate-only conditions. Ad Hoc's analysis demonstrates there is no discernible downward trend in productivity, and that the current X Factor is indeed set too low.

<b>Table 1</b>		
<b>Ad Hoc Updated Model Results</b>		
<b>(X-factors)</b>		
<b>Year</b>	<b>Total Company</b>	<b>Interstate</b>
1986	-1.21%	0.53%
1987	5.94%	9.86%
1988	9.10%	14.7%
	6.22%	7.36%
1990	9.12%	14.42%
1991	4.41%	11.63%
1992	2.90%	5.35%
1993	4.57%	10.01%
1994	5.83%	9.12%
1995	6.96%	10.56%
1996	5.33%	6.64%
1997	9.65%	10.04%
<b>Average</b>		
AVG (86,97)	5.54%	9.18%
AVG (87,96)	6.17%	9.97%
AVG (88,97)	6.21%	9.98%
AVG (89,96)	5.89%	9.46%
AVG (90,97)	5.92%	9.72%
AVG (91,97)	5.66%	9.05%
AVG (92,97)	5.87%	8.62%
AVG (93,97)	6.47%	9.27%

That the current X-factor is too low is strongly corroborated by evidence

presented by Ad Hoc and others demonstrating LECs are earning excessive rates of return for interstate services under the current 6.5% X-factor.<sup>37</sup> LEC Interstate earnings have soared into the high teens and beyond to levels well in excess of the last authorized rate of return of 11.25%. As GSA notes, the fact that reported rates of return for price cap LECs are well above 11.25% is clear proof that the LECs have been able to achieve productivity improvements far greater than the 6 percent figure adopted by the Commission.<sup>38</sup>

As to the LECs' claim that competition is depressing LEC productivity, there is simply no evidence whatsoever to support the contention that competition is sufficiently effective as to have any demonstrable impact on LEC productivity. To the contrary, as explained in section I, above, there is compelling evidence that with a few exceptions, competition is nowhere strong enough to constrain ILEC pricing for interstate access services.<sup>39</sup>

A. The Relatively Low X-Factors For 1996 And 1997 Presented In The USTA/Gollop Analysis Reflect Non-Publicly Available Data And Other Data Anomalies, Including The Effect Of LEC Earning Increases On The Cost Of Capital Input.

USTA asserts that Prof. Gollop's analysis utilizes the Commission's model "exactly as designed" and "from a framework wholly consistent with that applied to the 1985-1995 period."<sup>40</sup> USTA is wrong. Prof. Gollop's update of the Commission's model departs from a fundamental principle underlying the Commission's analysis. As clearly

---

<sup>37</sup> Ad Hoc Comments at 8-9.

<sup>38</sup> GSA Comments at 4.

<sup>39</sup> Ad Hoc Comments at 3-10.

<sup>40</sup> USTA Comments at 22.

enunciated in the FFNPRM, one of the key overarching criteria for a long-term price cap plan is that the calculation of the X-factor is to be based on publicly-available and verifiable data.<sup>41</sup> Prof. Gollop's analysis contains a number of data series that are neither publicly-available nor verifiable, notwithstanding assertions to the contrary.<sup>42</sup> In addition, Prof. Gollop's analysis fails to acknowledge that the relatively low X-factor for 1996 (and the impact the 1996 X-Factor has on all averages including the 1996 and 1997 data) is largely the result of a dramatic increase in LEC earnings between 1995 and 1996, and the manner in which the Commission's model develops the cost of the capital input, rather than a true decrease in LEC productivity.

1. Adjustment to Labor Compensation Value.

Prof. Gollop "adjusted" the 1996 reported and publicly available labor compensation value. According to Gollop/USTA, the reported labor compensation reflects some sort of change in reporting requirements by the FCC, but no documentation is supplied to support his contention. Moreover, this change cannot be verified nor confirmed by staff in the Commission's Industry Analysis Division. By contrast, Ad Hoc's updated model reflects the use of publicly available data.

2. Updated data for local calls and number of special access lines.

For these data series, where 1997 data was not available, Prof. Gollop's analysis relies on data supposedly revised by the RBOCs and provided to Prof. Gollop by USTA. These data are not publicly available to other parties and therefore cannot be verified.

---

<sup>41</sup> FFNPRM, para. 16.

<sup>42</sup> See GTE Comments at. 40. GTE seems to have no detailed knowledge of the USTA analysis, despite its reliance on USTA's study.

Ad Hoc's updated model applies estimation techniques consistent with the Commission's model and based strictly on publicly available data.

3. The 1996 X-factor revenue/cost of capital anomaly.

The relatively low X-factor for 1996 reported in the USTA/Gollop analysis, and which Prof. Gollop interprets as indication of a downward trend in productivity, is in fact, largely the result of a dramatic increase in LEC earnings between 1995 and 1996, and the methodology used in the Commission's model to develop the capital input. Specifically, between 1995 and 1996, the LECs experienced a 5% increase in earnings that caused a sharp increase (of about 9%) in the "Capital Rental Price Index." This phenomenon occurs because the Capital Rental Price Index is calculated on the basis of residual revenues, i.e., set equal to revenues minus labor and materials expenses. This increase in the Capital Rental Price Index in turn contributed significantly to the markedly lower 2.1% X-factor for 1996 reported by USTA/Gollop, although for reasons totally unrelated to any real reduction in LEC productivity.

In an attempt to quantify the impact of this defect, Ad Hoc performed a sensitivity analysis in which LEC revenues were adjusted downward to reflect the rate of growth experienced by the LECs from 1985 to 1995 (approximately 2 percent a year). As result of this reduction in revenues, and the concomitant reduction in the cost of the capital input, the X-factor for 1996 was shown to increase by approximately 1.3%. Thus, USTA's reported 2.1% X-factor increases to closer to 4%. This result, however, still understates the impact on the X-factor caused by excessive LEC earnings in 1996, because it does not reduce LEC earnings to levels that would achieve the authorized 11.25% rate of return or the even lower return that could be justified based upon current

economic conditions.

In principle, the Commission's model treatment of the cost of capital as an input is correct, since the cost that a firm incurs to finance its capital asset base constitutes part of its overall input mix. However, the specific capital cost measure that the model applies may produce spurious and anomalous results under the conditions in which the LECs operate, and this is exactly what appears to have occurred in the updating of the Commission's model to include 1996 and 1997 data.

Ordinarily, the cost of capital confronted by any firm is exogenously determined by the combined effects of general capital market conditions and the risk that investors ascribe to the firm's business. In competitive markets, it is convenient to measure the input cost of capital as the firm's overall return on investment (ROI), since the ROI will come to reflect the exogenous capital market rate and risk conditions. However, this method does not produce valid assessments of exogenous capital costs where the firm possesses substantial market power, confronts little if any effective competition, and is permitted to earn sustained supra-competitive profits. These latter conditions are precisely those in which the incumbent price cap LECs operate.

By utilizing the *realized* ROI as an estimate of the exogenous cost of capital, the Commission's model produces anomalous results. In particular, as it is presently structured, the more excessive the ILECs' earnings become, the *lower* the resulting TFP. This effect results because as earnings rise to supra-competitive levels, the cost of capital component of the TFP calculation is also increased, thereby raising input costs and reducing productivity growth relative to the given level of output. If this

process is permitted to continue unabated, the ILECs would use the FCC model to justify a *decrease* in the X-factor, thereby permitting their profits to become even more excessive which, in turn, would be plugged into the same model in a subsequent period, thereby resulting in an even lower X-factor. If left uncorrected, profits would soar, the X-factor would continue to shrink, and prices and profits would continue to rise. Surely, the Commission did not intend to put ratepayers in this economic death spiral. Rather than converge upon a correct estimate of TFP growth over time, the model's use of realized earnings as the capital input causes it to degenerate into a process that persistently and increasingly understates TFP.

It is critical that the Commission recognize and correct for this fundamental defect in the TFP model, by substantially increasing rather than decreasing the X-factor in response to excessive LEC revenue growth, and by insuring that sustained excessive ILEC earnings are not rewarded by an even lower X-factor applicable to future time periods.

**III. AD HOC'S ANALYSIS, BASED ON PUBLICLY-AVAILABLE DATA AND A MORE ACCURATE MEASURE OF LOCAL OUTPUT IN RECENT YEARS, SUPPORTS X-FACTORS SIGNIFICANTLY HIGHER THAN THOSE PRESENTED IN THE USTA/GOLLOP ANALYSIS.**

In the initial comment round, Ad Hoc presented estimates of interstate-only X-factors that were consistently in the range of 9 to 10 percent. Ad Hoc indicated that complexities arising from new government index formulations, availability of reporting, and apparent errors in reported data, prevented Ad Hoc from updating the Commission's analysis to incorporate data from 1996 and 1997, but that Ad Hoc's

preliminary analysis suggested that inclusion of data for 1996 and 1997 would not alter Ad Hoc's basic conclusions an interstate X-Factor of at least 9 percent.

Ad Hoc has now completed the update analysis, and as anticipated, that analysis confirms Ad Hoc's finding of an interstate-only productivity factor in the range of 9 percent. As displayed in Table 1 above, interstate-only X-factors for the series of X-factor averages comparable to those upon which the Commission based its selection of the X-factor in the Access Charge Reform Order,<sup>43</sup> fall in the range of 8.6 percent to 10 percent, with no perceptible downward trend. Similarly, on a total company basis, the series of X-factor averages fall in the range of 5.5 percent to 6.5 percent. Perhaps more interesting are Ad Hoc's findings regarding the total company X-factor. Ad Hoc estimates 1996 and 1997 total company X-factors that are significantly higher than those calculated by USTA/Gollop. In particular, Ad Hoc estimates 1996 and 1997 total company X-factors of 5.3% and 9.65%, respectively (see Table 2). The series of total company X-factor averages computed for the period 1986 to 1997 fall in the range of 5.5 percent to 6.5 percent. Significantly, the highest X-factor average of 6.5 percent is observed for the most current time period, 1993-1997, completely dispelling USTA claimed downward trend.

Ad Hoc's total company results reflect a correction to the FCC model to use local dial equipment minutes (DEMs) to measure local output. This correction is based upon the finding that the number of local calls, as used in the FCC model, clearly understates growth in output. Substitution of local minutes for local call counts in the FCC model has a significant impact upon the calculated X-factor (see Table 2).

---

<sup>43</sup> *Access Charge Reform Order* at 137.

TFP growth is determined by examining the year-over-year changes in physical inputs and comparing these with the corresponding year-over-year changes in physical outputs. The extent to which output growth exceeds input growth represents the year-over-year growth in overall TFP. The validity of the TFP growth estimate is thus critically dependent upon the accuracy with which input growth and output growth are measured.

For purposes of calculating total company TFP, the FCC model considers three output components: Local calls, intrastate toll and access DEMs, and interstate access minutes. No specific explanation is offered for the use of calls vs. minutes as the measure of local output volume. Ordinarily, the use of local calls vs. minutes might not pose any problem since the purpose of making these output measures is to identify year-over-year relative changes in output volume. If, for example, the average duration of local calls were constant over time, the use of local calls would be equivalent (on a relative basis) to the use of local minutes.

As it happens, however, average local call duration has been steadily increasing in recent years. Because of this systematic and sustained increase in local call duration, the use of a local call volume statistic decidedly understates year-over-year changes in local call output. From 1995 to 1996, and 1996 to 1997, growth in local usage output as measured by minutes was about 8% and 11% respectively, versus a 3% and 4% growth in local usage output as measured by call counts during the same periods.<sup>44</sup>

---

<sup>44</sup> See, ARMIS 4304 and FCC Statistics of Communications Common Carriers, Table 2.10.

There is no obvious reason why local output should be measured in terms of calls whereas intrastate and interstate toll and access output should be measured in terms of minutes.<sup>45</sup> There is thus no possible basis for intermixing calls and minutes for local and toll, respectively, in measuring total company output, particularly when it is apparent, as we have shown here, the continued use of call counts distinctly understates the growth in total company output.

---

<sup>45</sup> One possible explanation is that, historically, limitations on local usage measurement equipment may have limited the availability of accurate local DEMs data. That condition is, of course, no longer present. Virtually every central office switch currently in operation in the U.S. is either analog electronic or digital in nature, and all of these switches are fully capable of providing accurate local minutes-of-use data.

Table 2

Comparison of AdHoc and USTA Updated Models

(Total Company X-factors)

Year	AdHoc (Local DEMs)	AdHoc (Local Calls)	USTA
1986	-1.21%	-1.16%	1.13%
1987	5.94%	6.30%	6.36%
1988	9.10%	6.49%	6.42%
1989	6.22%	6.54%	6.52%
1990	9.12%	8.91%	8.99%
1991	4.41%	6.05%	6.06%
1992	2.90%	3.13%	3.08%
1993	4.57%	3.51%	3.51%
1994	5.83%	5.50%	5.47%
1995	6.96%	6.67%	6.70%
1996	5.33%	2.53%	2.11%
1997	9.65%	5.17%	4.14%
Average			
AVG (86,97)	5.54%	4.97%	5.04%
AVG (87,96)	6.17%	5.53%	5.40%
AVG (88,97)	6.21%	5.45%	5.30%
AVG (89,96)	5.89%	5.33%	5.18%
AVG (90,97)	5.92%	5.18%	5.01%
AVG (91,97)	5.66%	4.65%	4.44%
AVG (92,97)	5.87%	4.42%	4.17%
AVG (93,97)	6.47%	4.67%	4.39%

IV. CLAIMS BY USTA AND THE INCUMBENT LECs THAT INTERSTATE-ONLY PRODUCTIVITY IS NOT "ECONOMICALLY MEANINGFUL" IS BELIED BY STATE COMMISSION DECISIONS TO BASE INTRASTATE RATES ON INTRASTATE-ONLY PRODUCTIVITY AND CONDITIONS.

Once again, USTA and the price cap LECs argue there is no "economically valid" way to calculate a separate interstate productivity.<sup>46</sup> USTA's arguments are strongly belied by Ad Hoc and AT&T's calculations using the Commission's own model which demonstrate a persistent and significant difference between interstate and total company TFP. In support of its continued resistance to an interstate-only X-factor, USTA cites to the Commission's previous finding that, "no party 'provide[d] a factual or theoretical explanation' to support claims of differences between interstate and intrastate productivity growth."<sup>47</sup>

This finding has become increasingly untenable in light of a growing body of evidence from state commissions that they are in fact basing intrastate rates on intrastate-only productivity conditions based upon perceived differences between interstate and intrastate productivity. An extensive compilation of state findings (and also arguments presented by the ILECs themselves in state proceedings) is presented in Ad Hoc's initial comments.<sup>48</sup> This compilation presents new, and in Ad Hoc's view, irrefutable evidence of a distinction, in both theory and in practice, between intrastate and interstate productivity. In light of this compelling evidence, it would be unreasonable and unlawful for the Commission to continue to maintain that there is

---

<sup>46</sup> USTA Comments at 24-26; Bell Atlantic Comments at 14-15; GTE Comments at 33-37.

<sup>47</sup> USTA Comments at 24, citing Price Cap Order at para. 110.

<sup>48</sup> Ad Hoc Comments at 15-20.

insufficient evidence of a systematic difference between interstate and intrastate productivity.

USTA and the LECs continue in their attempt to confuse measurement issues associated with the calculation of an interstate-only productivity with the theoretical validity of an interstate-only X-factor. As evident from the preceding discussion of the data-related problems associated with the USTA/Gollop model, even the measurement of total company productivity involves a significant degree of estimation and assumptions. The problems associated with the measurement of an interstate-only productivity have been blown way out of proportion by USTA and the LECs, and understandably so, given the financial implications for the price caps LECs of using the much higher interstate-only productivity measures.

USTA and the LECs argue, as before, that Ad Hoc and AT&T's method of using growth in total company inputs as a proxy for interstate input growth is unsupported.<sup>49</sup> As detailed in Ad Hoc's initial comments, it is both reasonable and highly conservative to use this proxy approach.<sup>50</sup> USTA and other LECs once again use the red and blue paper clip analogy.<sup>51</sup> The paper clip analogy, as articulated by USTA and the LECs, is, however, simply not relevant to the provision of interstate and intrastate telecommunications services.

In their paper clip example, USTA and the LECs *assume* that the only difference is in the coloring of the clips. They assume away any potential differences relating to the production of the clips. In the case of interstate and intrastate services, there are a

---

<sup>49</sup> USTA Comments at 24.

<sup>50</sup> Ad Hoc Comments at 21.

number of fundamental differences that cannot be assumed away. These include differences in the rate of demand growth, differences in the input mix for individual services, differences in the mix of services and differences in the jurisdictional cost assignment process.<sup>52</sup>

Furthermore, even in the case of the rather silly paper clip example, it would be entirely reasonable for one to have assumed instead, for example, that the demand growth for red clips increased substantially as a result of a major shift in consumer preferences such that the manufacturer was able to switch to a more efficient, high-volume production process for that color clip, or that a new dye process applicable to only to the color red was invented that used substantially less dye to produce the same number of clips. In either of these two scenarios, the productivity growth of one color paper clip would be different from the productivity growth of the other, and the paper clip analogy works against the USTA position there is no valid interstate-only productivity. What is "ridiculous," to use USTA's word, is not the conclusion that the productivity of one color paper clip is different from the other, but rather that -- despite compelling evidence of differences in demand and supply characteristics and the recognition by state commissions nationwide of these differences -- USTA persists in its claim there is no difference between interstate and intrastate productivity growth.

As noted by both Ad Hoc and AT&T, a number of ILECs themselves have, on previous occasions, openly acknowledged what would appear to be an axiomatic truth, namely that the higher demand growth for interstate services will have a direct and

---

<sup>51</sup> USTA Comments at 24-25; Bell Atlantic Comments at 15.

<sup>52</sup> Ad Hoc Comments at 12-14.

positive impact on interstate output, and hence interstate productivity.<sup>53</sup> Unfortunately, these LECs (two of which have subsequently merged with other LECs) now appear to have reversed their positions without credible explanation.

To suggest as USTA does, citing its experts from NERA, that it is impossible to distinguish between productivity growth rates of intrastate and interstate services “irrespective of the output growth rates of the two services,”<sup>54</sup> defies the underlying definition of total factor productivity, which is change in outputs relative to change in inputs. Interestingly, the NERA argument is directly refuted by statements from USTA’s principal productivity expert, Dr. Laurits Christensen, cited in the AT&T Comments.<sup>55</sup> Not surprisingly, this statement by Dr. Christensen was made in testimony presented before a state public utilities commission where adoption of an intrastate-only productivity would result in a lower X-factor vis-à-vis total company productivity.

USTA further argues that AT&T’s own data suggests that separation of interstate inputs in an economically meaningful way would produce a lower level of productivity growth due to the use of more highly capitalized inputs.<sup>56</sup> This argument does not hold up at many levels. First, productivity growth is the result of changes in both output and input, while USTA’s argument focuses on only the latter. Even if interstate inputs were more highly capitalized, the higher degree of technological advances inherent in these

---

<sup>53</sup> Ad Hoc Comments at 13, *citing* CC Docket 94-1 Initial Round Comments of NYNEX at 13, Ameritech at 7; AT&T Comments at 18 (*citing* to concessions by NYNEX, Ameritech, BellSouth, and Pacific.)

<sup>54</sup> USTA Comments at 25-26.

<sup>55</sup> AT&T Comments at 19 (*citing* Dr. Christensen’s testimony in California PUC, Case No. 95-05-047, concerning the “direct relationship between demand (output) growth of the LECs and their total factor productivity growth, and consequently a change in the demand (output) growth for a LEC results in a proportional change in that LEC’s TFP growth.”)

input processes combined with the higher output growth associated with interstate services permit the ILECs to experience a higher level of productivity. Second, even if interstate services use “more highly capitalized” inputs, that does not mean interstate services use more capital input vis-à-vis intrastate services. Finally, to argue, as does GTE,<sup>57</sup> that any attempt to apply the Commission’s separations rules to the calculation of interstate productivity would be “capricious” is nothing short of remarkable, given the long-standing history of regulatory and legal reliance on the jurisdictional allocation of costs between intrastate and interstate.

Given the high rates of return being experienced by price cap LECs, combined with the slow inroads being made by competition in access markets nationwide, now is an opportune time for the Commission to embrace the concept of an interstate-only productivity measure for interstate services and the concomitant decreases in access charge rates nationwide that will occur as a result. As discussed in Ad Hoc’s comments, a significant increase in the X-factor is the most logical and feasible means of moving access rates toward their forward-looking economic costs and achieving the important goals of access charge reform as envisioned under the Telecommunications Act.

- V. EVEN IF THE COMMISSION ACCEPTS THE USTA/GOLLOP ANALYSIS, WHICH AD HOC MAINTAINS THE COMMISSION SHOULD NOT, THAT ANALYSIS ALSO PRODUCES INTERSTATE-ONLY X-FACTORS IN THE RANGE OF 9%.

---

<sup>56</sup> USTA Comments at 25.

<sup>57</sup> GTE Comments at 36.

While Ad Hoc does not endorse Commission reliance on the USTA/Gollop analysis for the reasons set forth above, the USTA/Gollop analysis can nonetheless be adapted to provide interstate-only estimates of productivity for the price cap LECs. Ad Hoc performed such a calculation using the methodology detailed in Ad Hoc's initial comments applied to the USTA/Gollop model,<sup>58</sup> the results of which are presented in Table 3 below. As shown in Table 3, the average interstate X-factors resulting from USTA/Gollop's updated model are in the range of 8.2% to 9.8%, substantially in excess of the total company figures USTA/Gollop derives from the model. These results provide further corroborating evidence of the robustness of Ad Hoc's interstate productivity calculations.

---

<sup>58</sup> Ad Hoc Comments at 20-21.

**Table 3**  
**USTA/Gollop Updated Model**  
**(Total Company and Interstate X-factors)**

<b>Year</b>	<b>Total Company</b>	<b>Interstate</b>
1986	1.13%	0.56%
1987	6.36%	9.92%
1988	6.42%	14.63%
1989	6.52%	7.34%
1990	8.99%	14.50%
1991	6.06%	11.64%
1992	3.08%	5.30%
1993	3.51%	10.01%
1994	5.47%	9.09%
1995	6.70%	10.59%
1996	2.11%	6.58%
1997	4.14%	7.81%
<u><i>Average</i></u>		
AVG (86,97)	5.04%	9.00%
AVG (87,96)	5.40%	9.77%
AVG (88,97)	5.30%	9.75%
AVG (89,96)	5.18%	9.21%
AVG (90,97)	5.01%	9.44%
AVG (91,97)	4.44%	8.72%
AVG (92,97)	4.17%	8.23%
AVG (93,97)	4.38 %	8.82%

VI. UNLESS AND UNTIL THE COMMISSION ADOPTS AN INTERSTATE-ONLY PRODUCTIVITY MEASURE, THE CPD, WHILE EXTREMELY SMALL, IS A VERY IMPORTANT COMPONENT OF THE PRODUCTIVITY OFFSET.

USTA and the LECS argue that the CPD has outlived its usefulness and should be eliminated.<sup>59</sup> According to USTA, the CPD “now serves to force added reductions which are beyond the Commission’s own excessive projections for achievable LEC productivity.”<sup>60</sup> While Ad Hoc agrees with the first part of USTA’s statement that the CPD “forces added reductions” to LEC interstate access service rates, Ad Hoc strongly disagrees with the claim that these reductions are “beyond achievable LEC productivity.” As demonstrated in these reply comments, achievable LEC productivity is conservatively in the vicinity of 9 percent, when viewed in its proper interstate context. Even from a total company perspective (which Ad Hoc firmly believes is wholly inappropriate in an interstate price cap plan), when local growth is more accurately reflected, evidence indicates a new upswing in LEC productivity (with data showing an X-factor over the period 1993-1997 averaging over 6.5 percent). Thus, the added reductions forced by the CPD, albeit small, remain an essential component of the Commission’s price cap plan, unless and until the Commission raises the X-factor to a level more reflective of achievable interstate productivity, *i.e.*, 9 to 10 percent.

VII. PRICING FLEXIBILITY

The Committee’s members, all large users of telecommunications services, would be among the first to benefit from pricing flexibility in the local exchange and

---

<sup>59</sup> USTA Comments at 29.

exchange access markets. The Committee believes, however, that the short term benefits associated with premature pricing flexibility do not justify the threat to long-term, sustainable and effective competition.

The RBOCs' comments supporting pricing flexibility assert that the level of competition that exists today is sufficient to warrant significant, deregulatory actions, including allowing geographic deaveraging, volume and term discounts, promotional pricing, and contract pricing.<sup>61</sup> Bell Atlantic states that "at a minimum, the Commission should act to remove from price regulation those services already facing significant competition."<sup>62</sup> U S West characterizes the Phase 1 pricing flexibility as the removal of asymmetric regulation.<sup>63</sup>

The Committee disagrees. As reflected in section I above, the Committee believes that local and access service market is not nearly as competitive as the ILECs assert, and thus must oppose the ILECs call for sweeping pricing flexibility to respond to that competition. The Committee supports MCI Worldcom's ("MCIW") position that the presence of substantial competition, as measured by traditional indicators of market power (*e.g.* demand elasticity, supply elasticity, market share, and relative cost structures), should determine whether the ILECs obtain pricing flexibility.<sup>64</sup>

GTE supports pricing flexibility even in the absence of a greater degree of competition because "cost-based pricing is good for customers, even in non-competitive

---

<sup>60</sup> *Id.*

<sup>61</sup> See, *e.g.*, USTA Comments at 28-38.

<sup>62</sup> Bell Atlantic Comments at 17.

<sup>63</sup> U S West Comments at 14. To support its own petition for regulatory forbearance, however, U S West attempts to show that it has satisfied the market-power analysis used in the AT&T non-dominance proceeding. See U S West Comments at 16.

<sup>64</sup> MCIW Comments at 50-57.

environments.”<sup>65</sup> It is not at all apparent, however, how the pricing flexibility proposals are intended to benefit customers in non-competitive situations. The ILECs have not sought cost-based pricing in non-competitive areas. Rather, they have sought a lower X-Factor, which will lower the Price Cap Indexes, which implies higher rates for their access service customers. Bell Atlantic’s consultant asserts that “with price caps and incremental cost-floors, price flexibility is not a threat to competition.”<sup>66</sup> Nothing on the record, however, demonstrates market forces strong enough to limit ILEC access service rates to proper cost-based levels. Moreover, MCIW’s analysis that, despite the availability of zone density pricing flexibility, the RBOCs have continued to price at the maximum allowed by the price cap index,<sup>67</sup> suggests that the RBOCs do not need additional broad pricing flexibility given that they are not using the pricing flexibility that they already have.

In contrast to MCIW, however, the Committee believes the emerging competition in certain LEC product and geographic markets warrants Commission exploration of how best to balance the public benefits that would come from allowing ILECs to compete fairly for business with the public’s interest in ensuring such ILEC competition does not produce unreasonable discrimination or retard the development of effective competition in the local exchange and exchange access service market. Accordingly, the Committee has suggested the availability of contract-based pricing prior to the emergence of substantial competition. The Committee’s position on contract-based prices is set forth in its reply comments regarding the U S West Forbearance

---

<sup>65</sup> GTE Comments at 22.

<sup>66</sup> Bell Atlantic Comments at Exhibit 1, *Declaration of Robert W. Crandall*, page 12.

<sup>67</sup> MCIW Comments at 38-43.

proceeding.<sup>68</sup> The Committee has suggested allowing ILECs to compete for contested customers where the ILEC can justify a single-customer competitive response offering using the competitive necessity doctrine and where the ILEC tariffs the offering as a contract tariff and makes it generally available to any similarly situated customer.<sup>69</sup>

The Commission has established a three-part test for determining whether individualized-pricing on generally available interstate special access services are lawful. First, equally or lower priced competitive alternatives must be generally available to customers of the discounted offering. Unlike the more broad-scale pricing flexibility proposals submitted in this proceeding, the availability of contract-based pricing need not be based on whether the market for a particular service or in a geographic area is, as a whole, sufficiently competitive to ensure efficient pricing. Instead, ILECs should be permitted to offer competitive prices where they face actual competition for a particular customer. To assuage Commission concerns about the availability of actual competitors, customers could be required to certify that they have received a bona fide offer for comparable service from a competitor.

Second, the discounted offering responds to competition without undue discrimination. The Commission has already concluded that contract-based prices are not *per se* unlawful where such offerings are both: (1) made generally available to all other similarly situated customers willing and able to meet those terms; and (2) memorialized in contract-based tariffs filed with the Commission prior to their effective

---

<sup>68</sup> *Petition of U S West Communications, Inc., for Forbearance from Regulation as a Dominant Carrier in the Phoenix MSA*, CC Docket No. 98-157, Reply Comments of the Ad Hoc Telecommunications Users Committee (filed Oct. 28, 1998).

<sup>69</sup> *Id.* at 6.

date.<sup>70</sup> If a dominant ILEC's single-customer offering meets both requirements established for AT&T's contract-based offerings, then the offering should be deemed to satisfy the competitive necessity doctrine's prohibition against undue discrimination.

Third, the discount must contribute to reasonable rates and efficient services for all users. The Committee believes that once a certain number of RFP contract tariffs in an area have been approved, a sufficient level of competition has been established such that Commission pre-approval of subsequent RFP contract price offers is no longer necessary. Under the circumstances described above, the use of contract-based pricing would benefit not only the individual customers who may obtain competitive prices from the ILECs, but also would promote effective competition which is beneficial to all users.

The Committee urges the Commission to initiate a rulemaking proceeding to consider the competitive necessity doctrine and a contract tariff approach as the means for assessing and granting dominant ILEC requests for pricing flexibility. In such a rulemaking, the Commission could seek comment on possible changes to the competitive necessity doctrine and safeguards to prevent adverse impacts on competition. For example, the Commission should modify the requirement that dominant carriers, such as ILECs can meet, but not beat, competitor's bids. This anomalous requirement is inconsistent with the way in which markets actually work. In addition, as described in the Comments to the U S West Forbearance proceeding, the

---

<sup>70</sup> *Competition in the Interstate, Interexchange Marketplace*, Report and Order, CC Docket No. 90-132, 6 FCC Rcd 5880, 5903 (1991).

Commission must determine how to treat competitive-response services under price caps.<sup>71</sup> Other changes may be in order as well.

---

<sup>71</sup> See Ad Hoc Reply Comments to U S West Forbearance Proceeding at 17-20 (suggesting that the Commission either exclude competitive-response services from price caps altogether or create an additional basket in to which services in this category could be moved.)

## CONCLUSION

In view of the foregoing, the Ad Hoc Telecommunications Users Committee urges the Commission to reform access charges, increase the X-Factor, and address pricing flexibility as recommended herein.

Respectfully submitted,

AD HOC TELECOMMUNICATIONS  
USERS COMMITTEE

By: 

Economic Consultants:  
Dr. Lee L. Selwyn  
Patricia M. Kravtin  
Scott C. Lundquist  
Sonia N. Jorge  
Economics and Technology, Inc.  
One Washington Mall  
Boston, MA 02108-2617  
617-227-0900

James S. Blaszak  
Valerie Yates  
Levine, Blaszak, Block & Boothby, LLP  
2001 L St. NW  
Suite 900  
Washington, DC 20036  
202-857-2550

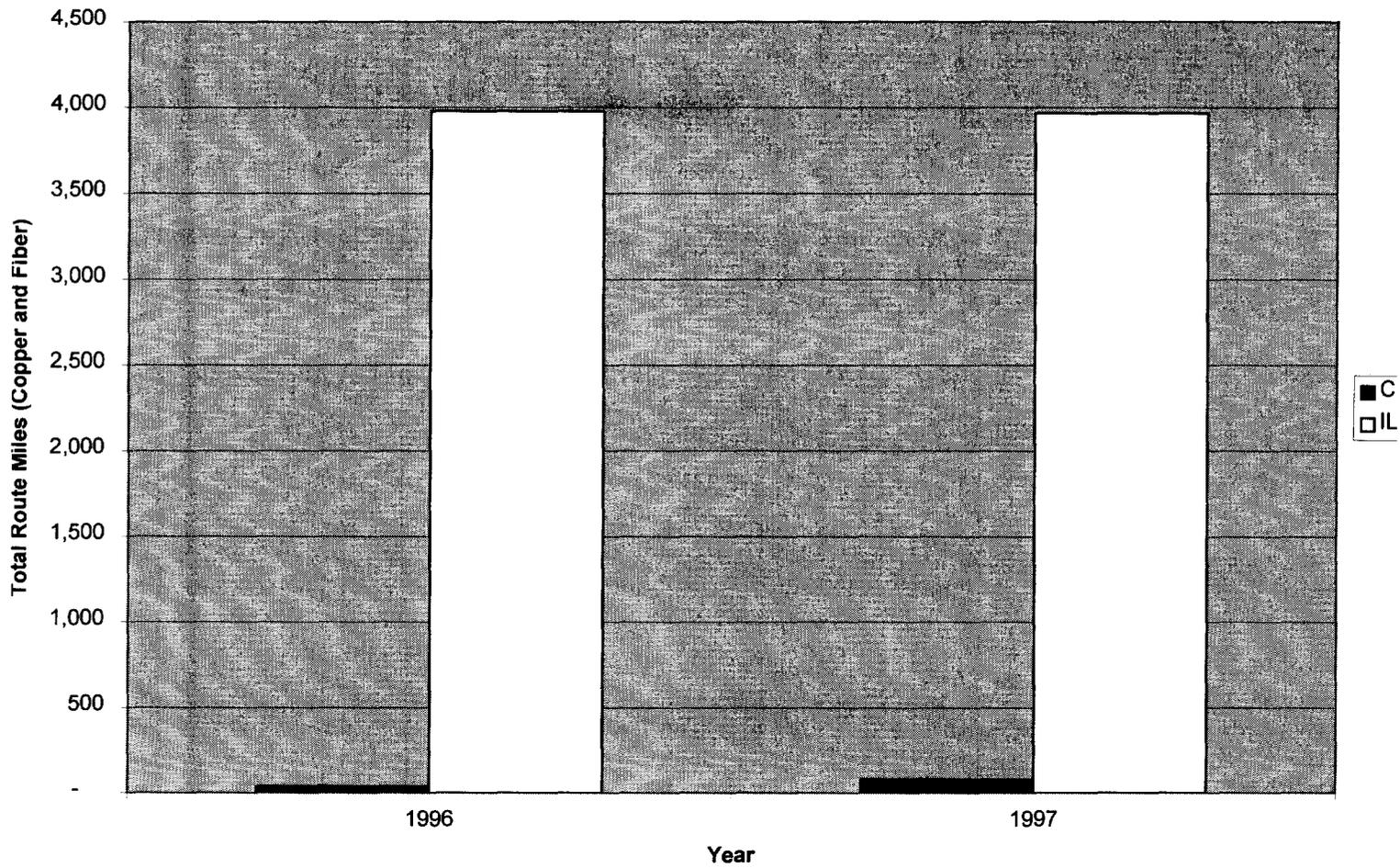
November 9, 1998

S:\CLIENT\ADHOC200\03ACSRVC\PriceFlexPN\REPLY COM Price Flex.doc

## Appendix 1

The Scope of the ILEC Networks Remains Vastly Larger than the CLECs'

### The Scope of the ILEC Networks Remains Vastly Larger than the CLECs'



Sources: *Statistics of Common Carriers, 1996, Table 2.10. Statistics of Common Carriers, Preliminary 1997, Table 2.10. USTA Comments, Attachment A (NERA Study) at 17, citing New Paradigm Resources Group, Inc.*

Appendix 2

Summary of FCC's Second Local Competition Survey

(Released October 28, 1998)

**Local Competition via Resale and UNEs for Major ILECs, June 1998**

	<u>Ameritech</u>	<u>Bell Atlantic</u>	<u>Bell South</u>	<u>SBC</u>	<u>US West</u>	<u>GTE</u>	<u>Sprint</u>	<u>Totals</u>
I. Lines in service as of June 30, 1998 that connect directly to an end-user premises. Do not include, for example, lines provided to carriers that are used for interoffice trunking.								
A. Switched service provided to end users and billed by you or your agent.	20,954,028	39,908,318	22,949,897	33,365,216	15,942,654	16,327,240	7,352,889	156,800,242
B. Lines you own or lease from a non-communications carrier that you provide to another communications carrier, categorized by:								
3. Total Service Resale, as defined in 47 U.S.C. §251.	466,508	431,681	376,464	644,845	296,325	82,540	27,593	2,325,956
<b>Percentage of lines sold to CLECs for resale</b>	2.2%	1.1%	1.6%	1.9%	1.8%	0.5%	0.4%	1.5%
4. UNE, as defined in 47 U.S.C. §251.	68,961	60,527	20,215	59,671	3,197	8,930	-	221,501
<b>Percentage of lines sold as UNE loops</b>	0.32%	0.15%	0.09%	0.18%	0.02%	0.05%	0.00%	0.14%
<b>Total Lines (Retail + Resale + UNEs)</b>	21,489,497	40,400,526	23,346,576	34,069,732	16,242,176	16,418,710	7,380,482	159,347,699

Notes: This table summarizes the responses to the FCC's Second CCB Survey on the State of Local Competition, October 28, 1998. Survey responses are available for download from [www.fcc.gov/ccb/local\\_competition/survey/responses](http://www.fcc.gov/ccb/local_competition/survey/responses). GTE provided no data for its service territories in: AR, AL, AZ, IA, ID, MN, MO, NE, NM, NV, OK, and SC.

## Certificate of Service

I, Andrew Baer, hereby certify that true and correct copies of the preceding Reply Comments of the Ad Hoc Telecommunications Users Committee in CC Docket Numbers 96-262, 94-1, 97-250 and Rulemaking 9210 were served this 9<sup>th</sup> day of November, 1998 via hand delivery to the following parties.

Jane Jackson  
Chief  
Competitive Pricing Division  
Common Carrier Bureau  
Federal Communications Commission  
1919 M Street, N.W.  
Room 518  
Washington, D.C. 20554

ITS  
Federal Communications Commission  
1919 M Street, N.W.  
Second Floor  
Washington, D.C., 20554



---

Andrew Baer

November 9, 1998