MCI Communications Corporation

1801 Pennsylvania Avenue, NW
Washington, DC 20006

RECEIVED

DEC 2 - 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

EX PARTE

EX PARTE OR LATE FILED

December 2, 1998

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

Re: Ex Parte Submission
Access Charge Reform; CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers; CC Docket No. 94-1
MCI WorldCom Telecommunications Corporation Emergency Petition for Prescription of Access Charges; CC Docket No. 97-250
Consumer Federation of America Petition for Rulemaking; RM 9210

Dear Ms. Salas:

In its Reply Comments in the above-captioned matter, the United States Telephone Association (USTA) urges the Commission to continue to reject the use of interstate total factor productivity (TFP) to set the X factor in its price cap plan for incumbent local exchange carriers (ILECs).[1] USTA argues that, because state, local, and interstate ILEC services are provided over joint and common plant, no economically meaningful computation of interstate productivity is possible. This purist approach to productivity measurement, while perhaps appropriate in a world without dual jurisdictional control over rates, leads to an absurd conclusion in the real world - an X factor that is, according to USTA, too high results in ILEC interstate earnings that continue to rise.

MCI WorldCom's position continues to be that access charges should be reduced to forward-looking economic cost. However, as long as the Commission continues to retain productivity adjustments to price caps that were initiated based on accounting costs, the separations treatment of these costs must drive Commission policy on future price cap adjustments. Costs are assigned to the interstate jurisdiction by the Commission's Separation rules, and the Commission's price cap rules should not inadvertently allow the

---

1 USTA Reply at 12, and Attachment A at 1-5.

No. of Copies rec'd _____
List A B C D E

ILECs to recover more than the interstate jurisdiction's share of ILEC costs. However, the Commission's current plan, by basing its X factor on total company TFP and not adjusting for the higher growth in interstate outputs, fails to protect interstate ratepayers from paying more than the share of ILEC costs that the Commission's rules assign to them. A simple numerical example, given below, illustrates this fact.

	Interstate	State	Total Company
Initial Cost	25.000	75.000	100.000
Initial Revenue (= Initial Cost)	25.000	75.000	100.000
Output Growth	8.8%	3.2%	
Total Company TFP	6.5%	6.5%	6.5%
GDP-PI	2.8%	2.8%	
Allowed Revenue	25.862	74.536	100.399
Allocated Cost (@ 25/75 split)	25.100	75.299	100.399
Percent Over-recovery	3.0%		

In the table above, the ILEC at the start of a price cap regime has total costs of 100, divided 25/75 between interstate and state services. Since its initial rates for price cap purposes are set equal to its costs, its interstate and state revenues are also equal to 25 and 75, respectively. The price cap plan limits changes in revenues to equal changes in cost. This example assumes that the Commission's price cap plan exactly captures the total company cost changes, such that the change in revenue allowed by price caps equals the change in costs. Since starting point revenues were set equal to costs, this implies that the revenues allowed by price caps is always equal to cost. Thus, Interstate revenues are allowed to rise to 25.862, which is 25 (the starting point revenues) times the weighted average of the Common Line formula [1 + (2.8% inflation - 6.5% X factor - 5% growth in minutes per line/2) / (1 + 5% / 2)], and the other baskets' Price Cap Index formulas, (1 + 2.8% inflation - 6.5% X factor), times (1 + 8.8% demand growth). State revenues grow based on the non-Common Line price cap formula, except that demand growth is 3.2%.[2] The sum of State and Interstate permitted revenues, and thus of costs, computed in this manner is 100.399.

The Commission's price cap plan allow interstate revenues to rise to 25.862, while total company costs rise to 100.399. However, since 25 percent of the ILEC's costs are assigned to the interstate jurisdiction, its interstate costs rise only to 25.100, not 25.862.[3] Thus, the Commission's price cap overstates interstate costs by 3 percent.

---

2 Demand growth rates used in these formulas are the averages for 1986 through 1995, as reported in Gollop's study attached to USTA's comments.

3 Because the Separations rules assign 25 percent of loop costs to the interstate jurisdiction, the actual percentage of costs assigned to the Interstate jurisdiction is fairly stable, regardless of the relative growth in State and Interstate services.

A price cap plan such as this one, which by assumption exactly captures the change in total company costs, allows the ILEC to recover in the interstate jurisdiction 3 percent more than its interstate costs. This result occurs even though the ILEC, as is assumed in this example, has done nothing to improve its productivity or in any way cut its costs beyond its historical trend. The Commission's price cap plan simply allows the ILEC to recover in the interstate jurisdiction costs that its own rules assign to the state jurisdiction, giving the ILEC a windfall.

USTA's claim that there is no such thing as interstate TFP, and thus that the X factor must be set based on total company productivity, has it exactly backward. In fact, because the total company TFP does not capture the changes to interstate costs that result from the Commission's Separations rules, total company TFP cannot be used, by itself, to determine the X factor. The Commission has already recognized this fact, by including the input price differential in setting the X factor. The Commission also needs to recognize in setting the X factor that interstate demand grows at a different rate than state services, and thus that a simple application of a total company TFP will have the unintended effect of allowing the ILECs to recover costs assigned to the State jurisdiction in the Interstate jurisdiction.

MCI WorldCom showed in its comments that the Commission's price cap does not adequately capture cost changes in the interstate jurisdiction, and this simple example shows why a price cap plan based on total company TFP cannot capture those cost changes. The Commission should adjust its X factor to reflect interstate cost changes. The most straight-forward manner for achieving this is to adjust the TFP computation to reflect Interstate output changes, as submitted in the Norsworthy study appended to AT&T's Reply Comments. This will result in an increase in the X factor to about 10 percent.

Respectfully submitted,

Chris Frentrup
Senior Economist
MCI WorldCom
1801 Pennsylvania Ave., NW
Washington, DC 20006
(202) 887-2731