

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of)
)
Price Cap Performance Review For Local) CC Docket No. 94-1
Exchange Carriers)
)
Access Charge Reform) CC Docket No. 96-262

REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

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January 24, 2000

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SUMMARY

U S WEST Communications, Inc. (“U S WEST”) hereby submits its Reply Comments in response to the Federal Communications Commission’s (“Commission”) Further Notice of Proposed Rulemaking (“FNPRM”) in the above-referenced proceeding. This proceeding was initiated in response to the order of the United States Court of Appeals for the District of Columbia Circuit (“Court”) reversing and remanding the Commission’s 1997 Order setting the X-factor at 6.5%.

U S WEST supports the Comments filed by The United States Telecom Association (“USTA”) and others demonstrating that the current X-factor is too high. For the period covered by the remand (i.e., July 1, 1997 to June 30, 2000), the Commission must carry out the Court’s decision by correcting the errors in its 1997 staff total factor productivity (“TFP”) study. The 1997 TFP model, as corrected and updated for 1996 and 1997 data, produces an average X-factor of only 4.5%. On a going-forward basis, the Commission should use an updated version of the 1997 TFP model (essentially the 1999 staff TFP study as corrected by USTA) to prescribe the X-factor. The average result of the updated 1997 TFP model over the historical period supports setting the X-factor at approximately 4% on a going-forward basis. In addition, the Commission should finally remove the consumer productivity dividend (“CPD”) from the X-factor.

A common theme of AT&T Corp. (“AT&T”) and other commenters arguing in favor of raising the X-factor is that the Commission should consider new data and develop new methodologies in prescribing the X-factor for the remand period. Not

surprisingly, all of the data and methodologies discussed in their comments are designed to produce a higher X-factor. U S WEST is not opposed to the Commission considering additional evidence relevant to the issues reversed and remanded by the Court, but it strenuously objects to these attempts to brush aside the Court's decision and use the remand proceeding as the forum for developing entirely new methodologies to support a higher X-factor. That is precisely the type of ends-driven approach which led the Court to reverse the Commission's choice of a 6.5% X-factor in 1997. Moreover, other than correcting the errors identified by the Court, the Commission should not make retroactive modifications to the X-factor because it would severely undermine the credibility and effectiveness of its incentive-based price cap system.

U S WEST agrees with USTA and other commenters that the Commission's alternative X-factor methodologies are fundamentally flawed and would produce an upwardly biased X-factor. The 1999 staff TFP study proposes extensive changes to the TFP model which uniformly have the effect of driving up the X-factor. Among the various errors identified in the 1999 staff TFP study is the use of dial equipment minutes ("DEM") rather than lines to measure local output and the reliance on the Moody's Baa bond rate to calculate the cost of capital. In addition, the overwhelming majority of commenters oppose adoption of the staff Imputed X study, which is essentially a rate-of-return methodology. Not only is the staff Imputed X study inconsistent with price cap regulation, but it relies on an inaccurate determination of interstate costs to calculate an interstate-only X-factor.

There is also no justification for continuing to include a CPD in the X-factor after nearly a decade of price cap regulation.

On a going-forward basis, the Commission should use an updated version of the 1997 TFP model to prescribe the X-factor. USTA demonstrates that, if the errors in the 1999 staff TFP study inputs are corrected, the results are consistent with the updated 1997 TFP model. The average result of the updated 1997 TFP model over the historical period supports setting the X-factor at approximately 4% on a going-forward basis.

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U S WEST supports the Comments filed by The United States Telecom Association (“USTA”) and others demonstrating that the current X-factor is too high. For the period covered by the remand (i.e., July 1, 1997 to June 30, 2000), the

¹ In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform, CC Docket Nos. 94-1 and 96-262, Further Notice of Proposed Rulemaking, FCC 99-345, rel. Nov. 15, 1999 (“FNPRM”).

² In the Matter of Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform, 12 FCC Rcd. 16642 (1997) (“1997 Price Cap Order”), rev. and remanded in part U.S. Telephone Ass’n v. FCC, 188 F.3d 521 (D.C. Cir. 1999) (“USTA v. FCC”). The Court agreed to stay issuance of its mandate until Apr 1, 2000 in order to give the Commission time to conduct the remand proceeding.

Commission must carry out the Court's decision by correcting the errors in its 1997 staff total factor productivity ("TFP") study. The 1997 TFP model, as corrected and updated for 1996 and 1997 data, produces an average X-factor of only 4.5%. On a going-forward basis, the Commission should use an updated version of the 1997 TFP model (essentially the 1999 staff TFP study as corrected by USTA) to prescribe the X-factor. The average result of the updated 1997 TFP model over the historical period supports setting the X-factor at approximately 4% on a going-forward basis. In addition, the Commission should finally remove the consumer productivity dividend ("CPD") from the X-factor.

I. INTRODUCTION

The focus of this proceeding must be on the Court's decision, which held that the Commission failed to provide a "rational explanation" for its choice of a 6.5% X-factor in 1997.³ On remand, the Commission's task is a straightforward one -- correct the errors in the 1997 staff TFP study and prescribe an X-factor that is legally supportable. Unfortunately, in its FNPRM the Commission largely ignored the Court's decision and instead initiated an open-ended examination of several alternative X-factor methodologies. Even more disturbing, the Commission is sending clear signals that it intends to raise the X-factor in this proceeding and reinitialize price caps as if the higher X-factor had been in effect since 1997.

Not surprisingly, a number of parties with a strong interest in lowering their interstate access rates responded to the FNPRM by filing comments advocating that

³ USTA v. FCC, 188 F.3d at 525.

the X-factor be raised. The underlying premise of these comments (which appears to be one shared by the Commission), is that a higher X-factor is needed to penalize price cap local exchange carriers (“LEC”) for their “excess” earnings levels.⁴ This argument reflects a fundamental misunderstanding of the purpose served by the X-factor and the goals of the incentive-based price cap system.

The X-factor was never intended to be a mechanism for driving down price cap LECs’ earnings. Rather, the X-factor is a mechanism for “capturing a portion of the expected increases in carrier productivity, so that these improvements, as under competition, will result in lower prices for consumers.”⁵ In particular, the X-factor is supposed to represent the “amount by which LECs can be expected to outperform economy-wide productivity gains.”⁶ By focusing entirely on LEC earnings, commenters conveniently ignore the benefit of approximately \$23 billion in access price reductions they received from 1991 through 1999.⁷

In addition, commenters fail to put LEC earnings in perspective by

⁴ See, e.g., MCI WorldCom, Inc. (“MCI”) at 3; General Services Administration (“GSA”) at 5-7.

⁵ USTA v. FCC, 188 F.3d at 524-25 (citing In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, 3 FCC Rcd. 3195, 3394 (1988) “Dominant Carrier Order”).

⁶ FNPRM ¶ 7.

⁷ See USTA at 8. If anything, the \$23 billion figure underestimates the actual benefit that customers have received from LEC price reductions. Because prices are based on the prior year’s demand and demand has been increasing steadily, the actual price reductions reflected in the price cap LECs’ annual access tariff filings are understated.

comparing them with the earnings that have been achieved by other companies.⁸ It should not be surprising that -- in a boom economy which is being fundamentally reshaped by computers and the Internet -- price cap LECs would be able to earn a healthy return without exceeding economy-wide productivity gains. In fact, Dr. William Taylor demonstrates that, as an empirical matter, the earnings of price cap LECs have not performed as well as the average industrial firm in recent years, whereas their wholesale and retail prices have dropped more than the average industrial firm.⁹

Moreover, commenters continue to ignore the fact that the Commission's system of price cap regulation is supposed to create incentives for price cap LECs to maximize their efficiencies. The whole point of price caps is to reduce LEC prices through the X-factor while allowing LECs to earn more than an 11.25% rate-of-return if they surpass the productivity gains reflected in the X-factor. However, the seemingly irresistible urge to penalize LECs for succeeding under price caps threatens to eliminate all of the positive benefits which led the Commission to adopt price cap regulation in the first place. If, as some commenters advocate, the Commission continues to eliminate any opportunity to earn more than was allowed under rate-of-return regulation by making retroactive adjustments to price caps, then LECs will stop responding to the incentives held out by the Commission. The unfortunate result would be a watered-down price cap system where LECs have

⁸ See id. (comparing LEC earnings to the earnings level of the Value Line Industrials).

⁹ See id. at 18.

little incentive to maximize efficiencies and consumers are worse off in the long run.

II. THE COMMISSION MUST CARRY OUT THE COURT'S DECISION AND CORRECT THE ERRORS IN ITS 1997 STAFF TFP STUDY

A common theme of AT&T Corp. ("AT&T") and other commenters arguing in favor of raising the X-factor is that the Commission should consider new data and develop new methodologies in prescribing the X-factor for the remand period.¹⁰ Not surprisingly, all of the data and methodologies discussed in their comments are designed to produce a higher X-factor. The comments of AT&T and other supporters of a higher X-factor are most notable for what they do not discuss -- namely, any of the issues reversed and remanded by the Court. Indeed, these commenters fail to provide any of the explanations required by the Court, and they make no attempt to defend the inputs used in the Commission's 1997 staff TFP study.

U S WEST is not opposed to the Commission considering additional evidence relevant to the issues reversed and remanded by the Court, but it strenuously objects to these attempts to brush aside the Court's decision and use the remand proceeding as the forum for developing entirely new methodologies to support a higher X-factor. That is precisely the type of ends-driven approach which led the Court to reverse the Commission's choice of a 6.5% X-factor in 1997. Rather than repeating the same mistake here, the Commission should utilize a fair and objective process in selecting inputs to its 1997 TFP model. U S WEST agrees with USTA that the Commission should correct the 1997 TFP model in accordance with the

Court's decision so that (i) each average from the historical period is given equal weight, (ii) there is no assumption of a permanent upward trend and (iii) no consideration is given to AT&T's estimates for the remand period.¹¹ The 1997 TFP model, as corrected and updated for 1996 and 1997 data, produces an average X-factor of 4.5%, which is significantly lower than the Commission's original 6.5% figure.¹²

The Commission cannot, as AT&T suggests, "develop new [X-factor] methodologies when prescribing an X-factor for the remand period."¹³ No party appealed the Commission's use of the TFP model in setting the X-factor, and the Court's decision did not disturb that portion of the 1997 Price Cap Order.¹⁴ Therefore, if the Commission chooses to completely abandon the X-factor methodology which it strenuously defended before the Court, then it must do so prospectively and in accordance with the Administrative Procedure Act.¹⁵ The Commission cannot accede to the demands of commenters who advocate changing the rules of the game to produce a higher X-factor. Instead, USTA's updated version of the 1997 TFP model addresses the concerns of the Court and should be

¹⁰ See AT&T at 19; Ad Hoc at 16-17.

¹¹ See USTA at 23.

¹² See id. at 24.

¹³ AT&T at 16.

¹⁴ AT&T acknowledges that "[t]he D.C. Circuit did not question either this general methodology or the Commission's rationale for it." Id. at 13.

¹⁵ See 5 U.S.C. § 553.

used to prescribe the X-factor for the remand period.¹⁶

Other than correcting the errors in the 1997 staff TFP study identified by the Court, the Commission should make only prospective changes to the X-factor. As U S WEST previously discussed, the Commission has been very cautious about retroactive modifications to the X-factor. There is a good reason for this caution. The mere suggestion of retroactive modifications to price caps severely undermines the credibility and effectiveness of the Commission's incentive-based price cap system. It is imperative that the Commission demonstrate its continued commitment to the price cap compact by setting clear prospective targets and allowing LECs to benefit when they exceed those targets.¹⁷ The Commission should promptly reject its reinitialization proposal before it does serious and irreparable harm to the price cap system.

III. THE COMMISSION SHOULD NOT ADOPT A FLAWED METHODOLOGY WHICH PRODUCES AN UPWARDLY BIASED X-FACTOR

U S WEST agrees with USTA and other commenters that the Commission's alternative X-factor methodologies are fundamentally flawed and would produce an upwardly biased X-factor. If the Commission were to use either of its alternative methodologies to set the X-factor, the result would be an artificially high X-factor that, once again, could not withstand judicial review. There is also no justification for continuing to include an additional CPD in the X-factor after nearly a decade of

¹⁶ See USTA at 22-26.

¹⁷ As SBC notes in its comments, the Commission's 1997 price cap plan was expressly denominated "permanent" to provide such assurance to the LECs. SBC at 10 (citing 1997 Price Cap Order, 12 FCC Rcd. at 16647-48 ¶ 7).

price cap regulation.

A. 1999 Staff TFP Study

The various errors contained in the 1999 staff TFP study have been well-documented.¹⁸ Of course, AT&T and other commenters who would benefit from a higher X-factor support the changes to the TFP model proposed in the 1999 study because these changes would uniformly have the effect of driving up the X-factor. However, these commenters fail to provide a reasonable explanation for the flawed assumptions behind many of the inputs underlying the 1999 staff TFP study.

For example, AT&T and others defend the use of dial equipment minutes (“DEM”) rather than the number of local calls to measure local output. But that is a false choice. As U S WEST and others demonstrated, the number of lines is a far superior measure of output to either local calls or DEMs because lines correspond directly to revenue growth.¹⁹

In addition, Ad Hoc Telecommunications Users Committee (“Ad Hoc”) claims that its own sensitivity analyses of various alternative price indices produced comparable results to the Moody’s Baa corporate bond rate index used by the Commission in the 1999 staff TFP study.²⁰ The problem with Ad Hoc’s approach is that the alternative price indices it analyzed (e.g., the Moody’s Aaa corporate bond rate and 10- and 30-year government securities) in its comparison do not represent

¹⁸ See USTA at 5-6; SBC at 3; Cincinnati Bell Telephone Company (“CBTC”) at 3-5; GSA at 10-11; BellSouth Corporation and BellSouth Telecommunications, Inc. (“BellSouth”) at 26-35.

¹⁹ See U S WEST at 16; USTA at 13.

²⁰ See Ad Hoc at 7-9.

a proper measure of LEC opportunity costs. As U S WEST and other commenters noted, the opportunity cost for LECs and their investors is more accurately calculated by looking at the returns enjoyed by like-sized firms, not by the return on bonds and government securities.²¹ Thus, Ad Hoc's comparison of various bonds and government securities proves nothing.

B. Staff Imputed X Study

The overwhelming majority of commenters oppose the Commission's adoption of the staff Imputed X study.²² As Sprint Corporation ("Sprint") observes, the staff Imputed X study "will not only fail to move the industry to cost-based rates, but will actually result in a giant step backwards."²³ Even AT&T urges the Commission to retain the TFP model in this proceeding, despite the fact that the imputed X approach is "very similar" to the Historical Revenue approach which AT&T proposed in 1995.²⁴ U S WEST agrees that the Commission should not adopt the staff Imputed X study, but neither should it rely on the study to support the interstate-only calculations set forth by AT&T,²⁵ or to corroborate the results of its X-factor calculations.

The Commission should reject AT&T's suggested modification of the TFP

²¹ See U S WEST at 16; USTA at 9-11.

²² See CBTC at 4-5; Missouri Public Service Commission ("Missouri PSC") at 3.

²³ Sprint at 4.

²⁴ AT&T at 12.

²⁵ See id.

model to reflect interstate rather than total company data.²⁶ By now, the notion that the Commission can accurately calculate an interstate-only X-factor has been disproved many times, including numerous times by the Commission itself. As the Commission itself argued before the Court, there simply is no meaningful way to measure interstate inputs when both interstate and intrastate services are provided over the same network.²⁷ Neither AT&T nor any other commenter has identified a legitimate method of assigning portions of common facilities to interstate services in a manner that would produce an accurate interstate-only X-factor. On that basis alone, the staff Imputed X study is hopelessly flawed and should not be adopted.

Further, the staff Imputed X study is fundamentally inconsistent with price cap regulation. The imputed X approach is essentially a rate-of-return methodology which calculates a hypothetical X-factor that supposedly would have been required to produce revenues equal to costs in a competitive market. As the Commission previously acknowledged, this approach “basically reprices access services over a historical period to achieve a target rate of return.”²⁸ The inevitable result would be to eliminate most, if not all, the efficiency incentives created by price caps. The Commission has “rejected the same idea in the past for that very reason.”²⁹ Thus, the Commission cannot adopt the staff Imputed X study or rely on it to validate the

²⁶ See id.

²⁷ FCC Brief in Case No. 97-1469, filed June 15, 1998 at 41-42 (“FCC Brief”).

²⁸ In the Matter of Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd. 13659, 13672 ¶ 81 (1995) (“1995 FNPRM”).

²⁹ Sprint at 4 (emphasis omitted).

reasonableness of its X-factor calculations.³⁰

C. CPD

The Commission has conceded that its original justification for including a 0.5% CPD in the X-factor -- the transition from rate-of-return regulation to price cap regulation -- is no longer valid. In defending the CPD before the D.C. Circuit, the Commission proffered a new justification -- the need to offset the elimination of sharing. Now the Commission has asked whether it should retain the CPD to “correct for prior years when the X-factor may have been set too low.”³¹

As a preliminary matter, AT&T attempts to argue that the Court upheld the Commission’s rationale for retaining the CPD, but merely questioned the level at which the CPD should be set.³² AT&T is clearly wrong. The Court decided not to reach the issue of whether the Commission actually relied on the expected effects of sharing elimination or any other reason to justify retention of the CPD because it assumed the Commission would articulate “a clearer statement of its reasons” on remand.³³ Of course, if the Commission cannot provide a rational explanation for including a CPD in the X-factor then it must be eliminated.

There is no valid justification for continuing to include a CPD of any amount in the X-factor. Most, if not all, the effects of the elimination of sharing have been

³⁰ It should be noted that the Court held that the Commission’s partial reliance on the AT&T Historical Revenue Approach was “irrational,” given its prior rejection of AT&T’s approach. USTA v. FCC, 188 F.3d at 526.

³¹ FNPRM ¶ 45.

³² See AT&T at 20-24.

³³ USTA v. FCC, 188 F.3d at 527.

reflected in LEC earnings growth since 1997. Thus, continuing to include a CPD effectively “double-counts” the effect of the elimination of sharing and defeats the purpose of eliminating sharing in the first place. Likewise, including a CPD in the X-factor as a penalty for past performance would simply replicate the efficiency-dampening effects of sharing.

IV. THE COMMISSION SHOULD USE PROPER INPUTS FOR THE TFP METHODOLOGY AND SET THE X-FACTOR AT APPROXIMATELY 4% ON A GOING-FORWARD BASIS

On a going-forward basis, the Commission should retain its TFP model and use a fair and objective process to select inputs. It should not adopt the 1999 staff TFP study which uses the same general TFP model as the 1997 staff TFP study but modifies many of the inputs in order to produce a higher X-factor. Just as the Court held that the Commission failed to provide a rational explanation for its choice of a 6.5% X-factor, the Commission cannot justify relying on the 1999 staff TFP study to prescribe a new X-factor.

Instead, the Commission should use an updated version of the 1997 TFP model to prescribe the X-factor. USTA demonstrates that, if the errors in the 1999 staff TFP study inputs are corrected, the results are consistent with the updated 1997 TFP model. Further, these results are consistent with the USTA TFPRP model.³⁴ The average result of the updated 1997 TFP model over the historical period supports setting the X-factor at approximately 4% on a going-forward basis.³⁵

³⁴ See USTA at 10.

³⁵ Id. at 25-26.

V. CONCLUSION

For these reasons, the Commission must carry out the Court's decision by correcting the errors in its 1997 staff TFP study for the period covered by the remand (i.e., July 1, 1997 to June 30, 2000). The 1997 TFP model, as corrected and updated for 1996 and 1997 data, produces an average X-factor of only 4.5%. On a going-forward basis, the Commission should use an updated version of the 1997 TFP model (essentially the 1999 staff TFP study as corrected by USTA) to prescribe the X-factor. The average result of the updated 1997 TFP model over the historical period supports setting the X-factor at approximately 4% on a going-forward basis. In addition, the Commission should finally remove the CPD from the X-factor.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Kristi Jones, do hereby certify that I have caused 1) the foregoing **REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.** to be filed electronically with the FCC by using its Electronic Comment Filing System, 2) a copy of the **REPLY COMMENTS** to be served, via hand delivery, upon the persons/entity listed (marked with a number sign) on the attached service list, 3) a courtesy copy of the **REPLY COMMENTS** to be served, via hand delivery, upon the persons listed (marked with an asterisk) on the attached service list, and 4) a copy of the **REPLY COMMENTS** to be served, via first class United States mail, postage prepaid, upon the other persons listed on the attached service list.

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