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January 24, 2000

Magalie Roman Salas
Office of the Secretary
Federal Communications Commission
445 12th Street, SW
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: PRICE CAP PERFORMANCE REVIEW
CC Docket No. 94-1
ACCESS CHARGE REFORM
CC Docket No. 96-262

Dear Secretary Salas:

Enclosed for filing please find an original plus four copies of Reply Comments of AT&T Corp. in connection with the above referenced matters.

Please contact me if you have any questions.

Very truly yours,

James P. Young

James P. Young

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Before the
Federal Communications Commission
Washington, D.C. 20554

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

REPLY COMMENTS OF AT&T CORP.

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ORIGINAL

January 24, 2000

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SUMMARY

The comments amply confirm that the Commission's price-cap system does not yet replicate the efficiency incentives of a competitive market. The comments also confirm that the best way to address that problem – and thereby to make this proceeding unnecessary – is to adopt the proposal of the Coalition for Affordable Local and Long Distance Services ("CALLS") for the entire LEC industry. However, if the Commission does not adopt the CALLS plan, it should use this proceeding, not only to respond to the D.C. Circuit's remand in *USTA* v. *FCC*, but to make the price cap regulatory system more effective at replicating the efficiency incentives of a competitive market.

With respect to the historical component of the X-Factor, virtually all commenters agree that the Commission should retain the TFP methodology it adopted in 1997, which was endorsed by the D.C. Circuit, rather than switching to a different methodology. The only disagreement among the commenters thus centers on (1) whether the Commission should correct certain errors in its 1997 TFP study, principally relating to the cost of capital index, and (2) whether it should calculate productivity growth on an interstate-only or a total company basis.

As the comments overwhelmingly demonstrate, both corrections are necessary and appropriate. As the Commission's staff and various commenters have explained, the 1997 study's cost of capital index was fatally flawed, and the LECs' attempts to show otherwise are meritless. Similarly, as AT&T showed in its comments, the alleged difficulties in calculating an interstate-only X-Factor can be easily addressed by making certain adjustments to the Commission's X-Factor formula. Making these two corrections (with some additional refinements explained in Appendix A to these Reply Comments) leads to historical X-factors in the range of 11.1 to 11.8 percent for the remand period (1997-2000) and 10.2 to 10.7 percent for

the future. These results amply support the proposal by AT&T and others that the X-Factor should be set at a level of at least 10.0 percent for the remand period and 9.5 percent for the future.

In addition, as AT&T demonstrated in its Comments, a Consumer Productivity Dividend (CPD) of approximately 1.0 percent is appropriate to account for in the increase in productivity gains that can be expected from the elimination of sharing. The LECs' only counter-argument is that such a CPD might double count such increases if calculated by reference to years after 1995. However, AT&T anticipated that problem and accounted for it in its calculation of the CPD. The comments also support AT&T's proposal for a reinitialization of the price caps to place the caps where they would have been had the X-factor been at the appropriate level during the remand period.

All of these measures are essential if the price cap system is to replicate the efficiency incentives of a competitive market. The Commission should adopt them immediately if it does not adopt the CALLS proposal.

Federal Communications Commission
Washington, D.C. 20554

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

REPLY COMMENTS OF AT&T CORP.

Pursuant to sections 1.415 and 1.419 of the Commission's rules, 47 C.F.R. §§ 1.415, 1.419, AT&T Corp. ("AT&T") respectfully submits these reply comments in response to the Commission's Further Notice of Proposed Rulemaking, FCC 99-345, released November 15, 1999 ("*Further Notice*").

Preliminarily, as a number of commenters note, the Commission "has the opportunity to render this proceeding unnecessary" by adopting the proposal of the Coalition for Affordable Local and Long Distance Services ("CALLS"). SBC at 1-2; BellSouth at 47; Bell Atlantic at 1-2; Sprint at 2-3; GTE at 4. As SBC states, adoption of the CALLS proposal "would obviate the need for the Commission to set a new X-Factor, either for the remand period or going forward." SBC at 1-2. The CALLS Plan offers enormous public interest benefits and should be adopted expeditiously.

If the Commission does not adopt the CALLS Plan as to all the LECs, however, it must recalculate the X-Factor in response to the D.C. Circuit's remand in *USTA* v. *FCC*, 188 F.3d 521 (D.C. Cir. 1999). As shown in Section I below, the comments overwhelmingly demonstrate that the Commission should correct the serious errors in the capital-cost methodology used in the

1997 model, and should determine the X-factor on the basis of interstate revenues rather than combined interstate and intrastate revenues. As shown in Section II, the comments likewise confirm that the Commission should adopt a consumer productivity dividend ("CPD") of at least 1.0 percent. Finally, as shown in Section III, the Commission should also order a full reinitialization of the price cap system, as it has in the past.

I. THE COMMENTS CONFIRM THAT THE COMMISSION SHOULD ADOPT THE OPTION 2 STUDY, MODIFIED TO CALCULATE THE PRODUCTIVITY GROWTH OF INTERSTATE SERVICES ONLY, AND WITH CERTAIN OTHER CORRECTIONS.

In the *Further Notice*, the Commission sought comment on which of three staff studies it should use as the basis for calculating the historical component of the X-factor. *Further Notice* ¶ 20. Virtually all commenters agree that the Commission should retain the basic TFP methodology and X-factor formula that it adopted in 1997 and that was not challenged in the D.C. Circuit. Therefore, the dispute among the commenters centers on only two issues: (1) whether the Commission should continue to rely on the 1997 study ("Option 1"), or make certain corrections to that study ("Option 2"); and (2) whether the Commission should calculate the X-factor on an interstate-only basis, rather than a total company basis (as both the Option 1 and 2 studies do). As explained below, the comments confirm that the Commission should use the Option 2 methodology, modified to calculate the X-factor on an interstate-only basis.

A. The Comments Confirm That The Commission Should Choose The Option 2 Study Over The Option 1 Study.

A number of commenters endorse the Option 2 study as superior to Option 1. *See, e.g.*, AT&T at 5; MPSC at 2. The LECs, through USTA, predictably oppose Option 2, and unjustly impugn the Option 2 study as "arbitrarily biased to increase the X-Factor." USTA at 8. The Option 2 study, however, makes only two changes to the Option 1 study that have any appreciable impact on the X-factor: it contains a new cost of capital index, and it uses local dial equipment minutes ("DEMs") instead of access lines to measure output. Although the second of these changes would be moot if the Commission adopts an interstate-only approach (as it should), both changes are entirely correct as applied to total-company data. Indeed, if anything, the failure to make these changes that would itself be arbitrary.

1. Cost of Capital.

As USTA correctly recognizes (at 11), "[t]he most significant difference between the 1997 TFP model and the 1999 staff study involves the treatment of cost of capital." The Commission staff's Option 2 model is based on a direct calculation of the LEC cost of capital that would prevail in a competitive market, as is AT&T's alternative approach to calculating the cost of capital. AT&T App. A at 6-7. USTA's experts attack the Commission staff's approach, but their criticisms are meritless.

The analysis of USTA's principal productivity expert, Gollop, accounts for almost the entire difference between the USTA study and the Commission's Option 2 study. As AT&T shows in Reply Appendix A, Gollop's analysis suffers from two fatal flaws. First, Gollop improperly uses Value Line's rate of return series for 875 large companies for 1991-98 as a proxy for deriving the LECs' cost of capital for the same period. The Value Line trend is necessarily distorted, because it begins in a recession year. Corporate earnings were artificially depressed during the recession of 1991 (8.5%) but have risen since then to 11.9% in 1998 – a 40% gain. Gollop's assumption that LEC cost of capital has similarly risen 40% over the same period is unfounded, because the LECs' earnings were robust in 1991. AT&T Reply App. A at 1-3.

Second, Gollop improperly uses these trends from the Value Line study to determine changes in the capital rental price. AT&T Reply App. A at 1-2. This is an apples-and-oranges calculation because the capital rental price in the FCC's model and the Value Line rates of return measure two different things. The FCC's capital rental price is measured with respect to the LECs' physical capital (*i.e.*, the LECs' "real" capital stock measured by a perpetual inventory method). By contrast, rates of return are measured with respect to a company's financial capital (*i.e.*, average net book investment). The LECs' physical capital, as measured by the FCC, has grown much faster than their average net investment. Accordingly, using rate of return data to estimate changes in the capital rental price tends to inflate the capital rental price and resulting levels of property income.[1] Thus, Gollop's conclusions are fundamentally unsound and should be rejected.

Indeed, Gollop's analysis is so off the mark that USTA's other expert, Vander Weide, does not agree with it. While Gollop contends that the LECs' cost of capital has sharply increased over the 1990s, Vander Weide contends merely that it has remained flat. But as Dr. William Lehr shows in the attached affidavit, AT&T Reply App. B, even Vander Weide's more restrained cost of capital estimates are biased upwards. Indeed, Vander Weide's analysis is flawed in two respects.

First, Vander Weide uses the S&P index as a proxy for the LECs' return on equity. Because the LECs are more capital intensive than the average firm in the S&P index, use of that index would tend to overstate return on equity. See Reply App. B at 8. Second, Vander Weide also uses the market value of equity to weight his already overstated return on equity in his weighted average cost of capital estimates. This again produces an upward bias in the cost of

[1] To the extent that the staff's Option 2 study could be considered to be subject to this same criticism, the solution is to apply the changes in cost of capital to the RBOCs' aggregate rate of return rather than to the capital rental price, and then adjust property income to produce whatever rate of return is associated with the cost of capital. AT&T Reply App. A at 2-3. AT&T proposed this method as an alternative to the Option 2 method in its Comments. See AT&T App. A at 6-8.

measure, because the market value of equity has increased so substantially in the bull market of the 1990s. Although Vander Weide is attempting to determine the optimal forward-looking cost of capital, his method implies that the LECs' optimal future capital structure is a mere 17% debt financing, which is highly implausible. In short, as Dr. Lehr puts it, Vander Weide's approach "takes advantage of current market anomalies to develop excessive cost of capital estimates." Reply App. B at 9.

2. Dial Equipment Minutes

The only other significant change that Gollop makes to the FCC study is to use access lines to measure local output, instead of dial equipment minutes (DEMs), as the Commission staff did in the Option 2 study. As long as the Commission is using an X-factor based on total company data, then DEMs are clearly the more appropriate measure of local output. *See* AT&T Reply App. A at 4-5; MCI at 9.

Indeed, as Gollop admits (at 20), "the choice of an appropriate output measure must follow from the very purpose of the X-factor as a public policy tool." USTA Att. 2. The purpose of the X-factor is to account for productivity gains in the provision of interstate access. Interstate access services are usage-sensitive, and the growth in usage on the network is a major source of productivity growth. Therefore, the usage-sensitive measure of local output – DEMs – is more appropriate than access lines. *See* AT&T Reply App. A at 4-5; Reply App. B at 2.

B. The Comments Confirm That The Commission Should Modify The Option 2 Study To Calculate The X-Factor Based On Interstate Data Only.

As AT&T showed, and as a number of commenters agree, the Commission should also modify its X-factor calculations to estimate the productivity growth of interstate services only, rather than using total company data. MCI at 10-12; GSA at 6, 11; Ad Hoc at 33 (use imputed

X, because it measures interstate only). The comments confirm that the use of total company data results in a substantial downward bias in the X-factor. *See, e.g.*, MCI at 11-12.

Moreover, as AT&T showed in its comments, calculating the interstate-only X-factor is far easier than had previously been thought. The standard objection to using interstate only data has always been that it is too difficult to separate intrastate inputs from interstate inputs, because such costs are joint and common. In 1997, the Commission found that the record at that time did not provide enough information to determine an interstate X-factor, and the Court accepted the Commission's conclusion. *USTA*, 188 F.3d at 528-529. AT&T has shown, however, that the input terms in the Commission's X-factor formula cancel one another out. Accordingly, the X-factor can be calculated by a more direct method without the analytical difficulties of having to separate out interstate inputs. With the only substantial objection to an interstate-only X-factor removed, the Commission should not continue to rely on downwardly biased total company X-factors any longer. *See USTA*, 188 F.3d at 528-529 (if any party had demonstrated that total company data resulted in a downward bias in the X-factor, reversal would have been warranted).

Although the LECs argue that the Commission should not adopt an interstate only X-factor, they have said nothing to cast doubt on AT&T's analysis. They merely repeat the old argument that separating interstate from intrastate inputs is difficult. SBC at 3-5; Bell Atlantic at 4, 6-7; GTE at 13; U S WEST at 17-18; CBT at 4-5; BellSouth at 35-41. Every single LEC in this proceeding, however, as well as USTA, has endorsed the Commission's 1997 X-factor formula. Because AT&T has shown that an appropriate interstate X-factor can easily be calculated using the very formula endorsed by the LECs, they can no longer maintain any legitimate objection to an interstate only X-factor.

C. The Commission Has Ample Discretion To Use The Methodology Advanced By AT&T To Establish The X-Factor Governing Both The Remand Period And Future Periods.

Finally, there can be no doubt that the Commission has ample authority to revise its methodology on remand as advocated by AT&T. Indeed, only U S WEST disputes the point. See U S WEST at 5-10. However, U S WEST does not provide any legal support for its assertion that the Commission's decision to consider new data and develop new methodologies to prescribe an X-factor is inconsistent with the Court's remand order.[2] *Id.* at 5.

Indeed, the Court specifically remanded the case to the FCC "for further explanation." *USTA,* 188 F. 3d at 526. The Commission has, on several occasions, recognized that this "language enables the Commission to examine in this rulemaking proceeding any public interest considerations that are relevant to the specific issues remanded by the Court." *See, e.g.*, Final Order On Remand, *Amendment of Parts 2, 22 and 25 of the Commission's Rules to Allocate Spectrum for and to Establish Other Rules ad Policies Pertaining to the Use of Radio Frequencies in a Land Mobile Satellite Service for the Provision of Various Common Carrier Services,* 7 FCC Rcd. 266, ¶ 28 & n.68 (1992) ("*Spectrum Order*"); *see also Eastern Carolinas,* 762 F.2d at 97, 101 n.8 (the Court's remand order "for an explanation" of the Commission's decision "simply cannot be read to foreclose the possibility of post-remand submissions.") In this case, that principle would obviously include a consideration of the relevance of updated data and the superiority of alternative methods of establishing the X-factor. Indeed, it would be

[2] U S WEST's position that new data and methodologies cannot be used by in any remand proceeding is directly contradicted by the holding in *Eastern Carolinas Broadcasting Co. v. FCC* where the court expressly recognized the Commission's long-standing policy of allowing parties to submit updated data concerning remanded issues, and to make new determinations based on those data. 762 F.2d 95, 98-104 (D.C. Cir. 1985) ("*Eastern Carolinas*"). For a complete discussion of this issue, *see AT&T* at 16-20.

entirely perverse and "contrary to the [Commission's] obligations under the Communications Act" for the Commission to read the Court's remand order as requiring blind adherence to outdated data and flawed X-factor methodology. *Spectrum Order,* ¶ 29; *see also id.*. ¶ 29 n.69 (an "inflexible interpretation of Section 402(h) . . . could easily lead to absurd results which would disserve the public interest").

Likewise, § 402 of the Communications Act, 47 U.S.C. § 402(h), does not preclude the Commission from considering new data or developing new methodologies when prescribing an X-factor for the remand period, much less the future. *See* AT&T at 18-19. Consequently, U S WEST's startling conclusion that the Commission must rely on outdated data and ignore new methodologies on remand is inconsistent with established legal principles and with the Court's remand order.

II. THE COMMENTS CONFIRM THAT THE COMMISSION SHOULD ADOPT A CONSUMER PRODUCTIVITY DIVIDEND OF AT LEAST 1.0 PERCENT.

The comments also confirm AT&T's analysis of the consumer productivity dividend issue. As the Commission recognizes in its *Further Notice,* the elimination of the sharing requirement can be expected to result in additional productivity gains for the LECs over and above their historical gains. *Further Notice* ¶ 44. The LECs do not dispute this fact. Indeed, even Dr. Taylor, USTA's expert witness, concedes that the elimination of sharing could plausibly lead to an increase in productivity. USTA Att. 1 ¶ 53. Instead, the LECs argue that *some* of those productivity gains are already captured by X-factors and that *any* CPD adjustment would necessarily "double-count" those productivity gains. *See* USTA Att. 1 ¶¶ 52-57.[3] This argument is logically flawed and should be rejected.

[3] *See also* SBC at 4; US WEST at 20; BellSouth at 42-43.

The fact that "some" of the productivity gains associated with eliminating the sharing requirements might be captured by X-factors implies that some portion of those gains are not captured by X-factors. The correct approach, therefore, is simply to reduce the CPD adjustment by an amount equal to the level of the productivity gains attributed to the elimination of sharing that is already captured by the calculated X-factors. This is the approach AT&T proposed in its Comments. *See* AT&T Comments, App. C at 5.

AT&T estimates that at most 0.5 percent of the productivity gains associated with the elimination of sharing requirements have already been captured in the historical component of the X-factor. *See* AT&T App. C at 5.[4] Consequently, to avoid any risk of double counting those productivity gains, AT&T proposes to *reduce* its original estimate of the CPD from 1.5 percent to 1.0 percent (= 1.5 – 0.5). *Id.*

In short, AT&T's estimate of the CPD adjustment already accounts for the only factual and theoretical problems identified by the LECs. The CPD adjustment proposed by AT&T does *not* "double-count" productivity gains. Moreover, AT&T's estimate of the appropriate CPD adjustment is the only one that accounts for: (1) the unchallenged fact that elimination of the sharing requirements led to significant productivity gains and (2) that some of those productivity gains may already be captured by the historical component of the X-factor. Accordingly, the Commission should adopt AT&T's proposed 1.0 percent CPD adjustment.

[4] This estimate reflects minor refinements in AT&T's analysis. The adjustments described in Reply Appendix A (at 7) lead to the conclusion that the estimated CPD should be reduced by 0.5 percent rather than 0.4 percent, as AT&T had previously calculated. *Compare* AT&T Comments, Appendix A.

III. THE COMMENTS ESTABLISH THAT THE COMMISSION SHOULD REINITIALIZE THE PRICE CAPS TO CORRECT FOR PRIOR YEARS WHEN THE X-FACTOR WAS SET TOO LOW.

As explained above, the record clearly establishes that the X-factor and the CPD adjustment have significantly underestimated the efficiency gains enjoyed by the LECs during the past several years. Therefore, Bell Atlantic's proposal to use the CPD and the X-factor as a basis for retroactive relief *in favor of the LECs* is groundless. *See Bell Atlantic* at 14-16. In any event, it would be inappropriate to use the CPD adjustment to provide retroactive relief. The CPD adjustment has never been used this way. Rather, it is used solely for the purposes of ensuring that consumers receive "the first benefits" of efficiencies gained from new regulations. *See Further Notice* ¶ 43. The Commission should not ignore this policy here.

Nevertheless, as noted in AT&T's initial comments, the Commission should act decisively to prevent past underestimations of the X factor from continuing to affect the price cap indices in the future. It should do so, moreover, by reinitializing the price caps and setting them equal to where they would have been if the X-factor had been set at the appropriate level since 1995.

Such a reinitialization would not be unusual. In both of the Commission's previous price cap review proceedings, the Commission reinitialized the price caps to prevent earlier errors in the estimation of the X-factor from infecting future periods. In both of these cases, the Commission's reinitialization was upheld by the D.C. Circuit. *Bell Atlantic Tel. Cos. v. FCC,* 79 F.3d 1195 (D.C. Cir. 1996); *USTA*, 188 F.3d at 529-530.

Reinitialization is especially important here because, as the Commission recognizes in the *Further Notice*, errors in the estimation of X-factors are not self-correcting, but continue to infect the price cap system and "may cause increasingly erroneous prices over time." *Further Notice* ¶ 45. As explained above, this is certainly true here. The Commission should give consumers relief that is as complete as possible given the prohibition on retroactive ratemaking. Accordingly, the Commission should reinitialize the price caps in this proceeding and set them where they would have been if the historical X-factor had been set at the appropriate level during the period from 1995 to 2000, with a CPD adjustment of 1.0 percent during the period from 1997 to 2000. *See AT&T* at 25.

CONCLUSION

For the reasons stated above and in AT&T's Comments, the Commission should prescribe historical X-factors of at least 10.1 and 9.5 percent for the remand and future periods, respectively; a CPD of at least 1.0 percent; and complete reinitialization.

Respectfully submitted,

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