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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 Twelfth Street, SW, Room TWB-204
Washington, D.C. 20554

Re: Notice of Ex Parte Meeting
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

Dear Ms. Roman Salas:

On February 17, 2000, Paul Malandrakis, Steve Friedlander, and I, of AT&T, met with Jay Atkinson, Chris Barnekov, Lloyd Collier, Aaron Goldschmidt, Rich Lerner, Jennifer McKee, Florence Setzer, and Noel Uri of the Competitive Pricing Division concerning matters related to the referenced proceedings. The attachment was referred to during the discussion.

Two copies of this Notice are being submitted to the secretary of the FCC in accordance with Section 1.1206 of the Commission's rules.

Sincerely,

Patrick H. Merrick

Attachment

cc: J. Atkinson, C. Barnekov, L. Collier, A. Goldschmidt, R. Lerner, J. McKee, F. Setzer, N. Uri

No. of Copies rec'd 0+1
List A B C D E

The X-factor must properly reflect the downward trend in unit costs for interstate services.

- Unit costs for access services have been declining rapidly over much of the post-divestiture period – a trend that has yet to show any sign of diminishing.

- The FCC's central objective in this proceeding, "that ongoing gains by the LECs in reducing unit costs are passed through to consumers" requires that this downward trend in unit costs be reflected in the X-factor.

- The LECs have employed various tactics throughout this proceeding to divert attention from the downward trend in costs.

TFP analysis should not be used to hide the downward trend in unit costs.

Use of TFP analysis was first proposed by the LECs in 1994 and served to effectively hide the downward trend in unit costs for access services.[1]

- LECs insisted that TFP studies be conducted at the total company level, since any attempt to measure interstate TFP would be "economically meaningless."

- LECs claimed that the favorable trend in LEC input prices, the "input price differential", was not statistically significant and could not be extrapolated into the future. A major source of unit cost reductions would thus be ignored.

FCC properly rejected LEC arguments regarding the input price differential and should also reject their arguments against an interstate X-factor.

[1] USTA's original TFP model was presented in its 1994 comments in Docket 94-1.

Calculation of an interstate-only X-factor does not constitute some kind of "economic sin."

- LECs claim: "Productivity growth must be calculated on a total company basis principally because there is no economically meaningful way to assign portions of common facilities to individual services." (Taylor comments, para 34)

- This has not prevented the LECs from advocating lower X-factors for their intrastate services.

  > "It is reasonable to expect that productivity growth experienced historically in this market [for interstate access services] would be substantially greater than the overall rate of productivity growth experienced by local exchange companies in supplying all services."[2]

- Nor has it prevented state commissions from adopting X-factors lower than those of the FCC, recognizing that intrastate productivity growth is less than interstate.

- It is therefore incumbent upon the FCC to operate within this broader regulatory framework and adopt an X-factor tailored to the services within its jurisdiction.

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[2] Amended Direct and Rebuttal Testimony of Dr. William E. Taylor (Carolina Telephone and Telegraph Co. and Central Telephone Co.), North Carolina Utilities Commission, Docket No. P-7, sub. 825, P-10, sub. 479, February 9, 1996, at 36.

There is ample evidence available to calculate an interstate-only X-factor.

Several reasonable approaches have been presented during the course of this proceeding:

- The FCC originally relied primarily on interstate data, basing the X-factor partly on the trend in interstate switched access rates, as measured in terms of revenue per minute. (1990 and 1995 price cap orders.)

- In prior TFP studies, AT&T provided estimates of interstate X-factors based on the assumption that interstate inputs grow at the same rate as total company inputs. MCI WorldCom used the same assumption in its comments.

- AT&T showed how an interstate X can be calculated directly based on growth in interstate output and revenue. Results are similar to those obtained from AT&T's previous approach.

- The FCC's imputed X study provides another constructive approach. It has been unfairly attacked by the LECs as a reversion to ROR regulation.

The inescapable conclusion is that X-factors based on total company data are significantly understated.

The mix of interstate services differs substantially from the mix of intrastate services.

- This fact has not been altered by access reform. Significant differences between interstate and intrastate still exist.

- Over 80% of local service revenue is recovered on the basis of access lines (Gollop, p. 21), which implies that over 63.1% of total intrastate revenue is recovered on a per line basis.[3]

- By contrast, only about 51.2% of interstate revenue is recovered on a per line basis.[4] The rest comes from per minute charges, dedicated transport that varies in proportion to traffic, and rapidly growing special access facilities.

- The 51.2% figure is nearing its peak and will soon start declining as growth in minutes and special access far exceeds growth in subscriber lines.

[3] This percentage is based on the revenue data shown in Table B-2 of the FCC's study.
[4] See ex parte letter from Evan R. Grayer, Dockets 94-1, 96-45, 99-249, 96-262; Sept. 1, 1999; page 28 of attachment. The 51.2% is based on July 1999 rates and 1998 demand.

Arguments against the use of interstate earnings data are without merit.

LECs claim that interstate earnings are based on "arbitrary allocations" and are not "economically meaningful", but fail to provide any substantive explanation of why such allocations are distorted.

- Growth in internet-bound traffic does not cause interstate earnings to be overstated.

  Growth in internet usage leads to lower unit costs equally for interstate and intrastate usage. This contributes both to the profitability of interstate services and to productivity growth.

- LEC profitability is not overstated because of unrealistically low depreciation rates.

  If higher depreciation rates were in effect, the depreciated value of LEC plant (ANI) would be much lower, so that RORs would not necessarily be reduced. LEC financial reports generally show higher RORs than their regulatory reports.

Direct calculation of X-factors

The X-factor can be calculated directly on the basis of the growth rates for LEC output (Q) and LEC revenue (REV), as well as the economy-wide measures of productivity growth (TFP) and input price changes (IP):

$$X = \%\Delta Q_{LEC} - \%\Delta REV_{LEC} - \%\Delta TFP_{US} + \%\Delta IP_{US}.$$

This is because growth in inputs (N) plus input price prices (IP) equals the growth in revenue:

$$\%\Delta REV_{LEC} = \%\Delta N_{LEC} + \%\Delta IP_{LEC}$$

For example, the X-factor for 1991-98 is:

$$X = (1/8)*[\ \ln(Q_{98}/Q_{90}) - \ln(REV_{98}/REV_{90}) - \ln(TFP_{US98}/TFP_{US90}) + \ln(IP_{US98}/IP_{US90})]$$

Advantages to the direct method:

- Greatly simplifies the analysis. Focuses attention on those variables that actually determine the X-factor and eliminates the complex calculations needed to develop indices that have no real bearing on the results.

- More conducive to measuring an interstate-only X-factor, since data on interstate output and revenue can be used in place of total output and revenue. There is no need to calculate a "theoretically pure" measure of interstate TFP.

- Provides an X-factor that is more appropriate for regulating interstate services and avoids the complications of measuring output of other, non-interstate services.

LEC attempts to criticize the direct method ignore that it is mathematically equivalent to X-factor calculations of the FCC, USTA, and other parties.

The FCC's capital cost index should be modified based on AT&T's and MCI/Worldcom's recommendations.

- The only component of property income that should be adjusted is return on equity, along with income taxes on that return.

- Variations in the cost of capital should be properly reflected in the capital cost index. Because the cost of capital is measured in terms of return on investment, it should be applied to average net investment.

Calculation of capital cost index

1. Use the "competitive ROR" calculated by MCI WorldCom (Table B-7A of reply comments), based on:

   - LECs' actual cost of debt, as shown in ARMIS.

   - Actual debt/equity ratios, from ARMIS and Form M data.

   - Cost of equity for 1989 is 13.19%, implied in FCC's 11.25% prescription order. (i.e., 13.19%). For other years, it's equal to 13.19% adjusted by the change in Moody's Baa bond return relative to 1989.

   The resulting "competitive ROR" is 11.53% in 1990, 11.25% in 1991, and declines to 8.89% in 1998.

2. Apply the "competitive ROR" to average net investment to obtain earnings associated with the cost of capital..

3. Adjust income taxes based on 39% tax rate. Multiply the change in earnings by [.39/(1-.39)].

The key assumption is that the equity risk premium, as measured by the differential between the cost of equity and Baa bonds, has been constant over time.

TABLE 1				
X-FACTORS FOR 1991-1998				
Based on alternative cost of capital assumptions				
	Total company X	**Interstate X**	**1990 ROR**	**1998 ROR**
USTA Comments	3.29		10.30%	19.00%
No adjustment	4.78		10.30%	15.43%
No adjustment		7.67	12.63%	15.40%
Constant 11.25% ROR	6.16	8.35	11.25%	11.25%
Constant risk premium	6.89	9.16	11.53%	8.89%
AT&T cost of capital	6.88	9.14	11.25%	8.63%
1999 FCC study	6.33		9.31%	6.49%
Except for USTA and 1999 FCC studies, X-factors are based on direct calculation.				
Interstate X-factors do not include adjustment for excess employee benefits				
Except for USTA, total company X-factors include adjustment for excess employee benefits.				

Table 2. Average Interstate X-Factors Based on Direct Calculation (From Table B-15)

	AT&T Cost of Capital (Reply Comments)	Revised FCC Cost of Capital (2/17 Ex Parte)
1986 to 1995	10.554	10.597
1987 to 1995	11.781	11.828
1988 to 1995	11.834	11.887
1989 to 1995	11.702	11.763
1990 to 1995	12.107	12.178
1991 to 1995	10.327	10.570
Mean:	11.384	11.471
Median:	11.742	11.796
1986 to 1998	9.773	9.724
1987 to 1998	10.628	10.575
1988 to 1998	10.562	10.503
1989 to 1998	10.343	10.278
1990 to 1998	10.462	10.390
1991 to 1998	9.143	9.161
Mean:	10.152	10.105
Median:	10.402	10.334

AT&T cost of capital based on ROR of 11.25% in 1990 and 8.63% in 1998.

Revised FCC cost of capital based on Baa bond yield and constant equity risk premium.

No adjustment for excess employee benefits.