Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

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
	)	

BELL ATLANTIC REPLY COMMENTS ON FURTHER NOTICE

Of Counsel:
Michael E. Glover

Edward Shakin
Bell Atlantic
1320 North Courthouse Road
Eighth Floor
Arlington, Virginia 22201
(703) 974-4864

January 24, 2000

TABLE OF CONTENTS

Before the
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
	)	

BELL ATLANTIC[1] REPLY COMMENTS ON FURTHER NOTICE

I. Introduction and Summary

The record in this docket is clear – the going forward X factor must be lowered to around four percent. On appeal, the productivity model adopted by the Commission in 1997 was upheld. In contrast, the Court rejected the X factor derived by the Commission using that model. It did so, however, not because of defects in the model itself, but because the Court concluded that that the Commission had manipulated the results produced by the model in ways that were not justified (or justifiable). On remand, a straight forward run using updated data of the very same productivity model that was developed by the Commission in 1997 and that was upheld on appeal produces an X factor of about four percent.

---

[1] The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; Bell Atlantic-West Virginia, Inc.; New York Telephone Company; and New England Telephone and Telegraph Company.

No party disputes these basic facts. Even AT&T agrees that the Commission should not "adopt an entirely new methodology for calculating X-factors." AT&T Comments at 12. Nevertheless, the long distance incumbents and their allies try to entice the Commission to repeat the same mistakes it made in its prior order by abandoning precedent and ignoring sound economics. By manipulating the productivity results or abandoning them altogether, these parties argue that higher and higher X factors are justified. They are not.

Most of the commenters that argue for higher X factors rely on the alternative methods proposed in the Notice here. But, as Bell Atlantic and USTA demonstrated in their comments, the alternative X factors proposed in the Notice rely on the very same kinds of erroneous manipulations of objective results that were squarely rejected by the D.C. Circuit.

II. <u>The X Factor Should Not Be Manipulated On Account of Changes in Earnings.</u>

Several commenters ignore productivity results and instead rely on the growth in the regulated accounting earnings of the price cap regulated carriers as proof that the X factor should increase. But their claims provide no sound economic basis for an increase to the X factor.

First, the Commission has already rejected reliance on earnings as a basis for setting the price cap X factor because it undermines price cap incentives. If the Commission were to rely on earnings growth as a basis for revision of the X factor, it "would create substantially similar incentives to those under rate of return regulation because the X-Factor would be explicitly linked to earnings." *Price Cap Performance Review*, 12 FCC Rcd 16642, ¶ 22 (1997) ("1997 Price Cap Order"). As the Commission explained in its brief to the Court of Appeals, "[b]ecause a price cap system stimulates LECs to be efficient through the lure of higher earnings," any regulatory cap on those earnings "effectively caps the incentive to be efficient." *USTA v. FCC*, DC Circuit Case No. 97-1469, Brief For Respondents at 21 (filed June 15, 1998).

Second, it is clear that regulated accounting earnings provide no reliable financial information for use in setting an economically-based X factor. Two recent examples show how malleable – and just how arbitrary and subject to distortion by regulatory decisions – such regulated earnings are.

Bell Atlantic was forced to revise upward its reported interstate earnings when the Commission rejected the assignment to the interstate jurisdiction of intercarrier compensation payments associated with internet-bound traffic. Despite a Commission finding that "ISP-bound traffic is non-local interstate traffic," the staff required Bell Atlantic to "reclassify, as intrastate, its 1998 reciprocal compensation expenses and revenues that are associated with ISP-bound traffic." *Compare Inter-Carrier Compensation for ISP-Bound Traffic*, 14 FCC Rcd 3689, ¶ 26, n. 87 (1999) *with* Letter from Lawrence E. Strickling to Don Evans re Separations Treatment of Internet-Related Reciprocal Compensation, 14 FCC Rcd 13148 (1999). The result significantly increased Bell Atlantic's reported earnings by adding several hundred million dollars in intrastate costs.

Even more recently, the Commission authorized carriers to modify their depreciation rates under certain circumstances to recognize the fact that regulatory required depreciation rates have been unrealistically low.[2] *1998 Biennial Regulatory Review – Review of Depreciation Requirements*, CC Dkt. No. 98-137, ¶ 25 (rel. Dec. 30, 1999). The Commission's willingness to accept financial depreciation for regulatory accounting calls

[2] In order to obtain such forbearance, however, a carrier must agree to "write-off" the difference between the costs on its regulated books and the costs on its financial books.

into question the overly long depreciation lives (and associated overly low deprecation expense) that account for most of the current difference between regulated earnings and the financial books' GAAP-based earnings.

Third, even if interstate earnings were a legitimate measure here, which they are not, it should not be surprising that average earnings have increased over the period of price cap regulation. As even Ad Hoc concedes, that is the intended result of price cap regulation. *See* Ad Hoc Comments at 15 (price cap regulated carriers expected to "increase their efficiency and reduce their costs overall"). *See also Bell Atlantic Telephone Companies v. FCC*, 79 F.3d 1195, 1198 (D.C. Cir. 1996) ("Price cap regulation is intended to provide better incentives to the carriers than rate of return regulation, because the carriers have an opportunity to earn greater profits if they succeed in reducing costs and becoming more efficient"). It would be utterly capricious to punish carriers now for meeting the Commission's own goals.

Fourth, despite the long distance carriers' rhetoric, the earnings of the price cap carriers have been below the earnings of other competitive businesses – including the long distance carriers themselves. For example, the interstate return on assets for the former Bell operating companies for 1998 was 15.67 percent. This compares with over 21% for Value Line's group of U.S. industrial companies and roughly 26% for the long distance operations of supposedly competitive AT&T. *See* Attachment. These lower returns occurred despite the fact that, unlike the price cap regulated carriers, these other companies' returns are based on GAAP accounting without artificial regulatory adjustments that manipulate the earnings upward. With local exchange carriers trailing the earnings of other competitive industrial companies, there is no justification for an earnings-based adjustment to the X factor.

III. <u>Productivity Must Be Calculated on a Total Company Basis.</u>

AT&T argues that, despite the Commission's previous rejection of an interstate only productivity calculation, it has magically solved the underlying problem that there is no way to isolate the true economic costs of inputs on an interstate only basis. According to AT&T, the interstate inputs in the X factor equations cancel each other out, allowing for a simple productivity calculation that does not need to isolate the cost of intrastate inputs. As Dr. Taylor demonstrates, however, AT&T is only able to accomplish this sleight of hand by assuming the problem away. AT&T's entire argument is premised on the unsupported assumption "that revenues and costs for interstate services are equal in every period. There is no basis for such an assumption and without it AT&T's entire house of cards comes crashing down." Reply Comments of William E. Taylor, ¶ 2 (Attachment 1 to USTA Reply Comments).[3]

In fact, AT&T has tried this trick before, and it was rightly rejected by the Commission. In its 1997 review, the Commission rejected the same argument – then called by AT&T the historical price method. The Commission saw through the AT&T arguments and recognized that "the Historical Price Method bases the X-Factor on historical trends in prices of telecommunications prices relative to the economy as a whole, and thus uses price changes as a surrogate for productivity growth." 1997 Price Cap Order, ¶ 23. Instead, the Commission found that total factor productivity is "a more

[3] AT&T's own witness acknowledges (outside of this proceeding) that he is not explicitly measuring productivity. *See* Taylor Reply Comments ¶ 6 (quoting Stephen Friedlander, "The Use of Productivity Studies in Price Cap Regulation: What do the FCC's X-factor Calculations Really Measure?" 18th Annual Conference of the Center for Research in Regulated Industries, Rutgers University, May 27, 1999) ("The fact that the X-Factor is often called a productivity factor does not make it necessary to measure productivity explicitly").

accurate measure of LEC productivity because it is based on incumbent LECs' actual outputs and inputs." *Id.* (footnotes omitted). That conclusion was correct in 1997 and it is correct today.

Indeed, not only is AT&T wrong in its argument, its claim is premised on a rate structure that no longer exists. AT&T's assumption that interstate productivity is higher than intrastate is based on a claim that interstate rates are disproportionately charged on a usage rather than a per-line basis when compared with intrastate rates. As Bell Atlantic demonstrated in its comments, that claim is not true. In fact, as USTA reports in its reply comments, less than 20% of the LEC interstate access revenues are recovered through usage based charges – roughly the same proportion that are recovered through usage based charges for intrastate services.[4]

It is ironic that AT&T tries to use rate of return regulation to push price cap carriers rates down. In another proceeding, AT&T is simultaneously making precisely the opposite argument. There, it is arguing that the Commission should rely on the results of price cap regulation as the best measure of appropriate price changes, and that rate of return regulation (for a carrier in Puerto Rico) results in insufficient rate

---

[4] For the same reason, AT&T's argument supporting a "q" factor adjustment is wrong. AT&T, the only carrier to file comments here in support of a "q" adjustment, claimed that if the Commission continues its policy of reliance on total company productivity results, the "q" adjustment – which purports to adjust rates for demand growth in switching minutes – is necessary because total company results do not adequately reflect the growth in minutes. But total company and interstate results are no different with respect to the proportion of revenues that are based on per-minute charges. Regardless, the X factor "already accounts for all changes in costs and revenues so that a price cap formula that included an adjustment for demand growth would effectively double-count a component of historical productivity gains already reflected in the measure of TFP." Taylor Affidavit, ¶ 41 (attached to USTA Comments, CC96-262 (filed Oct. 29, 1999).

reductions. *See Puerto Rico Telephone Company Petition for Waiver*, CCB/CPD No. 99-36, AT&T Opposition to PRTC Waiver Petition at 10 (filed Jan. 11, 2000) (citing to larger GTE price cap reductions in access rates as the appropriate standard to evaluate the smaller rate of return governed access reductions of PRTC).

IV. <u>There is No Justification for a So-Called "CPD".</u>

There is also no basis to impose a so-called "consumer productivity dividend" ("CPD"). Even GSA concedes that "it may *never* be possible to specify an analytically defensible procedure" to calculate a CPD. GSA Comments at 14 (emphasis added).[5] AT&T and Ad Hoc claim to offer quantification of a CPD, but their arguments suffer from the same flaws highlighted by the Court.

Like the Commission in the prior order, Ad Hoc and AT&T cite to potential reasons for a CPD – enhanced productivity as a result of the transition from rate of return regulation to price cap regulation, and the elimination of sharing. But neither of the reasons hold water.

Price caps have been in effect for a decade and the one thing almost all parties seem to agree on is that using data from the post price cap era is appropriate to measure going forward productivity.[6] If all of the data is based on performance under price caps,

---

[5] GSA makes this concession despite its relatively low threshold of what may be considered "analytically defensible." For example, it supports Option 3 from the Notice because that option lowers access charges and "requires only 8 pages" to explain (in comparison to 12 and 36 pages respectively for Options 1 and 2). GSA Comments at 12. GSA is the *only* party that supports Option 3 as the basis for determining the X factor.

[6] Of course, to the extent the Commission were to revert to some sort of rate of return based regulation (with its reduced efficiency incentives), then any reliance on productivity during the period of price cap regulation would overstate expected future productivity and would have to be reduced.

then there is no basis for an artificial add-on to account for the difference between such performance and the prior regulatory regime.

Similarly, there is no basis to assume additional productivity growth from the transition from sharing. Most price cap carriers have been out of sharing since 1995, allowing much of the data in the model to reflect price caps without sharing. Most states eliminated sharing even earlier.[7] Affidavit of William E. Taylor, ¶ 56 (Attachment 1 to USTA Comments). As a result, any effort to lard on an assumption of additional productivity growth on top of this data would be double counting. Taylor Reply Comments, ¶ 21.

Because there is no basis for any CPD, the comments that cite to a model for the proposition of quantifying the CPD are irrelevant. Regardless of the impacts of changes in regulation on productivity growth, they are already accounted for. Even if any growth was not already reflected in productivity data (which it is), the models that purport to measure the impact are themselves flawed.

First, the models assume that any increase in incentives translates directly into an identically sized increase in productivity growth. Taylor Reply Comments, ¶¶ 23-27. If desire were the only criteria for success, then every little leaguer would grow up to be a professional athlete. There is simply no basis for the AT&T and Ad Hoc assumption. Indeed, despite the absence of sharing, productivity growth actually decreased in 1996

[7] Elimination of sharing in state regulation increases incentives as well. Because productivity data must be calculated on a total company basis (which includes state results), that increased incentive impacts the results of the productivity study here.

and 1997. *See* F. Gollop, "Economic Assessment of the 1999 X Factor Model," Table 6 (Attachment 2 to USTA Comments).

Second, Ad Hoc and AT&T also err in their calculation of increased incentives. With respect to the transition from sharing, they wrongly assume that carriers will always increase their profits and thereby will lose half of their additional profits under sharing. With respect to the transition from rate of return, they assume that any difference in productivity growth between the period just prior to the start of price caps and the period just after is solely due to the change in regulation. This assumes away other changes, including changes in technology, the economy, and consumer demand. All of the assumptions are without basis and are unsupportable. In addition, the measure of productivity growth that they rely on is itself flawed (making the same mistakes proposed in the Notice and refuted in the initial comments).

Third, AT&T also tries to justify a CPD based on differences in X factors for carriers that selected sharing versus those that did not under the 1995 price cap regime. The selection of an X factor under that regime was a one year decision however. As a result, any decision to accept the higher X factor to avoid sharing was a simple analysis of expected regulatory accounting earnings for the following year, and provides no data with respect to the size of the impact from productivity growth as a result of the elimination of sharing.

While none of the arguments to impose a CPD have merit, no party even attempted to justify imposing a CPD on a retroactive basis. As the Court of Appeals explained, the concept of a backward looking incentive makes no sense because "the companies could not have responded to that incentive before its creation." *USTA v. FCC*, 188 F.3d 521, 529 (1999).

V. <u>There Are No Other Reasons to Deviate From The Current Productivity Model.</u>

Ad Hoc also resurrects another rejected argument, claiming that the X factor should be increased because the cost of capital inputs are lower than actually reported as a result of enhancements in technology. This so-called hedonic adjustment was already soundly rejected by the Commission. *See* 1997 Price Cap Order, ¶ 67 ("We find nothing in this record to suggest that our TFP calculation would be more accurate with a hedonic adjustment"). There is no reason to reverse that conclusion now.

As Dr. Taylor explains, Ad Hoc's argument assumes great leaps in technology in recent years, but none in prior years. Taylor Reply Comments, ¶¶ 44-46. Of course, such an assumption is contrary to the history of constant evolution in telecommunications technology. "Whether it is the change from manual to electromechanical switches or the change from mechanical to analog switches, the industry is constantly improving its technology. Therefore, choosing a series at random and modifying only part of the series for unmeasured changes in the quality of output misses the fact that the earlier data that are not modified were themselves representative of superior technology *vis-à-vis* earlier periods." *Id.*

Regardless, any increased productivity as a result of new technology is already captured in the productivity model. The benefit to the carriers from technology advances in their inputs is greater output at reduced cost. But output is already measured under the model so there is no "effect" left to capture, and any add-on to the productivity offset would be arbitrary double counting. Taylor Reply Comments, ¶ 46.

Finally, several smaller price cap carriers argue for a separate lower X factor. They offer outdated studies of past differences that provide no real empirical basis for such a claim going forward. While there are differences among all carriers, there is no reason to isolate size and then assume that the X factor is automatically lower for the smaller carrier.[8] Because the X factor purports to be a measure of changes in productivity and not absolute levels, there is no reason to assume that going forward productivity changes by smaller carriers will not exceed those of the larger carriers.

VI. Carriers Must Be Allowed To Recoup Amounts Wrongfully Removed From Rates.

The Commission also has an obligation to determine what the X factor should have been during the period between its 1997 order and its going forward determination. That decision must be based on the record before the Commission at the time of the original order. *See* 47 U.S.C. § 402(b). As a result, the Commission must allow the local exchange carriers to recoup the difference between what the X factor should have been under the Commission's model at that time and the inflated 6.5 X factor.

No party disputed the Commission's obligation to make such allowance if the prior X factor was overstated.

---

[8] For example, some smaller carriers are primarily rural while others have significant urban centers and have proportionally less rural areas than many of the large carriers. Moreover, to the extent that smaller carriers have not yet installed productivity enhancing switching equipment that is in use by Bell Atlantic and other large carriers, these smaller carriers have the potential for greater productivity gains going forward as they adopt such technology.

Conclusion

If the Commission does not accept the CALLS proposal, it should adopt an X factor of no more than four percent, and adjust local exchange carrier rates upward to reflect the period when an unlawful 6.5 percent X factor was in place.

Respectfully submitted,

____
Edward Shakin

Michael E. Glover
Of Counsel

1320 North Court House Road
Eighth Floor
Arlington, VA 22201
(703) 974-4864

Attorney for the
Bell Atlantic telephone companies

January 24, 2000

ATTACHMENT

PRICE CAP COMPANIES' INTERSTATE EARNINGS ARE LESS THAN AT&T'S OR OTHER INDUSTRIAL COMPANIES'

Rate of Return[1]	1998	1997	1996
BOCs – Interstate	15.7%	14.8%	14.6%
AT&T Long Distance[2]	32.5%	26.2%	30.1%
Value Line US Industrials	21.5%	23.8%	22.3%

[1] Net Operating Income/Average Assets. Net Operating income = earnings before interest and taxes less estimated taxes (EBIT – Taxes).

[2] Sum of business and consumer lines of business as reported by AT&T in its 1998 annual report. 1996 uses year-end assets in lieu of average assets (where was unavailable). This likely understates actual 1996 return.