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September 27, 2006

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, SW, TW-A325
Washington, DC 20554

***Re: WC Docket 05-342; Petition of BellSouth for Forbearance
from Enforcement of Certain of the Commission's Cost
Assignment Rules***

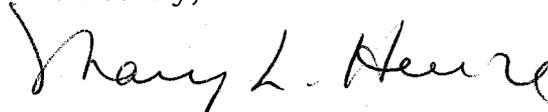
Dear Ms. Dortch,

On September 26, 2006, the undersigned, Theo Marcus, Lyn Haney, and Ron Hilyer, of BellSouth, and Joann Barron, a consultant representing BellSouth, met with Don Stockdale, Al Lewis, Deena Shetler, Randy Clarke, Jay Atkinson, Bill Kehoe, Debbie Weber, Pamela Arluk and Heather Hendrickson of the Wireline Competition Bureau.

The purpose of the meeting was to provide additional information on several topics as requested by staff in a previous meeting. In addition, BellSouth urged the Commission to forbear from the outdated rate-of-return era rules that are the subject of its petition. The company emphasized that the processes required by the Commission's cost assignment rules and the annual JCO audit combine to severely handicap the company in its effort to bring innovative new broadband services to the marketplace. All material used during the meeting is attached.

This notice is being filed pursuant to Sec. 1.1206(b)(2) of the Commission's rules. If you have any questions regarding this filing please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink that reads "Mary L. Henze". The signature is written in a cursive style with a large, looped initial "M".

Mary L. Henze

cc: D. Stockdale
A. Lewis
D. Shetler
R. Clarke
J. Atkinson
B. Kehoe
D. Weber
P. Arluk
H. Hendrickson

**BellSouth Petition for Forbearance
from Cost Assignment Rules**

September 26, 2006 Exparte Meeting

Introduction

During September 7, 2006 meeting, the FCC staff requested additional information on three topics:

- I. Historical Trends in Cost Allocation
- II. Use of Allocated Cost Data in USF High Cost Model
- III. Use of Cost Data in X-factor/TFP calculations

The information provided in the following sections supports grant of BellSouth's petition for forbearance from the Cost Assignment rules. The information shows that:

- Allocations between total, regulated, and non-regulated costs and revenues have been stable over time. Even if the allocated data is used for residual regulatory purposes, the social and competitive costs of complying with the detailed assignment procedures required by FCC rules are far out of proportion to either the volatility of the data or any regulatory benefit.
- Allocated data is not necessary for the USF Non-Rural Cost Model. Should the Model ever be re-run, total non-allocated data or a frozen factor would produce reasonable results. Total company non-allocated cost data will continue to be available after grant of the BellSouth petition.
- Allocated data is not used in the FCC's X-Factor and Total Factor Productivity procedures. Use of Total Company data for these procedures has been upheld by the Courts. Total company non-allocated cost data will continue to be available after grant of the BellSouth petition.

Section I. Historical Trends in Cost Allocations

A. BellSouth data indicates that allocations between total, regulated, and non-regulated costs and revenues have been stable over time.

- The percent of Operating Expense allocated to regulated was 86.9% in 2000 and 85.6% in 2005.
- The percent of Total Plant in Service allocated to regulated was 97.8% in 2000 and 96.7% in 2005.
- Year-over-year fluctuations in the costs allocated to regulated Operating Expense since 1996 average plus/minus 1%.
- Year-over-year fluctuations in the costs allocated to regulated Total Plant in Service since 1996 average plus/minus 0.2%.

B. Supporting data is provided in the following materials:

Table 1. Historical Data for Operating Revenue, Operating Expense, and Total Plant in Service. 1996-2005.

Chart 1. Trends in BellSouth Operating Expense; Regulated, Non-Regulated, and Total. 1996-2005.

Chart 2. Trends in BellSouth Total Plant in Service; Regulated, Non-Regulated, and Total. 1996-2005.

Table 1

HISTORICAL DATA FOR OPERATING REVENUE, OPERATING EXPENSE, TOTAL PLANT IN SERVICE												
Source FCC ARMIS 43-03 Lines 530, 720 and 2001												
BELLSOUTH												
											5-Year	10-Year
											Weighted	Weighted
											Average	Average
	Year 1996	Year 1997	Year 1998	Year 1999	Year 2000	Year 2001	Year 2002	Year 2003	Year 2004	Year 2005	Yr2001-2005	Yr 1996-2005
DOLLARS												
Reg Op Rev (530)	\$13,963,558	\$14,115,067	\$15,075,698	\$16,126,271	\$16,806,614	\$17,291,305	\$16,510,061	\$16,454,864	\$15,851,706	\$15,614,375	\$16,344,462	\$15,780,951
Nonreg Op Rev (530)	\$447,098	\$551,153	\$696,662	\$845,525	\$795,487	\$738,515	\$686,073	\$786,794	\$866,153	\$1,123,857	\$840,278	\$753,732
Total Op Rev (530)	\$14,410,656	\$14,666,210	\$15,772,360	\$16,971,796	\$17,602,101	\$18,029,820	\$17,196,134	\$17,241,658	\$16,717,859	\$16,738,232	\$17,184,741	\$16,534,683
Reg Op Exp (720)	\$9,653,183	\$9,483,112	\$9,638,837	\$9,633,471	\$9,465,616	\$10,643,814	\$11,145,574	\$11,097,505	\$11,379,154	\$11,648,949	\$11,182,999	\$10,378,922
Nonreg Op Exp (720)	\$556,706	\$702,007	\$811,927	\$1,043,580	\$1,422,379	\$1,541,658	\$1,514,861	\$1,581,242	\$1,787,440	\$1,954,229	\$1,675,886	\$1,291,603
Total Op Exp (720)	\$10,209,889	\$10,185,119	\$10,450,764	\$10,677,051	\$10,887,995	\$12,185,472	\$12,660,435	\$12,678,747	\$13,166,594	\$13,603,178	\$12,858,885	\$11,670,524
Reg TPIS (2001)	\$44,734,496	\$46,532,773	\$48,462,596	\$50,666,692	\$54,580,277	\$58,166,301	\$59,825,199	\$59,864,532	\$60,924,686	\$62,197,271	\$60,195,598	\$54,595,482
Nonreg TPIS (2001)	\$583,699	\$670,521	\$1,054,675	\$1,184,352	\$1,215,128	\$1,556,038	\$1,734,516	\$1,999,548	\$2,053,160	\$2,103,125	\$1,889,277	\$1,415,476
Total TPIS (2001)	\$45,318,195	\$47,203,294	\$49,517,271	\$51,851,044	\$55,795,405	\$59,722,339	\$61,559,715	\$61,864,080	\$62,977,846	\$64,300,396	\$62,084,875	\$56,010,959
											5-Year	10-Year
											Weighted	Weighted
											Average	Average
	Year 1996	Year 1997	Year 1998	Year 1999	Year 2000	Year 2001	Year 2002	Year 2003	Year 2004	Year 2005	Yr2001-2005	Yr 1996-2005
PERCENTS												
Reg Op Rev (530)	96.90%	96.24%	95.58%	95.02%	95.48%	95.90%	96.01%	95.44%	94.82%	93.29%	95.11%	95.44%
Nonreg Op Rev (530)	3.10%	3.76%	4.42%	4.98%	4.52%	4.10%	3.99%	4.56%	5.18%	6.71%	4.89%	4.56%
Total Op Rev (530)	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Reg Op Exp (720)	94.55%	93.11%	92.23%	90.23%	86.94%	87.35%	88.03%	87.53%	86.42%	85.63%	86.97%	88.93%
Nonreg Op Exp (720)	5.45%	6.89%	7.77%	9.77%	13.06%	12.65%	11.97%	12.47%	13.58%	14.37%	13.03%	11.07%
Total Op Exp (720)	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Reg TPIS (2001)	98.71%	98.58%	97.87%	97.72%	97.82%	97.39%	97.18%	96.77%	96.74%	96.73%	96.96%	97.47%
Nonreg TPIS (2001)	1.29%	1.42%	2.13%	2.28%	2.18%	2.61%	2.82%	3.23%	3.26%	3.27%	3.04%	2.53%
Total TPIS (2001)	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
YEAR-OVER-YEAR CHANGE IN PERCENTS												
(Change in Regulated Factor)												
	Years 1996-1997	Years 1997-1998	Years 1998-1999	Years 1999-2000	Years 2000-2001	Years 2001-2002	Years 2002-2003	Years 2003-2004	Years 2004-2005	Average		
Reg Op Rev (530)	Revenue is not displayed here because revenue accounts will continue to be identified as regulated and nonregulated.											
Reg Op Exp (720)	-1.44%	-0.88%	-2.00%	-3.29%	0.41%	0.69%	-0.51%	-1.10%	-0.79%	-0.99%		
Reg TPIS (2001)	-0.13%	-0.71%	-0.15%	0.11%	-0.43%	-0.21%	-0.41%	-0.03%	-0.01%	-0.22%		

Chart 1

TRENDS-BELLSOUTH OPERATING EXPENSE

Dollars are in Thousands

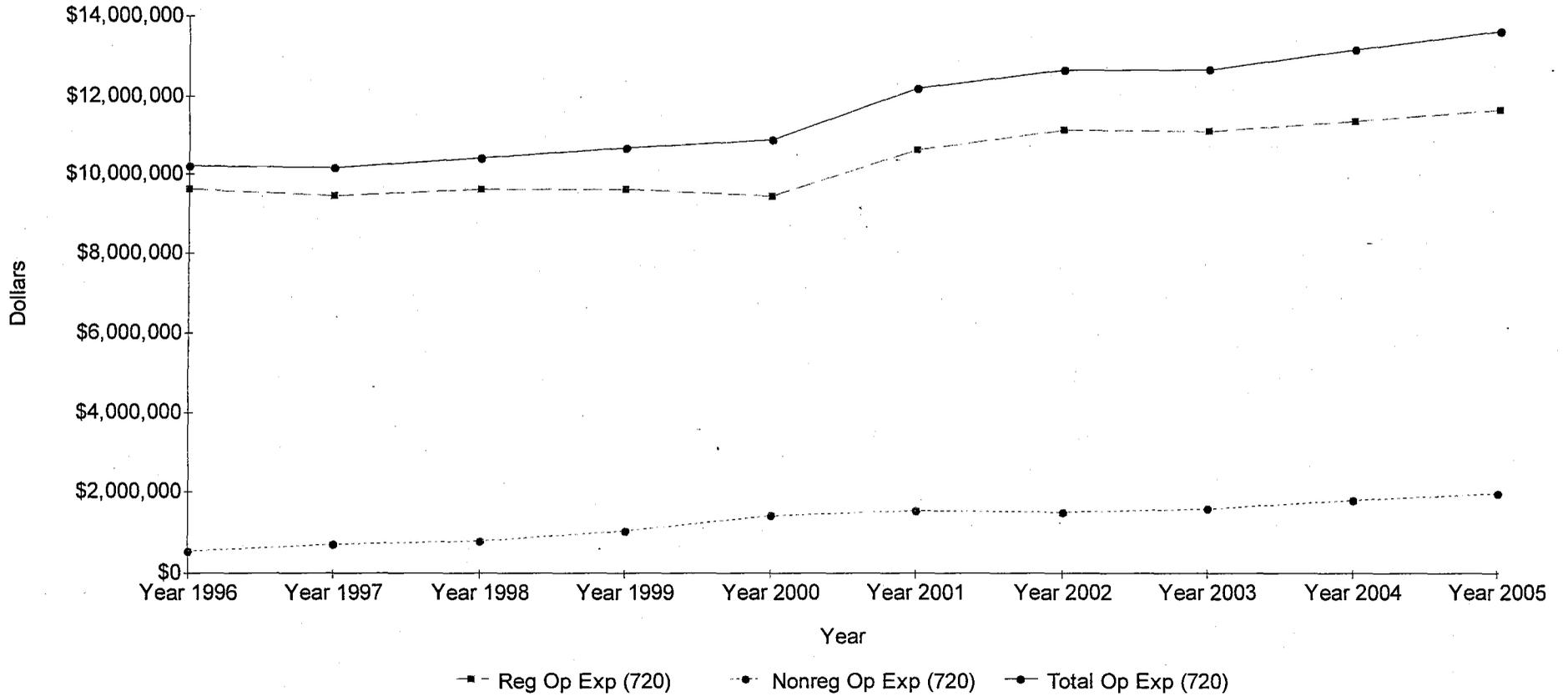
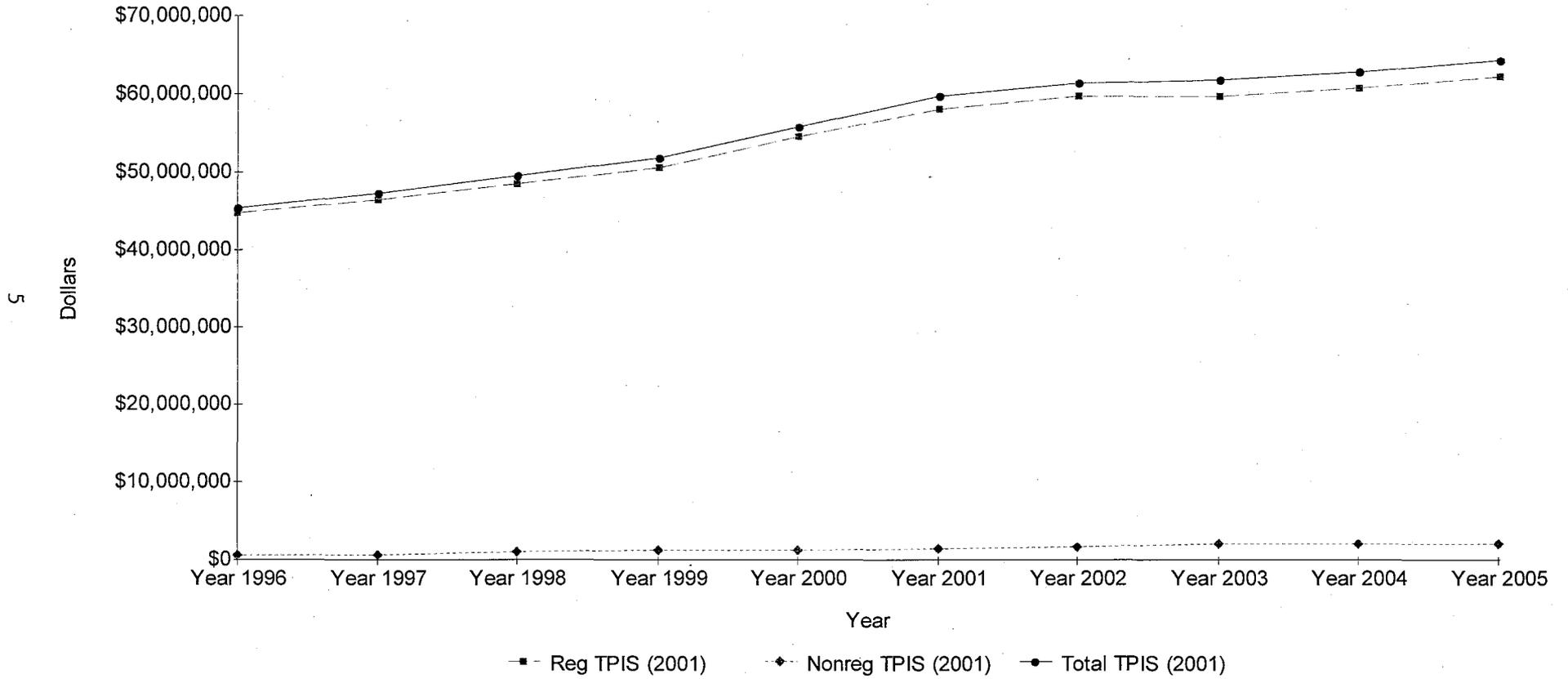


Chart 2

TRENDS-BELLSOUTH TOTAL PLANT IN SERVICE

Dollars are in Thousands

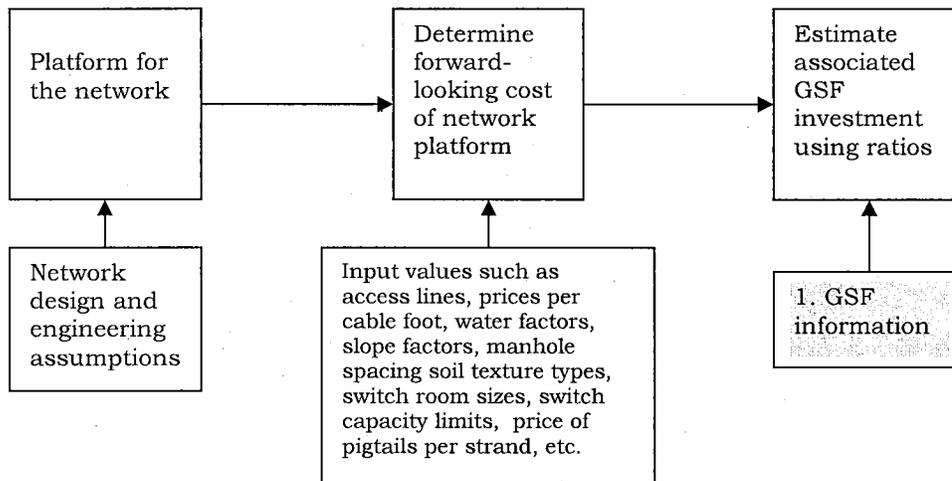


Section II. Allocated Cost Data and Non-Rural USF Model

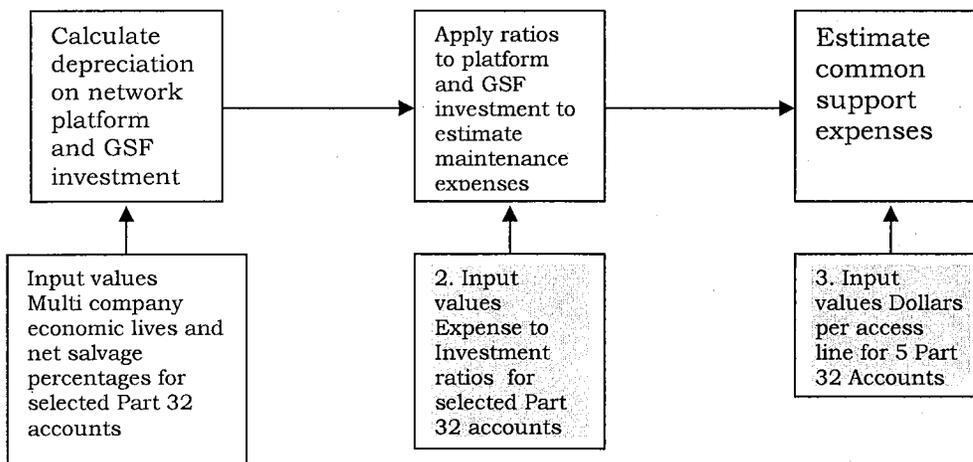
A. Our research indicates that the current USF Non-Rural Model uses booked cost data provided by ILECs in three ways as illustrated in the simplified flowchart of the model, below:

- 1) to determine General Support Facilities to Total Plant in Service Ratios
- 2) to develop Expense-to-Investment Ratios
- 3) to calculate Common Support Services Expense Dollars per access line

Investment



Expenses



B. While the USF Cost Model utilizes cost data it does not input “raw” ILEC accounting data and does not use company-specific data.

- Booked accounting data was used only as the starting point for relatively few inputs to the cost model.
- In those instances, further adjustments were made to convert the booked data¹ to forward-looking data because the cost model requires unseparated, forward-looking costs (FLEC) – See 47 CFR 54.309.
- Averages were used rather than company-specific data because:
 - Averages are a better predictor of forward-looking costs²
 - Scrutinizing company-specific data to identify anomalies and make adjustments would be exceedingly complicated and time consuming³
 - Anomalies exist in ARMIS data, but by using averages, highs and lows will cancel each other out⁴
- Original data sources included the ARMIS 43-03 Joint Cost Report and the ARMIS 43-08 Operating Data Report
 - Access lines were obtained from the ARMIS 43-08. The ARMIS 43-08 will continue to be reported.
 - Dial Equipment Minutes (DEM) and certain access lines were used to perform a regression analysis. DEM is currently frozen and does not change from year to year.
 - Although 111 accounts are reported now on the ARMIS 43-03, only 43 of the reported accounts have been identified as data for high-cost model input purposes should future model input be needed.⁵

C. Some inputs into the USF High-Cost Model started with allocated regulated cost data, however, it was not significant that the cost data was, in fact, *allocated* cost data. Allocated cost data was not, and is *not necessary* for the USF Model. As the following examples illustrate, because of how cost data is used in the model, total non-allocated data or a frozen factor would produce nearly identical results.

¹ Booked costs, not forward-looking costs, are allocated between regulated and nonregulated, with regulated costs further separated into state and interstate jurisdictions.

² FCC 99-304, released 11/2/99, Tenth Report and Order, Federal-State Joint Board on Universal Service CC Docket No. 96-45 and Forward-Looking Mechanism for High Cost Support for Non-Rural LECs CC Docket No. 970160, Par 348

³ FCC 99-304, Par 356

⁴ FCC 99-304, Par 356

⁵ See Appendix E of FCC 01-305, released 11/5/01, 2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2.

Example 1. How data is used for General Support Facilities to Total Plant in Service Ratios
(See Paragraph 409, FCC 99-304, released 1/2/99, USF 10th Report and Order)

- The USF nonrural cost model calculates a GSF investment ratio for each GSF Account by dividing the ARMIS investment by the ARMIS total plant in service less GSF investment. (Step 1)
- The model applies the ratio above to its own estimate of total plant in service and gets a preliminary result
- The preliminary result is then adjusted by a nationwide allocation factor derived from the regression methodology using lines and usage data to identify supported services. (See par 418)

Analysis: In the table below, the first row for each year illustrates an initial ratio calculation (Step 1 ratio) using allocated Regulated data. The second row for each year repeats the initial ratio calculation but using Total, unallocated, Part 32 data. The third row for each year shows the difference between the two methods and demonstrates that using Total Part 32 data provides nearly identical results. (Dollars are in thousands)

BELLSOUTH ARMIS DATA								
GSF Investment to TPIS Ratios Example								
Source ARMIS 43-03								
	a	b	c	d	e	f	g	h
Year and Classification	TPIS	GSF Buildings	GSF Motor Vehicles	GSF Gen Purpose Computers	TPIS Less GSF	GSF Building Ratio	GSF Motor Vehicles Ratio	GSF Gen Purpose Computers Ratio
	Line 2001	Line 2121	Line 2112	Line 2124	(a-b-c-d)	(b/e)	(c/e)	(d/e)
Year 2003 Regulated	\$59,864,532	\$3,760,191	\$621,070	\$1,251,947	\$54,231,324	0.0693	0.0115	0.0231
Year 2003 Total Part 32	\$61,864,080	\$4,103,186	\$712,289	\$1,537,950	\$55,510,655	0.0739	0.0128	0.0277
Year 2003 Difference						(0.0046)	(0.0014)	(0.0046)
Year 2004 Regulated	\$60,924,686	\$3,829,768	\$605,947	\$1,293,036	\$55,195,935	0.0694	0.0110	0.0234
Year 2004 Total Part 32	\$62,777,846	\$4,167,155	\$688,909	\$1,606,895	\$56,514,887	0.0737	0.0122	0.0284
Year 2004 Difference						(0.0044)	(0.0012)	(0.0050)
Year 2005 Regulated	\$62,197,271	\$3,844,339	\$614,540	\$1,180,424	\$56,557,968	0.0680	0.0109	0.0209
Year 2005 Total Part 32	\$64,300,396	\$4,208,728	\$703,778	\$1,483,330	\$57,904,560	0.0727	0.0122	0.0256
Year 2005 Difference						(0.0047)	(0.0013)	(0.0047)
5 Year Avg Regulated	\$60,195,598	\$3,691,331	\$627,789	\$1,303,037	\$54,573,441	0.0676	0.0115	0.0239
5 Year Avg Total Part 32	\$62,084,875	\$3,995,272	\$713,212	\$1,563,237	\$55,813,154	0.0716	0.0128	0.0280
5 Year Avg Difference						(0.0039)	(0.0013)	(0.0041)
10 Year Avg Regulated	\$54,595,482	\$3,246,343	\$537,263	\$1,589,438	\$49,222,438	0.0660	0.0109	0.0323
10 Year Avg Part 32	\$56,010,959	\$3,480,640	\$612,787	\$1,819,253	\$50,098,279	0.0695	0.0122	0.0363
10 Year Avg Difference						(0.0035)	(0.0013)	(0.0040)

Example 2. How Data is used for Expense-to-Investment Ratios

(See Appendix D, page D-4 of FCC 99-304, the USF 10th Report and Order)

- Two years of investment obtained from ARMIS 43-03 were each multiplied by a factor from special studies to convert booked costs to replacement costs.
- The updated investment was averaged.
- One year of expense was divided by the updated average investment to obtain a ratio for each account group.
- The cost model then applied that ratio to its own forward-looking investment to estimate forward looking-expenses.

Analysis: In the table below, columns a-e reproduce the ratio calculation using allocated Regulated cost data. Columns f-j repeat the calculation using Total, unallocated, Part 32 cost data. Column k compares the Regulated ratio (Col e) with the Total Cost ratio (Col j) and demonstrates that using Total Part 32 data provides nearly identical results. (Dollars are in thousands)

BELLSOUTH ARMIS DATA													
USF Expense-to-Investment Ratios Example													
Source ARMIS 43-03													
REGULATED COST ALLOCATED DATA*							TOTAL PART 32 DATA*						
Account Group	Exp Acct	Asset Acct	a	b	c	d	e	f	g	h	i	j	k
			Investment	Investment	Average	Expenses	Ratio	Investment	Investment	Average	Expenses	Ratio	Difference
			Year 2004	Year 2005	(a+b/2)	Year 2005	(d/c)	Year 2004	Year 2005	(f+g)/2	Year 2005	(i/h)	(e-j)
Network Support	6110	2112-16	\$987,695	\$1,002,821	\$995,258	\$15,185	0.0153	\$1,110,113	\$1,134,430	\$1,122,272	\$17,514	0.0156	(0.0003)
General Support	6120	2121-24	\$5,302,481	\$5,207,767	\$5,255,124	\$481,672	0.0917	\$5,960,320	\$5,882,187	\$5,921,254	\$550,587	0.0930	(0.0013)
CO Digital**	6212	2212	\$8,911,249	\$8,931,765	\$8,921,507	\$319,048	0.0358	\$9,151,497	\$9,201,132	\$9,176,315	\$328,098	0.0358	0.0000
Circuit	6232	2232	\$16,506,025	\$17,114,156	\$16,810,091	\$357,484	0.0213	\$16,785,620	\$17,399,779	\$17,092,700	\$358,953	0.0210	0.0003
Poles	6411	2411	\$1,098,941	\$1,124,582	\$1,111,762	\$128,814	0.1159	\$1,101,924	\$1,127,623	\$1,114,774	\$128,830	0.1156	0.0003
Aerial Cable***	6421	2421	\$6,151,746	\$6,324,653	\$6,238,200	\$486,437	0.0780	\$6,170,894	\$6,344,263	\$6,257,579	\$486,475	0.0777	0.0002
Undrgrnd Cable***	6422	2422	\$3,452,858	\$3,483,443	\$3,468,151	\$65,305	0.0188	\$3,469,443	\$3,500,080	\$3,484,762	\$65,360	0.0188	0.0001
Buried Cable***	6423	2423	\$13,802,408	\$14,349,627	\$14,076,018	\$830,234	0.0590	\$13,844,211	\$14,393,962	\$14,119,087	\$830,612	0.0588	0.0002
Conduit Systems	6441	2441	\$2,505,328	\$2,545,693	\$2,525,511	\$8,154	0.0032	\$2,517,651	\$2,558,117	\$2,537,884	\$8,161	0.0032	0.0000

*Current to Book Ratio was omitted from this example. A special study is needed to convert embedded investment costs to replacement costs.

**DDS vs. other than DDS was not included in the example because DDS breakdown does not appear on the ARMIS 43-03

***Metallic vs. Fiber breakdown was not included in the example because the Metallic and Fiber breakdown does not appear on the ARMIS 43-03.

Example 3. How data is used for Common Support Services Expense Dollars per Access Line

(See Paragraph 377-408, FCC 99-304, released 1/2/99, USF 10th Report and Order)

- Expense dollars from ARMIS 43-03 were used for Account 6510 Other Property Plant and Equipment Expense, Account 6530 Network Operations Expense, Account 6613 Advertising Expense, Account 6620 Services Expense, and Account 6700 (now 6720) General and Administrative Expense.
- Adjustments were made to Account 6530 and Account 6700 (now 6720) for costs related to mergers and acquisitions and work force restructuring. Security and Exchange Commission (SEC) reports were used for this adjustment. (Paragraph 400). The BellSouth forbearance petition does not affect SEC reports.
- Regression analysis was performed to estimate USF supported services by using access lines and dial equipment minutes (See Attachment D, Pages D-5, D-6). The BellSouth forbearance petition does not affect access line reporting. Dial equipment minutes have been frozen.
- Economics and Technology, Inc., performed a study using operating statistics for residential and single-line business (Table 2.10 of 1996 Preliminary Statistics of Common Carriers – sourced from the ARMIS 43-08), along with modifications by FCC staff to include some multi-line business lines, to estimate USF supported services for Account 6613 Advertising Expense. Paragraphs 403-407. (See Attachment D, Page D-7). ARMIS 43-08 will continue to be reported.

10

Analysis: As described above, the cost data for the five accounts used in this calculation is substantially modified before use in the USF model. While allocated Regulated cost data was originally used, the table below demonstrates that that allocation data has been stable over time. Use of either total costs or a Common Support Service Expense Composite factor could be used to provide reasonable results.

5-Year (2001 to 2005) and 10-Year (1996 to 2005)
BellSouth Weighted Average Percents

Expense	Account 6510 Other Property Plant and Equipment Expense		Account 6530 Network Operations Expense		Account 6613 Product Advertising Expense (ETI Special Study Performed for USF)		Account 6620 Services Expense		Account 6720 General and Administrative Expense		Common Support Service Expense (Composite of the 5 Accounts)	
	Reg	Nonreg	Reg	Nonreg	Reg	Nonreg	Reg	Nonreg	Reg	Nonreg	Reg	Nonreg
Weighted Average												
5-Year	89.72%	10.28%	84.08%	15.92%	28.53%	71.74%	80.50%	19.50%	85.49%	14.51%	81.48%	18.52%
10-Year	93.45%	6.55%	86.54%	13.46%	50.94%	49.06%	85.46%	14.54%	88.50%	11.50%	85.69%	14.31%

III. Cost Data and X-factor/TFP Calculations

A. The price cap plan⁶ for carrier access services creates price cap indices (PCI) representing the maximum prices that LECs may charge for the services covered by the index for each of several different categories of LEC access services.⁷

- PCI is adjusted annually based on a formula that offsets the nationwide rate of inflation (measured by Gross Domestic Product—Price Index, GDP-PI) by a productivity or ‘X-Factor.’⁸
- The X-Factor is then applied to each basket’s PCI, the result of which is to tie the weighted average of any rate increases in any given basket to the nationwide inflation rate less the X-Factor.⁹
- Under the *CALLS* plan, adopted by the Commission in 2000, service basket X-Factors for price cap LECs are pegged to inflation (*i.e.*, frozen) for the final year of the plan (July 1, 2004 to June 30, 2005) – and have remained so since June 30, 2005. 47 C.F.R. § 61.45 (b)(1)(ii).
- The X-Factor calculation methodology otherwise applicable to price caps LECs’ service baskets is based on “total factor productivity,” or “TFP.”¹⁰ TFP is a ratio of an index of total outputs (*i.e.*, all LEC services produced) to an index of total inputs (*i.e.*, labor, capital services and materials).¹¹

B. The FCC tentatively concluded in the *First Report and Order* that TFP should be based on total company productivity, and not productivity restricted to interstate access services, or restricted to regulated services.¹²

⁶ See *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) (“*LEC Price Cap Order*”).

⁷ See *In the Matter of Price Cap Performance Review for Local Exchange Carriers, Fourth Further Notice of Proposed Rulemaking*, CC Docket No. 94-1, 10 FCC Rcd 13659 (1995) (“*Fourth FNPR*”). See also 47 C.F.R. § 61.45.

⁸ See *Fourth FNPR* at ¶ 2. See *LEC Price Cap Order* at ¶ 74. See also *USTA v. FCC*, 188 F.3d 521, 524 (D.C. Cir. 1999).

⁹ See *In the Matter of Price Cap Performance Review for Local Exchange Carriers, Fourth Report and Order in*, CC Docket No. 94-1, and *Second Report and Order in* CC Docket No. 96-262, 12 FCC Rcd 16642 at ¶ 7 (1997) (“*Fourth Report and Order*”), *rev’d and remanded in part, petitions for rev’w denied in part*, *USTA v. FCC*, 188 F.3d 521.

¹⁰ *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, (1995) (“*First Report and Order*”).

¹¹ *Id.* at ¶ 106. See *Fourth FNPR* at ¶¶ 16, 22-24. See *USTA*, 188 F.3d at 524-25.

¹² See *First Report and Order* at ¶ 159; *Fourth FNPR* at ¶ 63. The FCC based this determination on its finding that interstate and intrastate services were largely provided over common facilities, and the record evidence showed no economically meaningful way to divide and measure the facilities used for the provision of interstate service from facilities used for provision of intrastate services.¹² Thus, the Commission concluded, TFP should be calculated on a *total company basis*, *i.e.*, without regard to interstate/intrastate separations or reg/non-regulated divisions (assignment).

- The FCC stated: “costs and demand that are ‘separated’ between the state and interstate jurisdictions pursuant to Part 36 of the Commission’s rules *may not be optimal benchmarks for setting interstate rates.*”¹³
- The Commission further noted “it [also] may not be possible to distinguish between the productivity associated with regulated services from that associated with nonregulated services.”¹⁴

C. In the *Fourth Report and Order*, the Commission resolved these issues by affirming its TFP methodology, and rejected arguments that this “might give LECs a windfall.”¹⁵

- In addition, the FCC determined that it would not measure TFP on any other “less-than-total-company basis,” such as on a regulated services only basis.¹⁶

D. Although it subsequently has had to re-set the actual X-factors that it has *chosen* pursuant to federal circuit court remand,¹⁷ the Commission’s core TFP methodology (and, more importantly, its reliance on total company [unit cost] data for determining an appropriate X-factor), was upheld by the D.C. Circuit in *USTA*.¹⁸

- If the FCC were to reset or “reinitialize” the X-Factor in the future it is unlikely to change the methodology for calculating the X-Factor. Any significant (“extensive”) change in methodology or re-initialization would likely run afoul of the *USTA* Court’s admonition against it. (“[U]niversal, complete reinitialization would impair the supposed incentive advantages of price caps- which derive from firms’ supposing that their efficiencies will *not* come back to haunt them”).

¹³ *Id.* (emphasis added). The Commission further observed that “relinquishing our reliance on separated costs and demand would represent a further step toward pure price cap regulation and away from rate-of-return regulation.”

¹⁴ *Fourth FNPR* at ¶ 69.

¹⁵ *Id.* at ¶¶ 63-70. Some commenters (including Ad Hoc) had argued that LECs’ interstate access services had grown faster than overall LEC output and, thus, interstate productivity growth outpaced total company productivity growth. Reliance on total company data, according to those commenters, would tend to understate the LECs’ interstate access productivity growth and introduce a systemic downward bias in the X-Factor so long as the methodology was based on total data. See *Fourth Report and Order* at ¶ 107.

¹⁶ *Id.* at ¶ 113.

¹⁷ See *USTA* at 526 (“The Commission having failed to state a coherent theory supporting its choice of 6.0% [X-Factor], we remand for further explanation”). For discussion, see *In the Matter of Price Cap Performance Review for Local Exchange Carriers, Further Notice of Proposed Rulemaking*, CC Docket No. 94-1, and *Access Charge Reform*, CC Docket No. 96-262, 14 FCC Rcd 19717 (1999) (“This Notice is limited to issues surrounding the setting of the X-factor, and does not include any broader changes to our method of price cap regulation”).

¹⁸ See *USTA* at 528 (“MCI argues that in calculating the X-Factor the FCC arbitrarily used the LECs’ productivity in all their telecommunications business rather than productivity only in their interstate operations. *Again, we disagree.* The FCC reasonably concluded that ‘the record before us does not allow us to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth’ . . . and this determination was enough to justify using the total company data”).