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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

RE: Ex Parte Meeting
CC Docket No. 94-1

Dear Mr. Caton:

On Monday, November 21, 1994, Frank McKennedy, Ed Lowry and Jeff Olson representing USTA met with James Coltharpe of Commissioner Barrett's office. The USTA representatives rebutted information previously presented by the "CARE" group. The points made by USTA are contained in the attached document and were consistent with the comments USTA has filed in this docket.

The original and a copy of this ex parte notice are being filed in the Office of the Secretary. Please include it in the public record of this proceeding.

Respectfully submitted,

Mary McDermott
Vice President & General Counsel

Attachment

cc: J. Coltharpe

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List A B C D E

LEC Price Cap Review

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"CARE" Has Alleged:

- *LECs have profited disproportionately from price caps.*
- *LECs are disinvesting in the network.*
- *Rates should be reduced further and ROR regulation concepts should apply to price cap LECs.*

The Facts Are:

- **LEC earnings have been below the market averages (Standard & Poors) and below IXC's.**
- **LECs have increased their investment in the network under price caps.**
- **Price cap regulation should focus on prices, not earnings.**

Earnings

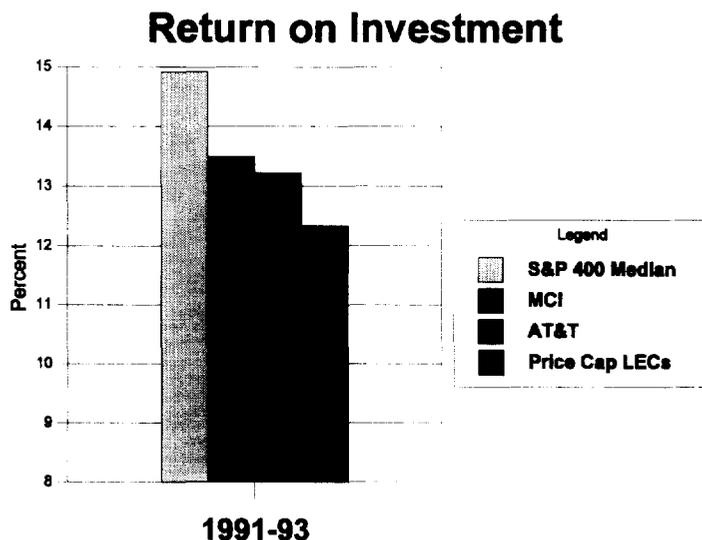
"CARE" Alleges:

LECs have profited disproportionately from price caps.

The Facts Are:

The earnings of the price cap LECs are demonstrably reasonable.

Even using the interstate accounting earnings, the earnings of the price cap LECs during 1991-93 (12.34) were below the median of the S&P 400 Industrials (14.92%) and below the interstate earnings of AT&T (13.22%).



The Commission's objective for incentive regulation was "to harness the profit-making incentives common to all businesses." The Commission "encouraged LECs to earn reasonably higher profits than were formerly allowed."

AT&T Price Cap Performance Review:

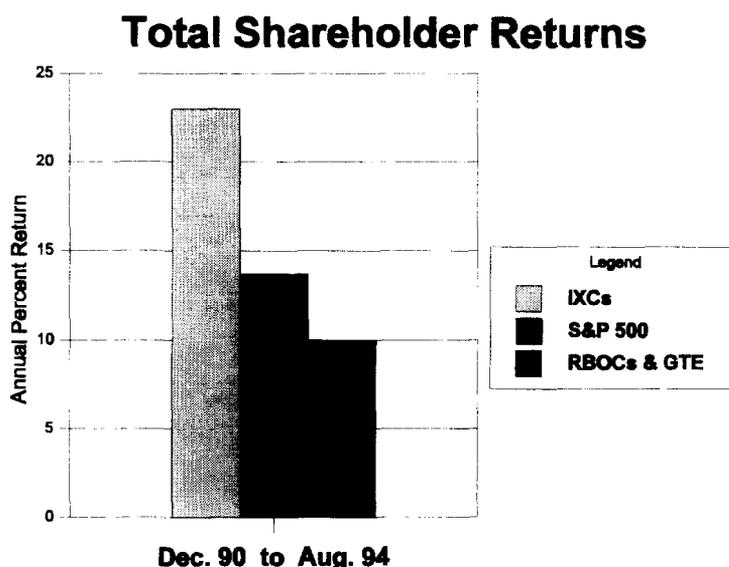
- Commission determined plan was working.
- AT&T interstate accounting earnings rose to 13.30% (avg.) during 1990-92.
- Commission decided that AT&T's productivity offset should not change.

Earnings

Facts (cont'd.):

To determine whether carriers are achieving earnings comparable to market returns it is necessary to calculate economic returns.

Economic returns are based on stock price and dividend performance.



Returns to shareholders in the RBOCs and GTE (10.0%) have been below the average for the S&P 500 (13.7%) and far below the returns the IXC shareholders (23%).

In cable rate TV regulation, did not use accounting earnings.

- The Commission reduced cable TV rates, some by as much as 17%, while the accounting earnings of the cable TV companies were about 0%.

Investment

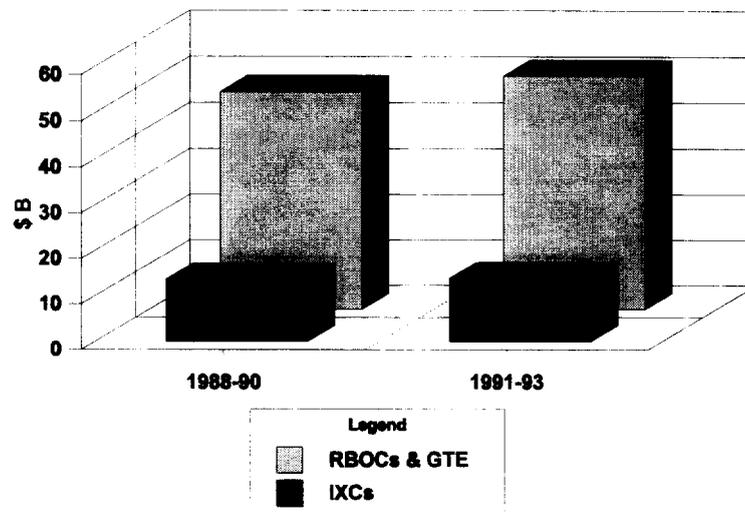
"CARE" Alleges:

LECs are not investing in the infrastructure.

The Facts Are:

The price cap LECs are a critical source of investment in U.S. telecommunications industry. During 1991-93, price cap LECs invested \$55.4 billion in plant and equipment (gross additions).

Investment Before and After 1-1-91



The price cap LECs account for 75% of all investment in the telecommunications sector (SIC 481).

The RBOCs increased investment in their networks by approximately \$3.5 billion during 1991-93 (under price caps) compared to 1988-90.

Access customers have benefitted from price cap LEC investment.

- **As of EOY 1993, 81% of the price cap LEC switches were digital, up from 64% at EOY 1990.**
- **As of EOY 1993, 79% of access lines equipped with SS7.**

Investment

Facts (cont'd.):

Study by Pablo Spiller, filed by Ameritech, shows that incentive regulation results in increased investment. By analyzing regulatory environments in detail, Spiller found that pure price regulation (price caps without sharing) provide greater incentives and results in more investment than plans with earnings sharing.

The RBOCs have increased the portion of their cash reinvested into the regulated portion of their business since 1990, from 48% during 1988-90 to 59% during 1991-93. The RBOCs and GTE together reinvested approximately \$51 billion in their networks during 1991-93.

"CARE" uses false premises regarding depreciation and investment:

- **Depreciation is not a fund for future investments.**
- **Depreciation is the process of allocating the historical costs of investments to current production costs. Thus, current depreciation expenses are a function of a series of prior period investments, not current investments.**

Prices

"CARE" Alleges:

Prices have not declined as much under price caps as under ROR regulation.

The Facts Are:

Interstate access customers have already benefitted by approximately \$5.3 billion from LEC access price reductions under the LEC price cap plan. Benefits will be over \$7.4 billion by end of 1995.

Interstate access prices have declined 11% under price caps while overall inflation has risen by 14%. Thus, real LEC access prices have declined 25%.

The average annual decline in LEC access prices under ROR regulation was in the -1% to -2% range annually (1984-1990). Under price caps, the average annual decline in access prices has been -3.0% (thru July 94).

Discrete periods under ROR regulation resulted in large price declines due to:

- **Lower CCL rates caused by increases in EUCL rates**
- **Demand stimulation caused by resulting lower per minute TS rates**
- **Lowering of interstate separations ratios**

Without similar policy changes again, these forces will not be present.

Under price cap regulation, access prices have fallen by a total of \$1.1 billion due to pricing below cap (cumulative amount through 7-1-94).

Productivity Offset

"CARE" Alleges:

The productivity offset should be increased based the recent short-term record of LEC accounting earnings. ("CARE" recommends 5.7%)

The Facts Are:

Total Factor Productivity (TFP) measured over the longer-term is the correct basis for an offset:

The Christensen TFP study prepared for USTA:

- **Is the only economically correct study on the record.**
- **Includes price cap LECs only.**
- **Uses correct weights for both outputs and inputs by category.**
- **Has been extensively documented on the record and can be validated.**
- **Shows that the productivity offset should be 2.3%.**

"CARE" implies they have as many as six different studies.

- **They do not have a productivity study at all, but instead depend solely on accounting earnings -- totally inappropriate for incentive regulation.**

"CARE's" flawed earnings analyses fall into three categories:

- **Direct earnings measurement -- reimposing ROR regulation**
- **Input inflation adjustments -- there is no differential**
- **Deleting data -- attempting to obtain predetermined results**

Rate of Return Regulation

"CARE" Alleges:

The FCC should regulate the price cap LECs using ROR regulation, decrease rates based on cost of capital and retain earnings sharing.

The Facts Are:

The proper focus for regulation is price, not earnings.

- **The Commission has consistently chosen price regulation over ROR regulation over the past six years.**
- **The perverse incentives caused by cost-plus ROR regulation are not viable in the competitive telecommunications environment.**
- **Incentives for continued efficiency should be improved by the elimination of earnings sharing.**

Price regulation supports the Commission's public policy goals.

The Facts

- **LEC earnings have been below the market averages (Standard & Poors) and below IXC's.**
- **LECs have increased their investment in the network under price caps.**
- **Price cap regulation should focus on prices, not earnings.**