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BELLSOUTH

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EX PARTE

EX PARTE OR LATE FILED

November 22, 1994

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

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NOV 22 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

RE: Ex Parte Presentation in Price Cap Performance Review, CC Docket No. 94-1

Dear Mr. Caton:

This notice of oral ex parte presentations in the above-referenced proceeding and the attached charts are provided for inclusion in the public record pursuant to the Commission's Ex Parte rules at 47 C.F.R. §1.1200 et seq. BellSouth representatives met with Karen Brinkmann, Special Assistant to Commissioner Hundt and James L. Casserly, Senior Legal Advisor to Commissioner Ness, to discuss BellSouth's position and to rebut positions advanced by opponents in ex parte presentations in this proceeding.

Representing BellSouth were G. Epstein, Attorney, Latham & Watkins, R. Blau, Executive Director, BellSouth, Inc. and the undersigned. The discussions at the meetings were consistent with BellSouth's position already on file in this proceeding. The attached charts were also passed out during the meetings as an aid to the discussion.

If you have any questions regarding this matter, please do not hesitate to call the undersigned.

Sincerely,



Maurice P. Talbot, Jr.
Executive Director-Federal Regulatory

Attachments

cc: James L. Casserly (w/o attachments)
Karen Brinkmann (w/o attachments)

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BELLSOUTH PRICE CAP PROPOSALS
EX PARTE PRESENTATION
CC DOCKET 94-1
NOVEMBER 22, 1994

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

I. REGULATORY REFORM AND INFRASTRUCTURE DEVELOPMENT ARE INSEPARABLE

- A. Price Cap Reform Provides Commission Opportunity To Promote Development of NII**
- B. Price Caps Plan Impacts LEC Investment Decisions**
- C. Current Price Cap Plan Damages Incentives to Invest in the Core Network**
- D. Commission's Current Rules Bias Market Outcomes by Handicapping LECs**

II. PRICE REGULATION IS SUPERIOR TO COST OF SERVICE REGULATION

- A. Price Regulation Emulates Economic Incentives of a Fully Competitive Marketplace**
- B. Interstate Access Market Is Increasingly Competitive**
- C. LECs Need Ability To Respond To Competition Through Pricing Flexibility and Introduction of New Services**

III. SPECIFIC PRICE CAP CHANGES PROPOSED BY BELLSOUTH

- A. Eliminate sharing and low end adjustment mechanisms**
 - 1. These mechanisms are no longer required as a "backstop" because of possible error in the level of the LEC productivity offset.
 - 2. They retain the perverse incentives associated with cost of service regulation.
 - 3. No sharing was required in either AT&T or Cable TV price regulation plans.
 - 4. Reported LEC earnings are inflated due to FCC prescribed uneconomic depreciation rates.
 - 5. Existence of sharing has been used to justify the continuance of burdensome depreciation regulations that are otherwise unnecessary.
- B. Adopt reasonable productivity target**
 - 1. Credible record evidence shows current productivity target is set too high.
 - 2. Christensen study commissioned by USTA shows current productivity offset before CPD should be 2.3%. Updated average of Commission studies is 2.4%.
 - 3. Increasing competition will slow growth in access minutes of use, a principal source of historical LEC productivity growth.
 - 4. Productivity gains resulting from force reductions and other "one time" events cannot be repeated, making it difficult to replicate historical performance.
 - 5. Cable TV companies have a 0% productivity offset.

C. Extend Depreciation Price Cap Carrier Option to Price Cap LECs

1. Commission's current depreciation procedures for price cap LECs do not permit timely recovery of invested capital.
2. Depreciation is not exogenous and will not impact rates at all once sharing is eliminated.
3. BellSouth has identified a multi-billion dollar reserve deficiency in major technology accounts because of Commission's inappropriately prescribed depreciation rates.
4. Other carriers have already announced multi-billion dollar write downs of inadequately depreciated plant for financial reporting purposes.
5. Commission chose not to regulate depreciation rates of Cable TV companies.
6. Commission extended depreciation price cap carrier option to AT&T. Commission does not regulate depreciation rates of other long distance carriers.
7. Commission should address this issue on reconsideration in CC Docket No. 92-296.

D. Simplify Present Price Cap Pricing Structure

1. Present procedures are extremely burdensome and cumbersome and inhibit introduction of new services.
2. Reform the current cost support, rate structure, and tariff requirements to facilitate the introduction of new services.
3. Modify baskets and bands to replicate the outcome of a fully competitive marketplace.
4. Reduce number of categories and subcategories, expand zone pricing to switching, and increase downward pricing flexibility to encourage competitive response by price cap LECs.
5. Streamline regulation as markets become competitive.
6. Effective competition is demonstrated when a significant percentage of customers (e.g. 25%) in a defined geographic area can be addressed by competitor.
7. Address transition issues now. If transition issues must be deferred, a new phase of this proceeding should be initiated without delay.

IV. ADOPTING BELLSOUTH'S PRICE CAP PROPOSALS WILL BENEFIT CUSTOMERS

A. Improved incentives for infrastructure investment will result in more jobs and more investment in infrastructure for education and health care.

1. WEFA study indicates that a proper price regulation plan for LECs would spur 5 to 15 percent increase in infrastructure investment.
2. The WEFA study also concludes that 510,000 new jobs will be created in the domestic economy. A \$47.9 billion increase in the Gross Domestic Product by 2004 is also forecast.
3. Consistent and positive signals will be given to capital markets.

B. Enhanced deployment of new services in response to consumer and market demand will be encouraged.

C. Greater efficiency by carriers will result in enhanced competition and lower prices to consumers. The WEFA study concludes that consumer price inflation will be 1.4% less by the year 2004 due to the efficiencies and cost reductions that would occur throughout the economy.

CARE---lessness on Price Caps

Facts, Factoids and Distortions

**BellSouth Ex Parte
November 22, 1994**

CARE

- **Mischaracterizes the purpose of the price cap regime**
- **Misstates key facts of the matter**
- **Fails to include important record data**
- **Addresses the wrong issue (RoR)**
- **Conceals the public's real interest**

"CARE" vs FACT

CARE

- Ratepayers benefit
- Excessive Earnings
- IXCs not rewarded
- Excess IXC payment
- Increase "X"

- Rate of return high
- LEC Investment low

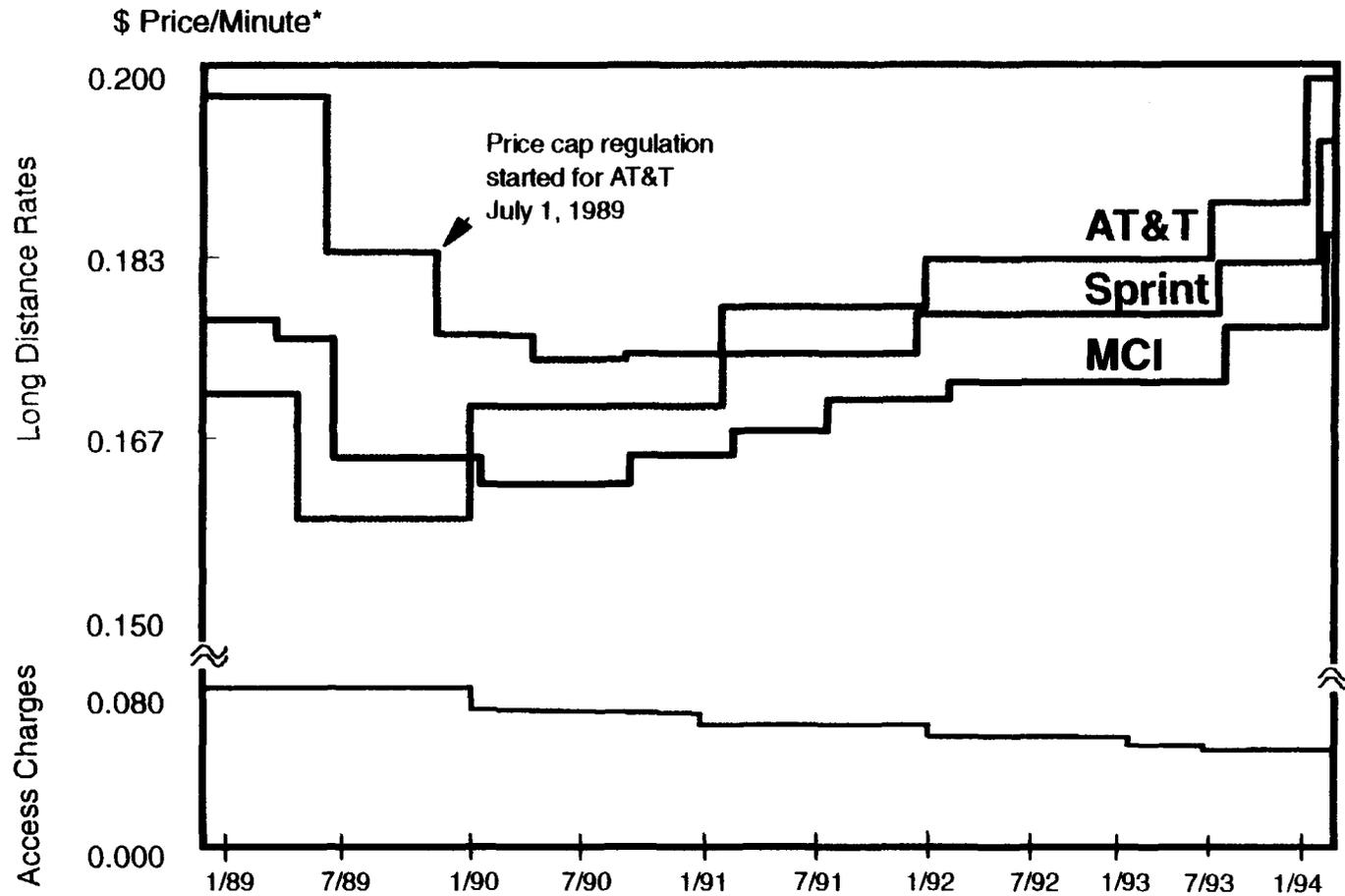
FACT

- IXC Owners Benefit
- Earnings Reasonable
- Substantial IXC Gain
- Declining Charges
- Excessive "X"
- Unsustainable
- IXCs overstate
- Investment high and growing

Who Benefits From Access Charge Reductions

- **IXCs and large users, and not consumers**
- **History shows:**
 - **IXC rates rising, even with access charge reductions**
 - **Residential customers don't see reductions**
- **Rate cuts accrue to IXC shareholders and users with market power**

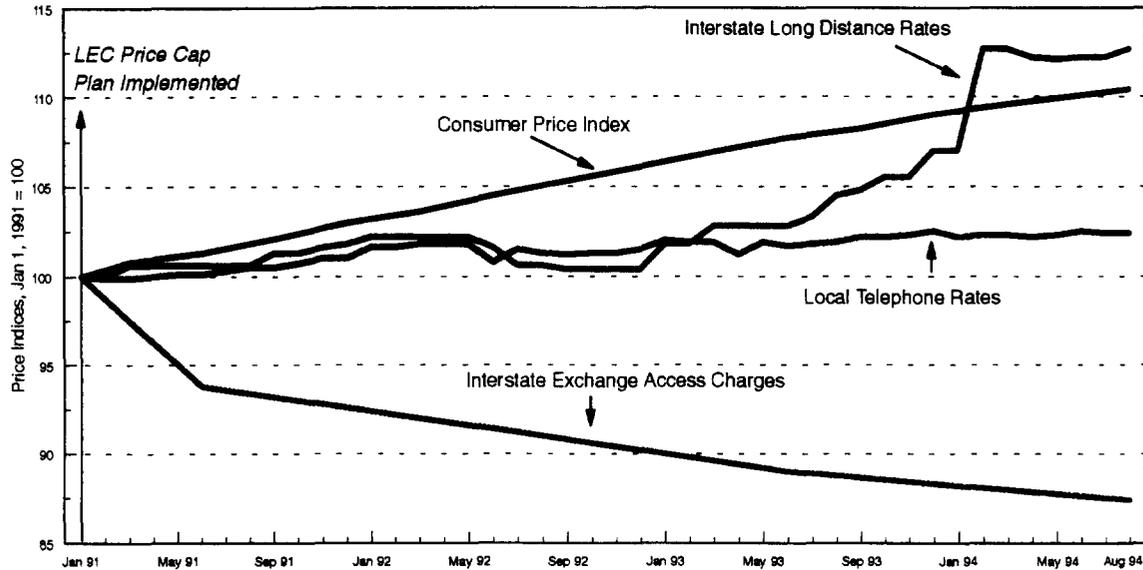
Trends in Long Distance Rates and Exchange Access Charges



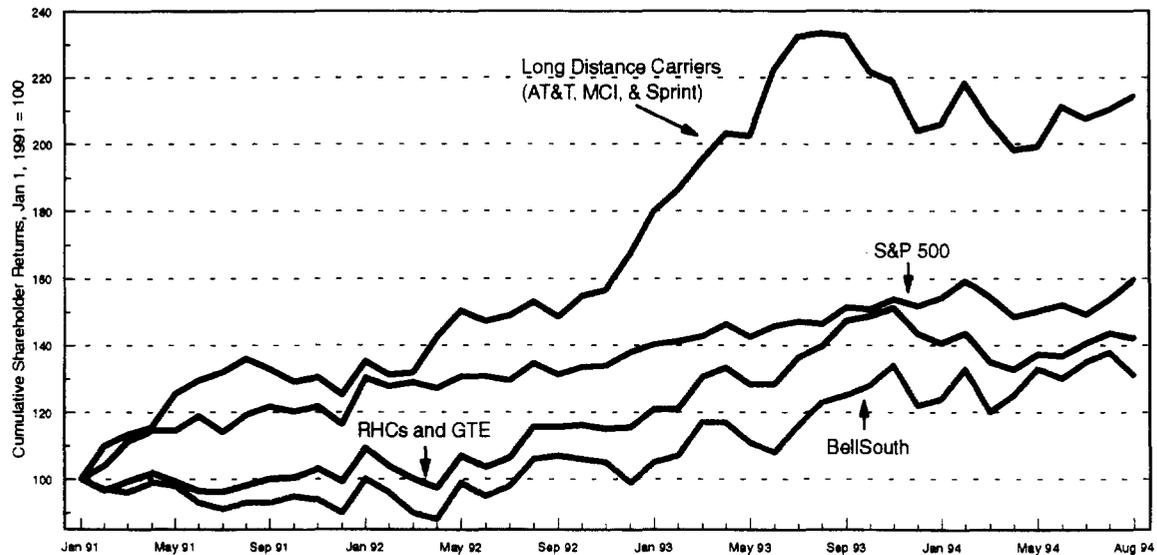
*Long distance rates based on the average price per minute for basic service.

Recent Trends In Prices And Shareholder Returns In Local And Long Distance Telecommunications Markets

Despite reductions in exchange access charges that have occurred since the LECs' price cap plan was implemented in January 1991, the interexchange carriers (IXCs) have raised interstate long distance rates sharply over the past 2 years...



... shifting billions of dollars from local and long distance customers to IXC shareholders.



Note: Cumulative shareholder returns are based on market weighted monthly averages of total shareholder returns for individual companies.

Sources: Bureau of Labor Statistics, FCC, Compustat

AT&T's Telecommunications Services

Dollars in Millions	1991	1992	1993	%Change 1991-93
Total Revenues	\$38,805	\$39,580	\$39,863	+2.73%
Access & Other Interconnection Costs	\$18,395	\$18,132	\$17,709	-3.73%
Gross Profit Margin	34.9%	36.2%	38.0%	+8.88%

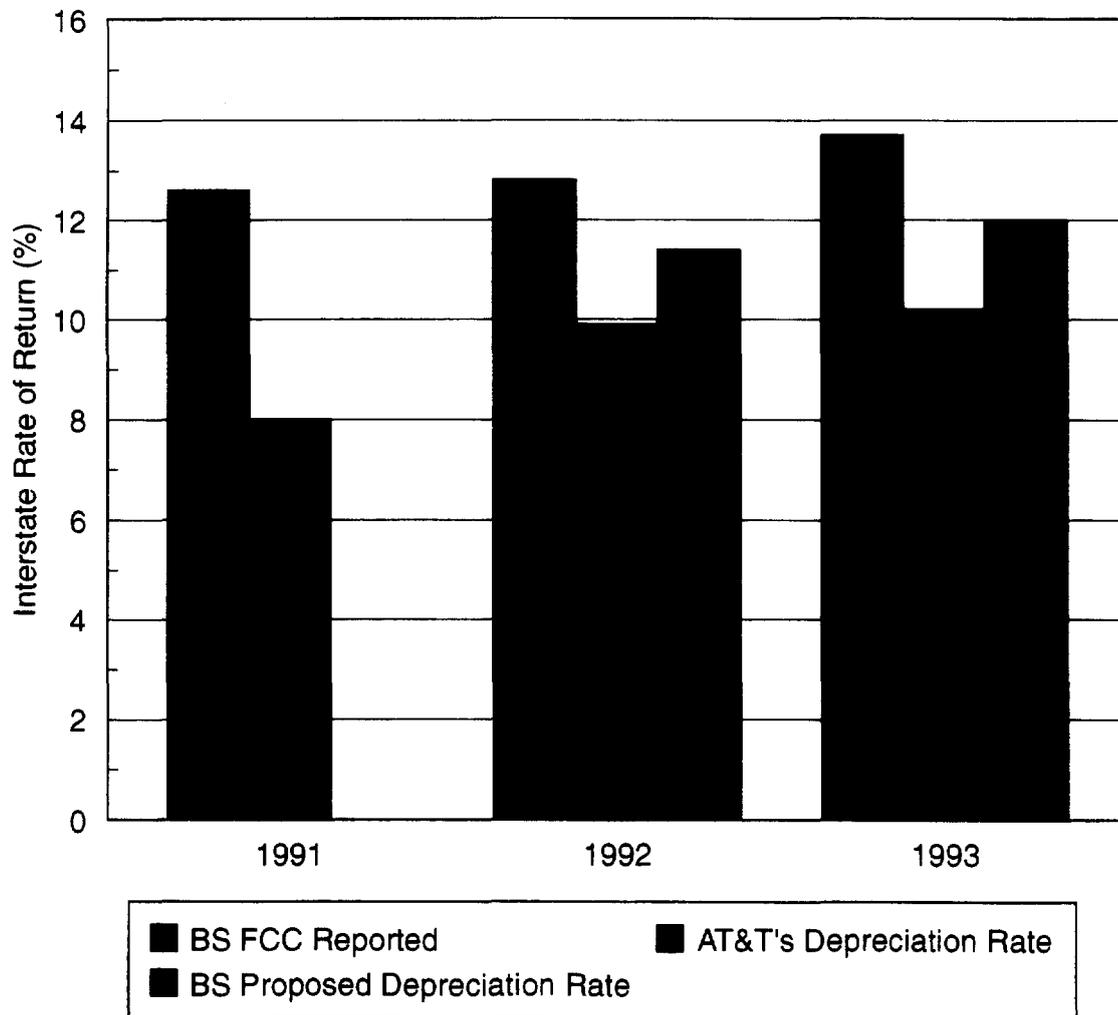
Source: AT&T's 1993 Annual Report

Earnings Sufficiency

- **Focus should be on prices not earnings**
- **This is not RoR case**
- **LEC earnings overstated due to depreciation distortion**
- **Adequate earnings incentive required for NII**
- **Purpose of price caps is to permit reasonable earnings as an incentive**

BellSouth's 1993 Interstate Rate of Return Would be Nearly Four Percentage Points Lower if it Depreciated its Plant and Equipment at the Same Rate AT&T Depreciates its Plant and Equipment

	BellSouth Reported Earnings	Earnings with AT&T Depreciation Rate	BellSouth Proposed Depreciation Rate
1991	12.6%	8.0%	N/A
1992	12.8%	9.9%	11.4%
1993	13.7%	10.2%	12.0%



Note: BellSouth's depreciation rate not applicable in 1991

Interstate Access Rates Have Declined Under Price Caps

- **CARE neglected to report that LEC access charges have diminished by over \$2.1 billion under price caps**
- **Cumulative value of LEC rate reductions Jan. 1991 - Dec. 1994 ---- \$5.3 billion**
- **During this period, IXC rates have increased by 12.7%, LEC Interstate Access Rates have decreased by 13%**
- **IXC Shareholders not consumers have received the benefit of LEC Access Charge Reductions**

Excessive "X"

Will Undercut Price Cap Goals

- **CARE summarizes its own self-serving and distorted studies**
- **CARE misstates Christensen results**
- **Fact is: Commission should not undercut efficiency incentives by "recontracting" and punishing success**
- **Increasing "X" difficult to achieve**

IXC Payments Are Reasonable

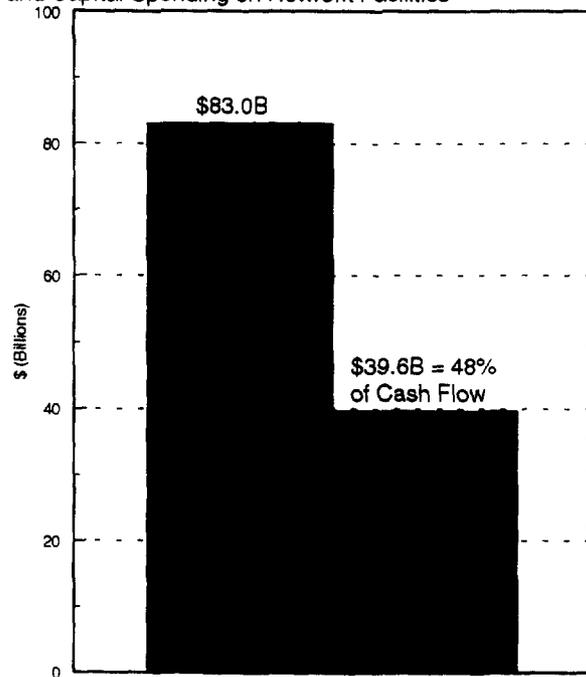
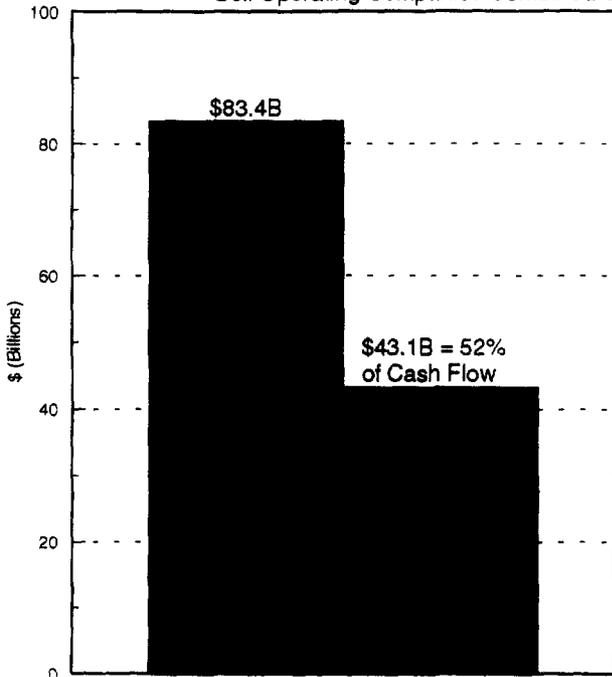
- **The \$8.2 Billion Fiction**
 - **GIGO - Garbage in, Garbage out**
 - **Assume the result and tailor the assumptions**
- **Access Charge payments have decreased by \$2.1 billion**
- **Current payments are consistent with Commission goals in this proceeding**

LEC Investment Large and Growing

- **Investment and depreciation linkage is misleading**
- **LEC investment relative to cash flow has been increasing**
- **LEC investment outperforms IXC's**
- **IXC's have not invested increases in cash flow resulting from access charge reductions**
- **This proceeding will "signal" investors**

Percentage of Cash Flow that the Bell Operating Companies and Interexchange Carriers Have Invested in Their Respective Telecommunications Networks Before and After the Implementation of Price Caps

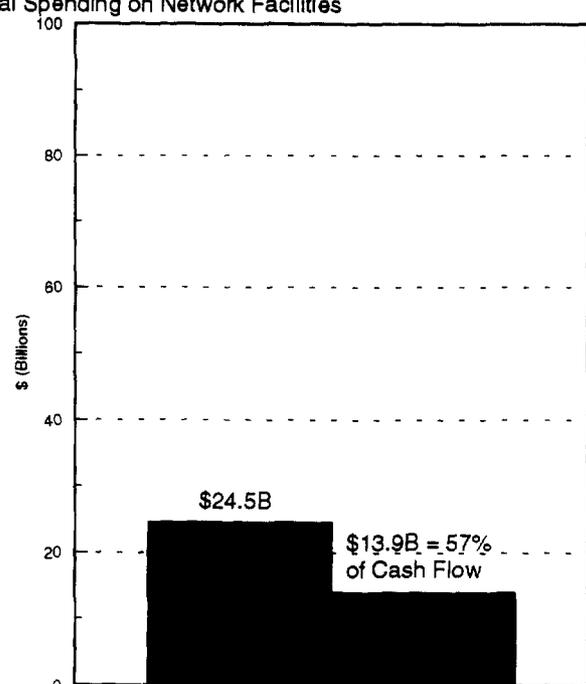
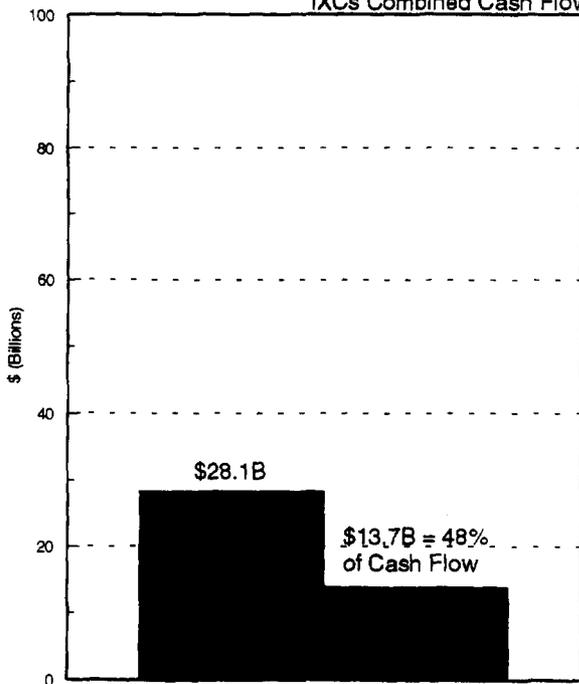
Bell Operating Companies Combined Cash Flow and Capital Spending on Network Facilities



1991-1993
Post LEC Price Cap Plan

1988-1990
Pre LEC Price Cap Plan

IXCs Combined Cash Flow and Capital Spending on Network Facilities



1991-1993
Post LEC Price Cap Plan

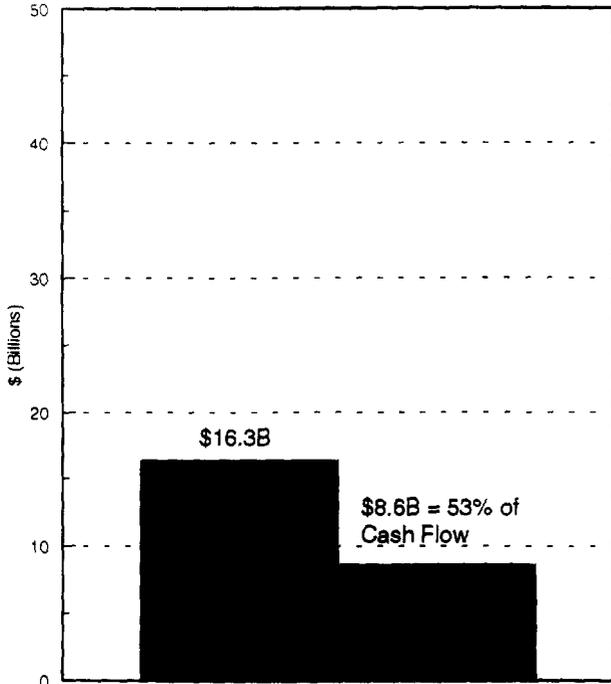
1988-1990
Pre LEC Price Cap Plan

Note: Cash flow is earnings before interest, taxes, and depreciation and amortization.

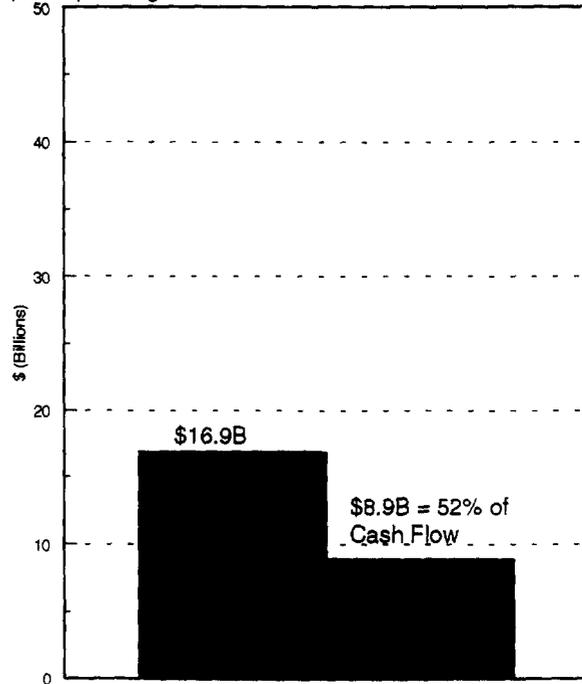
Sources: Compustat and FCC Form M

Percentage of Cash Flow that the BellSouth Telecommunications and Interexchange Carriers Have Invested in Their Respective Telecommunications Networks Before and After the Implementation of Price Caps

BellSouth Telecommunications Cash Flow and Capital Spending on Network Facilities

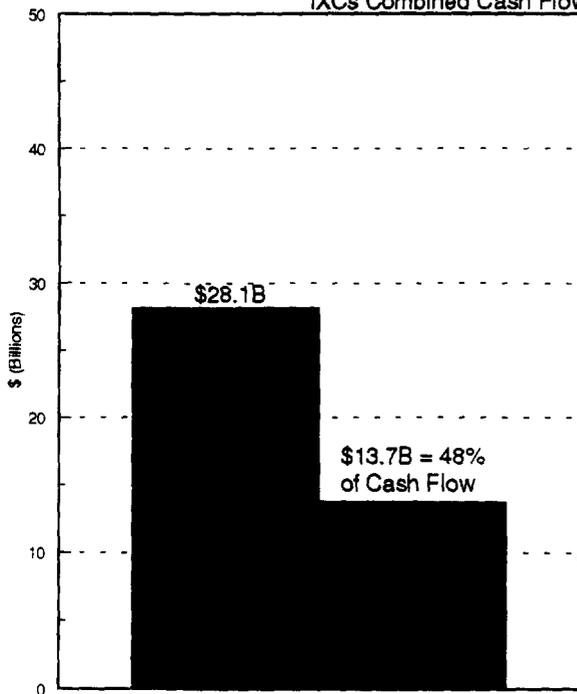


1991-1993
Post LEC Price Cap Plan

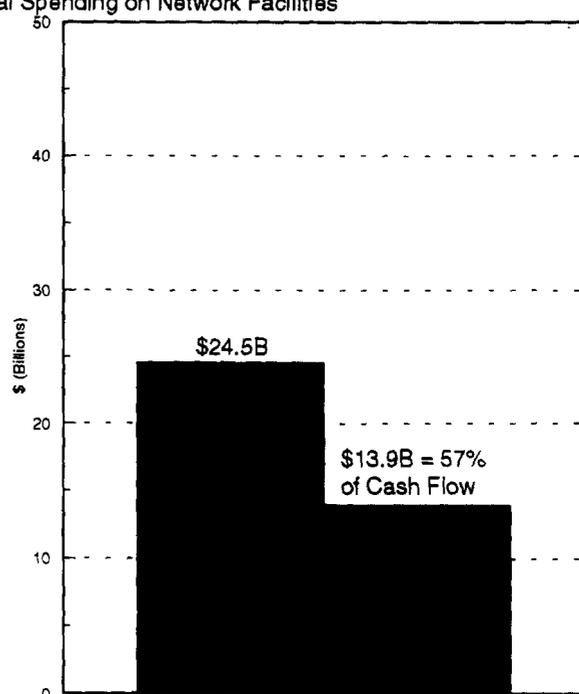


1988-1990
Pre LEC Price Cap Plan

IXCs Combined Cash Flow and Capital Spending on Network Facilities



1991-1993
Post LEC Price Cap Plan



1988-1990
Pre LEC Price Cap Plan

Note: Cash flow is earnings before interest, taxes, and depreciation and amortization.

Sources: Compustat and FCC Form M

Sharing Must Go

- **Sharing:**
 - **reintroduces Rate of Return Regulation and disincentives**
- **Bottom Line:**
 - **LEC owners need incentive to build NII**
 - **Investment dollars have greater incremental value in local networks**
 - **With proper incentives, LECs will finance and construct substantial portions of the NII**

Summary

- **Price caps are working, but need refinement**
- **Proceeding is test of FCC commitment to Infrastructure Development**
- **Decision is pivotal; will signal investors**
- **IXCs and large users have no intention to convert access charge savings to useful capacity**
- **FCC should continue on path to reform**