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March 17, 1995

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Ex Parte

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

Re: CC Docket No. 94-1

Dear Mr. Caton:

Today the undersigned representing BellSouth met with Richard Welch, Legal Advisor, Commissioner Chong's office. The attached information was discussed during this meeting.

Please call me if you have any questions.

Sincerely,

W.W. Jordan auk

W.W. Jordan
Executive Director - Federal Regulatory

cc: Richard Welch

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BELLSOUTH

David J. Markey
Vice President-
Governmental Affairs

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March 16, 1995

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M. Street, N.W., Rm. 814
Washington, D.C. 20554

Dear Chairman Hundt,

In an ex parte filing in this proceeding, NYNEX has abandoned its prior positions regarding the elimination of the sharing and low end adjustment mechanisms in the LEC price cap plan. NYNEX now advocates criteria for the elimination of sharing that would delay the removal of this vestige of rate of return regulation indefinitely for most LECs. BellSouth strongly opposes the new NYNEX proposal. As demonstrated below, the NYNEX proposal is illogical and contrary to public policy.

Throughout this docket, NYNEX has stated unequivocal support for the elimination of the sharing and low end adjustment mechanisms on sound economic and public policy grounds. In its initial comments, NYNEX noted that sharing has substantially lessened the efficiency incentives of the price cap plan. It stated that sharing dampens the incentives to invest in the domestic infrastructure, while encouraging investment in unregulated lines of business. NYNEX also noted that the existence of a sharing mechanism in the LEC price cap plan hinders the transition to a fully competitive marketplace by increasing the administrative difficulty of removing services from price cap regulation as they become competitive. NYNEX Comments (May 9, 1994) at 28-31.

On January 18, 1995, USTA proposed that the Commission include a no-sharing option in the LEC price cap plan that would include a self-adjusting productivity offset, an initial one-time reduction of one percent in the price cap indices, a phase out of the Consumer Productivity Dividend, and a more restrictive definition of "exogenous" costs. NYNEX fully supported the USTA no-sharing option, reiterating the multiple public benefits that would accrue from the elimination of the sharing and LFAM mechanisms. NYNEX Comments on USTA Proposal (January 31, 1995) at 2-3. NYNEX also urged the Commission to adopt a second, separate option that would eliminate sharing for those LECs facing substantial competition. Id. at 4 et seq.

On March 3, 1995, NYNEX filed with the Commission an ex parte pleading entitled "A NYNEX Proposal for the LEC Price Cap Plan". In an abrupt and largely unexplained change of direction, NYNEX abandoned the positions taken in its prior pleadings, and its support for the USTA proposal, in favor of a plan that would tie the elimination of sharing in the interstate LEC price cap plan solely to the development of competition in intrastate markets, a linkage of dubious legality. The NYNEX ex parte does not even discuss the serious jurisdictional issues raised by its proposal.

The NYNEX proposal would initially move all of the LECs away from price regulation and towards rate of return regulation by significantly narrowing both the "dead zone" around the initial rate target and the 50/50 sharing zone. Only when an initial competitive trigger was reached in each company would the LEC price cap plan return to its present structure. Additional hurdles would be required to expand, and ultimately eliminate the sharing and LFAM mechanisms.

The NYNEX proposal is based on the following syllogism: competition increases efficiency incentives; sharing dulls efficiency incentives; therefore, the Commission should link the two and retain sharing until competition develops. The illogic of the NYNEX proposal is apparent on its face. The Commission has already moved forward to encourage competition in the interstate access market and now should eliminate sharing to maximize the efficiency incentives in the LEC price cap plan.

The Commission has previously found that price regulation is superior to rate of return regulation in emerging competitive markets. LEC Price Cap Order, 5 FCC Rcd 6786 (1990) at para. 33. By initially moving back towards rate of return regulation, the NYNEX proposal would dull the very efficiency incentives that the Commission has found to be in the public interest. NYNEX offers no logical basis for this aspect of its proposal.

The NYNEX proposal is illogical in another respect. NYNEX posits a series of triggers that would result in LECs being regulated under pure price regulation only when all legal and economic barriers to entry are removed and actual competition is well entrenched. However, once such a state is reached, the appropriate government response should be to eliminate regulation all together, not to impose price regulation. Price regulation is appropriate only during the transition to effective competition. It should not be permanent. The NYNEX proposal has everything out of step: hybrid price/cost regulation when price regulation is appropriate and price regulation when no regulation is appropriate.

A final lack of logic in the NYNEX proposal is its premise that the LECs can "accept" local exchange competition on their own initiative. As noted above, eliminating barriers to local exchange competition will require state regulatory action and, in many cases, state or federal legislation. It makes no sense to condition the adoption of a superior form of interstate regulation on the occurrence of events at the state level that the LECs cannot control.

In addition to being illogical, the NYNEX proposal is bad public policy. It would discourage investment by making interstate returns dependent upon the actions of state regulators and legislators, thereby compounding the regulatory risk inherent in investing in the infrastructure. It would discourage economic efficiency, both by reintroducing the perverse incentives of rate of return regulation and by making carrier earnings more dependent upon political and regulatory skills than on skills in meeting customer needs. It would discriminate among carriers performing equally well in managing costs, improving productivity and serving the public by rewarding some with higher returns based on factors largely outside of the control of carrier management.

It also is clear that the NYNEX proposal was carefully crafted to ensure that NYNEX, and NYNEX alone, can meet the proposed criteria. For example, NYNEX does not propose a state by state approach to the application of its criteria, but rather a regional approach. Thus, NYNEX initial trigger is met when "30% of Access Lines in Operating Territory meet Criterion 1". Is it hardly coincidental that New York State represents more than 30% of NYNEX's access lines, so that NYNEX would satisfy the trigger in all of its states merely because of the agreements it has reached in New York. Indeed, it is apparent that each of the criteria proposed by NYNEX was specifically tailored to encompass something that it has already agreed to in New York.

The NYNEX proposal is also untimely. NYNEX waited until March 3, 1995 to propose an entirely new conceptual basis for the elimination of sharing. NYNEX's proposal is not set forth in sufficient detail for BellSouth to analyze the proposal in depth, but the issues raised herein demonstrate that the proposal is sufficiently questionable to warrant thorough debate before its adoption should be considered seriously by the Commission. By contrast, the January 18, 1995 USTA proposal consists largely of elements that have been thoroughly debated throughout this proceeding.

The Commission should not construe BellSouth's opposition to the NYNEX proposal as opposition to interstate access competition. BellSouth shares the Commission's goal of encouraging the development of interstate access competition. The Commission, however, must not be distracted from the urgent business of improving the LEC price cap plan by NYNEX's untimely proposal.

In conclusion, it is BellSouth's view that NYNEX's March 3, 1995 proposal lacks a logical framework, is of dubious legality, raises significant public interest issues, and comes far too late in this proceeding for the Commission to give it serious consideration. USTA's January 18, 1995 proposal for a no sharing option in the LEC price cap plan rests on a much sounder economic, legal and public policy base, and should be adopted.

Sincerely,

David J. Markey
Vice President-
Governmental Affairs

cc: Commissioner Andrew Barrett
Commissioner James Quello
Commissioner Susan Ness
Commissioner Rachelle Chong

A Factual Assessment of the LECs' Price Cap Plan

- ***LEC Price Cap Plan Is Lowering Access Charges.*** Since LEC price cap plan was implemented in January 1991, interstate access charges have declined by nearly **13 percent**, as compared to a **10 percent** increase in the consumer price index and a **12 percent** gain in the Bureau of Labor Statistics' price index for interstate MTS service. (Fig. 1)

- ***LEC Price Caps Have Spurred Investment In The Infrastructure.*** Since price caps were implemented, Bell operating companies have invested **52 percent** of their cash flow from local telephone operations in network facilities versus **48 percent** during the 1988-90 time frame. By contrast, the share of cash flow from long distance services that AT&T, MCI and Sprint reinvested in their respective networks declined from **57 percent** during 1988-90, to **48 percent** during 1991-93. (Fig. 2) Current investment rates imply that each dollar in cash shifted from the LECs (52% of cash invested) to IXCs (48%) will reduce investment by 4 cents.

- ***LECs Have Not Profiteered From Price Caps.*** Since 1991, total cumulative returns (i.e., dividend yield plus percentage change in price per share) to regional Bell company and GTE shareholders have remained below the S&P 500. (Fig. 1) Lackluster performance of these stocks indicates that true profitability of regulated local telephone services, including access services, are certainly not excessive. Economic returns on access services also tend to be well below accounting returns because regulated depreciation rates are too low and, thus, overstate reported earnings. In 1993, BellSouth's reported rate of return on interstate access services would have declined from **13.7% to 10.2%** if the company had been permitted to use the same depreciation rates that currently apply to AT&T's network operations. (Fig. 3)

- ***LEC Shareholders Are Being Penalized For Investing In Upgraded Local Networks.*** Since 1988, cumulative returns to RHC shareholders have varied inversely with the portion of total cash flow from local telephone operations that each of the companies reinvested in their local networks. That the stock market has rewarded individual RHCs for investing less in new network facilities is further evidence that true rates of return on local telephone services are, if anything, too low. Given that local telephone operations of the RHCs necessarily compete with other investment opportunities, any FCC action that reduces economic returns on access services will very likely diminish investment and slow the deployment of new technologies. (Fig. 4)

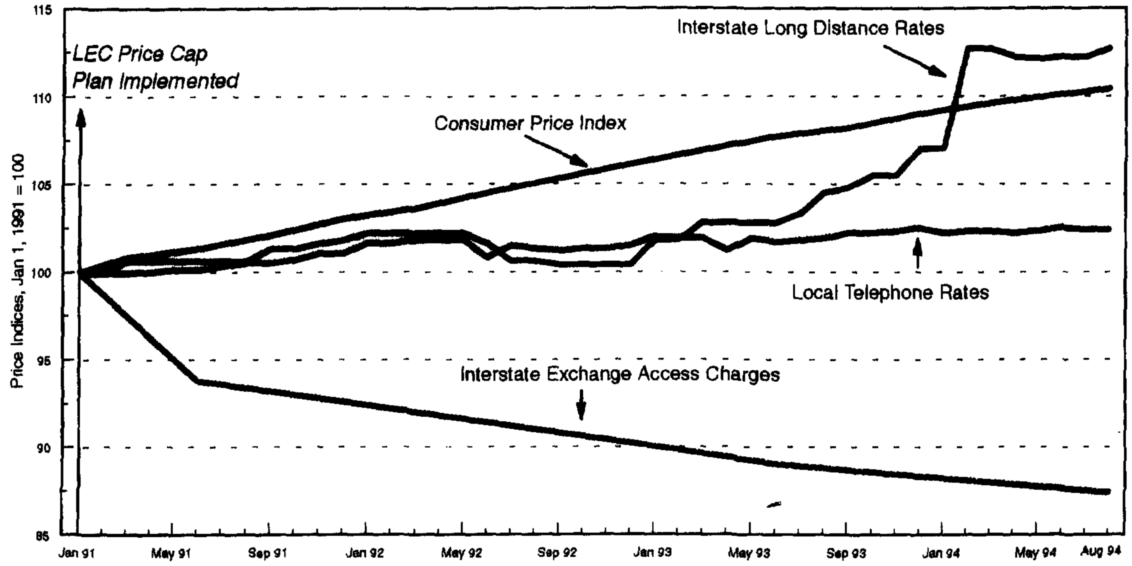
- **LEC Access Rate Cuts Are Being Flowed Through To IXC Shareholders.** Since 1991, MCI, Sprint and other long distance carriers have followed AT&T's lead in raising rates every six months or so, despite continuing reductions in interstate access charges. (Fig. 5) Subsequent improvements in IXC operating profit margins have resulted in even sharper increases in cumulative returns to IXC shareholders. (Table 1 and Fig. 1)

Modifying the LECs price cap plan in ways that further reduce earnings, therefore, will only further enrich IXC shareholders, while slowing investment in new network technology. At a time when the economy is becoming more and more information intensive and demanding an ever larger array of network services, consumers would be well served by eliminating the last vestiges of rate-of-return regulation (i.e., earnings sharing) and moving to a pure system of price regulation.

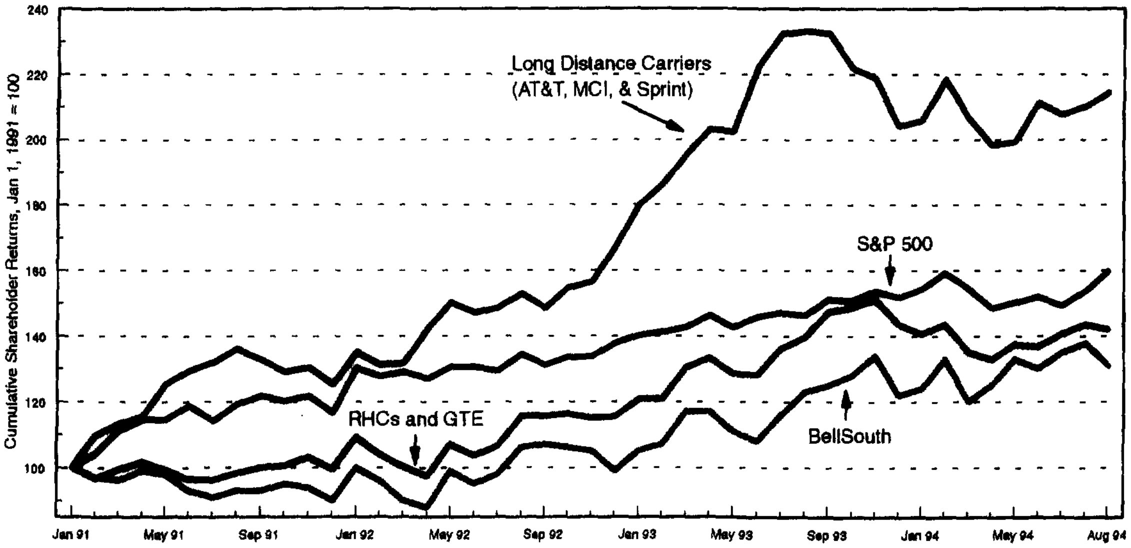
Figure 1

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.

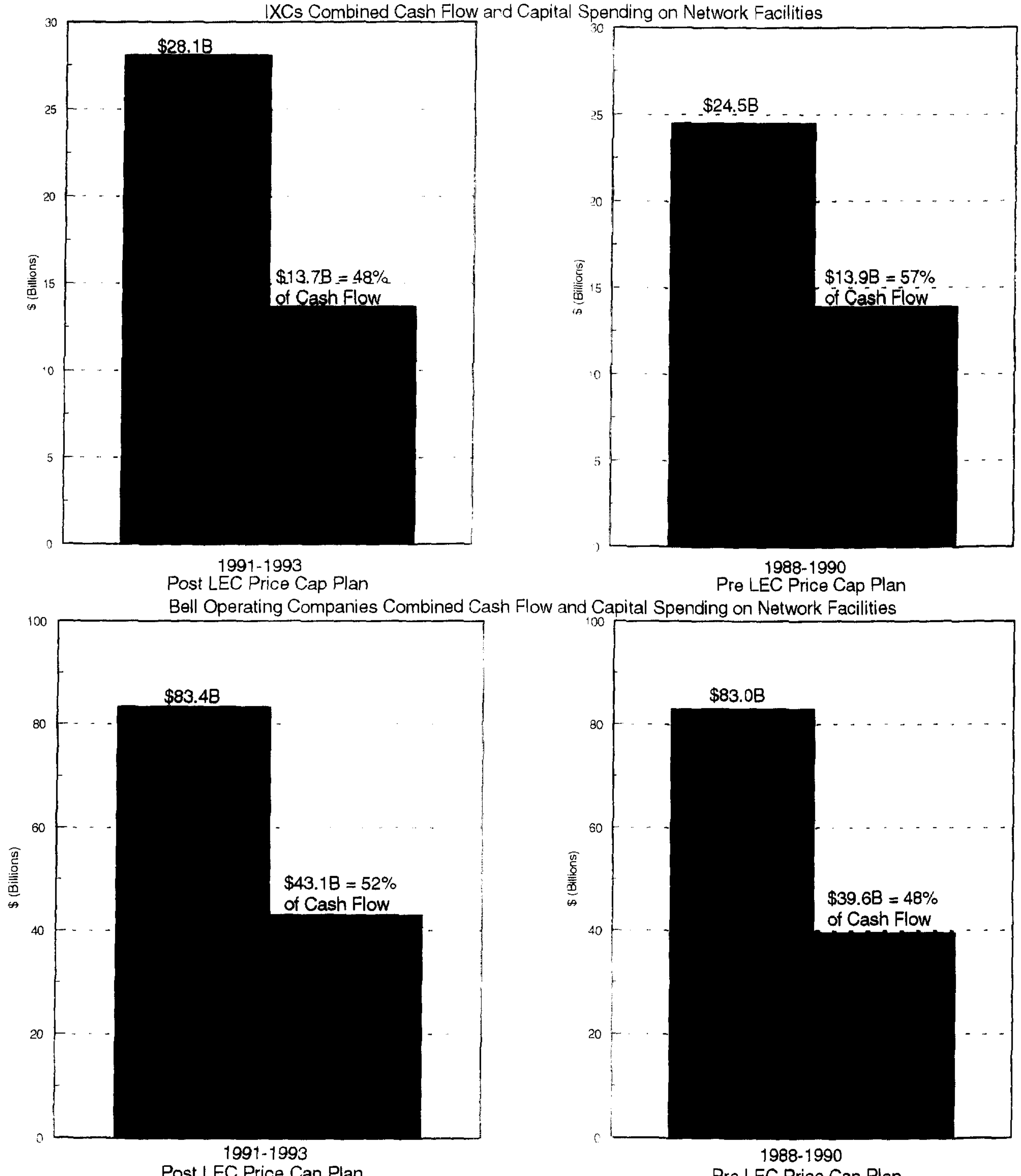


Note: Cumulative shareholder returns are based on market weighted monthly averages of total shareholder returns for individual companies.

Sources: Bureau of Labor Statistics, FCC, Compustat

Figure 2

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

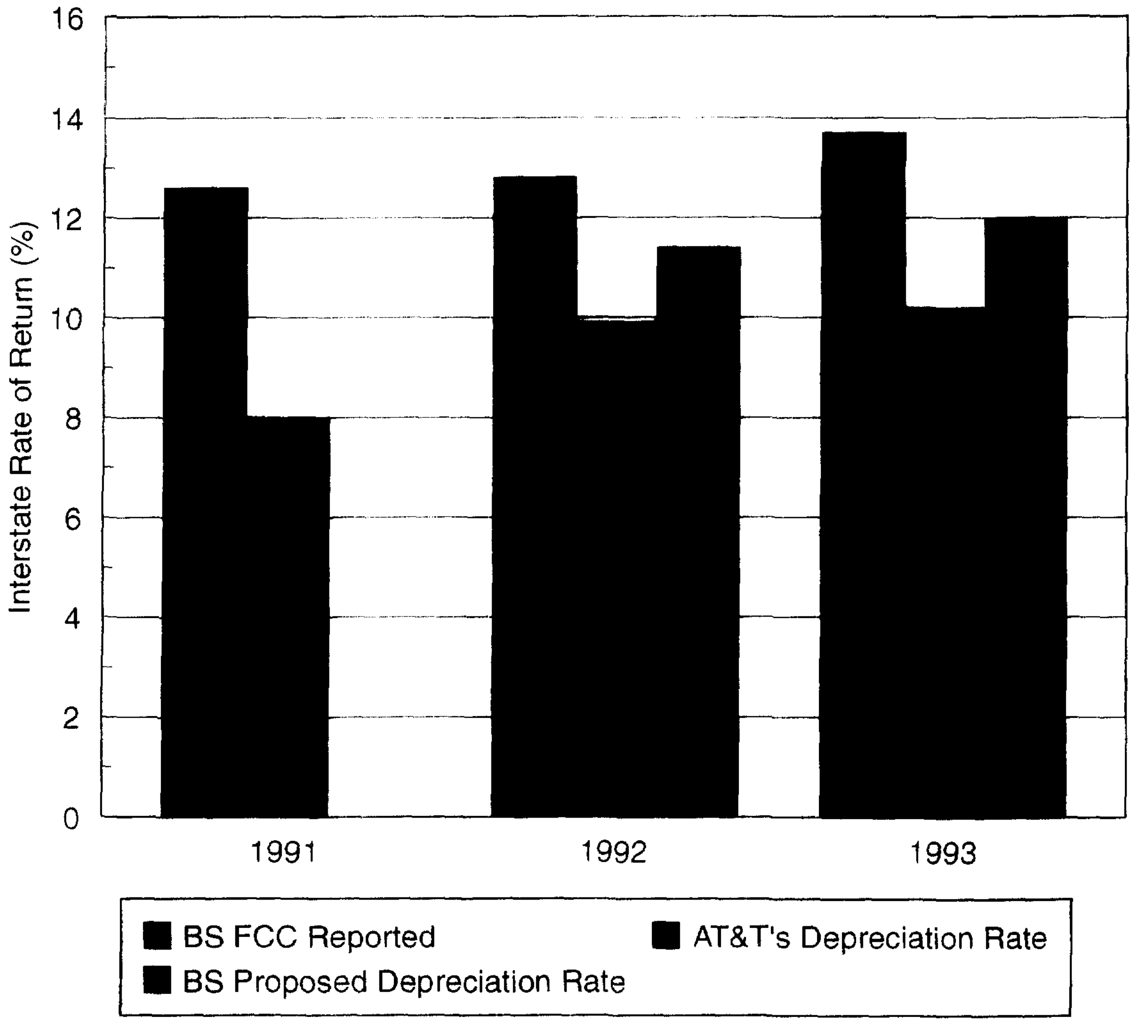


Note: Cash flow is earnings before interest, taxes, and drepreciation and amortization.
Sources: Compustat and FCC Form M

Figure 3

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

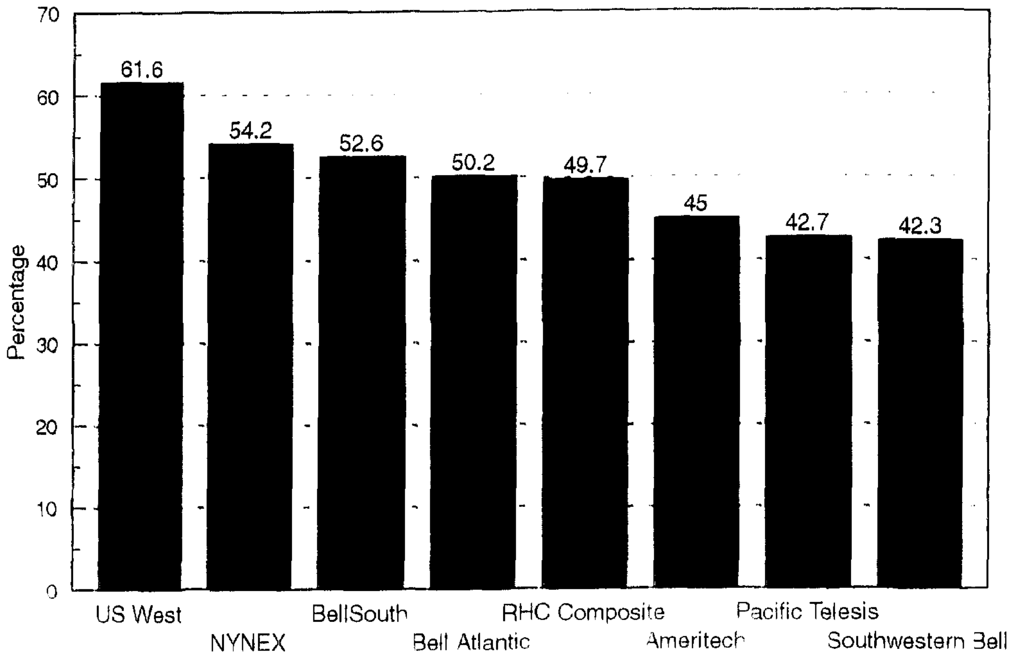
	BellSouth Reported Earnings	Earnings with AT&T Depreciation Rate	BellSouth Proposed Depreciation Rate
1991	12.6%	8.0%	N/A
1992	12.8%	9.9%	11.4%
1993	13.7%	10.2%	12.0%



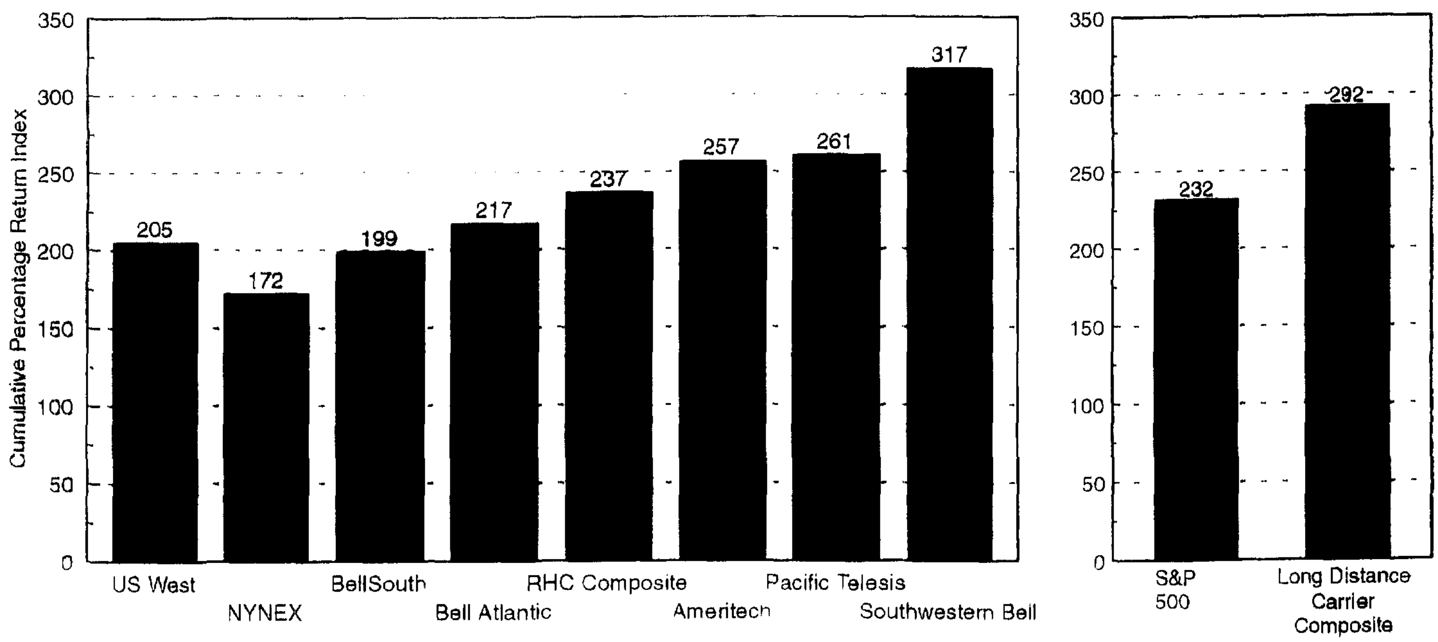
Note: BellSouth's depreciation rate not applicable in 1991

Figure 4

Bell Operating Company's Capital Spending as Percent of Cash Flow 1988-1993



RHC Cumulative Shareholder Return 1988-Present

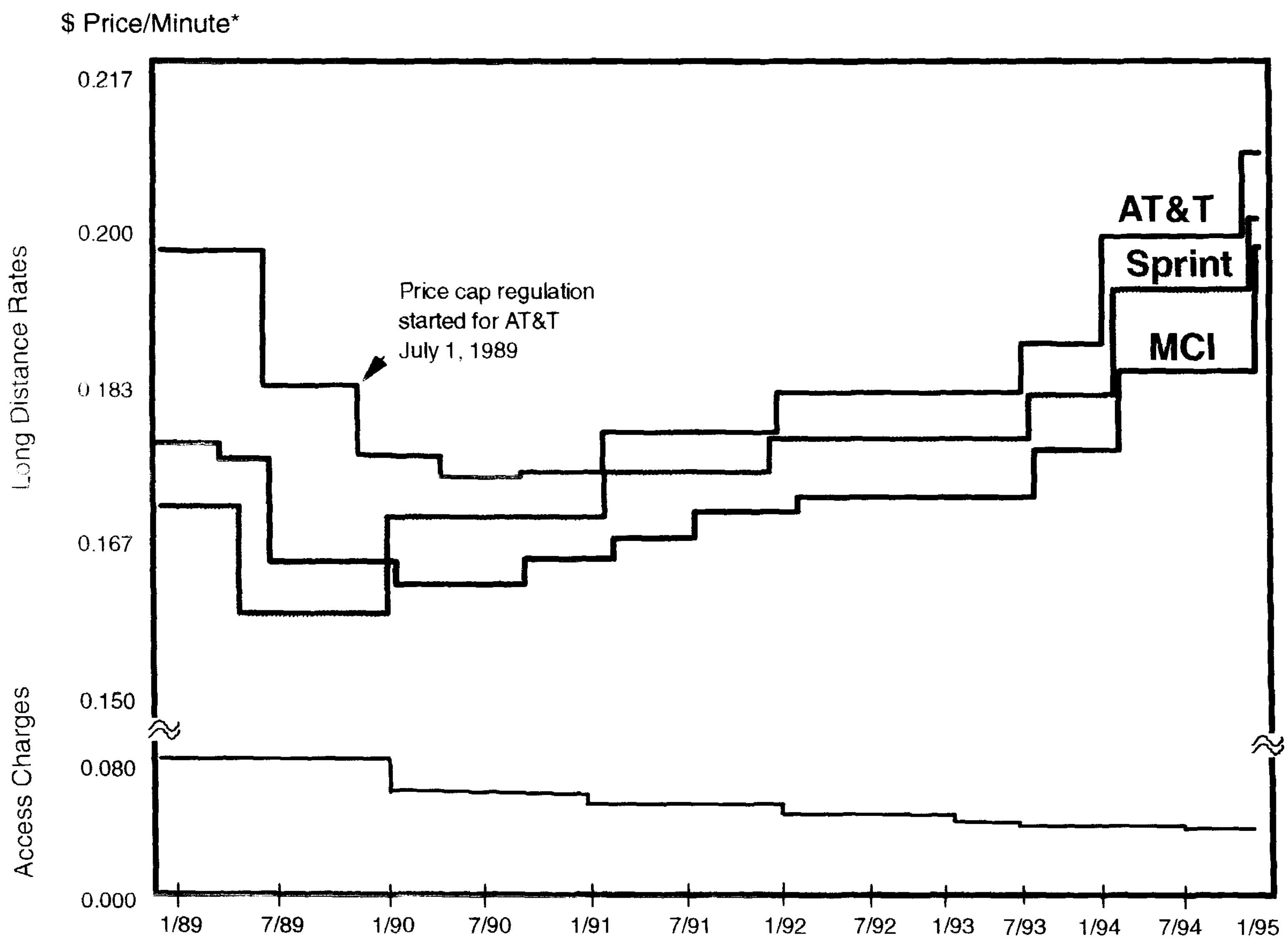


Source: One Source and Compustat

Note: Cash flow on earnings before interest, taxes and depreciation, and amortization. Cumulative shareholder return includes dividend yield and price appreciation of RHC stocks since January 1 1988.

Figure 5

Trends in Long Distance Rates and Exchange Access Charges



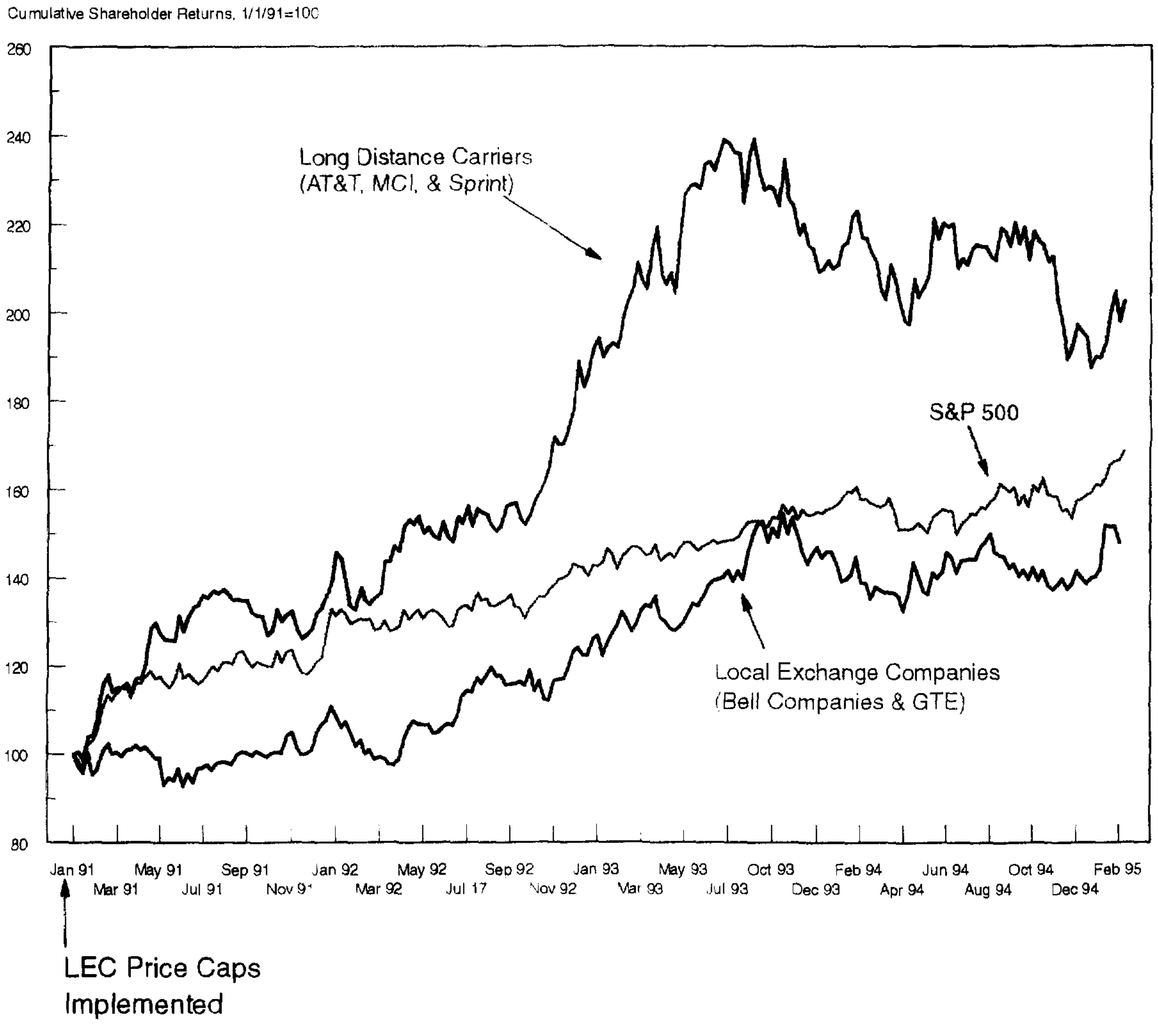
*Long distance rates based on the average price per minute for basic service.

Table 1

AT&T's Telecommunications Services

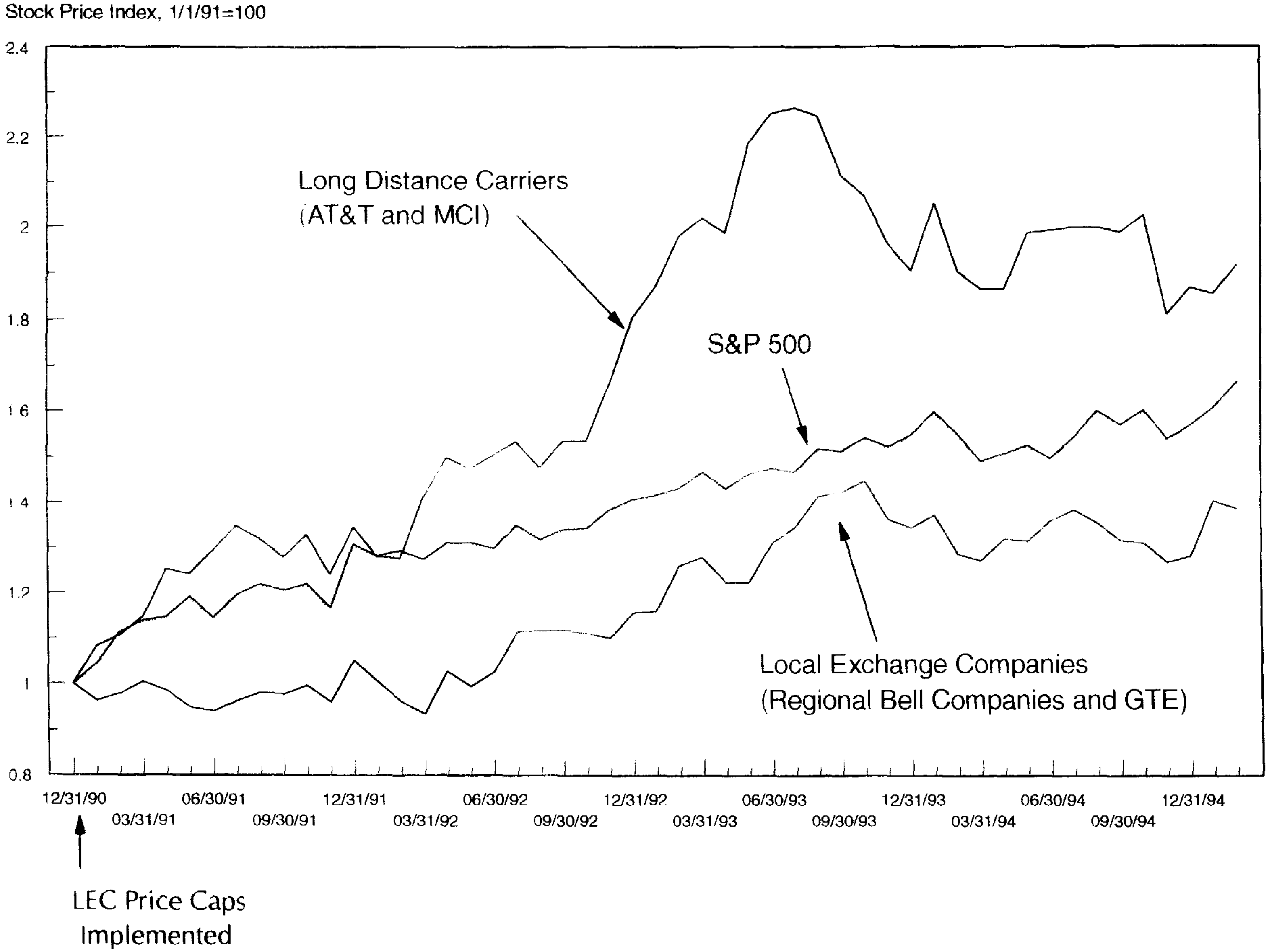
Dollars in Millions	1991	1992	1993	% Change 1991-93
Total Revenues	$38,805	$39,580	$39,863	+2.73%
Access & Other Interconnection Costs	$18,395	$18,132	$17,709	-3.73%
Gross Profit Margin	34.9%	36.2%	38.0%	+8.88%

Trends in IXC and LEC Shareholder Returns Since the Implementation of Price Caps



Note: Cumulative shareholder returns are based on weekly averages

Trends in Telecom Stock Prices
Since Implementation of LEC Price Cap Plan



Source: One Source; indices are based on market weighted monthly averages.

Performance of Telecom Stock Prices Since Implementation of LEC Price Cap Plan

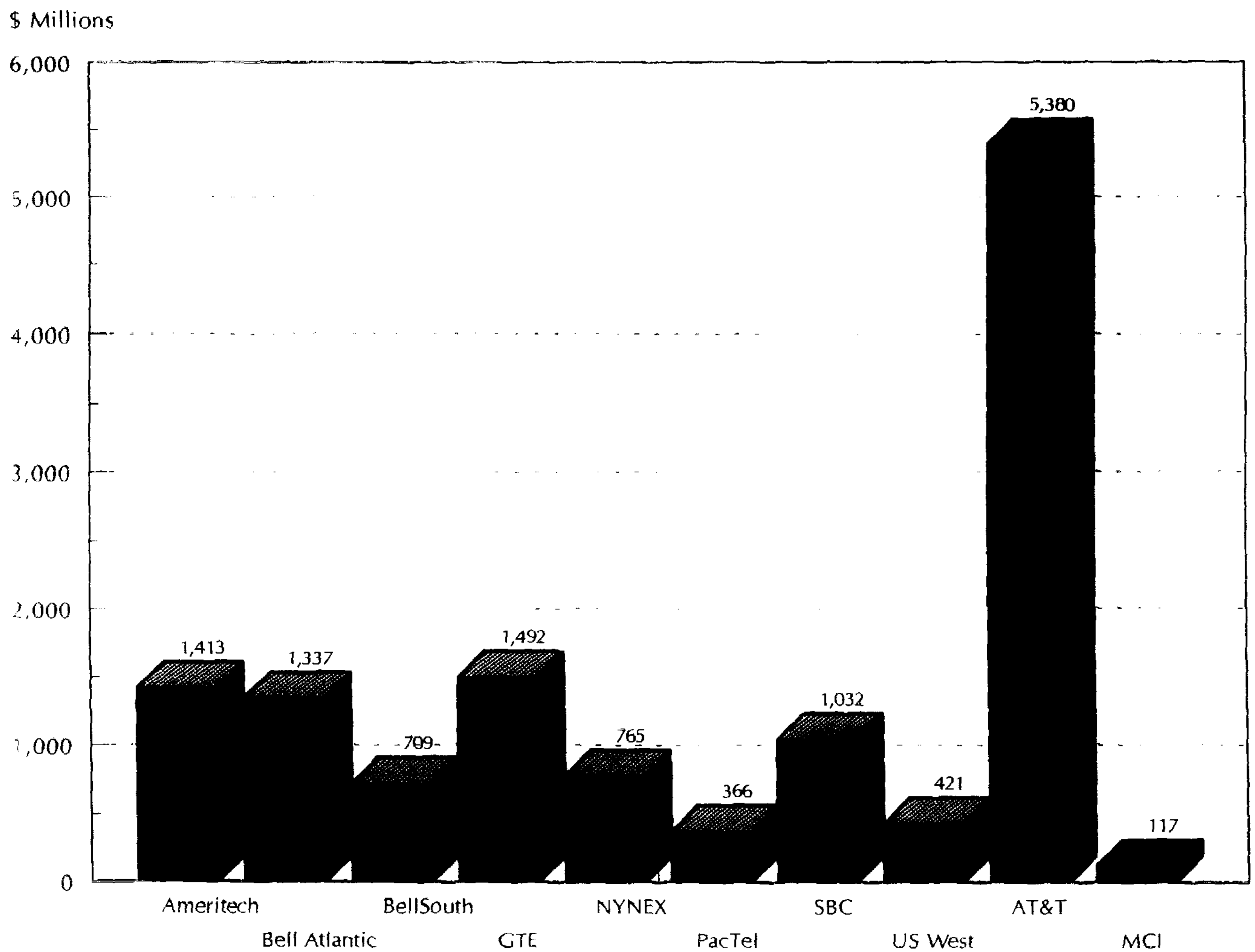
Price Per Share	Ameritech	Bell Atlantic	BellSouth	GTE	Nynex	Pacific Telesis	SBC	U S West	LEC Weighted Average
Mar 3, 1995	42.125	52.125	57.250	33.125	39.125	29.375	41.000	38.375	42.512
Dec 31, 1990	27.234	43.056	43.916	23.227	28.058	21.456	23.325	30.887	31.371
% Change	*35.35%*	*17.40%*	*23.29%*	*29.88%*	*28.29%*	*26.96%*	*43.11%*	*19.51%*	*26.21%*

Price Per Share	AT&T	MCI	IXC Weighted Average
Mar 3, 1995	51.250	19.750	46.744
Dec 31, 1990	26.905	9.833	24.075
% Change	*47.50%*	*50.21%*	*48.50%*

Index	S&P 500
Mar 3, 1995	485.406
Dec 31, 1990	293.409
% Change	*39.55%*

Source: OneSource; weighted averages are based on market values of outstanding shares for individual companies

Free Cash Flow for Leading Telecom Companies
(1993; $ Millions)



Source: Value Line
Note: Free cash flow equals operating cash flow and deferred taxes less capital expenditures.

Free Cash Flow -- Local Exchange Carriers

($ MILLIONS)

	1993	1990	1988	Avg. Annual Growth 1988-93
Ameritech Corp.				
Cash Flow	3,505.20	3,028.30	2,948.30	3.52%
Capital Expenditures	2,092.40	2,116.00	1,868.50	2.29%
Free Cash Flow	1412.80	912.30	1079.70	5.53%
Bell Atlantic Corp.				
Cash Flow	3,854.70	3,710.70	3,672.00	0.98%
Capital Expenditures	2,517.40	2,521.90	2,455.30	0.50%
Free Cash Flow	1337.30	1188.80	1216.70	1.91%
BellSouth Corp.				
Cash Flow	4,194.60	4,237.30	4,253.30	-0.28%
Capital Expenditures	3,485.90	3,190.70	3,207.30	1.68%
Free Cash Flow	708.70	1046.60	1046.00	-7.49%
GTE Corp.				
Cash Flow	5,385.00	5,150.00	3,891.41	6.71%
Capital Expenditures	3,893.00	3,453.00	3,087.01	4.75%
Free Cash Flow	1492.00	1697.00	804.40	13.15%
Nynex Corp.				
Cash Flow	3,482.50	3,366.90	3,400.30	0.48%
Capital Expenditures	2,717.20	2,493.20	2,783.60	-0.48%
Free Cash Flow	765.30	873.70	616.70	4.41%
Pacific Telesis				
Cash Flow	2,857.00	2,960.00	2,915.00	-0.40%
Capital Expenditures	2,491.00	1,937.00	1,500.00	10.68%
Free Cash Flow	366.00	1023.00	1415.00	-23.70%
SBC Communications				
Cash Flow	3,252.60	2,746.30	2,679.40	3.95%
Capital Expenditures	2,221.10	1,778.40	1,221.80	12.70%
Free Cash Flow	1031.50	967.90	1457.60	-6.68%
U S West Inc.				
Cash Flow	2,870.10	3,235.10	2,955.60	-0.59%
Capital Expenditures	2,449.20	2,558.90	2,278.70	1.45%
Free Cash Flow	420.90	676.20	676.30	-9.07%
RHCs and GTE Combined				
Cash Flow	29401.70	28434.60	26715.31	1.93%
Capital Expenditures	21867.20	20049.10	18402.31	3.51%
Free Cash Flow	7534.50	8385.50	8313.00	-1.95%

Source: Value Line; cash flow includes operating cash flow plus deferred taxes

Free Cash Flow -- Long Distance Carriers

($ MILLIONS)

AT&T	**1993**	**1990**	**1988**	**Avg. Annual Growth 1988-93**
Cash Flow	9,081.00	6,802.00	7,101.00	5.04%
Capital Expenditures	3,701.00	4,443.00	4,028.00	-1.68%
Free Cash Flow	5380 00	2359.00	3073.00	11.85%

MCI Communications

Cash Flow	1,850.00	1,403.00	962.00	13.97%
Capital Expenditures	1,733.00	1,274.00	796.00	16.84%
Free Cash Flow	117.00	129.00	166.00	-6.76%

AT&T and MCI Combined

Cash Flow	10931.00	8205.00	8063.00	6.28%
Capital Expenditures	5434.00	5717.00	4824.00	2.41%
Free Cash Flow	5497.00	2488.00	3239.00	11.16%

Source: Value Line; cash flow includes operating cash flow plus deferred taxes

The View From Wall Street: Competition in the Long Distance Telephone Market

AT&T and its rivals are pushing some prices up after almost 10 years of steady discounting. This gives AT&T more room to grow profits, and it creates an umbrella over MCI and Sprint, allowing them to raise prices, too. *(Kenneth Leon, Bear Stearns, 10/20/92)*

AT&T, MCI, and Sprint all have high-quality earnings because they operate in a stable, oligopolistic industry. . .without serious price competition. [T]he only real threat [is] posed by the Regional phone companies which are unlikely to gain regulatory freedom to enter this business for at least 3-5 years. *(Philip A. Managieri, Cowen, 8/23/93)*

Margins improved for all four [long distance] carriers, reflecting an impact from price increases and steady declines in access costs. *(Daniel P. Reingold and Richard C. Toole, Merrill Lynch, 2/10/94)*

The combination of a cozy oligopoly that wishes to avoid price wars and falling operating expenses primarily due to [exchange] access cost reductions is an unbeatable environment in which to do business. *(Timothy N. Weller and Nick Frelinghuysen, Donaldson, Lufkin & Jenrette, 6/1/94)*

The long distance industry is one of today's premier growth industries. Where else can you find: (1) double-digit unit volume growth, (2) declining unit costs, on a nominal as well as real basis, (3) a $10 billion barrier to entry, (4) a benign, stable oligopoly where the price leader [AT&T] is looking to generate cash to fund other ventures, and (5) a prohibition on competition. . . It is rare to see a full-fledged price war in an oligopolistic market, witness soft drinks. The same holds true in the long distance market. *(G.W. Woodlief and E. Struminger, Dean Witter, 10/28/94)*

Many investors still seem to believe that there has been some sort of "price war" among the major interexchange carriers. The fact is that although interstate telephone rates have come down by about 50% over the past decade, the entire decline has been "funded" by decreases in the amounts paid by interexchange carriers to the local exchange carriers for "access." *(John Bain, Raymond James & Assoc., 1/12/95)*

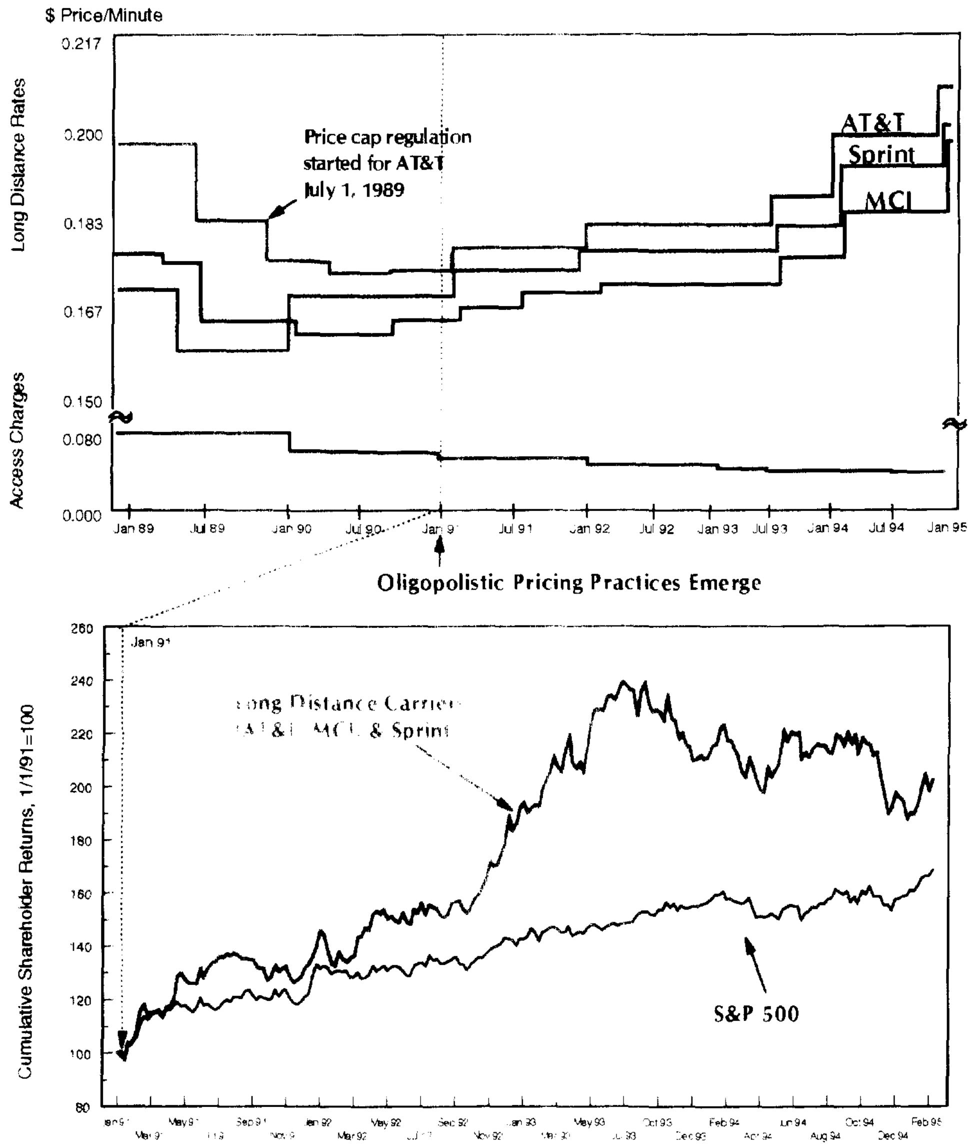
Overall, MCI's new Friends & Family program looks like just another round of discounting funded by previously announced increases in the base rates. By focusing on the discount instead of the rate, the industry has been able to quietly raise base rates while spending millions of dollars promoting ever-increasing discounts. *(D. Reingold and M. Kastan, Merrill Lynch, 1/20/95)*

Regardless of your carrier, you are paying higher and higher rates if you are among the tens of millions of Americans who have not signed up for a discount calling plan. The person paying the retail rate is bearing the disproportionate burden. And these are probably the people who can't afford to make a lot of phone calls and therefore [do not] qualify for those cheaper plans. *(D. Briere, Tele-Choice Inc., 1/21/95)*

AT&T now has the same revenues as the entire Bell system just before the break up in 1984, when they spun off about 85 percent of their assets. *(John Bain, Raymond James & Assoc., 1/24/95)*

MCI. . . filed for a 3.9% across-the-board rate increase. We fully expect AT&T, Sprint, and the second tier carriers to follow suit. This move by MCI is extremely bullish for the long distance stocks since it sends a clear message to the investment community that the long distance industry will practice 'safe pricing' which will lead to stable revenue per minute trends. *(Jack B. Grubman, Salomon Brothers, 2/6/95)*

In fact, a pattern of rising [long distance] prices has emerged in the past year, with a series of AT&T price increases immediately followed by MCI and Sprint price increases. The industry must be careful not to draw the anger of the voting public as the cable industry did before suffering recently at the hands of Congress and the FCC. *(T. Weller and N. Frelinghuysen, Donaldson, Lufkin & Jenrette, 6/1/94)*



The promotions may make it look like there is price competition in residential [long distance markets], but the fact is that the base rates have created profit margins that are much better than you get from [other] businesses. *(H.B. Thompson, LCI International, 9/19/94)*