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March 22, 1995

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

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MAR 22 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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

Dear Mr. Caton:

On March 21, Laurel B. Kamen of American Express, Del Moore of American Airlines and Colleen Boothby of Levine, Blaszak, Block & Boothby, representing the Ad Hoc Telecommunications Users Committee ("Ad Hoc") met with Commissioner James Quello, Senior Legal Advisor Lauren Belvin, and Rhonda Lien regarding its position on the LEC Price Caps Performance Review proceeding and the attached handout.

In addition, we discussed the recent decision in the New York Public Service Commission's proceeding regarding performance-based incentive regulation for New York Telephone. The decision notes that New York Telephone had agreed in the New York proceeding to an implicit "X" factor of 4.6 (or 5.1, if inflation reaches 4%), which differs markedly from the "X" of 3.3 advanced by NYNEX before this Commission. The relevant pages from that decision are attached.

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.

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If you have any questions regarding this filing, please do not hesitate to call us.

Respectfully submitted,

Leah Moebius

Leah Moebius

cc: Commissioner James Quello
Lauren Belvin, Senior Legal Advisor
Rhonda Lien

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LEC Price Caps Performance Review

Position of Ad Hoc Telecommunications Users Committee

Who we are

Ad Hoc is a cross-section of America's largest corporate users. The committee has been an active participant in FCC proceedings for over 20 years, supporting long-term public policy solutions, on which all of its members agree, rather than the short-term economic self-interest of individual members.

Where we stand

LEC access rates are too high

The LECs have enjoyed the fruits of unreasonably high rates for the past four years of price caps.

FCC deliberately took a conservative approach when it specified the price caps rules.

This performance review is a key part of the safety net for users. Now is the time for the Commission to make good on its promise to protect users from unreasonably high rates.

Subsidized entry into new markets is anti-competitive

We support infrastructure development; we are keenly aware of the economic benefits.

We can't support the LECs' broadband investment when they pay for it with monopoly rent from local exchange access service:

Hurts users -- our rates are too high.

Hurts potential competitors -- Subsidized entry enables the LECs to compete unfairly with competitors who may provide better, cheaper service.

Hurts LEC investors and shareholders -- LEC business plans are insulated from the normal corrective scrutiny of capital markets.

Flow-through by the IXCs is a red herring in this proceeding

LECs have claimed that the IXCs keep the savings from access rate reductions rather than flowing them through in the form of lower long distance rates. IXCs deny it.

There won't be *any* flow-through to users so long as the LECs are permitted to keep excessive profits because of a too-generous price cap plan. If there are no access rate reductions, there are no reductions for the IXCs to flow-through.

As the beneficiaries of access flow-throughs, we appreciate the LECs' concern for our interests. We use our buying power as customers and competitive alternatives to extract flow-through from the IXCs. If a problem arises in the interexchange market, we would expect the Commission to pursue it in the proper docket.

We have no competitive ax to grind

All the carriers (IXCs and LECs) claim to have our interests at heart. But as regulated companies and as potential competitors, they have their own business agendas.

Unlike the carriers, we have no secret agenda. When we say there's no LEC competition, we speak from our experience, not our legislative agenda.

The LECs are currently monopolists. When their rates are too high, we have no alternative providers to turn to. We can turn only to the FCC to keep LEC rates reasonable through firm regulation.

contemplated that the company would be able to make whatever productivity improvements were needed to achieve its return given that level of revenues. Those productivity improvements, therefore, should be considered in some sense "embedded"; and they should not be counted again in determining the incremental productivity needed for the company to thrive under the Plan. Whether or not the effect of this caveat can be quantified, we must keep it in mind, too, in evaluating the proponents' productivity claims.

Productivity Analyses

1. The Company's and Staff's Presentations

Taking issue with the opponents' suggestion that it will enjoy excess revenues during the term of the Plan, the company maintains that in order to succeed under the Plan, it "must radically change its ways of operation by markedly increasing its productivity."[1] Assuming constant volumes and no adjustments for inflation or exogenous cost changes (i.e., inflation is less than 4% and any exogenous cost changes that may arise net to zero), the Plan contemplates reductions in prices that total $425 million in revenues by the seventh year. This approximates a price decline in nominal terms of 7.6% over the term of the Plan, or about 1.1% a year. If inflation averaged 3.5% a year, the company's prices would fall in real terms by 4.6% a year (the so-called "X" factor)[2]; and those price reductions, the company emphasizes, would take place regardless of whether the company was able to increase its efficiency and its sales volumes enough to maintain its earnings levels despite

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1 New York Telephone's Initial Brief, p. 207.

2 The decline in real prices, representing the expected difference between the economy-wide growth in costs and that for the firm under consideration, is sometimes called the "X" factor. The significance of a calculated "X" factor may depend on the extent to which it reflects, on the one hand, the firm's own productivity achievements and, on the other, merely a slower growth in its input prices than in those for the economy as a whole.

the drop in price. Should inflation equal 4%, the "X" factor would be 5.1%. In the event of inflation exceeding 4.0%, the X factor would continue to grow, though it would be something less than a constant 1.1% above the inflation rate, for the Plan would permit the company to recover a portion of the inflation in excess of 4.0%. The company emphasizes, however, that the Plan does not allow recovery of inflation with respect to Basic Services, accounting for about 50% of its revenues, and that it might be unable to raise its price for competitive, non-basic services to the full extent needed to recover allowable inflation.[1]

provide incentives to the company but should ensure that customers enjoy a reasonable share of achievable productivity gains. The company suggests that a stretch factor is unwarranted here, in view of the Plan's guaranteed price reductions and the absence of an earnings floor, both atypical of the price cap plans that usually include stretch factors. That may well be so; and it may respond adequately to AT&T's argument that this Plan, in contrast to a "well crafted price cap regime," fails to insure that the company is rewarded only for achieving efficiencies specific to it but that productivity improvements inherent in the general economy are passed on to ratepayers.[1] But that begs the question of whether the prices are reduced <u>sufficiently</u> (or whether the frozen prices are frozen at levels that are too high). And while we are not setting an "X" factor to be used in determining a price level, we need some assurance, as the company and staff presumably recognized in offering productivity analyses, that a properly computed implicit "X" factor is high enough to show that ratepayers are being afforded adequate benefits, particularly as the company attempts to change its generally acknowledged, and unenviable, position as one of the highest-cost LECs.

As we said both at the outset and in the last paragraph, we need not resolve these issues in a manner that would permit adoption of a specific "X" factor. On the record before us as a whole, we conclude that the implicit "X" factors calculated by staff and the company lie toward the low end of a range of reason (particularly when one takes account of the need to reflect productivity captured in the Track 1 revenue requirement computation) and that slightly lower price points would provide added assurance that the Plan adequately protected ratepayers while not denying the company the opportunity to prosper if it reduced its high costs and increased its volumes.

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1 AT&T's Reply Brief, pp. 37-38.