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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

July 11, 1995

Ex Parte

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

RE: Simplification of the Depreciation Prescription Process
CC Docket No. 92-296

Dear Chairman Hundt:

In CC Docket No. 92-296, the Commission adopted price cap options designed to simplify the depreciation represcription process for AT&T and the local exchange carriers (LECs). In a Petition for Reconsideration of the Depreciation Simplification Order, BellSouth pointed out that the promise of simplification would not be realized by LECs such as BellSouth that had aggressively deployed new technology, thereby rendering much of their existing plant technologically obsolete. BellSouth therefore requested that the Commission extend the Price Cap Carrier Option ("PCCO") to the price cap LECs. BellSouth's Petition for Reconsideration remains pending before the Commission.

The Commission gave two primary reasons for extending the PCCO to AT&T but not to the price cap LECs: the potential for manipulation of the sharing obligation under the LEC price cap plan, and the relatively lower level of competition faced by LECs versus the interexchange carriers. Events since 1993 have reduced significantly the importance of these factors.

Earlier this year, in CC Docket No. 94-1, the Commission adopted a "no sharing" option in the LEC price cap plan. BellSouth and a majority of the other price cap LECs elected the "no sharing" option in their 1995 annual access tariff filings. These carriers now have absolutely no incentive to manipulate their depreciation expenses in order to reduce a sharing obligation.

The Commission also has taken steps to facilitate competition in the interstate access market. The Commission's decisions in Docket No. 91-141, Expanded Interconnection, and Docket No. 91-213, Transport Rate Restructure, have opened the interstate access market to greater competition. The Commission has approved the merger between AT&T and McCaw Cellular, and is now licensing multiple Personal Communications Service providers in each market area. These carriers will provide wireless alternatives to the local wireline loop.

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All state commissions in the BellSouth region now permit competition in the exchange access and intrastate toll markets. In BellSouth's largest states, Florida, Georgia, North Carolina, and Tennessee, the legislatures have gone further, passing bills that authorize full local exchange competition. Tennessee has already authorized six major competitors within a month of the governor signing the bill. The Florida, Tennessee and Georgia bills expressly authorize BellSouth to set its own depreciation rates in accordance with Generally Accepted Accounting Principles ("GAAP"). To this extent the states are already leading the FCC in giving LECs the ability to set their own depreciation rates.

In response to these initiatives, numerous providers are scrambling for a piece of the telecommunications market. Interexchange carriers, competitive access providers, power companies, wireless carriers and cable television companies are currently entering or are poised to enter markets that were formerly the exclusive preserve of the LECs.

On April 7, 1995, BellSouth filed with the Commission its 1995 Depreciation Study for the Southern Bell States (Florida, Georgia, North Carolina and South Carolina), which contains a detailed analysis of the emergence of competition in those states. BellSouth also filed an extensive competitive profile covering all nine of its states in Docket No. 94-1, the LEC Price Cap Performance Review.

The competition rationale for retaining tight control over the depreciation rates of the LECs was further undercut by the Commission's action in Docket No. 92-266, Cable Television Rate Regulation. In that proceeding the Commission determined that it was not necessary to actively regulate the depreciation rates of cable television companies, even when such companies are subject to cost of service regulation and operate in markets that, by definition, are not competitive.

When the present depreciation rules were adopted, there was an inherent assumption that regulators could assure capital recovery over the remaining life of the assets used to provide telephone service. The existence of an enforceable regulatory promise of capital recovery is a linchpin of regulatory accounting under SFAS-71. As competition continues to flourish in the telecommunications marketplace, the ability of regulators to deliver on that regulatory promise is rapidly being eroded. Even if the FCC desired to give us the opportunity, the marketplace will ultimately determine if we have sufficient revenues to recover investor supplied capital.

On June 30, 1995, BellSouth publicly announced the discontinuance of the use of Statement of Financial Accounting Standards (SFAS) 71 for financial reporting purposes. The Commission was advised of this change in my letter of June 29, 1995. The resulting financial impact for financial reporting purposes will be the recognition by BST of an extraordinary, noncash after-tax charge of $2.7 billion or about $5.47 per share in the second quarter of 1995. As a result, BellSouth expects to report a loss for the second quarter and for and for the year 1995 in total. This now brings the total to four of the largest LECs that discontinued the use of SFAS 71 for financial reporting purposes.

The largest component of the charge consists of a $4.9 billion charge to reduce the recorded value of long lived telephone plant and equipment. This represents a reduction in the net book value of BellSouth Telecommunications (BST) assets of over 20%. The magnitude of these numbers illustrates how critical it is for the Commission to permit LECs to recover their investment in a timely fashion.

Unfortunately, this reduction in the net book value of BST's assets is largely attributable to the fact that these assets have been under-depreciated due to regulator - prescribed asset lives which exceed the estimated useful lives. For years, BellSouth has asked for shorter lives than that prescribed by the Commission. The Commission can rectify this situation by giving price cap LECs more control over setting their own depreciation rates by extending the PCCO option to the price cap LECs. Since depreciation rate changes are "endogenous" under the LEC price cap plan, adoption of the PCCO for the price cap LECs will not result in rate increases for interstate access customers.

In conclusion, intensive regulation of the depreciation rates of price cap LECs is no longer necessary to protect customers. Such regulation jeopardizes the ultimate recovery of capital investments in the telecommunications infrastructure while it also greatly decreases LEC incentives to invest in the infrastructure in the future. Therefore, the Commission should promptly grant BellSouth's Petition for Reconsideration in Docket No. 92-296 and extend the PCCO to the price cap LECs.

Sincerely,

David J. Markey

Identical letters sent to Commissioners and Kathleen Wallman

cc: Secretary's Office