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September 11, 1996

BY COURIER

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

EX PARTE PRESENTATION

Re: **Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket No. 96-128**

Dear Mr. Caton:

The American Public Communications Council ("APCC") and the Georgia Public Communications Association ("GPCA") hereby respond to recent ex parte presentations of the Regional Bell Operating Companies ("RBOCs") regarding valuation of local exchange carrier ("LEC") payphone assets that will be reclassified/transferred to nonregulated status.

Summary of Position

In order to promote competition and eliminate all subsidies of LEC payphone services as required by Section 276 of the Act, 47 U.S.C. § 276, the Commission must require an assessment of the actual economic value of RBOC payphone assets being transferred to "nonregulated" status -- including the value added by payphone location contracts and intangibles such as goodwill. See Attachment 1 (excerpts from GPCA's Comments and Reply Comments).

The RBOCs' legalistic argument that valuation of the transferred assets cannot exceed their net book value disregards the legislative history of Section 276, which clearly refutes every legal premise of the RBOC's position. The committee reports clearly show (1) that Section 276 contemplates a transfer (not a mere "reassignment") of assets, (2) that the assets should be valued, not as isolated pieces of equipment, but as part of a going concern, and (3) that the Commission is not bound to follow regulatory practices from other contexts in conducting the asset valuation required by the Act.

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An approach that compensates ratepayers for the full value of the assets of the payphone business they have been subsidizing for years is also entirely consistent with Computer II and other Commission precedent. "Going concern" valuation was expressly endorsed in the Computer II CPE deregulation decision, and net book value was used in that decision only because it was found to be an acceptable surrogate given the time constraints of the impending AT&T divestiture and the availability of a check on valuation in the form of a customer purchase option. In the payphone context, net book value is not a good surrogate because it fails to capture any of the enormous value added by payphone locations and location contracts.

Further, the record in this proceeding demonstrates that assessment of the economic value of payphone assets is very feasible using the same appraisal techniques that have been used in numerous private-sector payphone company acquisitions (including a potential acquisition of Ameritech's payphone business), and that the Commission's rules contemplate be used for analogous types of affiliate transactions.

If the Commission fails to ensure that ratepayers are compensated for the full value of deregulated LEC payphone assets, ratepayer losses may be in the billions of dollars. In addition, competition in the payphone market will suffer, at minimum, a major distortive effect at the very moment when Congress has mandated that the payphone industry be restructured to promote competition.

Section 276 Requires A Full Valuation of RBOC Payphone Assets

The RBOCs oppose any attempt to assess the actual economic value of their payphone assets. The RBOCs contend that, because payphone location contracts and intangibles such as goodwill are not designated by LECs as assets on their regulated books of account, and because the payphone assets allegedly will not be "transferred," past precedents do not allow the Commission to consider contracts and intangibles, regardless of the extent to which they enhance the value of LECs' physical payphone assets or payphone operations, for purposes of implementing the transfer/reclassification of LEC payphone operations pursuant to Section 276. See "Reassignment of RBOC Payphone Assets," submitted with a letter to William F. Caton from Michael K. Kellogg, August 30, 1996. ("RBOC White Paper").

The RBOCs' legalistic arguments are largely beside the point.[1] The key point is that Section 276 expressly mandates the FCC to eliminate all subsidies of RBOC payphone service. In carrying out this express statutory mandate, the Commission is under no express or implied statutory obligation to be limited by past ratemaking practices at either the federal or state level. Indeed, the legislative history of Section 276 specifically notes that "[i]n crafting implementing rules, the commission is not bound to adhere to existing mechanisms or procedures established for general regulatory purposes in other provisions of the Communications Act." H.R. Rep. No. 458, 104th Cong., 2d Sess. 158 (1996).

Rather, the Commission's foremost obligations in implementing this portion of Section 276 are to eliminate preferential treatment and discontinue all subsidies of LEC payphone operations. 47 U.S.C. §§ 276(a), (b)(1)(B), (C). Eliminating such preferential treatment and subsidies requires the Commission to ensure that ratepayers are reimbursed for the full value of transferred assets. Valuation of LEC payphone operations at net book value will distort competition and will deprive ratepayers of the enhanced value of payphone assets which were purchased with ratepayer money. The legislative history of the Act specifically states Congressional intent that the Commission's rules to "eliminate . . . 911 subsidies or cost recovery for RBOC payphones from regulated interstate or intrastate revenue" should focus particularly on the valuation of the RBOC's payphone operations. H.R. Rep. No. 458, (104th Cong., 2d Sess. 158 (1996)) ("Conference Report"). In the very next sentence after explaining that all payphone subsidies must be eliminated, the committee report adds: "The RBOC payphone operations will be transferred, at an appropriate valuation, from the regulated accounts . . . to the RBOC's unregulated books." Id. (emphasis added). This report language clarifies several points. First, contrary to the RBOCs' claim that "[t]here is no transfer of assets" (RBOC White Paper at 1), the quoted language makes clear Congress' intent that assets be "transferred." Second, the quoted language makes clear Congress' intent that the entire payphone "operations," not just the physical equipment, be valued as a going concern. Third, the quoted language makes clear Congress' intent that the Commission conduct its own valuation of the transferred assets, rather than accepting the LECs' accounting constructs developed for regulatory purposes.

The amounts at stake are very substantial. If a RBOC has 150,000 payphones, and net book value averages $500 per payphone, while actual economic value is $1,500 per payphone, then that RBOC's ratepayers would suffer a $50 million loss by having the

1 As discussed below, and contrary to the RBOCs' implication, there is ample precedent in federal and state regulatory decisions for recognizing that ratepayers are entitled to payment for the value added by location contracts and intangibles to the value of physical assets transferred from regulated to nonregulated operations. Indeed, "going concern" valuation was expressly endorsed by the Commission in the very same Computer II decision that the RBOCs have urged the Commission now to accept as binding precedent. See below.

RBOC's payphone operations transferred at net book value instead of actual economic value. For all RBOCs, the loss to ratepayers could easily exceed $1 billion.[2] As discussed below, net book value is not required by precedent and is not an adequate approximation of the economic value of payphone assets. Since there are other practical means of estimating the economic value of payphone assets, such alternatives must be implemented in order to protect ratepayers and competition.

Commission Precedent Does Not Require Use Of Net Book Value

There is no merit to the RBOCs' suggestion that the Commission's Computer II decision to value deregulated CPE at net book value somehow dictates that the Commission use the same approach to transfer/reclassification of LEC payphone assets. The Commission is not implementing Computer II in this proceeding; it is implementing a new statutory provision. Neither Section 276 of the Act nor its legislative history mention the Computer II proceedings.[3] The Commission is not bound by Computer II's use of net book value.[4]

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[2] Such undervaluation would become obvious if a Bell company transfers its assets to nonregulated status at net book value, and then sells its payphone operations for a substantial multiple of net book value. Such a scenario is, in fact, likely to occur, and would make it even more difficult, to say the least, for the Commission to explain to Congress how it has carried out the directive to transfer RBOC payphone operations "at an appropriate valuation." See Attachment 2. The RBOCs have never denied that their payphone operations are worth substantially more than net book value.

[3] The Act does mention Computer III as a minimum safeguard. 47 CFR § 276(b)(1)(C). However, Computer III did not involve major decisions on reclassification of regulated assets, and in any event, the Act clearly authorizes the Commission to adopt stronger safeguards than the required minimum of Computer III.

[4] The RBOCs raise additional legal arguments, claiming that: (1) Democratic Central Committee is not applicable, (RBOC White Paper at 2-4), (2) state commissions have not applied economic-value or going-concern principles (id. at 4, n.3), (3) there is no "transfer," but only a mere "reassignment," of assets (id. at 5); (4) investors rather than ratepayers have borne the risk and burden associated with payphone contracts and intangibles (id. at 5-7); and (5) "going concern" valuation would conflict with the Commission's accounting rules (id. at 8-9), Generally Accepted Accounting Principles ("GAAP"), (id. at 10), and price cap rules (id. at 10-12). These largely makeweight arguments are briefly addressed in Attachment 3.

In any event, in Computer II the Commission specifically recognized that the standard for valuation of deregulated assets is not net book value, but economic value as defined by the D.C. Circuit in Democratic Cent. Comm. v. Washington Metro. Area Transit Comm'n, 485 F.2d 786 (D.C. Cir. 1973):

> [W]e find no reason to alter our tentative conclusion that economic value is the proper valuation standard, and that economic value should be defined to mean the price a carrier would be willing to pay for its CPE if, instead of owning it, the carrier had the opportunity to purchase it.

Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), ("Computer II Implementation"), Report and Order, 95 FCC 2d 1276, 1306 (1983) (subsequent history omitted). The Commission further stated:

> [M]ore than the economic value of physical assets must be considered in order to assess with any accuracy the actual value which will be received by ATTIS. ATTIS will be receiving a "going concern" in connection with the transfer of the CPE base. Clearly there is economic value in the goodwill associated with the established CPE business being transferred to ATTIS, and in the customer proprietary information which relates to the CPE base. These sources of economic value must be taken into account . . . .
>
> Id. at 1310 (emphasis added).

The Commission also recognized that "the conventional means of arriving at the economic value of [the Bell System's] embedded base . . . . would be to appraise all embedded CPE assets and use this appraised value . . . ." Id. at 1306. The Commission used net book value in Computer II only because it found, in the particular circumstances present at that time, that net book value was an adequate surrogate for the economic value of CPE and that, in the rush to prepare for the January 1, 1984 divestiture of AT&T, it was not practical to obtain a more precise determination of the economic value of the gigantic installed base of Bell System CPE in the short time remaining before the transfer of the CPE to AT&T.[5] In the current circumstances, by contrast, net book value is not a good

5 Part of the Commission's deregulation plan involved requiring AT&T to offer the embedded CPE base for sale to existing customers. The Commission decided it could not defer valuation in order to allow an appraisal because that would also require a delay in the sale-to-customers program. Id. at 1310.

surrogate for reclassifying payphone assets, and it is practical to measure economic value more precisely. See below.

Finally, in Computer II, the Commission also had a check on whether or not net book value was a reasonable approximation of economic value. The Commission required AT&T to offer customers who were leasing premises equipment an opportunity to capture any capital gains by buying the equipment at net book value. Computer II Implementation, Notice of Proposed Rulemaking, 94 FCC 2d at 92. See also Report and Order, 95 FCC 2d at 1301, 1308. The Commission specifically ruled that use of net book value was permissible because of the ratepayer protection provided by the customer purchase option. In the absence of such a check, the Commission can have no confidence that ratepayers are protected from loss of the value of assets.[6]

Net Book Value Is Not a Good Surrogate

In the payphone context, the net book value of payphone equipment is not a good surrogate for the economic value of the LECs' payphone assets. The value of payphone assets is enhanced by the payphone provider's selection of the locations where payphones are installed,[7] as well as by the contracts between the LECs and location providers. See Attachment 1. In addition to location contracts, the value of LEC payphone assets also is enhanced by the goodwill that has resulted from the investment of ratepayer money in maintaining payphones at a location.[8]

These value enhancements are reflected in the prices that have been paid when payphone businesses are sold. In GPCA's July 1, 1996 Comments in this proceeding, GPCA provided a study by NuCom, an IPP provider, which reviewed per-pay phone prices

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6 At a minimum, therefore, in the event that net book value is used to reclassify payphone assets, location providers must be given the same opportunity to buy the payphones currently on their property at net book value.

7 It is not just the payphone equipment that is being transferred. The equipment will remain at the existing locations pursuant to contracts and relationships established at ratepayers' expense. Unless the contracts are rescinded in order to give location providers a "fresh look," the location contracts are also being effectively reclassified or transferred, and the RBOCs' shareholders, not their ratepayers, will reap all the benefits of those contracts as well as associated goodwill.

8 Indeed, the RBOCs have admitted that ratepayers for other RBOC services have subsidized the RBOCs' payphone operations, which include commission payments and other services intended to enhance location provider satisfaction with RBOCs' payphones.

paid in recent acquisitions of IPP providers. GPCA Comments at 17 and Attachment 1. The average per payphone price was approximately $3,200, which at a minimum can be used as a benchmark for reviewing transfer valuation methods. Id. Likewise, in the Reply Comments of Communications Central Inc. ("CCI"), CCI shows that it has allocated over 65% of payphone business acquisition purchase prices to intangibles such as location contracts. CCI Reply comments at 15-16 and Attachment B. These benchmarks demonstrate that the economic value of payphone assets is enhanced by intangibles such as goodwill and location contracts, and that net book value would be a totally inadequate measure of economic value.

Finally, in GPCA's July 15, 1996 Reply Comments, GPCA showed that U S West offered to pay $1,600 per site to acquire a bankrupt IPP provider's payphone business, and U S West sought to acquire only the IPP provider's location contracts and good will -- U S West did not even want any of the physical equipment. GPCA's Reply Comments at 14 and Attachment 3. This example is overwhelming proof that net book value does not capture the value of pay telephone assets transferred out of regulation.

It Is Practical to Determine the Economic Value of LECs' Payphone Assets

The Commission has a number of means to determine the economic value of LECs' payphone assets. One alternative is to require the RBOCs to obtain an independent appraisal of their payphone assets. Unlike Computer II, where the Commission questioned the feasibility of an appraisal because "transfers of this type, and on this scale, have never before been undertaken" (Computer II Implementation, Report and Order, 95 FCC 2d at 1307), the transfer of a Bell company's payphone assets is not an event of unprecedented scale. Indeed, one of the Bell companies, Ameritech, has already offered its payphone operations for sale. See Attachment 1. As shown in GPCA's Comments, Attachment 1, sales of payphone companies that are smaller than an RBOC's payphone operations, but nevertheless of substantial size, are commonplace in the industry. As the Ameritech example shows, LECs keep records of their payphone location contracts and are able to provide a breakdown of the "remaining lives" of their location contracts on a payphone-by-payphone basis. See Attachment 1. Such information, together with other available information about RBOC revenue streams, would enable an independent appraiser to provide a reasonable estimate of the market value of each major LEC's payphone base. Certainly, such an independent appraisal would yield a substantially more accurate valuation than net book value.

Even a formulaic valuation based on a multiple of net book value derived from past purchases of independent payphone operations would provide a valuation that is more reasonable than net book value. See Comments of GPCA at 17, Att. 1; Reply Comments of CCI at 15-16, Att. B (showing examples of the premiums over net book value paid in acquisitions of various payphone companies' assets).

Competitive Effects

In addition to the impact on ratepayers for regulated services, there can be little question that undervaluation of payphone assets would have a distorting effect on the payphone marketplace. If net book value is, for example, only 50% of economic value, then the LEC would begin nonregulated operation by effectively being given half of its payphone base "for free." It is not credible to find that such a large and unwarranted economic windfall would have no effect on the behavior of the dominant payphone competitors.[9]

There may be a theoretical argument that LECs' market behavior would not be affected by undervaluation of their payphone assets. However, this argument flies in the face of reality. It is simply not credible that LECs and their shareholders would be unaffected by incorrect asset valuation that affect the assets and liabilities carried on the nonregulated accounts of their payphone operations. Such valuations would, at a minimum, affect the perceptions of LEC shareholders and bondholders about the profitability of the LEC payphone operations.

At a minimum, to the extent that LEC shareholders are misinformed about the actual profitability of their payphone businesses, they will be unable to correctly evaluate management decisions. Marginally profitable payphone operations may be mistakenly viewed as highly profitable, while unprofitable operations may be mistakenly seen as competitive. Such distorted perceptions would, at a minimum, cause major inefficiencies by encouraging an inefficient competitor to remain in the market or encouraging a marginally efficient competitor to expand. Moreover, to the extent that the LECs have an incentive to maximize long-run profits by conducting predatory activity in the payphone market, they will have far more freedom to engage in such activity if they are able to avoid repaying ratepayers for the full value of their deregulated assets.

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[9] It is clear that the RBOCs believe that the Commission's decision on valuation of their payphone assets will have an economic effect. If the RBOCs did not believe they would be affected, they would not have directed their attorneys to submit a 13-page single-spaced legal memorandum opposing "going concern" valuation.

* * * * *

In conclusion, valuation of LEC payphone assets at net book value is not required by precedent and is not adequate to protect ratepayers or competitive markets. Valuation at actual market value is legally correct, feasible, and necessary to protect ratepayers and competition.

Sincerely,

Albert Kramer

Albert H. Kramer

RFA/nw

cc:	J. Muleta	R. Spangler	J. Casserly
	M. Carowitz	R. Baca	G. Rosston
	M. Richards	D. Gonzalez	J. Nakahata
	P. DeGraba	K. Gulick	

ATTACHMENT 1

Excerpts from GPCA's Comments and Reply Comments

separate billing agreements that are also available to IPPs. Again, volume discount limits and aggregation requirements should apply.[10]

f. Commission Payments

Commission payments for operator services (or any other services for which commission payments are offered) provided by the LECs must not discriminate between LEC payphones (or LEC payphone location providers) and IPPs, and that such commission payments should be subject to restrictions on volume premiums, and aggregation requirements, similar to the restrictions on volume discounts discussed above.

B. Transfer to Unregulated Status (¶ 49)

As explained in the Conference Committee's Joint Explanatory Statement, in order to carry out Section 276 "[t]he BOC payphone operations will be transferred, at an appropriate valuation, from the regulated accounts associated with local exchange services to the BOC's unregulated books." Conference Report at 158. Such a transfer is, of course, generally necessary whenever assets paid for by ratepayers are removed from regulated status. The transfer of payphone equipment out of regulation is analogous in many respects to the transfer that took

[10] The Commission's past decisions draw a distinction between a LEC's billing and collection services, which are classified as nonregulated, and other services such as validation and billing-name-and-address, which are considered regulated common carrier services. However, Section 276(a)(2) does not distinguish between regulated and non-regulated services of a LEC. It simply states that a Bell company "shall not prefer or discriminate in favor of its payphone service." 47 U.S.C. § 276(a)(2). This prohibition would apply to any nonregulated service provided by a BOC to a payphone division. See Citizens Utility Company, DA96-556 (April 22, 1996).

place when the Commission deregulated CPE in the Computer II proceedings. See Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), Report and Order, 95 FCC 2d 1276 (1983) ("Detariffing Order"). However, there are certain differences that require different treatment, as discussed below.

1. Assets to be Transferred

First, the Commission should identify the types of assets to be transferred. The assets to be transferred should include the types of assets that were included in CPE deregulation, i.e., all facilities at the payphone location, including the payphones, any internal processors, booths, pedestals, pads, etc., and related property. GPCA agrees that including network support facilities generally would be inappropriate[11] because it would allow the Bell companies to continue providing a different form of interconnection to their payphones than is available to IPP providers.

The assets to be transferred also must include long-term space rental contracts or analogous contracts between the Bell companies and location providers. Location is clearly a key element in the value of a payphone. For example, a payphone located inside the lobby of a major hotel undoubtedly produces far more revenue and profit to the payphone provider than does a payphone located on an isolated country road -- or, for that matter, than a payphone located at an office building next door to the hotel. Since the contract is a key determinant of the value of the payphone as installed, long-term contracts should be transferred with the payphone and the value of the contract should be included in the valuation of the payphone. Detariffing Order, 95

[11] However, GPCA agrees with the Inmate Calling Service Providers' Coalition that specialized network facilities such as inmate calling service modules which are a discrete, separable equipment dedicated to particular customers such as confinement facilities, should be transferred out of regulation.

FCC 2d at 1310 (1983) ("economic value" includes more than physical assets, and should consider valuation of deregulated business as a "going concern"). See also discussion below.

2. Mechanism for transfer

Next the Commission must determine the most appropriate mechanism of transfer. The most effective means of ensuring that payphone operations are transferred at fair value is to hold an auction. Each LEC's existing payphone base could be auctioned to establish the market price of LEC payphone operations to the highest bidder -- be it the LEC's unregulated payphone entity or a third party.

Such auctions would be feasible. The Commission recently has acquired a good deal of experience in auctioning spectrum. Auctions could be structured so that only parties other than LECs would actually bid. To keep bidders honest, procedures similar to the spectrum auctions could be followed. Bidders could be required to submit a certified application with an up-front deposit, and to pay the balance of their bid within a set time after being declared a winner. Amounts deposited could be forfeited if the winning bidder failed to follow through. See 47 CFR §§ 1.2105-2107. However, the LEC would have the option of "buying back" its payphone operation by matching the winning bid. This approach would satisfy any concerns about forced divestiture of property. In order to be manageable, auctions could be limited to the largest 10 or 15 LECs' payphone operations, with other LEC payphone divisions valued in proportion to the prices established for largest LECs.

Alternatively, the Commission could prescribe the valuation of the payphones. If valuation is to be prescribed, the value standard, of course, is economic value as defined by Democratic

National Committee v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C. Cir. 1973), cert denied, 415 U.S. 935 (1974). In Computer II, the Commission concluded that net book value provided an appropriate surrogate for the economic value of the Bell companies' CPE transferred out of regulation. Detariffing Order, 95 FCC 2d at 1206-10. In this case, however, net book value is not an adequate measure of the economic value of the Bell companies' payphone assets. Net book value does not capture the value of the Bell companies' location contracts, which as we have just explained is an important element in the overall value of their payphone assets.[12]

Other possible valuation methods include appraisals by disinterested parties, mimicking of capital budgeting, and the per-payphone prices of recent acquisitions of IPP payphone providers. In regard to the last alternative, GPCA is attaching to its comments the results of a study performed by NuCom, an IPP provider, which reviews the per-payphone prices paid in recent acquisitions of IPP providers. See Attachment 1. As shown, the average per payphone price was about $3,200. At a minimum, this establishes a benchmark for reviewing other proposed transfer valuation methods.

C. End User Common Line Charges (¶¶ 53-54)

The Commission also requests comment on the question of how the elimination of carrier access charge elements for subsidizing Bell payphones should affect end user common line

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[12] In the Inmate CPE decision, adopted before enactment of the Telecommunications Act of 1996, the Commission directed the LECs to reclassify inmate CPE based on net book value. However, the Commission did so because it found that as a legal matter, inmate CPE was already subject to the Computer II rules. Pursuant to Section 276 of the new Act the Commission is free to adopt a stricter standard, if appropriate.

available to aggregators of IPPs that yield a level of traffic volume or revenue that is equal to one-third of total IPP operator service traffic or revenue.

B. Transfer To Unregulated Status (¶ 49)

The RBOC Coalition contends that only physical assets should be transferred, and only at net book value. RBOC Coalition at 27-30. The only rationale on which they significantly rely is that this is how it was "always"[4] done in the case of CPE. However, transfer of payphones present a materially different problem from the Computer II transfer of CPE. The Computer II transfer was a wholesale transfer involving hundreds of millions of dollars worth of equipment. Payphones, by contrast, represent a much smaller universe. Value appraisals, which could be conducted in a number of ways (see GPCA's initial comments), will be much easier to manage in this smaller universe than they would have been in the case of CPE.

Second, as GPCA explained in its comments, there is significant value tied up in a payphone business in addition to the physical assets. Contracts with location providers, for example, represent a major source of value that in many cases far exceeds the value of the physical payphone set alone. The RBOC Coalition is silent on whether they intend that contracts should be transferred to the payphone operation. If the contracts are not transferred, however, that would place the LEC in the anomalous position of holding the contract -- and assessing on local exchange ratepayers the obligation to pay commissions --

[4] The instances cited as examples of how CPE transfers "always" have been done are basically all different permutations of the original Computer II proceeding.

for placement of payphones that have been transferred to the deregulated payphone operation.

The location contract is of immense importance in the valuation of payphone assets. Unlike ordinary CPE, the value of a payphone is inextricably tied to its location. A payphone located in an airport is far more valuable than the same payphone located on an isolated country crossroads. These intangible factors explain why, when payphone companies are acquired, the purchase price is typically many times the book value of the equipment alone, as shown in the NuCom study attached to GPCA's initial comments. Furthermore, at least one Bell company has demonstrated a willingness to pay a substantial price merely to acquire an IPP provider's payphone business and site contracts <u>without</u> any of the physical equipment. As shown in Attachment 3, in a recent bankruptcy proceeding in Colorado, U S West offered to pay more than $1,600 per site to acquire the bankrupt company and its contracts while replacing all of the company's phones, booths, and enclosures with U S West's own equipment. Thus, US West <u>did not even want</u> the payphone companies' equipment--they only wanted the contracts and good will. US West offered to pay $1,600 per site for these assets alone, and even offered to clear the sites for free!

This example provides dramatic and concrete proof that net book value does not come close to capturing the value of the assets being taken out of regulation pursuant to Section 276.

ATTACHMENT 2

Ex Parte Letter Accompanying
APCC's Submission (in Confidence)
of "The Payphone Business of Ameritech"

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August 29, 1996

EX PARTE PRESENTATION

CONFIDENTIAL DOCUMENT ENCLOSED
Section 0.457

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

Re: **Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket No. 96-128**

Dear Mr. Caton:

On behalf of the American Public Communications Council, we hereby submit for consideration in this proceeding a document entitled "The Payphone Business of Ameritech," consisting of a "Descriptive Memorandum" and an "Additional Information Package" prepared by Merrill Lynch & Co. on behalf of Ameritech Corporation. This document has been widely disseminated, and has become generally available in the payphone industry, and APCC believes the document should be put on the public record. As we explain, this document is vital to the Commission's consideration of the issues in this proceeding, particularly the question of how to value the payphone assets of the Bell companies and other local exchange carriers ("LECs") for purposes of reclassifying those assets from regulated to nonregulated status.

Nevertheless, although APCC does not believe the document is entitled to confidential treatment, in an abundance of caution, because the document is marked "Confidential" and purports to have been distributed at least initially on a confidential basis, we make this submission under seal and initially under the Commission's rules for protection of confidential documents, 47 CFR §§ 0.457 and 0.459, so that the Commission can decide for itself whether this document should be made part of the public record in this matter, and so that Ameritech may be heard prior to disclosure.[1] We submit, however, that there is ample basis for making this document part of the public record.[2]

The accompanying declaration establishes that Ameritech's document has been widely disseminated well beyond the document's purported confidential scope. For instance, the document and its contents are frequently the topic of discussion in conversations at meetings of payphone providers. See Declaration of Vince Sandusky, attached to this letter. As such, it has lost any confidential status it may have had.

"Confidential commercial information is information which, if disclosed, would cause substantial economic harm to the competitive position of the entity from whom the information was obtained." Diamond State Insurance Co. v Rebel Oil Co., 157 F.R.D. 691, 697 (D. Nev. 1994) (denying motion to quash subpoena seeking discovery of allegedly commercial confidential information) (citing Allnet Communications Services, Inc. v. FCC, 800 F. Supp. 984, 988 (D.D.C. 1992); Zenith Radio Corp. v. Matsushita Elec. Indus. Co., 529 F. Supp. 866, 889-91 (E.D. Pa. 1981)). In Allnet Communications, the court denied a FOIA request because the information sought was competitively sensitive and had been maintained as confidential. Here, disclosure of the Ameritech document by entry into the Commission's public record could not conceivably injure Ameritech's competitive interests because the information has already flooded the public domain.

In an analogous situation under the Freedom of Information Act, the D.C. Circuit has stated the settled rule that "the government cannot rely on an otherwise valid exemption claim to justify withholding information that . . . is in the 'public domain.'" Davis v. United States Department of Justice, 968 F.2d 1276, 1279 (D.C. Cir. 1992); see also The Nation Magazine v. United States Customs Service, 71 F.3d 885, 896 (D.C. Cir. 1995) ("public disclosures effectively waive right" to confidentiality, and "puts information in the public domain"). If Ameritech had been truly concerned with preserving the confidentiality of this information, it would have released it only to those from whom it

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1 The document itself is not enclosed with the original or copies of this letter filed with the Secretary's office. However, it is enclosed with copies of the letter which have been hand delivered to Mary Beth Richards, Deputy Chief of the Common Carrier Bureau, and William Kennard, General Counsel of the Commission. Counsel for Ameritech was notified last night that this document would be filed this morning and a copy of this letter was furnished to him.

2 Even if the Commission determines that the document should not be made part of the public record, APCC urges the Commission to retain the document in order to make appropriate use of its contents in deciding the issues in this proceeding.

had in advance secured an agreement of confidentiality. In that way, Ameritech would have been able to support its claim of confidentiality by pointing to such promises as the consideration for its release of the information. Instead, Ameritech released its information with a mere request for confidential treatment. Not surprisingly, that information has become part of the public domain, as is amply supported by the attached affidavit. Ameritech may not hide this information from the public since its disclosure would entail no competitive harm to Ameritech.

Moreover, this is information as to which the public's right to know is great. The Bell companies have taken the position that their transfer of their payphone assets at net book value adequately captures the economic value of those assets, and that valuation of payphone assets should not include any attempt to evaluate payphone location contracts or up-front bonuses because the value of such contracts and bonuses does not appear as a separate asset on the Bell companies' books. See Comments of the RBOC Payphone Coalition at 27-30; Reply Comments of the RBOC Payphone Coalition at 19-21.[3] The Bell companies argue that attempts to appraise the value of payphone assets, including the contracts under which payphones are currently operated, "would mire the Commission in an endless stream of impossibly subjective judgments about the valuation of LEC payphone assets. . . . [and] would require the Commission to make arbitrary judgments about the value of payphone assets in any event." Id. at 19.

"The Payphone Business of Ameritech" utterly contradicts these arguments. The document states that payphone location contracts are part of "the basics of the [payphone] business." Payphone Business at 5. The document states that such contracts involve sharing of up to 50% of revenues with the location owner. Id. at 14. The document consistently stresses the importance of successful site selection in marketing payphone services. Id. at 3, 14, 15, 16. The basis of the revenue projections of Ameritech's payphone business is a chart based on the remaining life of Ameritech's location contracts and showing groups of contracts by remaining life. See Tab 8 of Additional Information.

The document not only illustrates the importance of location contracts in establishing the economic value of payphone assets, but also demonstrates the feasibility of determining the economic value of such assets. For example, without identifying specific payphones, the document contains detailed information on the distribution of revenues among Ameritech's payphone stations. In addition, again without identifying specific payphones, the document includes a complete breakdown of location contracts based on when they expire and the revenues obtained from contracts with different expiration dates.

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3 Ameritech itself filed separately from the RBOC Coalition, but also stated that "the Commission should simply use net book value" and that location contracts should not be valued. Reply Comments of Ameritech at 12.

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See Tab 8 of "Additional Information." This information is clearly intended to, and does, assist an appraiser in valuing Ameritech's payphone assets. The fact that such information is available from the records of Ameritech's payphone business suggests that similar information is available from, or could easily be developed by, other Bell companies and LECs. Such information would enable the Commission or an independent appraiser to relatively objectively determine the economic value of LEC payphone assets, contrary to the claims of the RBOC Payphone Coalition that such valuation "would mire the Commission in an endless stream of impossibly subjective judgments about the valuation of LEC payphone assets. . . . [and] would require the Commission to make arbitrary judgments about the value of payphone assets in any event." Reply Comments of the RBOC Payphone Coalition at 19.

The document contains a substantial amount of additional information that would assist the Commission in resolving other issues in this proceeding. For example, the document states that the payphone industry comprises "an estimated 600 payphone operators nationwide,"only 25 of which have more than 1,500 payphones. Id. at 3, 5. This contradicts a recent statement by the RBOC Payphone Coalition estimating that there are 15,000 independent payphone companies in the United States.

In summary, "the Payphone Business of Ameritech" would materially assist the Commission in resolving a key issue in this proceeding concerning the valuation of LEC payphone assets. While the document is being submitted under the Commission's confidentiality procedures in order to allow the Commission to make a determination as to whether the document is properly included in the public record of this proceeding, APCC believes that there is no legitimate reason to prohibit disclosure of the document and that, in any event, it should be a part of the record in this proceeding.

Respectfully submitted,

/S/

Albert H. Kramer

AHK/nw
Attachment
cc: Mary Beth Richards (w/confidential enclosure)
William E. Kennard (w/confidential enclosure)

ATTACHMENT 3

Response to Additional RBOC Arguments on Asset Valuation

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Response to Additional RBOC Arguments on Asset Valuation

The RBOCs raise additional legal arguments against assessing the actual value of their payphone operation claiming that: (1) Democratic Central Committee is not applicable, (RBOC White Paper at 2-4), (2) state commissions have not applied economic-value or going-concern principles (id. at 4, n.3), (3) there is no "transfer," but only a mere "reassignment," of assets (id. at 5); (4) investors rather than ratepayers have borne the risk and burden associated with payphone contracts and intangibles (id. at 5-7); and (5) "going concern" valuation would conflict with the Commission's accounting rules (id. at 8-9), Generally Accepted Accounting Principles ("GAAP"), (id. at 10), and price cap rules (id. at 10-12).

None of these arguments have merit. Regarding Point 1, by arguing that Democratic Central Committee is inapplicable, the RBOCs disregard that, in its Computer II and joint cost decisions, the Commission expressly endorsed the application of Democratic Central Committee principles to asset transfer occasioned by deregulation. Indeed, where asset transfers are made to the LECs' own affiliated entities, post-Computer II precedent is, if anything, even more protective of ratepayers than Democratic Central Committee was. Southwestern Bell v. FCC, 896 F.2d 1378, 1380 (D.C. Cir. 1988).

Regarding Point 2, there is substantial precedent at the state level for ensuring that ratepayers are made whole for the economic value of economic benefits conferred on non-regulated operations. Decisions applying this concept at the state level frequently take the form of imputation of a "royalty fee." See Attachment 4. Similar legal and policy considerations support valuation of nonregulated assets at their actual economic "going concern" value.

Regarding Point 3, as stated above, the legislative history of Section 276 specifically states that "[t]he RBOC payphone operations will be transferred, at an appropriate valuation, from the regulated accounts . . . to the RBOC's unregulated books." House Report at 2 (emphasis added). Regarding Point 4, it is not credible that investors' rather than ratepayers have borne the risks and burdens associated with the value of LEC payphone contracts and goodwill, when LEC payphone operations have been subsidized for years by other regulated services. The RBOCs themselves even acknowledged that their payphone operations have been subsidized; thus, there can be no dispute that their payphone businesses have been built on the backs of ratepayers.

Regarding Point 5, the RBOCs have not shown that the Commission's rules even address valuation of assets that are transferred because they have been reclassified as nonregulated. To the extent they do, of course, the applicable rule requires transfer "at the higher of [net book value] or estimated fair market value of the asset." 47 CFR § 32.27(c). And even if "going concern" valuation were inconsistent with the Commission's rules, it is axiomatic that the Commission may change its rules, especially where such a change is required in order to implement new statutory requirements.

Contrary to the RBOCs' claim (RBOC White Paper at 8), in Separation of Costs of Regulated Telephone Services from Costs of Nonregulated Activities, 2 FCC Rcd 1298 (1987), the Commission did not reject consideration of the value of contract rights or intangibles when assets are transferred as part of a going concern. When an entire payphone business is being sold, it is obviously not possible to establish the fair market value of assets by reference to the "preferred" valuation method of a tariff rate or price list. In these circumstances, the Commission's rules clearly provide for establishment of "fair market value" by means of alternative methods such as "competitive bids, appraisals, market surveys, etc." Id. at 1336, n. 469.

Further, to the extent that GAAP requires asset transfers between a LEC's regulated and nonregulated operations to be accounted for at historical cost, GAAP is simply inconsistent with the Commission's rules and policies, which expressly provide for transfers to be valued at fair market when it is higher than historical cost. 47 CFR § 32.27(c).

Finally, there is nothing in the FCC's price cap rules that prevents exogenous treatment of an asset transfer occasioned by reclassification. Removal of assets from regulation clearly requires exogenous treatment. Price Cap Performance Review for Local Exchange Carriers, 10 FCC Rcd 8961, 9081 (1995). Such changes are obviously quite different from changes in GAAP such as the adoption of SFAS-106. Thus, the Commission's treatment of such accounting changes is irrelevant to the treatment of asset transfers occasioned by deregulation. The Commission may accord exogenous treatment to recognition of the gain resulting from such transfers, on the same basis that it accords exogenous treatment to removal of the deregulated asset from the carrier's regulated books. The gain could be taken as a one-time event, or amortized over a period of years.

ATTACHMENT 4

Recent State Decisions Re Compensation for Intangible Benefits to Nonregulated Operations