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Economic | STRATEGY | Institute

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February 7, 1997

IBDK-96-261

Mr. Reed Hundt
Chairman
Federal Communications Commission
1919 M St, NW
Washington, DC 20554

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MAR 27 1997

Federal Communications Commission
Office of Secretary

Dear Mr. Hundt:

I would like to take this opportunity to commend the FCC on its recent notice of proposed rulemaking addressing international settlement rates.

As the United States, and indeed the world, accelerates the process of opening markets and fostering competition, anticompetitive safeguards take on new relevance and importance. It is an era of transition, where some firms operate in both competitive and monopoly/oligopolistic markets, it is crucial for governments to implement market entry rules that both foster competition while simultaneously protect consumers from anticompetitive behavior. International settlement rate reform is one such vital rule. It is a vital measure to creating competitive, efficient markets and furthermore, ensuring that consumers reap the benefits of these markets.

The Economic Strategy Institute has been analyzing the implications of above-cost settlement rates for the last three years. In 1994, we argued for major international reforms in the settlement regime as well as FCC action to reduce the above-cost nature of the rates. In 1995, we argued for the inclusion of cost-based accounting rates into the effective competitive opportunities (ECO) test in order to ensure that foreign firms entering the U.S. IMTS market could not practice anticompetitive behavior, particularly in the form of a price squeeze.

Recently, the Economic Strategy Institute has undertaken an extensive analysis of the potential dangers that arise from foreign firm entry into the U.S. market while maintaining the ability to price settlement rates above cost. We have also conducted a detailed scenario-based analysis that estimates the outpayments that could be generated via above-cost settlement rates, and hence, could be used to price squeeze firms in the U.S. IMTS market.

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If settlement rates are not reduced to long run incremental costs, our analysis shows that a price squeeze is a real and sizable threat to the U.S. IMTS market. The tobacco, steel, and aluminum industries have all suffered the disastrous effects of price squeezes. In each case, firms with dominant power in one industry were able to leverage that power into a competitive market and significantly change the structure of those industries. Competitive, and at times, more efficient, firms were forced out of the market or weakened to such an extent that they became unable to compete effectively. History clearly shows that firms with the ability to initiate a price squeeze will do so, and in the long-term, their efforts will pay off at the expense of consumers and the industry as a whole.

Both of these studies conclusively show that the consequences of not reforming the settlements regime are significant. Absent LRIC-based settlement rates, ESI estimates that foreign firms will accumulate between \$32 and \$60 billion in above-cost settlements from 1997-2005 that could be used to subsidize price squeeze behavior in the United States. These monies are effectively monopoly rents taken from U.S. consumers. At least \$4 and \$7.5 billion could be applied to underprice efficient U.S. firms out of the IMTS market on crucial routes. The potentially devastating impact of this degree of price squeeze can not be understated. Allowing dominant firms to enter the U.S. market through an affiliate and continue collecting above-cost settlement rates could easily drive efficient U.S. firms from the IMTS market and lead to an oligopoly structure.

In addition, not acting to bring settlement payments to long run incremental costs will have several other significant negative impacts on the U.S. telecommunications industry and the U.S. economy. Prices for international services will be higher in the long-run, leading to billions in consumer losses. In addition, prices for other telecom services, such as domestic long distance and local service could be significantly higher as competition in the U.S. market is reduced. Since the emerging telecommunications and information technology sector represents 1/7th of the entire economy and is a major input to all manufacturing and service industries internationally, these price increases could lead to greater inflationary pressures within the United States and a less competitive economy, adversely affecting U.S. exports and job creation especially in the evolving industries that so heavily rely on telecommunication services.

It is therefore imperative to force settlement rates down to long run incremental costs. The Economic Strategy Institute submits that the long run incremental cost of settlement rates for all countries is between 5 and 8 cents. Pursuant to this, a settlement benchmark ceiling no greater than 9 cents would more than adequately compensate foreign firms who terminate traffic while minimizing the potential for price squeeze abuses within the U.S. market. Every penny of settlement rate above 9 cents would transfer between \$1 and \$1.5 billion to foreign firms annually, and would significantly increase the possibility of harmful anticompetitive behavior in the U.S. international market.

I have enclosed a copy of each of the studies for your review. Again, I would like to commend the FCC on its efforts to date and urge the ordering of an LRIC-based settlement rate. This action will ensure that international telephone consumers and the entire economy benefit from a competitive industry.

Respectfully submitted,



Dr. Lawrence Chimerine
Chief Economist

Enclosures



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STATE OF ISRAEL

MINISTRY OF COMMUNICATIONS

DIRECTOR GENERAL

IB DK1.No. 96-261

February 27, 1997
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**KATHREEN O'BRIEN
INTERNATIONAL BUREAU
2000 M STREET, ROOM 822
WASHINGTON, D.C 20554**

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MAR 27 1997

Federal Communications Commission
Office of Secretary

Dear Sirs,

It is a great honour for us to refer to the proposals you have made on the subject of the accounting rates published on the 19th of December 1996.

As we know, a meetings with American representatives which lasted from the 12th to the 14th of February 1997, took place in the framework of the WTO agreements in Geneva during which the enclosed document was passed on to your representatives. This document shows the Israeli view point about your proposals.

There is, between Israel and the USA, a free trade agreement which takes into account the fact that the Israeli economy is evolving little by little. Indeed, the annual income rate per person gives to Israel the privilege to be counted as one of the countries reaching a high income rate per person eventhough, as the agreement with the USA stipulates, the Israeli economy still remains at a developing stage.

What we are concerned about is not so much the way in which the cost prices were reckoned but rather the time granted to the countries which possess a high income rate per person for matching the accounting rates with the American operators. The time granted is not reasonable and is neglecting the economic circumstances in which each country finds itself. Although the rules you set up regarding the costs reckoning seemed to be reasonable, the goals are various and the particular regulatory business reality obliges us to set up a gradual matching with the accounting rates.

Since 1992, the Israeli Government has entered a privatization phase in the field of the Telecommunications services which was translated by the granting of a license to the big cellular phone operators such as Motorola as a part of the first operator and including the American company "Bell South" as a partner in the second operator.

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STATE OF ISRAEL

MINISTRY OF COMMUNICATIONS

DIRECTOR GENERAL

The Israeli government has chosen to open up this branch to competition at a worldwide level and in a gradual but not systematic way. The noticeable decrease that took place during the last years was significant and shows the consciousness on behalf of Israel regarding the need to decrease the accounting rates according to the tariff based on the cost price.

On the occasion of the meetings between your representatives and us in Geneva, one could notice an understanding about the particular economic regulatory situation in which we found ourselves and about the crucial economic need in the gradual decrease of accounting rates so that the settling of the competition process shouldn't be affected.

ACCOUNTING RATES

DATE	STANDARD	DISCOUNT	ECONOMY	(U.S) \$
08.01.87	2.4	2.1	1.9	
01.01.92	2.28	1.97	1.63	
01.01.93	2.16	1.85	1.4	
01.01.95	1.94	1.67	1.26	
01.07.95	1.9	1.63	1.23	
01.01.96	1.7	1.45	1.1	
01.06.96	1.18	1.18	1.18	

The considerable decrease in the accounting rates as mentioned in your proposals (within one or two years) might put all of the leaders in the field of the Israeli international telecommunications (in particular, the two new leaders) in such conditions that they wouldn't be able to function and would unwillingly prevent the competition from taking place in the field of international services in Israel.



STATE OF ISRAEL

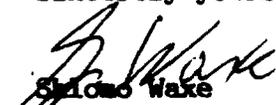
MINISTRY OF COMMUNICATIONS

DIRECTOR GENERAL

The limited competition in the field of international services that is taking place between the three important operators in Israel represents the first step in the Israeli Telecommunications services (excluding the competition in the field of cellular phones) and a stepping stone in the settling of competition within the Israeli Telecommunications services. The three international operators have the exclusivity until the first of January 2002 and one of the conditions to enhance competition is essentially dependent on the possibility to reach an agreement about the decrease in the accounting rates so that it should reach a total of 15% per year.

We are of the opinion that Israel, the economy of which is still developing and which is endowed with particular conditions regarding the opening up of the Communications branch to competition, needs to benefit from a longer period for the adjustment of the accounting rates so that it reaches a decreasing rate of 15% per year for at least the next three years in order for us to appreciate the achievements as regards to competition in three more years. According to those results, we will then be able to decide whether or not to increase the decreasing rates up to more than 15% per year so that by the end of the exclusivity period and opening up to more competition and by the time the accounting rates will match with a tariff closer to the cost price as mentioned in your proposals regarding Israel.

Sincerely yours,


Shimon Waxe
Director-General



MISSION PERMANENTE D'ISRAEL
AUPRES DE L'OFFICE DES NATIONS UNIES
ET DES ORGANISATIONS INTERNATIONALES A GENEVE

נציגות ישראל
ליד משרד האומות המאוחדות
והארגונים הבינלאומיים בג'נבה

Geneva - February 10, 1997

Ambassador Jeffrey Lang
Deputy U.S.T.R.
Embassy of U.S.A.

Dear Mr, Ambassador,

Re: The Response of the State of Israel to the Position of the FCC Regarding
Accounting Rates

In 1992, the Ministry of Communications of Israel commenced the process of opening the field of communications to competition, in stages and in accordance with our unique approach which will be explained below.

In the past, a license for providing cellular phone services was granted to a group headed by Motorola. In the framework of introducing competition, an additional license was now granted to a group headed by the American company BellSouth.

Last week two licenses were granted to companies which had won our tender for the provision of all international services. Each one of the winning companies is headed by an American company, either Southwestern Bell or Sprint.

The tender outlined a strict regulatory system with regard to international services and detailed the basic obligations to which operators must commit themselves. Half of the points that could be won in the tender were awarded according to the criterion of consumer prices. The strict regulatory system determined that for countries from which incoming traffic exceeds outgoing traffic by 50% or more, the maximum reduction in accounting rates per year would be 15%.

telecommunications market to competition in general, and to the area of international services in particular.

Taking into account the significance of international services in the Israeli communications market as a whole, such dramatic reduction in accounting rates would cripple the chances of opening the communications market to competition, and cause a loss of confidence in the liberalization process of the Israeli communications market among foreign investors, and perhaps most especially among large American companies,

We agree to the FCC's general proposal regarding the reduction of accounting rates, and even to the principle of cost-based accounting rates which establishes the rate at 31 - 47 cents per minute. However, we request that the preparation time allotted to new operators in Israel be much longer than proposed. The State of Israel insists that the rate of annual reduction be 15%. Any larger reduction in accounting rates over a shorter period of time could, as previously mentioned, hinder the prospects of introducing competition in international services, and thus, seriously harm the American companies which are partners with the Israeli companies who have licenses.

Sincerely,



Shlomo Waxe
Director General
Ministry of Communications

**Agreement
on the Establishment of a Free Trade Area
between the Government of Israel
and the Government of the United States of America**

{PREAMBLE}

The Government of Israel and the Government of the United States of America,

- Desiring to promote mutual relations and further the historic friendship between them;
- Determined to strengthen and develop the economic relations between them for their mutual benefit;
- Recognizing that Israel's economy is still in a process of development;
- Wishing to contribute to the harmonious development and expansion of world trade;
- Wishing to establish bilateral free trade between the two nations through the removal of trade barriers;
- Wishing to promote cooperation in areas which are of mutual interest;

have decided to conclude this Agreement:



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INTERNATIONAL TELECOMMUNICATION UNION

THE SECRETARY-GENERAL

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MAR 27 1997

Federal Communications Commission
Office of Secretary

Ambassador Vonya B. McCann
United States Coordinator
International Communications
and Information Policy
Department of State
WASHINGTON D.C. 20520
USA

21 February 1997

Dear Ambassador McCann,

The ITU has recently followed with particular attention the outcome of the WTO negotiations on basic telecommunication services as well as the development of FCC's Notice of Proposed Rule Making (NPRM) on international settlement rates as issued on 19 December 1996.

I am delighted with the excellent results of the WTO negotiations and I am convinced that this will give an additional opportunity to consolidate the process of market reform that is already under way in the sector. I would like to congratulate all the countries which participated in the successful negotiations, especially those countries which led the negotiations for the benefit of all telecommunication communities and particularly the users.

Concerning the FCC's NPRM, I have noted the great interest shown by the ITU Members. ITU has received a number of representations and many letters from the Member States and the private sector concerning the FCC's initiatives. In particular, they expressed concerns about any unilateral action the United States might be undertaking in the near future. In examining the comments filed by the interested parties to the FCC, I have also noted the desire of a great number of countries to move forward in a multilateral way towards the shared objective of achieving cost-orientated accounting rates.

Let me assure you that I am personally committed to achieving a reform of accounting rates and to that end I have already submitted a contribution to Study Group 3 of the Standardization Sector of the Union which is responsible for economic issues. The Council in June of this year will be called upon to decide on the holding of the second ITU Policy Forum, where one of the subjects to be discussed might be accounting rate reform. The ITU is taking the necessary action and I do hope that the FCC's final outcome on this issue will not

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threaten the viability of efforts carried out in our organization in this respect. At the same time, in the interest of facilitating the development of the global telecom industry and the markets it serves, I would officially invite the US Government, as in the past, to contribute to the work of the Union in order to achieve the objective of reforming the accounting rate regime and to take an active role in a constructive debate to attain a successful outcome on a multilateral basis.

Yours sincerely,



Pekka TARJANNE

Copy : Mr. Reed Hundt
Chairman, Federal Communications Commission