We have not and do not view this level of access cuts to be dramatic. This level of cuts is in line with the revenue reductions absorbed by the LEC industry in their annual price cap adjustments. This level of cuts certainly holds down revenue growth, but it in no way compromises their ability to fund capital investment and maintain the local networks, which is a key concern of regulators and politicians.

The FCC is committed to changing the way access charges are collected. The agency wants to make the method of collection more reflective of the way in which costs are incurred by the LECs. Thus, it wants to get away from collecting the access charges purely on a usage sensitive basis. The FCC is supporting the Joint Board's recommendation to make access charge collection a combination of a fixed monthly per line fee, and a smaller usage sensitive component. Just as access charges today are collected directly from the long distance carriers, these newly formulated access charges will still be collected directly from long distance carriers. And, just as long distance carriers make their own decisions today on how to recover their access costs in pricing to end users, they will do the same in the future. Thus, if the per line charge ends up being $2 per month for standard telephone lines, (a reasonable level) the long distance carriers would be able to make the choice whether to pass this fee directly to consumers, or to some how mask it in their long distance rates.

- **Implications of A Fixed Per Line Charge Combined With a Usage Sensitive Component.** The change in the way access charges are collected has positive and negative consequences for both LECs and new entrants. For the LECs, the positive is that it will remove some of the opportunity for competitors to cherry pick high end customers, who generate a lot access revenues through long distance calling. The negative is that with a smaller usage sensitive charge the LECs won't enjoy as much of a revenue pick-up with volume growth. For CAPs the new regime would take away some of the opportunity for cherry picking at the top. But as Reed Hundt said yesterday: "we want to turn CAPs into CLECs" (Competitive Local Exchange Carriers.) The opportunity for CLECs remains undiminished by this change. Similarly, for long distance carriers, eager to become CLECs this change would not be significant. For long distance carriers the key issue is the size of the access revenue cut, not so much its distribution. However, if long distance carriers have to pay a high per-line fee, then very low end customers become unattractive. If a current pre-subscribed customers makes little to no long distance calls, than the carrier will want to drop this customer, since the revenue might not even cover the per line fee.

- **Implications For Stocks.** We continue to believe the growth outlook for the RBOCs is a 3% to 7% growth rate. This is based on the level of access cuts described above, entry into long distance in the second half of 1998, and competitive pressures starting in the second half of 1997. With this outlook, we think the RBOCs have gotten ahead of themselves recently. On the long distance side, there is no "group call." Its company specific. This is also true for the CLECs. Companies that can operate successfully in the current environment, and transition successfully to full service operators will be winners.

Excerpts From The Chairman's Speech : we've lifted quotes from Reed Hundt's speech below. We think these comments can help understand the FCC's current position on a variety of topics.

> *Pro-Competition ...means we want to promote all competitors and competitive strategies, even-handedly and indifferently, as opposed to following the United Kingdom model and promoting specifically and unevenly alternative infrastructure development by the cable industry, or a single facilities-based long distance carrier like Mercury*
>
> *Our choice of being pro-competition instead of being pro-any specific competitor is why we at the state and federal level are supposed to guarantee all three of the basic rights of new entrants under the Act: buying at wholesale, leasing elements, and interconnecting from new facilities. Effective enforcement of all three rights is necessary to expedite the entry of new competitors into the local exchange and access markets.*
>
> *Our vigilance in enforcing these rights is essential because the scope of the challenge facing new entants is quite broad. In every single existing service territory the market is dominated by one company - the historic monopolist.*
>
> *...I think that our target is clear: over time lowering traffic sensitive interstate access charges to forward looking cost and restructuring the cost recovery such that prices charged*

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...ct the way in which costs are incurred by LECs. That's what would happen in a competitive market and thus we should seek to emulate this result in the absence of such competition. Where and when the market for a particular access sergice is workably competitive, access prices should be set by them arket, not by government. The big qeustion in access reform is not our target, but how – and how fast—we get there.

This inefficient pricing [of access] discourages broad entry by new entrants (because revenues are concentrated in high volume users) and deters usage of long distance (because it is priced artificially high).

To get from where we are today to where we would like to be, the Joint Board thought we should move some traffic sensitive charges to flat rate charges imposed on IXCs by the LECs. We're calling this the flat and equitable rate charge or FERC...

...We still have to decide how much usage-based charges should be reduced on what we call Day One, the effective date for the changes in our access reform order, and how long we shold take to phase in the rest of the reduction required to get to forward looking costs.

Nor is it obvious that FERC ought to be imposed on all access lines.

In terms of rate levels, we may wish to have different approaches for originating and terminating access charges. There seems to be broad consensus among economists that originating access rates will experience significantly more market pressure than terminating access.

The combined effect of the changes I'm discussing here todayis to take a significant step toward getting access charges to cost immediately, with the bulk of additional reductions coming later, over time.

As to future access reductions, it will be critical to set in motion a predictable process in our order that will reduce access to forward looking economic cost within a reasonable time period.

...we also intend to address the question of LEC recovery of historic costs...I do not believe however, that we shol dbegin the inquiry into the historic cost issue with the supposition that the LEC is necessarily guaranteed as a matter of law a complete certainty of recovering al such investment. Takings is certainly one of our concerns here, but we must not forget "givings". Let me mention three: first, giving the LECs cellular licenses worth billions; second, giving LECs yellow pages publishing opportunities (also worth billions); and third giving LECs the opportunity to enter long distance, where they can leverage their regulated local asset.

Smith Barney Research

Industry Note

Headline: FCC MEETING PROVIDES POSITIVE VIEW ON ACCESS CHARGE REFORM

Analyst: CHARLES W. SCHELKE (212) 816-6264
Analyst: TIMOTHY K. HORAN (212) 816-5544
Release Date: 02/27/97

Industry(s): Telecommunications
Associated Ticker(s): AIT, BEL, BLS, GTE, NYN, PAC, SBC, USW

--SUMMARY:---

* FCC staff, at a meeting, indicates support for balanced access charge reform

* Primary thrust of reform is to replace variable with fixed costs on rough justice basis

* We believe context of reform discussion positive for telcos

--OPINION:---

Yesterday, several other Wall Street analysts and I met with senior staff members of the Federal Communications Commission (FCC) Office of Plans and Policy to discuss access charge reform. The intent of the meeting was to provide some input to the FCC as to investor expectations for access charge reform. Thus, there was a lot of discussion at the meeting as to the objectives of access charge reform (which all agreed was to align the access charge rate structure with costs), the desirability of a flash cut or phased-in change in the structure, and the political problems with implementation reform. While the staff characterized itself as still being in a fact-finding mode, their comments indicated a predisposition toward balanced reform from a revenue standpoint, with most of the revenues recovered on a fixed rather than variable basis. This would be highly beneficial to the telcos and consistent with our expectations as discussed in our industry report released on February 21 and our February 7 Call Note. We continue to recommend purchase of telephone stocks generally.

In the meeting, there was general agreement by the staff that: (1) the cents per minute charges need to be almost entirely eliminated and replaced by a flat per-month access charge, to be either paid by the end user or the long-distance company, and (2) this rebalancing should be accomplished on a rough justice basis from the telcos standpoint.

The tone of the latter comments was that rough justice could be interpreted in two ways:
(1) if rate reductions continue to be dictated by the FCC, :rough

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justice might involve a $1 billion rate cut, i.e. variable charges reduced by $8 billion or $9 billion and replaced by $7 billion-$8 billion of flat-based revenues in the first year; or (2) a sharper--$2 billion-$4 billion net--rate cut in the first year with no further cuts required in subsequent periods.

Additionally, it was noted that the telcos would benefit from restructuring rates from a variable to a per-access line basis since high usage LD customers would become more equalized. In summary, we believe the overall tenor of the discussion was quite positive for the telcos.

Prior to this meeting, on February 24, in a speech before the Communications Committee of the National Association of Regulatory Utility Commissioners, FCC Chairman Reed Hundt outlined his current views on access charge reform. Chairman Hundt indicated that there should be a significant step-down in usage based access rates, to be recovered by the telcos through flat, per access line rates. He did note that the access line charges need not be similar across all lines, which would be a step away from cost-based pricing. He also noted that in a transition to competitive markets, there may also be historical costs that are difficult to recover. We think this is probably correct but we also think that overall industry cuts of about $1.5 billion to $2 billion per year over a 3-5 period largely corrects a lot of these discrepancies. In summary, and not surprisingly, Chairman Hundts comments in his speech were consistent with the views expressed by the Staff at yesterdays meeting.

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