Stephen S. Melnikoff
Vice President -
Federal Regulatory

SBC Communications Inc.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
Phone 202 326-8885
Fax 202 408-4806

April 30, 1997

EX PARTE OR LATE FILED

EX PARTE

RECEIVED
MAY 2 1997
DOCKET FILE COPY ORIGINAL

The Honorable Reed E. Hundt, Chairman
The Honorable James H. Quello, Commissioner
The Honorable Susan Ness, Commissioner
The Honorable Rachelle B. Chong, Commissioner
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: *In the Matter of Federal-State Joint Board on Universal Service and Access Charge Reform, CC Docket Nos. 96-45 and 96-262*

Dear Mr. Chairman and Commissioners:

On April 16, 1997, a proposal was filed with the Commission entitled the "Consumer/Business Consensus Proposal for Access and Universal Service Reform." Far from a consensus of consumer and business groups, this proposal is essentially the positions of the International Communications Association (ICA). The ICA Proposal, as it will be referred to here, does not address any of the critical issues confronting the Commission with regard to universal service and interstate access charge reform. Instead, the proposal merely offers a series of "meat cleaver" rate cuts unfounded on any logical basis of cost causation. In fact, ICA makes no attempt to deal with the subsidies inherent in the interstate access structure, but rather merely offers a timetable to reduce access charges to hypothetical Total Element Long-Run Incremental Cost (TELRIC) levels. As the Commission knows, true access charge reform is much more than mere rate cuts. The issues are complex. The unfounded recommendations presented by ICA provide no basis for bringing telecommunications competition into the 21st Century.

As ICA acknowledges, no new concepts or mechanisms are introduced as a part of its plan.[1] Rather, the plan is merely a series of rate cuts, reducing local exchange carrier (LEC) access revenues $10.7 billion over five years. Although the ICA Proposal asserts that the cuts do not imperil the financial health of incumbent LECs, this result is virtually impossible given the magnitude of the reductions. Rate cuts of this magnitude represent approximately 44% of the current LEC interstate revenue stream. Losses of this magnitude would turn LEC rates of return negative, resulting in large employee layoffs and service

[1] ICA Proposal, p. 4.

No. of Copies rec'd 0
List ABCDE

quality endangerment.

The opening salvo of the ICA Proposal is a $2 billion dollar rate cut, effectively reinstating rate of return (ROR) regulation and abrogating the principles that established the Commission's price cap regime. Customers have received the benefits of price caps in the form of reduced prices resulting from ILECs' productivity. At the same time, price cap ILECs were given the incentive to increase productivity by removing the cap on earnings that exists with rate of return regulation. Price caps works because it rewards companies that are efficient by allowing these companies to keep additional earnings that accrue from their efficiencies. In contrast, the ICA Proposal opens with a $2 billion confiscation of LEC efficiency gains as one of many regressive regulatory policies.

ICA attempts to justify its recommendation that ILEC rates be "reinitialized" to an 11.25% return based on a claim that 11.25% is what "ILECs were supposed to earn."[2] This Commission could not have been clearer on this point. The price cap LECs' earnings results must be held lawful as long as the price cap LECs adhered to the Commission price cap productivity offset, price cap index constraints, and earnings sharing provisions, if applicable. The LEC Price Cap Order specifically states that "complaints that overall company earnings that comply with the sharing mechanism are excessive in view of costs will not lie."[3] This Commission expressly implemented an incentive regulation framework "to harness the profit-making incentives common to all business"[4] and recognized that "rate of return methods . . . cannot create the positive incentive that are embodied in incentive-based regulation." Thus, contrary to the claims of ICA, the Commission was clear that the limited incentives of cost-plus ROR regulation were not supposed to apply to the price cap LECs.

The ICA Proposal discusses use of a 7.5% productivity offset ("X-Factor") in years 1 and 2, substituting a transition to TELRIC-based access rates in years 3, 4, and 5. Thus, the ICA Proposal eliminates the use of a productivity offset in year 3 and beyond, and places the FCC in the role of using hypothetical cost proxy models to explicitly manage ILEC access prices in competitive markets. Chairman Hundt has recognized that micromanaging business is not a proper role for the Commission in the new competitive environment.[5]

---

[2] ICA Proposal, Section II. A, p. 9.

[3] *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd. 6786 (1990) ("LEC Price Cap Order"), at para. 406 (emphasis added).

[4] Id., at para. 3.

[5] Telecommunications Reports, February 26, 1996, at p. 3.

The ICA Proposal is unfounded for a number of reasons. First, the ICA Proposal of a 7.5% productivity offset rests on evidence that has been thoroughly discredited and cannot be rehabilitated. The ICA Proposal relies on the following discredited evidence: (1) an MCI "break-even" table; (2) a Norsworthy analysis filed by AT&T; (3) an Economics and Technology Inc. (ETI) paper filed by Ad Hoc Telecommunications Users Group (Ad Hoc); and (4) an *ex parte* by a group calling themselves Customers for Access Rate Equity (CARE) that references the prior three filings.[6] USTA and other parties have shown that each of these three attempted analyses contains fatal flaws that make their basic approaches invalid for setting an X-Factor.

MCI's so-called "break-even" analysis is computationally dishonest. It contains a wrong assumption that each price cap LECs' rates were retargeted to an 11.25% return each year prior to its annual filing. Such was clearly not the case. While imposing this prior-year assumption on its analysis, MCI simultaneously assumed that each of these ROR-regulation retargetings had absolutely no effect on the actual interstate earnings results achieved by each LEC in the current year -- a completely preposterous result. Also, MCI uses an incorrect marginal income tax rate. Ad Hoc presented a similar analysis for a prior period, repeating MCI's errors. It has been shown that even accepting MCI ROR-regulation methods, which SBC does not, both MCI's flawed construct and Ad Hoc's copy yield much lower X-Factor estimates (in the 2.8% to 3.5% range) when the obvious computational errors are corrected.[7]

The Norsworthy analysis sponsored by AT&T contains numerous method and computation errors. A simple example of one of these errors is Norsworthy's improper calculation that End User Common Line (EUCL) demand growth can be measured by minutes of use growth when, in fact, EUCL rates are charged on, and revenue only grows by, access lines. Norsworthy's substantial errors have been extensively documented[8] and no corrections for those errors have been

---

[6] ICA Proposal, Section III., C., pp. 17-18.

[7] *Ex Parte* Letter to Mr. William F. Caton, Secretary, FCC from Frank McKennedy, USTA, CC Docket No. 96-262 (dated April 23, 1997) (containing Letter from Roy M. Neel, President and CEO, USTA to The Honorable Reed E. Hundt, Chairman, The Honorable James H. Quello, Commissioner, The Honorable Susan Ness, Commissioner, and the Honorable Rachelle B. Chong, Commissioner); USTA Comments, CC Docket No. 96-262, Attachment 7, "Response to MCI Productivity Analysis," filed January 29, 1997; and *Ex Parte* Letter to Mr. William F. Caton, Secretary, FCC from Frank McKennedy, USTA, CC Docket No. 94-1 (dated May 28, 1996), Fourth FNPRM.

[8] *See, e.g., Ex Parte* Letter to Mr. William F. Caton, Secretary, FCC from Frank McKennedy, USTA, CC Docket No. 96-262 (dated April 23, 1997); USTA Comments, CC Docket No. 96-262, Attachment 6, "Critique of the AT&T Performance-Based Model," Christensen Associates, filed Jan. 29, 1997.

placed on the record. USTA demonstrated that even Norsworthy's flawed construct, when scrubbed for errors, yields a productivity result of approximately 2.9% to 3.1%.[9] As a result, the AT&T analysis referred to by ICA cannot serve as a lawful basis for any X-Factor recommendation.[10]

Ad Hoc has presented no productivity evidence in CC Docket No. 96-262, instead relying on an ETI study submitted in the record in CC Docket No. 94-1.[11] USTA and Christensen Associates have demonstrated that the Ad Hoc analysis makes unwarranted adjustments to its recommended input inflation estimates without processing the offsetting changes to its productivity estimates that its recommendations require. As such, the Ad Hoc X-Factor estimates are incorrectly biased upward and are completely unreliable.

Also, no reasonable analysis of the input inflation analysis can result in significant increases to the X-Factor. USTA has demonstrated that over the most recent five years, input inflation for the price cap LECs has been approximately 0.7 percentage points greater than input inflation for the U.S. economy as a whole.[12] Thus, using the most recent data, inclusion of an input inflation differential would reduce, not increase, the X-Factor estimate. Any analysis that purports to measure a significant input inflation differential as an additive to an X-Factor must, therefore, be based on an arbitrary and capricious "gerrymandering" of results-oriented selections from older, less relevant studies. Such calculations could not be sustained upon review.

The ICA Proposal also indicates that, in the second year, the FCC would reduce the transport interconnection charge (TIC) to 20% of current levels, resulting in another $1.8 billion rate reduction. ICA again provides no basis for these reductions.

---

[9] USTA Comments, CC Docket No. 96-262, Attachment 6, filed Jan. 29, 1997, pp. 3, 28-29, Exhibit 1, & Tables 1 and 2.

[10] The CARE *ex parte(s)* alluded to by ICA contain no independent productivity evidence and instead relies on the presentations by Ad Hoc, AT&T, and MCI discussed elsewhere herein. Thus, SBC's arguments here also apply equally to the CARE *ex parte(s)*.

[11] Ad Hoc Comments, CC Docket No. 94-1, Fourth FNPRM, "Establishing the X-Factor for the FCC Long-Term LEC Price Cap Plan," L.L. Selwyn and P.D. Kravtin, filed January 11, 1996.

[12] *Ex parte* Letter to William F. Caton, Secretary FCC from Frank McKennedy, USTA (dated March 24, 1997) (transmitting to Anthony Bush, FCC, table and machine readable disk containing detailed historical input inflation data from five separate telecommunications studies performed by Christensen Associates and subsequent USTA *ex parte* letter, filed March 31, 1997 providing additional background detail on input inflation and output growth and amending nine individual entries for input quantity from the March 24, 1997 submission).

As we have stated previously, Congress did not mandate the confiscation of ILEC revenues. ICA's suggestion to significantly reduce access revenues, while providing only minimal universal service support is contrary to the Act and would ultimately harm the very consumers ICA purportedly represents. The suggestion that implicit subsidies should be eliminated provides clear evidence that the proposal is not intended to protect universal service, but rather is solely meant to reduce ILEC revenues. Congressional intent is very clear -- implicit support is to be replaced with explicit support -- implicit support was not to be simply confiscated.[13]

One of the requirements of the Act is that support be sufficient and predictable.[14] As SBC has previously argued, the use of theoretical proxy models promoting the use of so-called forward-looking economic cost, such as the one proposed by ICA, fails to satisfy this requirement. Contrary to their assertion that universal service can be supported by subsidies of $1.657 billion, SBC has demonstrated that the current level of interstate universal service support is approximately $5.7 billion.[15] The ICA Proposal assumes that ILECs can simply eliminate this implicit support, yet maintain the universal service goals required by the Act.

The ICA Proposal also supports the inclusion of internal connections and Internet access in the "Education Fund." Such a proposal clearly contradicts the plain language of the Act and is, therefore, beyond the Act's intent and beyond the Commission's authority.[16]

The ICA Proposal purports to provide significant benefits to incumbent LECs, interexchange carriers (IXCs), and consumers that they characterize as a "win-win-win" proposal. In reality, if the ICA plan were adopted, everyone would lose. First, ICA postulates that LECs benefit because they will receive pricing flexibility in only five years and will be able to "keep all their earnings from access, no matter how great." Given that the ICA Proposal would reduce rates by over $10 billion, there will certainly be no positive earnings for ILECs and likely little need for pricing flexibility. From consumers' perspective, while it appears that in the short term consumers will benefit, the long-term effect will be reduced supply and lower quality. Just as cable re-regulation crushed outside investment in the cable industry, the draconian cuts proposed by ICA would devastate the access marketplace. Finally, even the IXCs would see little benefit, as total pass-through of access charge reductions in long distance prices would be required through prescribed methods.

---

[13] 47 U.S.C. § 254(e).

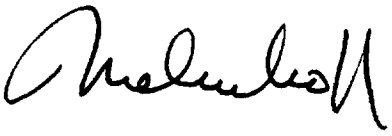
[14] 47 U.S.C. § 254(b)(5).

[15] SBC *Ex parte* Letter, CC Docket Nos. 96-45 and 96-262 (dated April 15, 1997), at p. 3.

[16] *See* 47 U.S.C. § 254(h)(1)(b).

On April 2, 1997, SBC, BellSouth Corporation, and Pacific Telesis Group submitted an interim proposal that would preserve universal service, reduce carrier switched access charges, and promote continued progress toward a fully competitive industry. In recent weeks, U S WEST, Inc. joined in support of the proposal. If adopted, the proposal would provide the Commission with a balanced first step toward solving the numerous and complex issues surrounding universal service and access charge reform. Unlike the ICA Proposal, SBC's proposal is based on sound economics, benefits consumers, and moves the industry in the right direction. We look forward to the opportunity to assist the Commission in its efforts to reform the interstate access charge regime and expand universal service.

Sincerely,



Stephen S. Melnikoff
Vice President-Federal Regulatory