UNITED STATES TELEPHONE ASSOCIATION

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May 29, 1998

Mr. A. Richard Metzger, Jr.
Chief, Common Carrier Bureau
Federal Communications Commission
1919 M Street, NW, Room 518
Washington, D.C. 20554

Re: Written Ex Parte Presentation
CC Docket Nos. 94-1 and 96-262

Dear Mr. Metzger:

Relying on the same unsupported arguments as in the past, in recent ex partes AT&T and MCI are requesting that the Commission increase the productivity offset for incumbent local exchange carriers (ILECs) subject to price cap regulation. This time, without benefit of a record supporting any increase, AT&T and MCI suggest that the Commission increase the offset on July 1, 1998. AT&T claims that the productivity offset should be set at 9.3% on a going-forward basis and also be used to re-initialize access prices from July 1, 1995. AT&T's ex parte provides no support for such an arbitrary increase, and its representation that a 9.3% productivity offset would produce a $3.6 billion access reduction, even if true, does not address the relevant question of the just and reasonableness of access rates.[1] It simply states the obvious — a higher productivity offset provides greater year-over-year give backs by ILECs from their access rates. The IXCs' motivation to advocate for such a result, irrespective of its reasonableness, is self-evident.

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[1]AT&T's calculations do not reflect current Commission estimates. AT&T's proposal contradicts its own statements opposing increases in its productivity offset. "...[productivity factor] changes would penalize AT&T for responding to the incentive of price cap regulation and reimpose the efficiency-dampening features of rate of return regulation...if the productivity factor were ratcheted up in this fashion, the disincentive to achieve any further increases in either productivity or profitability would itself ensure that such gains would not persist." Additionally, AT&T has noted that "...any attempt to eliminate or recapture the profits resulting from such higher efficiency would not only breach the promise of price cap regulation, but destroy the incentive to make the difficult decisions necessary to yield additional efficiency gains in the first place." *See*, Comments of AT&T, CC Docket No. 92-134.

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MCI claims that the Commission should grant AT&T's pending petition for reconsideration and set the offset at 8.5%, ignoring the fact that the Commission already rejected AT&T's position and adopted the current offset of 6.5%. This was done even though 6.5% was not supported by any facts in the record and apparently was adopted as part of an agreement facilitated with AT&T.[2] MCI's rationale for increasing the offset is based on its analysis of earnings, which has been refuted in the record in both CC Docket Nos. 94-1 and 96-262.

The suggestions to arbitrarily increase the productivity offset are entirely without merit and would eviscerate the benefits of price cap regulation. These suggestions should be summarily rejected, and USTA would expect the Commission will, as required by law, make an independent determination on the just and reasonableness of ILEC access rates. In any event, such suggestions are premature and should not be considered prior to the price cap performance review.

The Commission is aware that any arbitrary increase in the productivity offset advocated by AT&T and MCI will have no beneficial impact on consumers. While MCI claims that without an increased productivity offset, price cap ILEC shareholders will benefit at the expense of consumers, neither MCI nor AT&T have shared the benefit of previous access charge reductions with most long distance customers. In its February 11, 1998 letter to Chairman Kennard, USTA pointed out that the major IXCs increased charges to their customers by approximately $2 billion at the beginning of this year. On March 18, USTA provided an analysis of the IXC's unresponsive answers to Chairman Kennard which refuted their claims of reductions. Clearly, the IXCs are motivated by economic self-interest, not the interests of end-user customers, especially residential and small business customers.

The reasonableness of access rates cannot lawfully be determined based on the need to "fund" a specific dollar amount for universal service. The Commission's authority to regulate interstate access charges is derived from Section 201 of the Act. There is no connection established between access charges and the level of support needed for universal service. Section 254 requires the Commission to ensure that carriers contribute on an "equitable and non-discriminatory basis" to "preserve and advance universal service." Access charges recover the reasonably incurred and legitimate costs of providing access services. There is no legal justification for the Commission to arbitrarily reduce access charges in order to leverage increased contributions to support universal service.

Contrary to the assertions of MCI, the record before the Commission in both CC Docket Nos. 94-1 and 96-262 provides ample evidence that the use of accounting returns to measure

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[2] *See,* May 3, 1997 Letter from Gerald Lowrie, Senior Vice President, AT&T, to the Honorable Reed E. Hundt.

progress under price cap regulation.[3] The level of return on earnings is irrelevant to price cap regulation. As Dr. James Vander Weide discussed in two affidavits submitted by USTA, the accounting earnings results of the price cap ILECs cannot serve as the basis to increase the productivity offset since the economic rates of return are significantly less than 11.25%.[4] Using the same methodology used by the Commission to set the 11.25% return, Dr. Vander Weide showed that the achieved economic rate of return for the period 1991- 1995 was only 8.75%. Dr. Vander Weide explained that comparing accounting rates of return to 11.25% is comparing apples to oranges. MCI's miscalculations persist as its accounting earnings understate the impact of the $1.7 billion reduction in access charges which were effective July 1, 1997. That reduction, on an annualized basis, would reduce accounting returns by 234 basis points. Further, MCI fails to consider the impact of the access restructure adopted by the Commission which shifts recovery from a usage basis to a per line basis. Historically, lines have grown at a slower rate than minutes.

Since 1991, interstate earnings for price cap ILECs have improved at a moderate rate. These companies have achieved significant efficiency improvements in response to the opportunities under incentive regulation and benefitted from reduced inflation and the strong U.S. economy.[5] Since 1991, their earnings have grown at a 4.8% annual rate while overall U.S. corporate after-tax earnings rose at a much higher 12.2% rate. Earnings per share for the S&P 500 companies increased at an annual 16.5% rate. [See the attached chart]. The 11.25% rate of return is a less relevant reference point for incentive regulation and would fall well short of the earnings performance that other U.S. corporations are achieving. Given the recent financial

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[3]AT&T also objected to the use of accounting returns to measure its results under price cap regulation. It stated, "...efficiency is a function of changes in output with given inputs, which include economic capital costs rather than any changes in book capital, as used in the calculation of rates of return...AT&T's interstate returns are even more clearly reasonable when evaluated as the product of price cap regulation rather than rate of return regulation. Under the former, AT&T assumes far greater risk and commensurate potential to increase profitability...A broader zone of reasonable returns is a necessary complement of providing both greater risk and reward, and increased returns demonstrate that the price cap system of incentives is proving successful." Comments of AT&T, CC Docket No. 92-134.

[4]Comments of USTA, CC Docket No. 96-262 at Attachment 4 and Reply Comments of USTA, CC Docket No. 96-262 at Attachment 9.

[5]A phenomenon not guaranteed into the future despite the fact that reductions captured by the price cap formula are forever reflected in access rates.

performance of U.S. corporations overall, a rate of return benchmark provides no financial incentive for continued efficiency initiatives or investment in riskier advanced technologies.

The productivity offset has proven to be the single most critical financial aspect of price cap regulation. There is no sustainable record to support the changes suggested by AT&T and MCI. The Commission should neither endorse nor aid their self-serving price cap agenda. USTA strongly urges the Commission to reject any effort to increase the productivity offset.

Sincerely,

Lawrence E. Sarjeant

Lawrence E. Sarjeant
Vice President Legal and Regulatory Affairs

Attachment

cc: James Schlichting
Jane Jackson
Rich Lerner
Chris Barnekov
John Scott
Tom Power
Kyle Dixon
Paul Gallant
James Casserly
Kevin Martin
John Nakahata

1991 - 1997 EARNINGS GROWTH COMPARISON

OVERALL U.S. CORPORATE AFTER-TAX EARNINGS:

	1991	1997	**Annual Compound Growth Rate**
$ Bill	$240.8	$480.4	12.2%

U.S. S&P 500 EARNINGS PER SHARE:

	1991	1997	**Annual Compound Growth Rate**
$	$15.91	$39.77	16.5%

USTA PRICE CAP LECs INTERSTATE EARNINGS

	1991	1997	**Annual Compound Growth Rate**
$ Bill	$3.6	$4.7	4.8%

SOURCE: Standard & Poor's DRI Review of the U.S. Economy, Table 11.2, April, 1998

FCC Form 492 Interstate Earnings Reports, Sum of BOCs, GTE, Frontier, SNET

EARNINGS GROWTH COMPARISON, 1991 TO 1997