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Celia Nogales
Director - Federal Relations

EX PARTE OR LATE FILED

June 10, 1998

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, DC 20554

RECEIVED

JUN 10 1998

Re: **Ex Parte Statement**
CC Docket 96-45

Dear Ms. Salas:

On Sunday, June 7, 1998, Richard Kolb and I met with Martha Hogerty, Missouri Public Council and State Member of Universal Service Joint Board.

We discussed Ameritech's position regarding the various proposals for high cost universal service support, as reflected in our comments filed May 15, 1998. The attached material was used as part of our discussion.

Sincerely,



Attachment

cc: Martha Hogerty

No. of Copies rec'd 022
List A B C D E

HIGH COST FUND DEFINITION

It is Ameritech's position that the pending definition of the Federal High Cost Fund should be driven by the following notions:

1. Definition should be grounded in sound public policy principles such as those offered by Chairman Kennard.
2. There should be minimal disruption of the federal/state partnership with states in the lead.
3. Universal service has generally been achieved -- fund purpose is to preserve and advance.
4. Fund size should minimize regulatory intrusion into the marketplace so as to not disturb emerging market forces and incentives.

Ameritech takes the position that a small Federal High Cost Fund is the best solution for the following reasons:

1. It is the best public policy solution
 - a. best replicates the existing level of support flow.
 - b. best replicates existing partnership
 - c. incents state USF reform
2. Preserves USF
 - a. minimizes cost burden on carriers, end users and more generally on society as a whole
 - b. smaller support levels better accommodated by existing rate structures and levels
 - c. less likely to incent carrier posturing and manipulation
3. Incents Competition
 - a. state action will necessarily include rate rebalancing
 - b. rate rebalancing will operate to enhance residence competition
 - c. rebalanced rates will prompt economically efficient entry and investment
 - d. minimizes intercompany subsidy flows
4. Maximizes End User Benefits
 - a. enhanced choice
 - b. market driven rates
 - c. market driven service
 - d. less rate impacting subsidy cost burden
 - e. proper economic signals for products and services

American Enterprise Institute
May 19, 1998
Richard C. Notebaert

Thank you, Greg. I appreciate the invitation to join you this evening – and I'm pleased to contribute in whatever ways I can as you examine the wide-ranging implications of competition in worldwide communications markets.

I have looked forward to participating in this prestigious forum, because authenticity is valued over hyperbole here – and America's social and economic well-being demand priority over the agendas of special interests or the partial truths advanced by overzealous competitors.

It is in that spirit of sticking with reality that I'd like to focus tonight on an aspect of global telecommunications that is rarely discussed in the United States – at least not out in the open. The issue is subsidies, the role these subsidies play as hidden taxes designed to further certain social goals, and especially, the incompatibility of such a system with the creation of a competitive marketplace.

While nations throughout the world work to eliminate subsidies and thereby advance their competitive markets, advocating such a thing in America is deemed political suicide. And while scholars, analysts and economists increasingly conclude that we absolutely must face up to this issue, their reports do little more than gather dust on the desks of those in a position to respond.

In fact, such was the power of this political hot potato that legislators scrupulously avoided even the word "subsidy" in the Telecommunications Act of 1996. But unless we say the word out loud – and more importantly, unless we deal with the concept in a forthright manner, a fully competitive American communications market may never materialize.

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Now, in spite of the nearly "unmentionable" status of subsidies in political circles, let me acknowledge right away that some of you are quite knowledgeable about this topic. The American Enterprise Institute has published a great deal of thoughtful commentary on subjects surrounding the issue, notably Milton Mueller's book, *Universal Service*, that the AEI Press released in 1997.

In addition, some of you closely follow the progress of communications deregulation overseas, and you know that other countries consider rate-rebalancing – or the elimination of subsidies built into some telephone rates – as a high priority.

In fact, as I prepared for this talk, I asked our regulatory folks for an update on the progress other nations are making. In response, I got a stack of references about 4 inches thick. I read about Mexico's gradual process of rate rebalancing and the Philippines' more aggressive approach. I paged through studies on New Zealand's restructured prices and looked at newspaper articles on the progress Canada has made in reducing its subsidies. I saw a status report on the European Union. There, a directive to all member nations mandated rate rebalancing at the very outset of the Continent's preparation for competition.

In short, I saw that the rest of the world is putting us to shame. Because we have yet to make rebalancing part of the national dialogue. And as a result, some of you may not yet be familiar with the issue.

So before I go further, let me offer a brief explanation of the pricing devised to further a social agenda under the umbrella that came to be known as universal service. This plan of subsidies deliberately transfers wealth from one segment to another. And while it is not my purpose to enter the debate over the technical definition of taxation, I have to say that if it walks like a tax, and talks like a tax, then in my view – it's a tax!

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Universal service evolved from a slogan used to describe the interconnection of early networks into the goal of providing all Americans with affordable voice-grade communications service. The crux of that statement is the word "affordable." Because in many cases, the cost to initiate and maintain service is far more than a customer can pay. Therefore, to make the service affordable, providers had to reduce their charges to below cost.

Now if that concept is a bit difficult to comprehend in a densely populated area like Washington, think about the nation beyond the beltway. Think about individuals who live among the logging camps of northern Maine or on the ranches or mountainsides of Montana or Wyoming. They could never afford the true cost of wiring up their telephones. In a case I know well, it cost Ameritech \$100,000 to provide service to a customer in southern Indiana. That customer now pays us about \$14 a month for basic service. I'll let you do the math.

To overcome such disparities, regulators came up with an ingenious plan of hidden taxes – excuse me, I mean subsidies – to offset those losses.

They came in three flavors: First, we would recover the excess costs to serve rural customers by charging artificially high rates to those in urban areas. Second, we would charge business customers substantially more for the identical service that we provided to homes. And third, we would recover higher contributions from toll calls in order to keep basic local rates low. After divestiture in 1984, the latter took the form of higher-than-cost access charges that the long distance companies paid local service companies for the use of their networks – not nearly as higher than cost as they would have you believe, mind you, but more than they'd pay without the tax.

As long as we had a closed monopoly system, this rate-averaging scheme worked pretty well. Regulators decided what rate of return local-service companies could earn, then determined what they could charge various customer groups to even everything out and prevent excess profits. America claimed one of the highest phone penetration rates in the world – and the subsidies were so well hidden that few city dwellers even suspected they were being taxed to subsidize the vacationers in the mountains or the farmers 13 miles from nowhere.

Now I have to tell you that as an individual – as a citizen of this country, I'm okay with this. I think the goal of making phone service available to everyone who wants it is worthy, and certainly it is consistent with society's belief that every American should have access to basic necessities. I find this quite acceptable.

But when competition gained a foothold, this grand plan began to unravel – just as any first-year economics student could have told you it must. And as a citizen, what I don't find acceptable is the lack of political will to address the consequences.

Certainly, tackling these consequences will be no walk in the park. They are complex issues in a society that prizes simplicity. And they'll require long-term commitment from a culture geared to short-term results. So far, though, all we've done is work *around* the problem. And at the rate we're going, we may never find a solution.

The situation reminds me of an old Far Side cartoon that you may remember. In the first frame, a professor presents a complex mathematical problem, which then grows increasingly convoluted and difficult in subsequent frames. Finally, the professor shrugs, turns to the class and says, "Then, a miracle happens!"

A lot of people here in Washington seem to be waiting for a miracle to wipe away the ramifications of telephone subsidies.

But I think it's far more appropriate to bring these problems out into the light of day so we can at least begin a rational dialogue.

Let me contribute to that process by highlighting just a few of our most obvious challenges.

Number one. When residential rates are already priced below their cost, why is anyone surprised when there is no competition in those markets? Why would any competitor want to go there?

Let me give you a real world example. In one of the Midwestern states where Ameritech provides local service, a competitor who wants to resell our service can buy a local loop – a connection to the customer – for \$12.19. Now, Ameritech's retail price for that same loop is about \$12 for a subsidized residential customer or \$52 for a business customer.

Which of those customers do you suppose the competitor will target? And once they slightly undercut our artificially high price and win the business customer's business, what exactly will happen to the rest of the margin that was intended to keep prices low for homes? It goes in the reseller's pocket, of course! Now the tax we're forced to collect from businesses is subsidizing our competitors!

Those competitors are perfectly happy cherry-picking the business market, so why would they even consider entering the local market? Despite AT&T's constant drumbeat that they'd enter local service if the mean old incumbents would just let them, last November, one of their executives told the Chicago Sun Times that AT&T could not afford a major entry into local phone service in Chicago. He knew the margins are too small. I read that article and said, "No kidding! Thank you for that slip into reality!"

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As a footnote to that situation, let me add this. The AT&Ts of the world are not stupid. But neither are the local incumbents like Ameritech. If the subsidy for local service is going to my competitors and I'm forced to serve that market below my cost, how can I square my continued investment in that infrastructure with my fiduciary responsibilities to my shareowners?

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I could spend the rest of the evening on that one, but let me move on. Problem number two is that the subsidies in place are not even serving the people they were designed to serve.

I've already described how these taxes are eliminating any hope for competition in the local market. But beyond that, consider the fact that with the structure now in place, the urban poor are subsidizing the rural rich.

One of Ameritech's vice presidents likes to use himself as an example. He and his wife own a condominium in Beaver Creek, Colorado. He knows enough about phone rates to realize that the amount he pays each month for his local telephone service there is roughly one-fourth to one-third of what it costs U.S. West to deliver his dialtone. Who is paying the tax to keep his rates low? Well, part of that tax is coming from the wallets of the urban poor in cities like Denver. Is that appropriate? He doesn't think so.

The existing system subsidizes everyone in a high-cost locale, whether they need it or not. An economist formerly with the FCC and now a fellow at Stanford estimates that these taxes disguised as subsidies would drop from a current level close to \$20 billion to somewhere in the neighborhood of \$1 billion if we would just base prices on cost and then subsidize those who truly need the help.

“But look at businesses,” you may be thinking, “at least they are benefiting from increased competition.” I’d beg to differ. The lower rates they are seeing are not competitive prices. As I mentioned a moment ago, competitors simply shave off enough to beat the incumbent’s price and then pocket the bulk of the subsidy. If the subsidies were eliminated, business rates would drop like rocks. Because competitors would offer cost-based pricing – not tax-based pricing. This same principle applies for long distance rates.

Let’s move on. You don’t need me to tell you about the next problem – by now, you’ve figured it out. This subject is just plain difficult. Understanding it requires some work and some mental acuity.

Last week, an Ameritech employee told me she’d had dinner the night before with a friend who happens to be a reporter for an all-news radio station in Chicago. The conversation turned to Ameritech’s current rate-rebalancing filing with the Illinois Commerce Commission. The reporter understood the situation, sympathized with her friend’s frustration at getting this message across, then offered the following advice: “It’s way too complex. What you need are three or four good sound bites.”

I’d like to nominate “It’s a tax!”

But the truth is, this issue doesn’t lend itself to feel-good sound bites. Nor is it an issue that is going to create a groundswell of support from the general public to do the right thing. Instead, it depends on people with intelligence and influence like yourselves and on public policy makers with the courage to speak the truth and to ask the hard questions. Does this society really want competition? Or does this society want subsidies that require hidden taxation? They are mutually exclusive. We can’t have both.

Let me add a footnote here as well. The complexity of these issues makes them very susceptible to the rhetoric of misinterpretation and manipulation. In some cases, people who offer opinions on this issue just have little or no basic understanding of it. In other cases, their statements are part of a hidden agenda that does its best to thwart the greater good. In either event, thoughtless rhetoric does enormous harm.

In Indiana, for instance, so-called consumer advocates are clamoring for a reduction in residential local-service rates – exactly the opposite of what needs to happen. This kind of rhetoric hides the real issues from the public. And it contributes to a great deal of trepidation among public servants – even those who thoroughly understand and agree that these issues must be resolved. In such an environment where forthrightness is considered political suicide, it takes real political courage and integrity to speak the truth.

To this point, I've tried to wear the hat of the overall communications industry – and to discuss this issue from a fairly high-level perspective. Just for a moment, though, I'd like to put on my incumbent local-service provider hat and get down to the nitty-gritty. I'd like to share the scenario that's been created by regulators desperate to perpetuate the myth that we can have it all and no one has to pay.

Regulators mandate low-cost Internet access to schools and libraries. A worthy goal, but ask them how they're going to pay for it. Well, we'll just tell the incumbents to tax communications users and this time, transfer that money to schools. And here's an even better idea. We won't call it a tax. We'll call it the universal service fund – that won't scare anybody. But it's a tax!

And here's an even better idea. Since this whole subsidy issue prevents real competition in residential local service, we'll create some contrived competition. We'll make the incumbent providers collect taxes from the businesses that haven't yet abandoned them for their competitors. Then instead of using that money to subsidize residential customers, we'll make them give it to those very same competitors!

Never mind that these incumbents already can't make money on residential service – we'll cut the rates 20% lower than below cost. Then competitors can mark those rates back up so they can compete. They'll love it! And by the way, it might also be nice if we could get rid of those taxes called access fees that competitors have paid to the incumbents – they just make those long distance companies so irritable!

Now that I've got that off my chest, let me suggest a simple solution. Call the tax a tax.

If we as a society agree that we want to maintain affordable telephone service for every citizen – and I think we do – then subsidize those who truly need it with general tax revenues. I don't want to be a tax collector – the federal government is the expert in this area. Ask the long distance providers or Internet providers or cable companies or whoever they deem appropriate to pay their taxes directly to the government.

Then subsidize individuals with tax credits or with vouchers for service. When our society agreed all Americans ought to have access to food, we didn't ask the food distribution industry to serve as tax collectors. We didn't require supermarkets to tack on excess charges as some customers went through the checkout so they could reduce the cost that others paid for the same items. Instead, we created the food stamp program paid for by general revenues. It's a tax! And no one pretends otherwise.

I'd suggest that its high time to remove the pretense from the telecommunications sector as well. And in the process remove the single most significant barricade on the path to robust competition.

Thank you.