COMSAT CORPORATION

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EX PARTE OR LATE FILED

June 28, 1999

Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

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JUN 28 1999

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: Ex Parte Statement
Direct Access to the INTELSAT System
IB Docket No. 98-192

Dear Ms. Salas:

On June 11, 1999, COMSAT Corporation ("COMSAT") submitted an *ex parte* statement in this proceeding to respond to certain inquiries from the International Bureau regarding the need for a surcharge if the Commission decides to adopt Level 3 direct access. The staff has now raised additional questions which we will endeavor to answer herein. COMSAT again requests that this statement be made part of the record in this proceeding.

Insurance. One inquiry involves Exhibit C of the June 11 statement. This exhibit breaks down into categories the insurance costs shown in Exhibit 4 of the December 1998 Boll affidavit. Exhibit C shows the original cost of insurance to COMSAT. The third column from the left shows the cost of insurance obtained by INTELSAT that was assigned to COMSAT based on its ownership share. The fourth column shows the cost of the additional launch insurance that COMSAT purchased, and the fifth column shows the cost of the additional post-separation insurance that COMSAT purchased. The last column (first from the right) breaks out the amount of the premiums that were paid by COMSAT to insure the cost of the premiums themselves. These amounts are already included in the "Total" column. The total insurance cost for the INTELSAT VI series of satellites was $54.8 million. INTELSAT purchased no insurance whatsoever for the VI series (or for the INTELSAT K satellite).

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The staff has again asked why COMSAT has bought launch and spacecraft insurance in addition to the coverage purchased by INTELSAT. To elaborate on our June 11 statement, COMSAT is by far INTELSAT's largest Signatory, and compared to other Signatories, its INTELSAT business is the core of COMSAT's overall business. Thus, both in absolute and relative terms, COMSAT faces, compared to other Signatories, by far the largest potential loss from a launch or satellite failure. Underinsuring the risk of failure is simply not an approach that COMSAT can responsibly follow, given its obligations to its shareholders and its status as a publicly-traded corporation.

COMSAT also has an obligation to support the INTELSAT system which arises from its statutory role as U.S. Signatory. Among other things, COMSAT is the most important underwriting entity of INTELSAT's debt. INTELSAT as a cooperative is the sum of its Signatories, nothing more. Hence, COMSAT as the largest Signatory must be financially solid, and that means it must be fully insured (assuming, of course, that insurance is available at reasonable rates).

COMSAT's practice of fully insuring its investment has ample precedent in the commercial space business, and the real risks (and real financial consequences) of launch and in-orbit failures have been amply demonstrated by the many failures that have occurred in recent months. It is misplaced to compare COMSAT to INTELSAT, which is a cooperative, not a business, or to foreign Signatories, all of which have relatively small stakes in the organization. Rather, COMSAT's practice relative to the insurance issue should be compared to that of other U.S. commercial satellite companies.

When COMSAT raises capital in the market to satisfy its statutorily-mandated investment obligations to INTELSAT, it must abide by U.S. GAAP rules. These rules require COMSAT to write off failures and their associated capitalized interest *when they occur*. The accumulated interest under construction is part of the cost of the satellite that must be written off in the event of a failure. (INTELSAT's past practice was not to capitalize interest under construction.)

Without full insurance coverage, COMSAT would suffer dramatic financial impacts from launch or in-orbit failures, which in turn would increase COMSAT's cost of capital and perhaps impair its ability to raise capital at all. Clearly, foreign entities whose accounting treatments do not require them to report failures in this fashion and that do not raise their capital in the open market may have a different perspective on insurance.

In particular, we have been asked why British Telecom does not buy additional insurance. We do not know what BT does or why, but if it does not buy insurance, the reason could be that BT is a much larger company than COMSAT and has a much smaller stake in INTELSAT. BT's revenues last year were 42 times greater than COMSAT's: $26 billion compared to $616 million for COMSAT. BT's total assets as of March 31, 1999 were $47.5 billion compared to COMSAT's $1.8 billion, and BT's INTELSAT assets as a percentage of total assets were only .4% compared to COMSAT's 34%. Thus, the effect of an INTELSAT failure would be virtually imperceptible for BT, but enormous for COMSAT.

We have also been asked to explain the term "self-insurance," which we used in our June 11 statement. Self-insurance means that one would absorb the loss in the event of failure. One might have set aside funds to cover a loss, or one might have purchased a spare satellite in anticipation of a failure or arranged for funding to purchase a replacement, but one would not have purchased insurance coverage.

In sum, insurance is a necessary cost of the satellite business to anyone who is in that *business*, and the satellite business *is* COMSAT's business. Thus, it is not useful to compare COMSAT's insurance needs to those of foreign Signatories, whose satellite investments in INTELSAT are pale in comparison to COMSAT's and represent only a fraction of their overall local, long distance, national and international operations. Instead, COMSAT should be compared to fully commercial U.S. companies like Globalstar and PanAmSat. Those companies *do* purchase insurance, and their experience with failures in the past year or so is ample proof of the need for commercial companies to incur this cost. Accordingly, COMSAT's insurance costs are a necessary part of its statutory obligation to support the INTELSAT system through private capital from shareholders, and are properly included in any direct access surcharge.

<u>The INTELSAT Return</u>. The staff has asked for an explanation of the 14.8% pre-tax "return on Signatory capital employed" reported for 1998 in INTELSAT's Annual Report, since that figure is considerably lower than in the previous year when it was 18.3%. This decline was largely due to the substantial increase in depreciation charges resulting from the launch of the VIII series spacecraft throughout 1997 and in 1998. This can be confirmed by comparing the depreciation entries for the past three years shown

on page 29 of the Annual Report. Another factor is the cumulative adjustment for the capitalization of interest in 1998, which increased the value of Signatory capital employed.

The 14.8% pre-tax figure can be approximated by means of the following calculation using information from INTELSAT's 1998 Annual Report (page numbers refer to that report):

	1998	1997
Signatory Equity (p. 30)	$ 1,628,019	$ 2,037,331
Undistributed Capital Repayments (p. 28)	$ 121,360	$ 105,189
New Skies Shares (for 11 months) (p. 30)	$ 587,959	
Signatory Capital Employed	$ 2,337,338	$ 2,142,520
Average Balance	$ 2,239,929	
Revenue Over Expenses (p. 29)	$ 338,870	
Estimated Return on Signatory Capital	15.1%	

While this calculation does not precisely match the 14.8% figure, the reason is that INTELSAT calculates the average balance on a daily basis rather than the two-point basis shown here (YE 1998 and YE 1997). However, the difference is essentially rounding, amounting to only three-tenths of a percentage point.

The calculation above reflects two important adjustments to the Signatory equity figure. First, capital repayments are made on a quarterly basis with one quarter lag. Hence, Signatory equity, which is shown on an accrual basis, understates the capital invested by a substantial amount. Therefore, the undistributed repayment has to be added back for the return calculation.

Second, New Skies was spun off from INTELSAT only in the last month of 1998. INTELSAT's 998 statement of operations reflects eleven months of results prior to the transfer of assets to New Skies (see note 5 in the Annual Report). Hence, an unadjusted two-point average of invested capital would substantially understate the true balance and skew the return. Therefore, an adjustment is necessary to reflect that New Skies assets were a part of INTELSAT for eleven months of the year [$641,410 (p.30) * 11/12 = $587,959].

COMSAT's filings in this proceeding calculated INTELSAT's rate of return on the basis of average net communications plant after-tax, which represents the basis for comparison with the companies listed in the Commissions Rate of Return Report. The return calculated on this basis for 1998 and submitted as part of the June 11 statement is 8.72%. This return calculation was based on a two-point average and did *not* reflect the fact that New Skies was spun off only in the last month of the year, as this adjustment would have made the calculation more complex and more difficult to duplicate. If this factor had been taken into account, *the actual after-tax return would have been lower.*

The staff has asked why INTELSAT lowered its target return for 1998. The answer is that INTELSAT is a cooperative with its own form of accounting, and that it lowered its target range knowing that the actual return would otherwise fall below the range. By lowering the range, INTELSAT avoided creating a shortfall that it would have had to carry forward and that would have affected net book value as well as payments associated with ownership share changes. Again, this demonstrates that INTELSAT is not a commercial enterprise. Its relevant audience for financial disclosures is the Signatories, not public investors who typically would seek this sort of information.

<u>The Significance of the IUCs</u>. The staff also asked us to clarify the significance of COMSAT's payment of INTELSAT Utilization Charges (IUCs) and its receipt of revenue distributions from INTELSAT. The answer is that these financial flows do not relate to COMSAT's Signatory costs now, and would not under a Level 3 direct access regime. There are two things that matter under direct access: INTELSAT's return and COMSAT's Signatory costs. We have demonstrated that INTELSAT's return alone would not be compensatory under a Level 3 direct access regime, and we have provided information about the kinds of Signatory costs that would need to be recovered through a direct access surcharge.

Our only reason for showing past IUC payments in our exhibit was to illustrate how a calculation would be done *if* Signatory costs were recovered through a surcharge on the IUCs, as the Commission has proposed. To calculate such a surcharge for future years, the Commission would have to estimate what IUCs direct access users would pay to INTELSAT. That of course would depend on what direct access users bought from INTELSAT, which might well be different (*e.g.*, in volume or lease term) from what COMSAT has bought in the past, or would buy in the future. Accordingly, COMSAT's IUC payments are irrelevant.

COMSAT's Surplus Ownership. Finally, the staff has again asked why, if INTELSAT's return is not compensatory, COMSAT is willing to hold surplus ownership in the INTELSAT system (*i.e.*, ownership in excess of utilization). This issue was addressed at length in the analysis by The Brattle Group that accompanied our initial comments in this proceeding.

COMSAT's willingness to hold surplus ownership might be interpreted as evidence that the IUCs would cover COMSAT's direct access-related costs. This inference is invalid for several reasons. First, it is undisputed (and the Commission has previously held) that COMSAT incurs Signatory costs that are not covered by the IUCs. Thus, even if the IUC-based return did cover COMSAT's cost of holding surplus investment, allowing direct access at the IUCs without a surcharge would not allow COMSAT to recover its other Signatory costs.

Second, surplus ownership under Article 6(d) of the INTELSAT Operating Agreement is held *voluntarily* on behalf of foreign users of the INTELSAT system. Moreover, because ownership is adjusted annually, COMSAT's surplus ownership is only a short-term (*i.e.*, one-year) commitment. Each year, the surplus is returned at net book value, with no obligation to reacquire any ownership in excess of usage. This feature clearly limits COMSAT's downside investment risk, and in fact makes surplus ownership attractive compared to other types of short-term investments. In contrast, under Level 3 direct access, COMSAT would be *required* to hold ownership in accordance with direct access customers' INTELSAT utilization. This *involuntary* and hence riskier obligation would require a higher level of compensation than that provided by the IUC alone.

Third, COMSAT can only "buy" what other Signatories do not want to hold, presumably because of their cost of capital and/or lack of access to capital. Historically, these Signatories have been from developing nations that the U.S. has encouraged to join INTELSAT. COMSAT's surplus ownership helps other Signatories and strengthens the universal service aspect of the system as a whole. Moreover, strengthening the system makes commercial sense for COMSAT as the largest owner.

Fourth, COMSAT's willingness to hold surplus ownership today is due in large part to the U.S. government's desire for INTELSAT privatization to occur quickly. Because voting power in the Board of Governors is based on ownership, surplus ownership increases COMSAT's ability to fulfill the U.S. government's instructions with respect to policy matters. This has been an important factor in the past (e.g., with respect to procurements), and is even more critical today, when the U.S. is working to achieve a pro-competitive privatization of INTELSAT. COMSAT's surplus ownership increases its voting power and, hence, its ability to ensure that the U.S. government's objectives for INTELSAT privatization are fulfilled.

For all these reasons, and particularly in light of the impending privatization of INTELSAT, COMSAT's current surplus ownership is indeed a "good investment," as COMSAT's CEO has stated. However, that does *not* mean that a return or COMSAT based solely on the IUC would be compensatory in a Level 3 direct access regime.

Respectfully submitted,

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