AT&T management report

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Ending a two-year proceeding, FCC authorizes Bell System a 12.75% interstate rate of return

The Federal Communications Commission late yesterday authorized a 12.75% rate of return on the Bell System's interstate and foreign communications services after AT&T Chairman C.L. Brown and other company officers reiterated the urgent need for higher earnings during oral argument presented earlier in the day.

In addition, the Commission said it would not be unreasonable to permit AT&T to earn within a range of 13% to 12.5% on its interstate investment. Such a .25% variation on either side of the 12.75% figure is necessary, the FCC said, "to reflect the volatility in current economic and financial conditions."

Commenting on the FCC's decision, James R. Billingsley, Vice President-Federal Regulatory Matters, said, "The FCC's decision, after an exhaustive two-year proceeding, clearly recognizes the importance of adequate earnings to our service capabilities. This is a good faith effort on the part of the Commission to accommodate our needs to the galloping inflation with which we all have to contend. We hope it will be sufficient to enable us to hold our own in the fiercely competitive capital marketplace."

Upon receiving FCC authorization for an increased return rate, AT&T said it would file new interstate tariffs as soon as practical for the revenues that would achieve the return allowed.

The company estimated that the new rates it will seek will significantly increase revenues. It also noted that if pending private line rate increases are approved, the overall revenue requirement and rate levels to be proposed will be reduced.

Chairman Brown, in his appearance before the Commission earlier in the day, stressed that inflation has forced up the cost of financing the construction program to prohibitive heights. He pointed out that while the Consumer Price Index has risen 53% since the first quarter of 1976, interstate rates have gone up only 5% in that period.

Brown asserted that under these conditions the issue of adequate earnings was a critical one. He claimed that "no issue has more importance currently confronting our business . . . than the Commission's decision in this

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Urgency of rate of return is underscored by Brown's appearance before the FCC

In a marked departure from convention, Chairman C. L. Brown participated in today's oral argument before the Federal Communications Commission. Before introducing Vice President and Treasurer Virginia A. Dwyer, Brown reiterated the need for a reasonable rate of return for interstate services and outlined the potentially serious impact that inadequate earnings would have on the Bell System's service capabilities. His appearance at the session underscored the significance of the company's request for a higher rate of return. What follows are excerpts from his remarks.

I am here for one reason only. It is my belief that no issue has more importance currently confronting our business—and there are more than a few—than the Commission's decision in this matter. It has serious bearing on the Bell System's ability to continue to render good, efficient service to its customers.

More is at stake here than the financial health of the Bell System. At stake is the long-term capability of a vital part of the nation's social and economic nerve system.

This Commission has repeatedly recognized the relationship between service quality and earnings. For example, in a 1967 decision the Commission said, "A rate of return which is too low could impair the ability of the respondents to raise additional capital and also imperil the integrity of the existing investment with adverse effects on the quality of the service."

Today those risks are very real.

In the past few years, economic conditions have changed dramatically—most notably the rate of inflation.

When the inflation rate was 2% or 3% or even 4%, we had a fighting chance of offsetting its effects through engineering cost reductions, improvements in operating methods, and other productivity gains.

But the inflation we have experienced since then has far outstripped our ability to hold down costs.

We thus confront two alternatives. One is to scale down our expenditures

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Interstate rate of return increase is only the fourth granted by FCC in ten years

Yesterday's Federal Communications Commission decision is the fourth interstate rate of return increase to be granted AT&T in 10 years. Significant increases in the rate of return were allowed in 1972 and 1976. In 1980 an interim rate of return was authorized pending completion yesterday of the proceeding initiated by AT&T in 1979.

In general, each petition for a rate of return increase was spurred by the need to raise earnings of interstate offerings to levels that would help offset the pressures of inflation.

Inflation rates

Inflation rates hovering around 5% to 6% in the late 1960s and through the early 1970s and 11% to 13% in the mid- to late 1970s had the effect of forcing up operations expenses faster than revenues were able to increase, thus driving up the cost of debt and equity capital.

In the 1950s through to the mid-1960s, when inflation rates rarely exceeded 3% or 4%, the Bell System's own steady productivity growth rate of about 3.5% was able to absorb the effects of modest inflation. During that time, productivity improvements helped to hold down telephone rates and helped to make more frequent rate of return increases unnecessary.

Responding to the changing economic conditions of the 1960s, AT&T filed in 1970 for a $386 million rate increase to yield 9.5% on interstate operations. Postponing AT&T's increase, the FCC permitted the company to file revised interim tariffs a year later to produce $175 million of revenues. It was not until 1972 that the FCC finally approved an 8.5% rate of return and allowed AT&T to propose increases on interstate rates to produce additional net income of $145 million annually.

The rate of return was raised to 9.5% in 1976 after the FCC had determined that the Bell System's cost of equity had climbed to 12% in four years. AT&T had asked for a 10.5% rate and had said that it needed an annual increase of $660 million in revenues to reach that point. The FCC granted an increase of only $225 million.

Last June, the FCC authorized an interim rate of return of 10.5%. With approval of this interim rate, a 5.1% increase in interstate and overseas rates was granted. This raised the Bell System interstate revenues by some $499 million and boosted total industry revenues by nearly $568 million. The company had originally sought an increase of $1.2 billion, maintaining that a 13% rate of return was reasonable in light of economic conditions. □

. . . Brown *continued*

for growth and modernization. That would set afoot a steady deterioration of service. This Commission surely does not want that. The other alternative is to seek rates that will produce a reasonable and realistic rate of return on invested capital, rates which will permit us to raise the billions of dollars of outside money we need every year to maintain the long-term service capabilities of the Bell System.

Our obligations to our customers and to our share owners now require that the Bell System commit itself to an "extraordinary and determined effort" to achieve regulatory understanding of our need for rates of return that match today's economic circumstances. □

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matter. It has serious bearing on the Bell System's ability to continue to render good, efficient service to its customers." (See accompanying excerpts from Brown's comments.)

Vice President and Treasurer Virginia A. Dwyer also appeared, pointing out that the two years over which the rate of return case has been pending have been "two years of galloping inflation and surging capital costs." She added that the Bell System is at a point where "substantial and rapid rate relief is absolutely essential.

No choice

"Without fast improvement in earnings, we may have no choice but to scale back our debt financing program and curtail our construction plans—with all the attendant problems."

She emphasized that to compete for investor dollars, the Bell System must offer earnings which are competitive in today's markets.

Further, Howard J. Trienens, Vice President and General Counsel, pointed out to the Commission that "present depressed rate levels send out false economic signals that not only produce an artificially high demand, but are inconsistent with the pro-competition policy reflected in numerous rulings of the Commission over the last decade."

The initial request for a higher rate of return was made in 1979, when AT&T said it needed to earn 12% on its interstate offerings. That figure was raised to 13% a year ago as economic conditions continued to deteriorate. Last June the FCC authorized an interim rate of return of 10.5%. Eight months later, in February, an FCC administrative law judge recommended a 10.87% rate of return. The full text of the Commission's latest decision will be available in several weeks. □