Evidently, the Commission here supports the apposite analysis that all of the involved service categories are close substitutes to one another, that AT&T as the supplier of these offerings is best placed to decide on their relative prices and timing, and that AT&T's business decisions in these regards are consistent with the public interest. This is correct economic analysis under conditions of competition, and even under non-competitive conditions for a supplier who is subjected to a basket-wide price cap formed with appropriate weights. Thus, the Commission's proposal to consolidate service categories is a good one for the public interest, it is based on sound reasoning, and it makes it that much more puzzling that the Commission proposes to entirely reverse and move further backward from any beneficial effects of consolidation by dint of its other proposals, as we shall see below.

2. Proposed Basic Rate Index

Despite its proposal for consolidation of services, the Commission proposes to constrain AT&T's undiscounted rates by means of a separate basket of basic services which would nest inside the newly consolidated set of services. The Commission proposes to cap a new basic rate index, formed from the sub-service category composed strictly of undiscounted MTS rates, excluding even automatic discounts.

The basic rate index is analogous to the old basic residential index, which was used when commercial services were still in Basket 1. The basic residential index was created to protect residential customers from subsidizing low rates to commercial customers. Such forms of protection were the Commission's motivation for the initial creation of the basket system, to prevent price changes in one regulated service from influencing a dissimilar service.[8] This motivation is difficult to reconcile with the current basic rate index proposal, however. A Commission view that APPs are dissimilar from undiscounted MTS would be strikingly inconsistent with the proposal for the consolidation of service categories, and even more strikingly inconsistent with the acknowledged cross-elasticity of demand as indicative of close substitutability. In fact, the Commission concludes "...that an APP does not differ from an

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[8]*Further NPRM*, paragraph 4.

existing service in the domestic MTS service category ... except in ways related to pricing and terms and conditions affecting pricing."[9]

The Commission offers four reasons for the proposed basic rate index, the first three of which are somewhat intertwined. First, the Commission is concerned that basic schedule rate increases do not allow "...just and reasonable rates, without unreasonable discrimination, and universal availability of such reasonably priced service."[10] That is, the Commission is concerned that AT&T might impose discriminatory rates against low volume users or against users without equal access to alternative carriers. Second, the Commission is concerned that there may be certain societal groups that comprise usage groups facing higher rates than is appropriate. Third, the Commission may be concerned that higher basic rates may affect users who may be eligible for discounts but who do not self-select into applicable APPs. Fourth, the Commission is concerned that increases in basic schedule rates for MTS affect the availability of local telephone service.[11]

Addressing the first concern, evidently the Commission fears that low volume customers will be forced to pay more than their incremental cost of service in order to subsidize high volume users.[12] This could only occur if market forces facing low volume users were somehow less competitive than those for high volume users -- perhaps if low volume users had more inelastic demand or were systematically located in non-equal access areas. However, low volume customers appear to have elastic demand and are essentially as likely to change long distance carriers as are high volume users.[13] In fact, their incentives to switch carriers may be driven by greater percentage savings than those offered to high volume

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[9]*Further NPRM*, paragraph 38.

[10]*Further NPRM*, paragraph 58.

[11]*Further NPRM*, paragraph 61.

[12]*Further NPRM*, paragraph 62.

[13]See Tab 1 and Tab 2, pp. 3, 6.

customers.[14] They are evidently sensitive to attempts to raise their rates above the competitive level. Also, only 9 percent of long distance company customers do not have equal access,[15] and less than 3% of telephone lines are not so equipped. Furthermore, those without equal access tend to reside outside MSAs, but low volume users are predominantly residents of MSAs.[16] Thus, it is implausible that the low volume segment of the long distance market is less competitive than the high volume segment. That is, there is no basis for any concern that AT&T would raise rates to low volume users as exploitation of market power over that segment.

An alternative scenario with evidentiary support is that prices for basic service are such that the prices paid by low volume users are below the competitive level. This is consistent with an incentive for AT&T to seek flexibility to raise basic rates, and also is consistent with a finding that basic rates charged by Sprint and MCI are nearly identical to AT&T's;[17] the rivals have little incentive to divert non-compensatory business away from AT&T.[18]

There is no public interest in a form of regulation, or in a basic rate index mechanism, driving prices for low-volume users to be below incremental cost. In fact, the opposite is the case -- there is significant social benefit from the ability of APPs to make it possible or more

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[14]For example, some incentives offer $10 or more in cash or long distance credit. A customer who makes $3 per month of long distance calls will then receive nearly a 30 percent discount over the year. See letter from R. Gerard Salemme, Vice President for Government Affairs, AT&T, to Kathleen Wallman, Chief, Common Carrier Bureau, Commission, April 24, 1995.

[15]See Michael R. Ward, *"Measurement of Market Power in Long Distance Telecommunications."* Federal Trade Commission, April 1995.

[16]See Tab 2, p. 4a.

[17]See Tab 3.

[18]This scenario is described fully in the NDC request, attachment G, p. 137, and on p. 51 of the *Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Non-Dominant Carrier*, CC. Docket No. 79-252. It is also illustrated in Tab 2, p. 8.

efficient for interexchange carriers to charge compensatory prices to both high and low volume users, without charging non-competitive mark-ups to the high-volume users. Where the costs of handling customers' business include components that are volume sensitive, as well as components that are fixed and insensitive to volume, complex pricing is generally a valuable business tool for cost coverage to be accomplished efficiently and in the public interest.

The Commission also seeks comment on another cost related matter. Specifically, there is concern that low volume users may be hurt if they experience "spikes" in their demand which offset the cost of service to them but which cannot receive discounts. As a matter of theory, the likelihood of such spikes would be expected to generate both demand for and supply of insurance-like elements in the applicable pricing terms, if regulation were configured with sufficient wisdom to so allow. As a matter of practice, the discounts available in AT&T's True programs accrue whenever call volume exceeds a certain level, and significant numbers of low volume users participate in the True programs. Therefore, given that the volume discounts align prices and costs along a wide range of usage levels, low volume users with sporadic periods of higher demand pay the lower price exactly when they impose the lower average incremental cost, and pay an appropriately higher price when they impose the higher average incremental cost.

The Commission is concerned about the possibility that low volume users are low income users, and that higher prices for low volume users should thus be avoided in order to protect the low income group of society. Similarly, there may be some other target demographic group worthy of protection that largely overlaps with the low volume users. These possible concerns are not supported by the demographic data on AT&T customers based on long distance volume.[19] As can be seen in the charts, low levels of long distance usage are displayed significantly across income groups, and across other demographic indicators of age, ethnicity, and location as well. There is no discernible demographic group that might be especially worthy of social concern that overlaps to a special degree with those who have low volume of long distance usage.

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[19]See Tab 4 and Tab 2, pp. 3 - 4a.

Third, the Commission also has a possible concern about high volume customers who do not participate in AT&T's discount programs. For example, high volume users may be ineligible because they live in areas "...where the advanced billing techniques upon which these offerings rely may not be readily available."[20] As a matter of fact, however, the True programs, AT&T's largest and most generous discount plans, are 100% available in the United States, as are most other AT&T promotional offerings.[21] Additionally, there are high volume users who choose not to participate, but it is my understanding that they are not demographically distinct from those that do participate. In this case, then, the pricing structure is likely to associate relatively low prices with the customers who have relatively elastic demands, in accordance with economic efficiency, (Ramsey pricing). There is no foundation for concerns about price discrimination against consumers based on differences in eligibility and program availability. This conclusion is consistent with the Commission's statements upon their earlier proposal to remove OCPs from price caps, largely because "...customers would retain the option of choosing between AT&T's basic schedule or the discounted services of AT&T and other carriers."[22]

Finally, on the subject of the concern about the availability of phone service, the Commission acknowledges recent studies which have attempted to blame increases in long distance rates for subscribers' losses of phone service.[23] While it is true that long distance charges are a substantial fraction of the amounts past due,[24] the customers who lose phone service due to nonpayment typically are high volume users who are eligible for one of AT&T's

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[20]*Further NPRM*, paragraph 63.

[21]See Tab 5.

[22]*Further NPRM*, paragraph 24.

[23]See Field Research Corp., *Affordability of Telephone Service, Vol. 1, Non-Customer Survey*, for GTE/Pacific Bell (Oct. 1993); *Chesapeake and Potomac Telephone Co.'s Submission of Telephone Penetration Studies*, Docket 850 (D.C. Pub. Service Comm'n., Oct. 1993).

[24]The C&P study found that $75.90, or 52%, of the average current amount due for DNP's was from IXC charges. See *C&P Telephone Company Penetration Project: Disconnect Study*.

discount plans. For those individuals, increases in basic service rates do not affect the Affordability of phone service. Also, it is difficult to reconcile ordinary principles of personal accountability and responsibility with the notion that high volume long distance users cannot pay their telephone bills due to high long distance prices.[25] Respect for consumer sovereignty is evident in the decision by the Commission to consolidate day, evening, and night/weekend calls into the same service category. For residential use, these calls are all close substitutes. Given that toll prices are different at different times of day, customers must decide for themselves when they choose to make telephone calls. The implication of the FCC's decision is that government regulation should not be used in place of decision making on the part of consumers. Therefore, higher basic long distance rates should not be held responsible for anyone's loss of phone service.

In conclusion, I have reviewed the most directly expressed concerns of the Commission that seem to underlie the proposed cap on a new basic rate index. These concerns do not withstand economic analysis and confrontation with basic factual data -- they do not provide any valid rationale for the proposed additional regulatory constraint on basic rates. As I shall explain below in Section 4, there would be significant social costs and consumer harm caused by the proposed cap on a basic rate index. Thus, the application of such an additional instrument of regulation should not be undertaken lightly. Even apart from findings that interexchange services are all effectively competitive, so that all regulation of them is unwarranted and counterproductive, a constraint on basic rates that does not permit full counterbalancing with discount plans is itself an unwarranted and socially counterproductive form of regulation.

3. Proposed Rules for Including APPs in the API

In addition to proposing to repress AT&T's incentives to employ APPs by introducing the cap on the basic rate index, the Commission has also proposed rules which would further

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[25]The studies cited above find that many individuals who were disconnected for non-payment would like a service that controls their ability to make toll calls.

repress these incentives by systematically undercounting the benefits of APPs in their inclusion in the actual price index (API). No credit would be available in the API from a new APP for at least 90 days, and maybe significantly longer than that. Thus, a promotion designed to last for less than 90 days would yield AT&T no credit in the price cap mechanism for the lowered prices it would bring consumers. Further, a longer lived APP with a steadily growing base of customer demand would receive price cap credit that remained too low, even after the first 90 days, by virtue of the proposed rule that would weigh the promotional price by a volume figure that reflected demand during the previous 90 day period. For a new and growing APP, under the proposal, the lost price cap credit would never be recovered, despite the benefits that the program actually would bring to consumers.

The current rules for self-selecting promotions allow AT&T to forecast demand for the promotion as a fraction of the total demand for the service. For example, suppose at the introduction of True USA, AT&T forecast that 52% of all evening minutes would originate with customers electing to participate in the new program. That fraction is then used to divide the base period demand figure in the API calculation between the discounted and the undiscounted service. Hence, if X_0 is base period demand for a service and P^I and P^{IP} are the proposed basic and promotional prices, respectively, then the entry in the API is $(0.48)P^I X_0 + (0.52)P^{IP} X_0$. There is Commission concern that the current rules permit AT&T to overestimate demand for a promotion, thus creating exaggerated headroom in the API which might be used to increase basic residential rates.[26] However, AT&T's data show that the company's forecasts of promotion demand have been quite good, and that errors typically underestimate rather than exaggerate demand for the promotion. That is, AT&T's forecasts have been conservative in that they have created less headroom in the API than if the company had forecasted demand perfectly.

Of course, the self-selection aspect of APPs does make demand difficult to predict, and

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[26]To see this, suppose the forecast were strategically overinflated to 98% of all evening minutes originating with customers who would be joining the promotion. Then AT&T could make P^I very large, because $(0.02)P^I X_0$ would remain relatively small, and because $(.98)P^{IP} X_0$ would be small.

the Commission feels that the new rules prevent the abuse of demand forecasting while also allowing AT&T quicker API credit for APPs than for a new service.[27] Nonetheless, the new rules are designed to correct a problem that has not occurred -- the creation of API headroom through incorrect forecasts -- and the proposed solution is sufficiently severe in its distortions that the new rules would surely systematically discourage or halt AT&T's use of APPs that would otherwise provide real consumer benefits.

4. APPs, Basic Rates, and Social Welfare

The proposed new cap constraint based on the basic rate index and the proposed rules just discussed would clearly reduce the incentives of AT&T to use APPs. It seems that this result is intended by the Commission, which has expressed a general preference for competition through basic rates rather than through discounted offerings.[28] The discussions in Sections 2 and 3 above have shown that the specific reasons articulated by the Commission for proposing the new regulations are misguided. Commission concerns about harmful price discrimination and loss of phone service because of manipulation of the API via promotions and inaccurate demand forecasts are unfounded.

What may be a greater surprise to those who have not much thought about it, or who have yet to be exposed to the ideas of Ramsey pricing, is that a pattern of pricing that responds to differences in costs, in levels of demands, and in elasticities of demand, among different consumers and over different periods of time, is generally better for consumers than an unresponsive pattern of prices with less variation. This is certainly so where conditions of competition act to constrain the overall level of markups and of profits. It is also so where an idealized non-distortionary overall profit constraint applies (as in the classic model of Ramsey pricing). And it is likewise so where the firm is constrained only by a single aggregate price

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[27]*Further NPRM*, paragraph 49.

[28]*Further NPRM*, paragraphs 24 and 32.

cap over a single basket of all rates and rate elements with appropriate volume weights. In these contexts, the profit incentives of the firm and the self-selection incentives of consumers work well together to yield optimized levels of social welfare, subject to the level of the firm's overall contribution to overhead cost. Here, regulatory policy like the Commission's proposals that would distort the incentives for APPs relative to movements in basic rates can only harm social welfare and injure consumers. Thus, reducing the desirability of APPs to AT&T in order to promote competition through basic rates alone is simply injurious to consumer welfare.

A simple example may help to show that variations in pricing, especially those based on self selection, may well generate greater gains for consumers than discounts that automatically apply to all customers. Initially, suppose all consumers are identical in their demand for a particular service. Consider two discount plans. The first gives a 10% discount to all customers, while the second gives two 10% discounts (or, less colorfully, just a 20% discount) to a randomly selected half of the customers. Both plans generate the same headroom in the API.[29] However, the second plan leads to greater overall consumer surplus. This can be seen from the fact that the gain the lucky consumers receive from the second 10% price decrease is greater than the gain anyone would receive from the initial 10% decrease. The second 10% decrease applies to a greater base of demand, in view of the stimulation achieved by the first 10% discount. So, giving the 20% discount to one half of the customers and nothing to the other half yields a greater total benefit to consumers than giving each half a 10% price decrease.

Now suppose that consumer demands are not identical. If the selection is non-random by the consumers, then presumably those who select the discount are those who value it the most. This is intuitively reasonable, particularly if there is some fixed cost of selecting the discount plan, say in terms of time and effort. For a given level of demand at the common base price, those with more elastic demand will gain more from a given discount, and thus be

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[29]Plan 1 generates $(0.1)P_0X_0$ in headroom while plan 2 generates $(0.5)(0.2)P_0X_0 = (0.1)P_0X_0$.

the ones who are more likely to self-select the plan. Here the self-selection process is favorable for social welfare inasmuch as it expands output that is otherwise priced above marginal cost. And it is also favorable for the incentives of the supplier who gains from the demand stimulation, so long as the discounted price remains above marginal cost.

It may also plausibly be the case that consumers with the most elastic demand for the services of a given carrier are also those with the most elastic demand for calling services. Then, the discounts that target those most likely to change carrier are also those most efficiently stimulating of demand, through self selection. This situation might arise where consumers have positively correlated degrees of uncertainty about the quality of the offerings of AT&T's rivals and about the quality of AT&T's discount programs. Then, the total benefit to consumer welfare from the self-selection discount that the carriers would be motivated to offer would be larger than the benefit which would accrue if a discount generating the same API headroom were automatically applied to all customers.

There is another important point regarding self-selecting versus automatic discounts and the level of competition. Generating a given amount of API headroom involves less of a discount for automatically applicable plans than for self-selecting plans. Therefore, if AT&T offered only automatic discounts to its customers, the discounts would be smaller than if they were self-selecting. Smaller discounts by AT&T, however, would imply that AT&T's rivals would only be impelled to offer smaller discounts to attract customers. Thus, an artificial restriction to only automatic discounts will lead to a softening of competition and to higher prices for consumers. This extra effect on competition adds to the case for flexible choices of self-selecting discount programs, and adds to the case against artificial disincentives and restraints of such programs, in the interests of consumers and social welfare.

This discussion has centered thus far on the benefits of APPs that flexibly offer different prices to different consumers, on a self-selecting basis. The proposed basic rate index would exclude all such APPs, and the proposed new price cap regulatory mechanism would thereby discourage the utilization of such beneficial pricing. The same conclusion applies to temporarily discounted rates, even those offered automatically with no elements of

self selection.[30] Temporary discounts, whether automatic or not, would also be excluded from the proposed basic rate index, and would also be strongly discouraged by the proposed new price cap rules. This is another reason why the Commission's proposals would be adverse to the public interest -- the use of temporary discounts can be advantageous to consumers, even when compared to more permanent discounts having similar impacts on price cap headroom.

Temporary price decreases are likely to induce greater demand responses than do non-temporary decreases. For example, if the price of calls from New York to Chicago were announced to be thirty percent less for this month only, then customers would make some calls that would never have otherwise been made, and would make some calls that would otherwise have been deferred. At least some of the latter calls would not have been placed this month even if the discount rates were available, but were known to be permanent. It is this effect, among others, that leads consumer benefits to be greater from several temporary discounts on different routes, than from one route with a steady discounted price.[31] The amount of affected traffic, the further stimulation of more usage, and the consumer benefits would all be greater in total from several temporary discounts as compared with a steady discounted rate having the same price cap headroom. Consequently, AT&T would have incentives to provide benefits to its customers through temporary discounts, if they were treated within the price caps constraint on a non-distorted basis. However, this source of consumer benefits would be repressed by the proposed rules that systematically deny appropriate price cap credit for temporary discounts.

5. Conclusion

The Commission is clear in the Further Notice that effective competition renders

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[30]*Further NPRM*, paragraph 65 and footnote 141.

[31] Since the use of temporary discounts causes a time shift of calls from the future to the present, their use during periods of off-peak demand will smooth out network utilization. Certain AT&T offerings fit this beneficial category, such as Select Saver, AnyHour Saver, Evening Plus, and the Reach Out America 24 Hour Plan. See Tab 6.

continued regulation unnecessary and counterproductive. It should proceed to make the findings that are indicated concerning effective competition, and then eliminate all remaining regulatory constraints on interexchange carrier pricing and offerings. This course of action would make moot the more detailed issues that have engaged our attention here, and provide a maximally stimulating environment for the benefits of competition.

It is also clear from the Further Notice that the Commission is uncomfortable with price variations and with self-selection. Concerns about price discrimination and loss of telephone service access led to the proposal of a new cap constraint on a basic rate index. These concerns are unfounded for three reasons. First, the differential pricing allowed by promotions is one of the efficiency enhancing aspects of price cap regulation. Prices are in line with the cost differences between high and low volume customers. Also, prices are higher for high volume customers with inelastic demand who choose not to participate in discount programs. Universal availability of most APPs ensures there are no high volume customers who are unable to participate. Therefore, APPs should not be condemned due to their self-selection property. Second, discounts serve to strengthen price cap regulation. Third, customers who lose service for non-payment are typically eligible for a discount plan, and so are unaffected by basic rate increases. Concerns of falsely estimated demand led to the new proposals on how to include APPs in the price cap. However, the demand estimates are quite good, and if incorrect tend to err on the side of underestimation. Further, AT&T's forecasts are much closer to actual demand than is the new method proposed by the Commission. Thus, across the board, the possible rationales advanced by the Commission for its concerns and proposed rules fail to stand up to analysis and simple facts. These new rules would lead to a decrease in the use of APPs by AT&T, which will adversely affect social welfare and the interests of consumers.

July 2, 1995

Respectfully submitted,

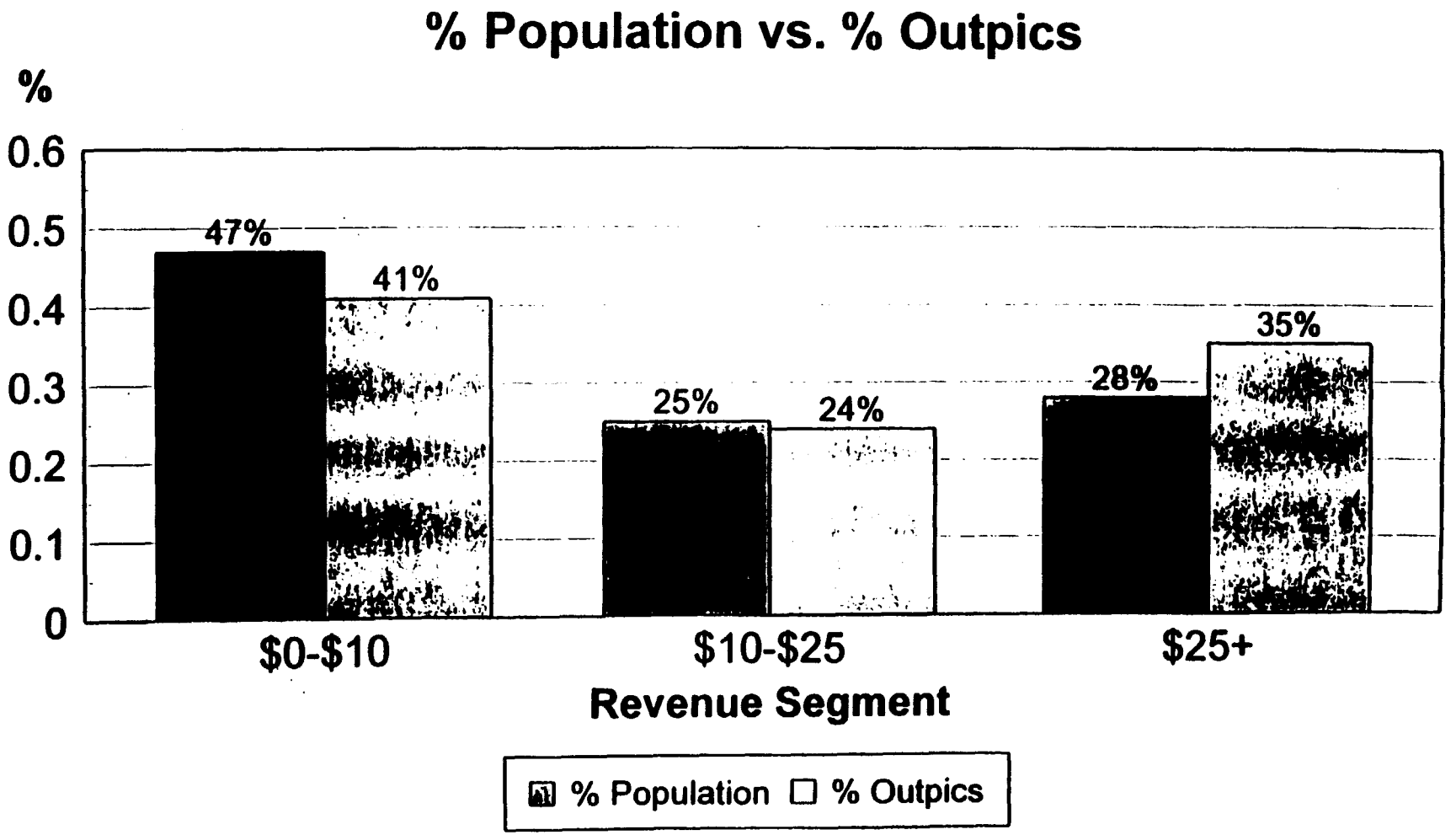
Robert D. Willig

Robert D. Willig

TAB 1

Compeution - Customers' Freedom of Choice

Lower usage customers are as likely to make choices about long distance companies as all other customers.



TAB 2

THE LIGHT USER SEGMENT OF THE LONG DISTANCE MARKET

Presented by:
D. J. Quinn
AT&T Consumer Communications Services
March 8, 1995

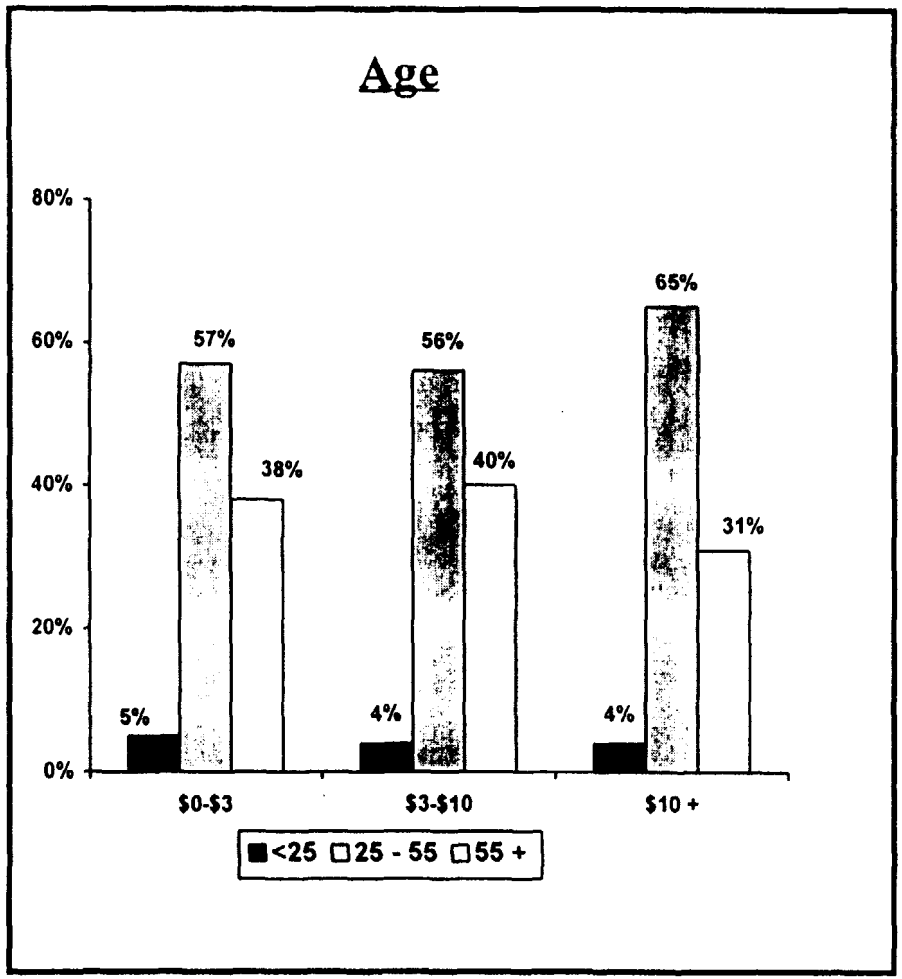
Purpose

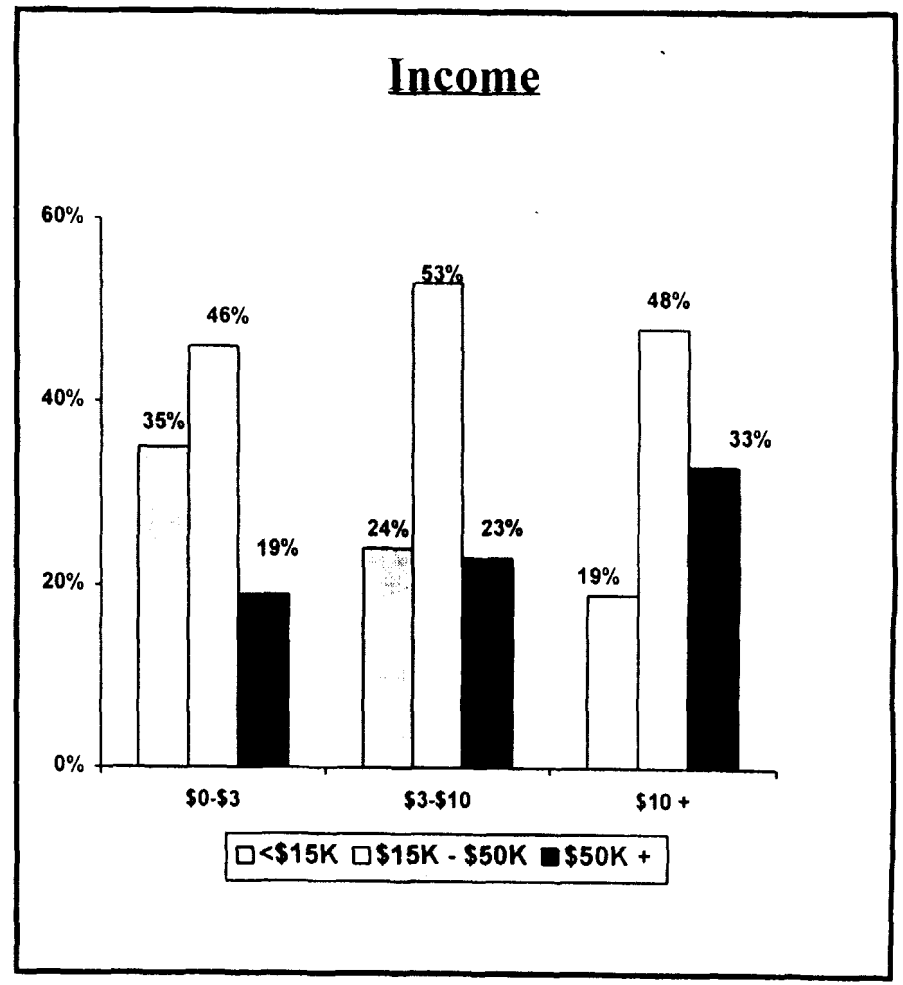
- **Provide insights on "Light Long Distance Users"**
- **Follow-up on $0-$3 Long Distance customers**

Existing marketplace dynamics adequately serve light users

- **Consumer Profile comparable to heavier users**
- **Competition for light users exists**
- **Excessive Low End Pricing would alienate 47% of total AT&T customers - most having high future potential**

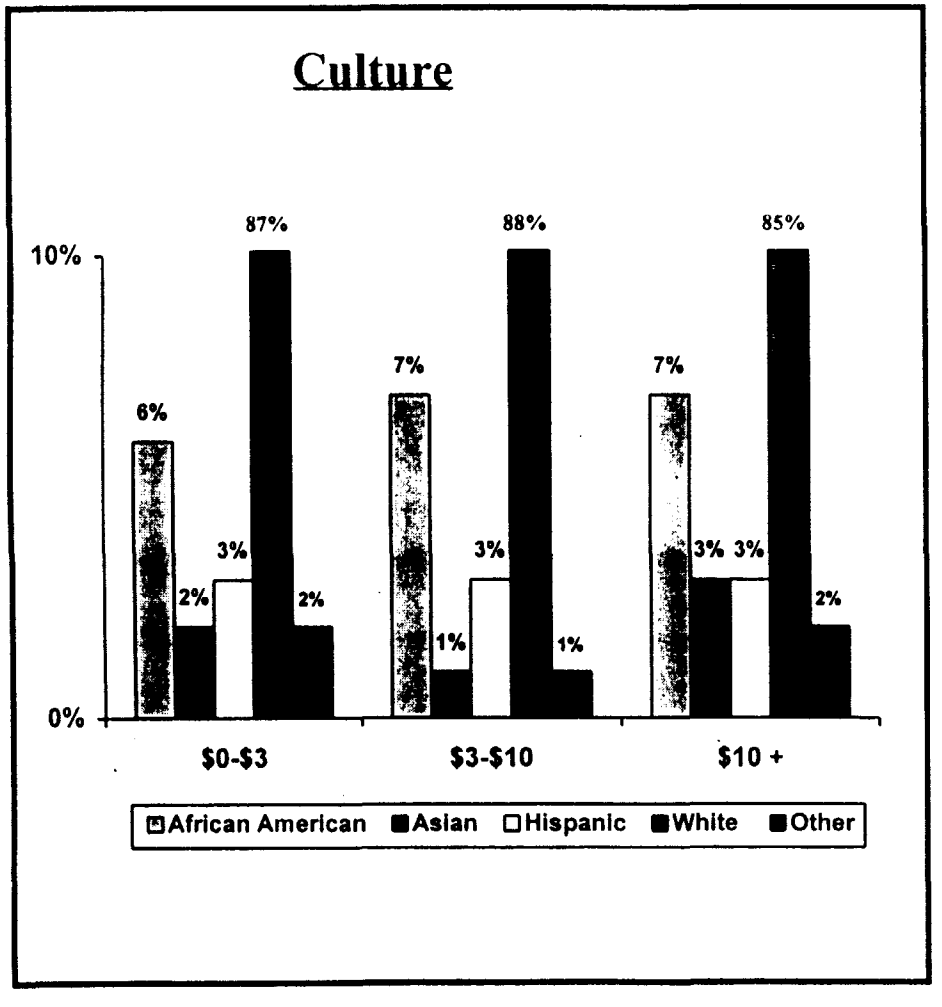
The Consumer profile of Light LD Users is comparable to heavier users

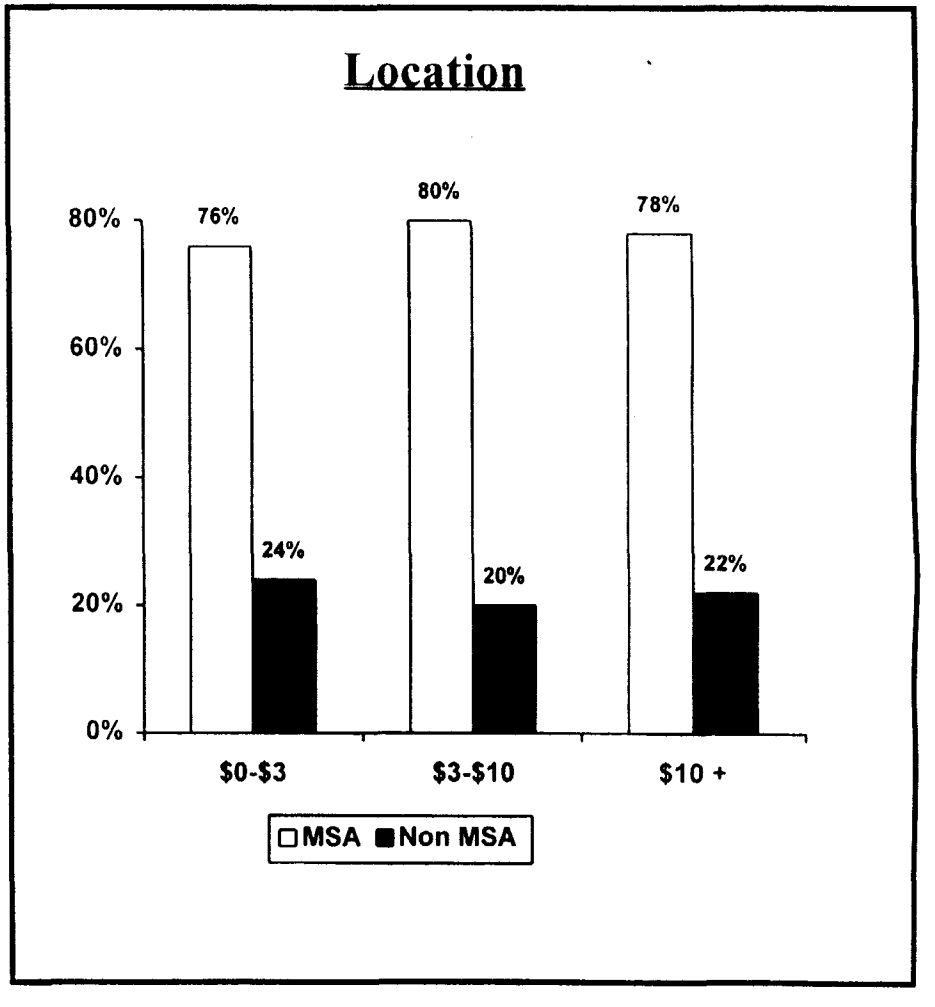




Source: PNR; Monitor; Customer Reported Industry Data

The Consumer profile of Light LD Users is comparable to heavier users

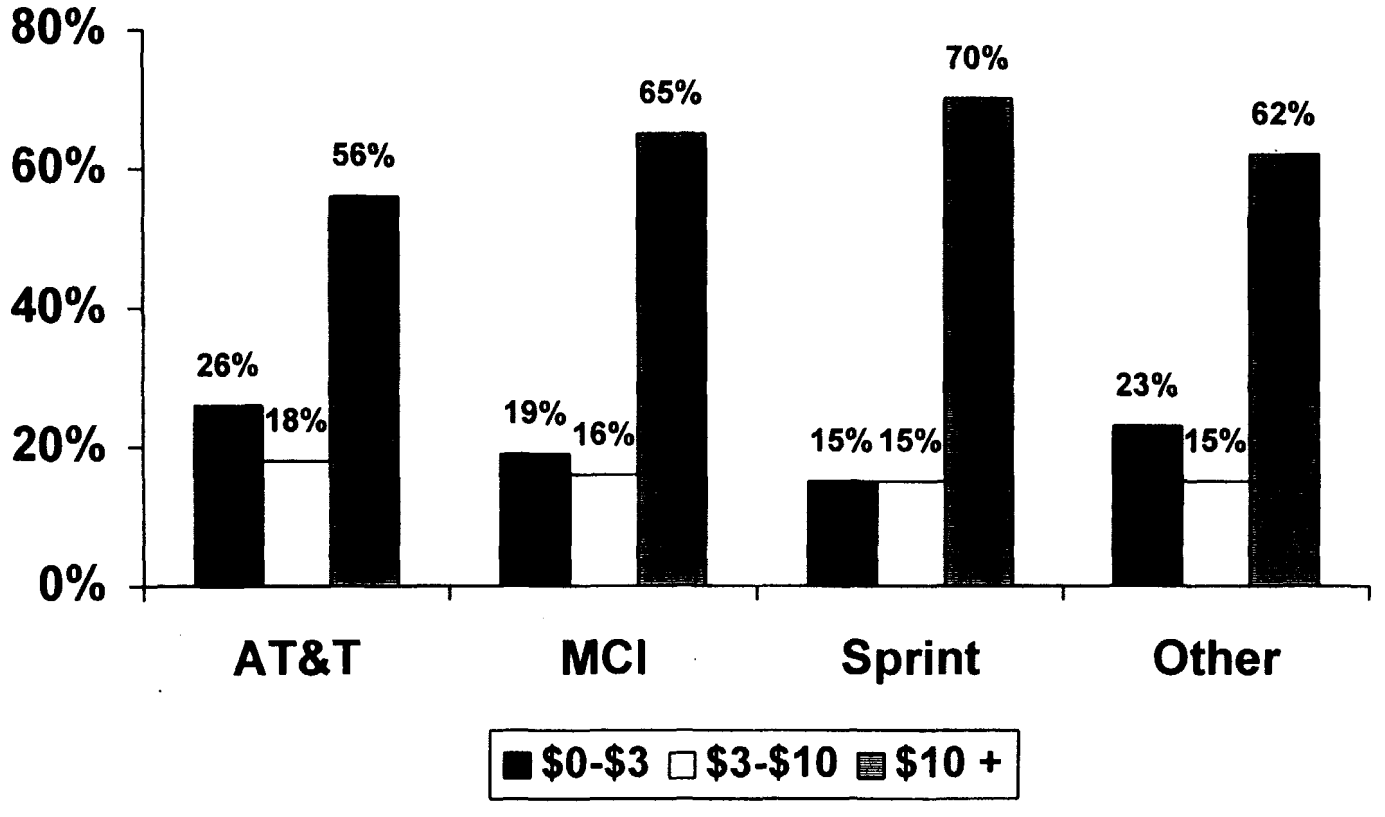




Source: PNR; Monitor; Customer Reported Industry Data

All Major Carriers have light users in their customer base

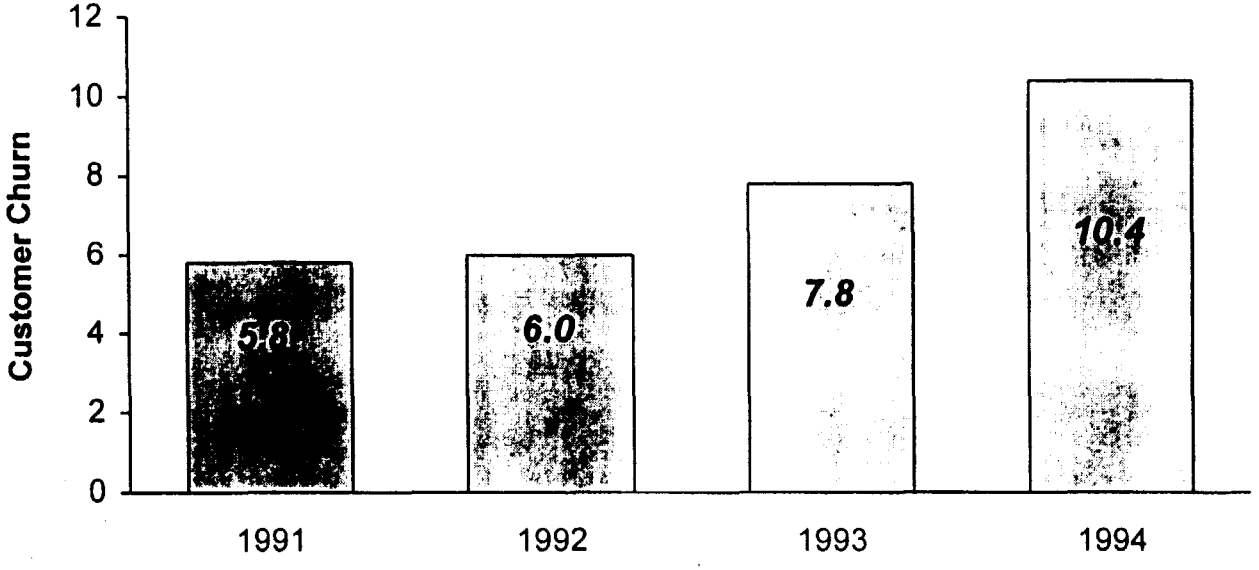
Distribution of Customers by Long Distance Carrier based on Customer-reported Long Distance Usage Level



Source: PNR - Industry Data - 1994

Competitive Movement in the Light User LD Market is Growing Rapidly

Light User LD Customer ($0-$10/month) Industry Churn
(in millions of customers)



Source: AT&T Internal Data

The majority of Light Users have high future potential

Average Monthly Dollars per Customer
Customer Reported Industry Data

[redacted]	$0-$3 LD/month	$3-$10 LD/month	$10 + LD/month
LD	$.50	$6.00	$38.75
Local/IntraLATA	$26.25	$30.50	$46.75
Cellular	$2.00	$2.75	$5.00
Cable	$13.75	$17.00	$18.50
Equipment	$2.25*	$2.25*	$2.50
Total	$44.75	$59.00	$111.50

* $0-$10

Source: PNR-Industry Data (Rounded)

However, over half of Light Long Distance Users currently fall below break even

Monthly LD Revenue	% Total AT&T Customers	% Total AT&T Minutes	% Total LD Revenue
$7-$10	8	4	3
$5-$7	6	2	2
$3-$5	8	2	1
			Break Even
$.01-$3	21	2	1
Hard Zero	4	0	0
Total	47%	10%	7%

Source: AT&T Internal Data

Improving profitability cannot be achieved through pricing alone but through a combination of initiatives

Initiatives

- **Cost Improvements (e.g., bi-monthly billing)**
- **Creative, cost-effective marketing to stimulate usage**
- **Alternate allocation approach of USF/Life-Line Assistance**
- **Pricing Action**

Source: AT&T