JUN 12 1996

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	)	CC Docket No. 96-112
	)	

REPLY COMMENTS OF THE UNITED STATES TELEPHONE ASSOCIATION

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SUMMARY

In its initial comments in this proceeding, USTA demonstrated that the continued application of Part 64 is unnecessary for price caps telephone regulated companies. To the extent the Part 64 rules are still considered necessary, it is unwise and impractical to adopt a detailed, uniform cost allocation scheme. USTA does not believe that the comments of the other parties effectively contradict that demonstration. Indeed, the record taken as a whole supports USTA's position.

The cable company commenters seek to have the Commission impose heavy-handed regulation in a thinly-veiled attempt to stifle competitive entry by the local exchange carriers into the video services market now dominated by the cable companies. Those commenters fail to refute the demonstrations of USTA and others that telephone services ratepayers will be adequately protected from cross-subsidization by price caps and, for carriers not electing no-sharing price caps, by Part 64

The cable companies' advocacy of a uniform fixed allocator cannot be justified on economic or public policy grounds. The proposed allocation of 75% of the joint costs to nonregulated activities is not based on any rational economic theory, and indeed runs counter to important economic principles. With respect to the public policy analysis, the cable companies conveniently ignore important policies, including the grave risk of losing the manifold benefits that will accrue to telephone and video services ratepayers if the cost allocation rules artificially discourage the deployment of shared advanced broadband networks.

Finally, the record does not support the use of a uniform, fixed allocator. There are significant differences in the carriers' plans to enter the video marketplace and other

unregulated markets, through significantly different means, using different technologies and architectures, and at different rates of deployment. The telephone companies can also be expected to continue to provide different types and amounts of "regulated" broadband services (including video-conferencing and video-telephony). Insofar as the State PUC and cable company commenters argue that the Commission should revisit the allocator over time to account for changes in that carrier's network, the Commission should also take into account the vast differences between carriers' networks that exist presently as a basis for rejecting a uniform fixed allocator.

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I. INTRODUCTION

The United States Telephone Association ("USTA") respectfully submits these reply comments in response to the initial submissions addressing the Commission's *Notice of Proposed Rulemaking* in the above-captioned docket.[1/] In its initial comments in this proceeding, USTA demonstrated that the continued application of Part 64 was unnecessary, but to the extent the Part 64 rules were still considered necessary, that it was unwise and impractical to adopt a detailed, uniform cost allocation scheme. USTA does not believe that the comments of the other parties effectively contradict or refute that demonstration.

The large number of issues raised and the substantial number of parties participating in this proceeding (despite the relatively short deadlines) evidences the importance of this

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[1/] *Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services*, CC Docket No. 96-112, FCC No. 96-214, released May 10, 1996 (hereafter "*Notice*").

Notice.[2] The cost allocation requirements adopted here could significantly affect when or whether the local exchange carriers will deploy advanced broadband networks that have the potential to bring new and better services to telephone customers, and to bring competition to the video services markets now dominated by the cable companies.

The commenters generally fall into three broad categories: (i) current and potential competitors of the local exchange carriers, which argue in favor of heavy-handed regulation (including the use of uniform, fixed allocators) as a means of forestalling competition; (ii) State regulators, which can accept the Commission's use of uniform fixed allocators as an interim solution while stating that greater knowledge is required; and (iii) the local exchange carriers, who consistently object to the *Notice's* suggested "one size fits all" highly regulatory approach, and contend instead that the Commission should be attempting to streamline or forebear from regulation.[3] USTA believes that this last set of commenters present the most cogent arguments from an economic perspective, and provide solutions that will best serve the public interest.

2/ In contrast to the relatively short deadlines in this proceeding, the Commission spent more than two and a half years developing and refining its Part 64 cost allocation rules. The Notice of Proposed Rulemaking was released in April of 1986 (*Separation of the Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, 104 FCC2d 59 (1986), and the Further Reconsideration was released in November, 1988 (3 FCC Rcd 6701 (1988)).

3/ The local exchange carriers bring out the fact that in the recent telecommunications legislation, Congress directed the Commission to forebear from regulation if, *inter alia*, "the Commission determines that such forbearance will promote competition among providers of telecommunications services .." 47 U.S.C. § 160(b).

II. THE CABLE COMPANY COMMENTERS HAVE NOT JUSTIFIED THE HEAVY-HANDED REGULATION THEY ADVOCATE

Several cable companies submitted comments in response to the *Notice* seeking to have the Commission impose significant regulatory burdens on the local exchange carriers. While they endeavor to cloak their arguments in the guise of "protecting ratepayers," their pleadings are little more than thinly-veiled attempts to use the regulatory processes to stifle competitive entry into their markets by the local exchange carriers. The Commission should reject those efforts as inconsistent with the policies adopted by Congress in the Telecommunications Act of 1996, and inconsistent with the goals set by the Commission in this proceeding.

A. Ratepayers Will Be Adequately Protected Under USTA's Proposal

Although the Commission recognizes that it must balance several important policies, the cable companies limit their focus to only three of those -- "protecting" telephone company ratepayers from having to subsidize video services, ensuring that the telephone companies' customers "share" in the economies of scope, and administrative simplicity.[4] The cable companies ignore other important policies at stake here, and also overlook the fact that even those three policies can be met without adopting the restrictive cost allocation scheme advocated by those cable companies.

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[4] *E.g.*, NCTA Comments at p. 12; Cox Comments at p. 9; Time-Warner Comments at p. 5. NCTA also argues that the heavy-handed regulation is necessary to support "congressional and Commission policy supporting low telephone rates." NCTA Comments at p. 9. USTA disagrees with this characterization of telecommunications policy. Congress and the Commission support market-driven, cost-based rates, and the use of targeted subsidies to ensure universal service, not simply "low rates" as NCTA asserts.

For the vast majority of local exchange carriers' subscribers, the Commission's price cap regulation (where the carrier has elected the no sharing option) effectively precludes those subscribers' telephone companies from unreasonable cost shifting. Simply put, under price cap regulation the telephone company has no incentive to unreasonably shift expenses or investment into the regulated accounts, because the price cap indices will preclude the telephone company from raising its prices to recover those costs.[5/] As several of the telephone company commenters pointed out, the Commission recognizes the efficacy of price caps in precluding such cost-shifting.[6/] Likewise, price cap regulation ensures that the telephone company subscribers do not bear an economically unreasonable share of the common costs, to the extent that the price cap indices establish a proxy for "stand-alone" costs of providing telephone service. Indeed, through the productivity offset, price cap regulation already incorporates a mechanism to allow the telephone company subscriber to "share" the economies of scope.[7/] The interexchange carrier and cable company commenters ignore or give short

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5/ Thus, as USTA demonstrated in its initial comments, the current level of "spare capacity" represents a prudent investment, and merely reflects the nature of forward-looking network engineering by the carriers. USTA Comments at pp. 20-21. *See also*, Sidak Affidavit attached hereto at pp. 12. Moreover, under price cap regulation a carrier has no incentive to deploy facilities unreasonably or inefficiently, because it cannot use any investments to justify raising its prices. *See generally*, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961 (1995) at ¶'s 27-28 (contrasting incentives for overinvestment under rate of return regulation (the "Averch-Johnson" effect) with efficiency and innovation incentives created by price cap regulation).

6/ *E.g.*, BellSouth Comments at p. 5; Ameritech Comments at p. 5; Pacific Telesis Comments at pp. 3-4. *See also*, Sidak Affidavit attached hereto at pp. 3-7.

7/ USTA also reminds the Commission that any economies of scope that do not flow to the telephone service subscribers will not "evaporate." Rather, they will be flowed through to the video services customers (since the telephone companies lack market power in the video services marketplace), and hence the <u>public</u> welfare will be maximized by the deployment of

(continued...)

shrift to the effectiveness of price cap regulation.[8] Since the linkage between costs and prices is broken for price cap carriers electing the no sharing option, the Commission should forbear from Part 64 regulation for those carriers in the manner proposed by Ameritech or Bell Atlantic.[9]

AT&T and the Pennsylvania OCA assert that the Commission should require the price cap regulated carriers to adjust the indices to account for the "exogenous" change.[10] As USTA explained in its initial comments, there is no valid basis for imposing any such artificial price reduction. Such treatment would result in a "double counting," since the productivity offset will capture the increases in efficiency made possible by the sharing of facilities. As a result, mandating reductions in the price cap indices pursuant to exogenous treatment would overallocate costs to the nonregulated operations, thereby retarding incentives to invest in shared broadband facilities. In fact, the deployment of shared facilities is not beyond the control of the carrier and thus not appropriate for exogenous treatment. Moreover, the provision in Part 64 cited by AT&T was directed at another concern as a transition from rate of return regulation,[11] and indeed the Commission more recently recognized that exogenous

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[7](...continued)
shared-services broadband networks. Conversely, those public benefits will be forever lost if the telephone companies are artificially discouraged from deploying these networks because of regulatory cost misallocations.

[8] *E.g.*, AT&T Comments at p. 11; MCI Comments at pp. 16-17; CCTA Comments at p. 13; Cox Comments at p. 11.

[9] *See* Ameritech Comments, Attachment A; Bell Atlantic Comments, Exhibit B.

[10] AT&T Comments at pp. 10-11; Pennsylvania OCA Comments at p. 16.

[11] *See* Comments of BellSouth at pp. 11-14.

treatment has the effect of reversing the progress towards market-based rates price caps have produced.[12]

With respect to the telephone companies subject to rate of return regulation, the Commission already has a proven cost allocation system that prevents unreasonable cost shifting -- the Commission's Part 64 requirements.[13] The Commission and the carriers are already experienced in applying the cost allocation guidelines, cost allocation manual, and independent audit requirements of Part 64. While more complex than a single nationwide fixed, uniform allocator, the Commission and the carriers have successfully implemented that cost allocation scheme, which was specifically designed to separate the costs of regulated and nonregulated activities (including the use of common plant).[14] The cable companies have provided no basis for abandoning Part 64.[15] Indeed, the cable companies' calls for heavy-

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[12] *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961 (1994) at ¶ 299.

[13] Part 64 also serves to preclude any unreasonable cost-shifting by the price cap carriers subject to sharing, assuming *arguendo* that they still have a theoretical incentive to shift costs. To the extent Part 64 is retained for rate of return or price cap carriers subject to sharing, Part 64 should be streamlined or made more flexible. *See e.g.*, Ameritech Comments, Attachment B; NYNEX Comments at p. 4; U S WEST Comments at p. 20; BellSouth Comments at pp. 17-18.

[14] *Cf.*, Southwestern Bell Comments at p. 3, observing that the Commission devoted 65 paragraphs of the *Joint Cost Recon Order* to the network cost allocation issues discussed in the *Notice*; Sprint Comments at p. 3, noting that the Commission has previously relied on Part 64 in similar circumstances (citing the *VDT Cost Allocation Order*).

[15] As GSA observes in its Comments at p. 8:

> The Commission's Part 64 rules for separating regulated and nonregulated costs have served the public well for nearly a decade. Throughout this period, the Part 64 system of cost allocation manuals and independent audits has protected telephone ratepayers from

(continued...)

handed cost allocation regulations for the local exchange carriers must be contrasted with their recent efforts to prevent the Commission from imposing any cost allocation requirements on the cable companies (which remain dominant in the provision of video services).[16]

B. A Uniform Fixed Allocator Can Not Be Justified

The cable companies are attempting to use this proceeding to handicap the telephone companies' competitive entry into video services through their support of a uniform fixed allocator that imposes excessive costs on the telephone companies' nonregulated activities. The cable companies advocate use of a uniform fixed allocator that is wholly unsupported, or supported by specious analysis.[17] NCTA argues for an allocation of no more than 25% of common costs (including outside plant, maintenance and switching) to regulated services, basing that number on the attached analysis of Leland Johnson. That analysis asserts that an allocation of more than 50% of the common costs to video would be warranted. Time-Warner

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[15](...continued)

subsidizing LEC nonregulated ventures. *Considering their importance, these rules have generated surprisingly little controversy since their implementation.* (emphasis added)

[16] Time-Warner's feeble attempt to distinguish the cable companies' situation wherein it asserts that the cable companies have not been subject to "public utility regulation," should be given no weight. Time-Warner Comments at n. 8. This carefully crafted phrase attempts to gloss over the 1992 Cable Act, in which Congress felt compelled to reinstate federal and local regulatory oversight of the cable industry's rates and service quality. Indeed, the imposition of cost allocation and other safeguards on incumbent cable operators could be appropriate means to protect their customers from improperly bearing the costs of cable operators' ventures into competitive telephony. *See* Sidak Affidavit attached hereto at p.12; *see also* note 26 *infra*.

[17] *See* Sidak Affidavit attached hereto at pp. 7-12.

argues for the same 25% regulated/75% nonregulated allocator without citing to any basis at all for the numbers selected.[18] CCTA compares cost figures from two different studies to attempt to justify its 24% regulated/76% nonregulated allocator.[19] Scripps Howard argues for a uniform, fixed allocator, but does not specify any particular percentage.[20] Continental Cablevision does not specify an allocator,[21] but it claims that the Commission's suggested 50%/50% allocator does not take into account measurement methods that the Commission has already tentatively concluded are "inconsistent with the goals of the 1996 Act."[22] Cox now argues for a 25% regulated/75% nonregulated allocator, but does not provide any reasoned basis for its departure from its previous advocacy (in a VDT context) of allocating more than 50% of the common costs to regulated services.[23]

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[18] Time-Warner Comments at pp. 10-11. Curiously, the section heading is titled "Public Policy Considerations And Available Data Indicate that No More than 25 Percent of Common Costs Should be Allocated to Regulated Services; The Remaining 75 Percent (Or More) Should be Allocated to Nonregulated Services", but there is no reference to any data whatsoever.

[19] CCTA Comments at p 19.

[20] Scripps Howard Comments at p. 3.

[21] Continental Cablevision Comments at p. 5. That analysis, however, focuses on only one measure of usage (bandwidth), and even then does not appear to fully take into account the use of broadband regulated services (including high-speed data services and videoconferencing). Continental Cablevision also asserts that the "FCC should strive to establish a factor that is tied to actual usage." *Id.* at p. 7. Continental Cablevision does not reconcile that assertion, however, with its advocacy of a uniform fixed allocator that does not take into account the disparate usage, technology, service offerings and deployment schedules of the different local exchange carriers.

[22] *Notice* at ¶ 33.

[23] Compare Cox Comments at p. 8, with Cox Comments Exhibit A (its *ex parte* filing of July 12, 1995 in CC Docket No. 87-266).

In addition, other commenters advocated different standards for determining the fixed allocator. AT&T suggested the performance of TSLRIC studies (AT&T Comments at p. 4), GSA proposed the use of a relative incremental cost test (GSA Comments at p. 4), and MCI advocated the use of a 72% allocation to regulated based on a stand alone ceiling (MCI Comments at p. 7). The varying and inconsistent claims by the cable companies and other commenters reinforce the arbitrary nature of the proposal to use a uniform, fixed allocator.

C. The Public Interest Would Be Disserved by the Cable Companies' Proposals

NCTA acknowledges the arbitrary nature of any proposed fixed allocator, and argues that the Commission should rely on public policy grounds for selecting a uniform, fixed allocator heavily weighted to allocating costs to nonregulated operations.[24] While USTA recognizes the importance of satisfying multiple public policy goals in this debate, USTA believes that NCTA and the other cable companies' proposals fall short on two counts. First, use of Part 64, which allows the companies to propose an allocation manual (governed by general guidelines and some specific rules) tailored to that company's operations, will be much more cost-causative than the uniform, fixed allocators suggested by the cable companies. Second, the cable companies' comments have conveniently ignored several important public policies (adopted by the Congress and the Commission) that are implicated by this

[24] NCTA Comments at n. 42.

proceeding.[25] Those policies argue against the use of uniform fixed allocators as suggested in the *Notice* and proposed by the cable companies.

As noted above, the cable companies try to wrap their efforts at regulatory protectionism in the mantle of "protecting ratepayers." However, effective and proven protection will be provided by price caps and, for rate of return companies, by Part 64 regulation. More importantly, the cable companies fail to address the policy favoring the deployment of new technologies and new services, including the ability of the local exchange carriers to bring genuine competition to the video services marketplace now dominated by the cable companies.

Thus, to the extent that the Commission will necessarily balance the different policies, it should adopt a regulatory scheme that will likely lead to an outcome that best serves the public interest by fully considering all of the relevant goals. The Commission therefore must consider both the positive and negative possibilities of the different proposals. To the extent application of Part 64 is still considered necessary and the Commission adopts USTA's proposal of allowing the telephone companies to address the cost allocations in their CAMs, price caps and Part 64 will effectively minimize the risk that the telephone services customers will be "worse off" than if the shared broadband networks were not deployed (*i.e.*, that the telephone company customers will subsidize the nonregulated activities of the local exchange carriers by allocating more than the stand alone costs to the regulated services).

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[25] By way of example, in footnote 3 of the Leland Johnson testimony attached to NCTA's Comments, he acknowledges the Commission's recognition in the *Notice* that an over-allocation of common costs to nonregulated activities could dissuade the telephone companies from deploying these advanced broadband networks. The main text of NCTA's Comments, however, ignores this important point altogether.

On the other hand, there is a much greater likelihood that the proposed use of a uniform fixed allocator will overallocate costs to the telephone companies' regulated operations, and there will be much graver consequences from such a misallocation. To the extent that an excessive level of common costs is allocated to the nonregulated operations under regulatory joint cost allocation schemes, the local exchange carriers are much less likely to deploy shared, advanced broadband networks.[26/] The public interest would be significantly disserved by such an outcome.

Both telephone services customers and video services customers would be deprived of the economies of scope of the shared networks.[27/] Video services customers would lose the benefits of the vigorous competition in the marketplace that otherwise would arise from local exchange carrier entry, including greater choice and increased innovation. Telephone services customers would also be denied the opportunity to take advantage of new capabilities and improved "traditional" telephony services.[28/] The local exchange carriers' customers would not have access to broadband "regulated" services. The local exchange carriers would also be less likely to be able to offer schools, clinics and hospitals access to advanced, broadband

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26/ *See*, Broadband Technology Comments at pp. 3-4. *Cf.*, *Implementation of Section 301(j) of the Telecommunications Act of 1996*, CS Docket No. 96-57, FCC 96-257, released June 7, 1996 at ¶ 2 ("The amended rules contained herein [loosening the cost allocation requirements on cable companies] are designed to reflect the Congressional intent to promote the development of a broadband, two-way telecommunications infrastructure.").

27/ *See generally* Sidak Affidavit attached hereto at pp. 16-19.

28/ In explaining why it was deploying hybrid fiber cable networks in its own systems, Continental Cablevision's head of engineering and technology explained that such fiber optic systems improve quality and enhance reliability. Affidavit of David M. Fellows at p. 5. These same benefits of using advanced technologies would likely be denied to the local exchange carriers' customers under the cable companies' proposals.

services that would support distance learning and telemedicine applications.[29] Under any rational cost-benefit analysis, USTA's proposal would come out far ahead of the cable companies' and the *Notice's* suggested use of a uniform, fixed allocator.

III. THE RECORD DOES NOT SUPPORT THE USE OF A UNIFORM FIXED ALLOCATOR

In its initial comments, USTA demonstrated that the "one size fits all" approach underlying the proposed use of a uniform fixed allocator was inaccurate and ill-conceived. USTA's position was confirmed by the comments of many of the other parties. Not only did the local exchange carrier commenters cite to the differences in their contemplated offerings, technologies, markets and deployment plans,[30] but the cable company comments and the State PUC comments, as a result of their internal inconsistency, also support USTA's call to reject a "one size fits all" fixed allocator. Even though several of the State PUCs support use of the suggested 50% fixed allocator on an *interim* basis, they also contend that there is a need to review the fixed allocator over time to take into account changes in the technology and markets.[31]

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[29] Thus, the telephone services customers will "share" in the economies of scope not only through the productivity offset in the price caps formula, but also through the myriad benefits that flow from the availability of an advanced broadband network.

[30] *E.g.*, Southwestern Bell Comments at p. 14; BellSouth Comments at p. 21; Puerto Rico Telephone Company Comments at p. 6; U S WEST Comments at p. 2; Pacific Telesis Comments at p. 7.

[31] *See*, Alabama PSC Comments at pp. 2 and 9; New York DPS Comments at p. 4; NCTA Comments at pp. 11-22 and attached Johnson Testimony at p. 2 ("As technological advance proceeds and consumer demands change, modification in that allocation may, of course, be needed."). *See also*, Florida PSC Comments at p. 3 (advocating an annual

(continued...)

Although those commenters focus on the need to adjust the allocator to account for changes in a carrier's network and market over time, there already exist (and will continue to exist) wide variations in technology, markets and services of different local exchange carriers presently.[32] To the extent that modification in the same carrier's network warrants changes to the allocator, the current differences between local exchange carriers' markets and architectures requires use of varying cost allocators that account for those significant differences. A single fixed allocator (whether the 50% to regulated operations suggested in the *Notice* or the 75% or greater figure now proposed by the cable companies) ignores the wide variations in shared network operations that the local exchange carriers exhibit.

USTA proposes that the Commission not impose a uniform fixed allocator, but instead allow the local exchange carriers to apply (through their cost allocation manuals) a cost allocation scheme that is appropriate for their networks, their services and their markets (including potentially the use of LEC specific fixed factors). While a single, uniform fixed allocator has the virtue of simplicity, USTA does not believe that simplicity alone is sufficient to overcome the general recognition that such an allocator is likely to be inappropriate in many cases, because it will result in a correct allocation of costs only by chance. USTA believes that the potential adverse impact on the public interest from overallocating costs to the

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[31](...continued)
calculation of the allocator to account for deployment of video capable loops).

[32] *Cf.*, Pennsylvania Office of Consumer Advocate Comments at p. 8 ("This is particularly true given that integrated broadband architectures are likely to be complex and will vary from location to location."). The NCTA Comments at p. 11 state that "Of course, cost determinants such as population density, terrain and other factors vary widely within and among LEC territories." NCTA next asserts, without any explanation: "That does not, however, mean that allocations between regulated and unregulated services should vary substantially." NCTA provides no support for this *non sequitur*.

unregulated activities is sufficiently great that whatever benefit is derived from simplicity would be more than offset by disincentives to deploy shared advanced broadband networks.[33] Moreover, the Commission's history with Part 64 requirements suggests that some variation in the CAMs would certainly be administratively tolerable.[34]

V. CONCLUSION

For the reasons discussed in its initial comments and in these reply comments, USTA respectfully urges the Commission to forbear from Part 64 regulation or, to the extent those rules are still considered necessary, to adopt a flexible, streamlined approach to the cost allocation issues raised in the *Notice*. The Commission should reject the cable companies' attempts to forestall competition by having the Commission impose heavy-handed regulation on the local exchange carriers while not applying similar cost allocation rules on the cable companies. Such action will best serve the public interest by creating the proper economic

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[33] *See* Sidak Affidavit attached hereto at p. 4.

[34] Indeed, the Commission has explicitly rejected calls for strict uniformity in the carriers' Part 64 cost allocations. *E.g.*, *Implementation of Further Cost Allocation Uniformity*, 8 FCC Rcd 4664 (1993); *Telephone Company-Cable Television Cross-Ownership Rules*, 10 FCC Rcd 244 (1994)(VDT Recon. Order) at ¶ 180.

signals that will encourage the local exchange carriers to deploy shared broadband networks benefitting both telephony and video customers.

Respectfully submitted,

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June 12, 1996

BEFORE THE
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REPLY AFFIDAVIT OF J. GREGORY SIDAK

J. Gregory Sidak, being duly sworn, deposes and says:

1. My name is J. Gregory Sidak. I am the F.K. Weyerhaeuser Fellow in Law and Economics at the American Enterprise Institute for Public Policy Research. A description of my professional qualifications appears in the affidavit that I filed on behalf of the United States Telephone Association (USTA) in this proceeding on May 31, 1996. At USTA's request, I evaluate here from an economic perspective the initial comments of various parties in this proceeding that urge the Commission to rewrite the Part 64 cost allocation rules as they concern the provision of unregulated broadband services by local exchange carriers (LECs).

I. THE CABLE INDUSTRY'S COST ALLOCATION PROPOSALS ARE RESULT-ORIENTED FORMULAS THAT SEEK TO USE PART 64 TO RECREATE THE CABLE-TELCO ENTRY BAN.

2. The sophistical discussion of the various "allocation factors" and "cost pools" proposed by the cable television industry should not obscure two elemental points. First, all the schemes for allocating common costs are inherently arbitrary, such that any result can be produced if one searches long enough for the "right" allocator. As William J. Baumol and I have written:

> Fully allocated cost figures and their corresponding rate-of-return numbers have no economic content. They cannot pretend to constitute approximations to *anything*. Any claim of "reasonableness" for a particular basis of cost calculation is irrelevant, except to the success of the advocates of those particular figures in deluding others about the defensibility of the numbers. There can be no excuse for regulators to make vital economic decisions on the basis of calculations that are, at their best, random, and, at their worst, fully manipulable.[1]

Professor Baumol and I did not write that passage with the proposals of the cable television industry in mind. But we could scarcely have found a more apt example than the proposals that industry makes in this proceeding.

3. The second fundamental point raised by the cable industry's comments is that, because of their inherent susceptibility to result-oriented manipulation, the cost allocation procedures of Part 64 invite strategic abuse of the regulatory process to impede competitive entry by the LECs into other markets.[2] The proponents of any given cost-allocation formula will predictably justify their recommendation on the grounds that it will advance "the public interest." Yet elementary economic theory will usually reveal the contrary—that the recommendation has the practical effect of suppressing competitive entry into the proponent's market and thus reducing consumer welfare.

4. The cable television industry's principal proposal—that 75 percent or more of common costs be allocated to the LEC's video services and 25 percent to its telephony services—has no economic substance. With as much intellectual weight the industry could have proposed that the Commission allocate the LEC's common costs between video and telephony on the basis of the ratio

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[1] WILLIAM J. BAUMOL & J. GREGORY SIDAK, TRANSMISSION PRICING AND STRANDED COSTS IN THE ELECTRIC POWER INDUSTRY 64 (AEI Press 1995) (emphasis in original); *accord*, William J. Baumol, Michael F. Koehn & Robert D. Willig, *How Arbitrary is "Arbitrary"?—or, Toward the Deserved Demise of Full Cost Allocation*, 21 PUB. UTIL. FORTNIGHTLY, Sept. 3, 1987, at 16.

[2] Of course, the cable industry ignores that LEC filings under Part 64 are subject to public review and comment, as well as periodic audit.

of the total offensive yardage of the Washington Redskins to that of the Dallas Cowboys. And, of course, within the industry there are subsidiary proposals for fixed factors for cost allocation, which collectively are a hodgepodge of recommendations that demonstrate more than anything else the susceptibility of full cost allocation to result-oriented analysis.

5. In short, the cable industry's recommendations in this proceeding would erect new regulatory barriers at the Commission to shield that industry from competitive entry by telephone companies. That result would be neither in the interests of consumers of video services nor permissible under the provisions in the Telecommunications Act of 1996 that repealed the statutory barrier to LEC entry into video programming. The Commission cannot restore the largesse that Congress saw fit to end. The fact that cable television operators are entreating the Commission to hinder competitive entry into their market through a rewrite of arcane rules for allocating common costs underscores that it would be impossible for those firms even to solicit the same indulgence from Congress in a manner that was transparent and comprehensible to consumers.

II. The Commenters Have Failed to Provide Any Cogent Economic Rationale for Applying the Part 64 Cost Allocation Rules to LECs Subject to Price Caps Without Earnings Sharing.

6. The companies that have the most to lose from the competitive entry of the LECs into other telecommunications markets—namely, cable television operators and AT&T—have failed to provide any cogent rationale for why the Commission should continue to apply the Part 64 cost allocation rules to LECs subject to pure price-cap regulation. Indeed, those parties *cannot* do so because the weight of economic analysis is against them.

7. It may be useful to formalize the conceptual process, discussed in my affidavit,[3] by which the Commission would optimally define its rule under Part 64 for allocating the LEC's common costs of providing video and telephony. The proper goal should be to maximize consumer welfare, which can be achieved at a operational level if the Commission seeks to minimize the total costs C:

$$C = aX + bY + Z,$$

where

a = the probability that the cost allocation rule will permit cross-subsidization from telephony to video to occur

b = the probability that the cost allocation rule will deter competitive entry by the LEC into video

X = the loss in consumer welfare in the telephony market from the LEC's cross-subsidization of video by telephony

Y = the loss in consumer welfare in the video market from the deterrence of the LEC's entry into video

Z = the administrative costs to public and private parties of enforcing, and complying with, the cost allocation rule

This formulation of the problem helps to illustrate the inherent tradeoffs in the formulation of the cost allocation rule. A particular allocation factor, for example, may cause a or X to fall while causing b or Y or Z to rise, perhaps by a larger amount. That is why the Commission's objective should be to minimize C, which is the sum of the expected costs of false negatives, the expected cost of false positives, and the administrative costs of the rule.

[3] Sidak Affidavit at 4–7 ¶¶ 6–9.

8. AT&T proposes that the Commission continue to subject all price-capped LECs, even those without earnings sharing, to Part 64.[4] AT&T's argument appears to be that any less intrusive approach would raise *a*, the probability that the cost allocation rule will permit cross-subsidization from telephony to video to occur: "If the Part 64 process were to be eliminated for incumbent price cap LECs, it would be difficult to identify and monitor the reasonableness of the LECs' regulated telephone rates to ensure that those rates are not loaded with costs associated with their competitive services."[5] That reasoning is flawed in four respects.

9. First, that argument simply ignores the volume of economic literature showing that a firm subject to pure price caps has no incentive to cross-subsidize[6]—that is, *a* is already zero because, for reasons independent of the cost allocation rule, there is no likelihood that cross-subsidization from telephony to video will occur.[7] Second, AT&T's argument ignores that *X*, the loss in consumer welfare in the telephony market from the LEC's cross-subsidization of video by

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[4] AT&T Comments at 11–12.

[5] *Id.*

[6] *See, e.g.*, DAVID E.M. SAPPINGTON & DENNIS WEISMAN, DESIGNING INCENTIVE REGULATION IN THE TELECOMMUNICATIONS INDUSTRY ch. 3 (MIT Press & AEI Press 1996); David E.M. Sappington, *Revisiting the Line-of-business Restrictions*, 16 MANAGERIAL & DECISION ECON. 291, 293–96 (1995); Kenneth J. Arrow, Dennis W. Carlton & Hal S. Sider, *The Competitive Effects of Line-of-business Restrictions in Telecommunications*, 16 MANAGERIAL & DECISION ECON. 301, 303–04 (1995); Paul S. Brandon & Richard L. Schmalensee, *The Benefits of Releasing the Bell Companies from the Interexchange Restrictions*, 16 MANAGERIAL & DECISION ECON. 349, 356 (1995); Daniel F. Spulber, *Deregulating Telecommunications*, 12 YALE J. ON REG. 25, 58–63 (1995); Susan Gates, Paul Milgrom & John Roberts, *Deterring Predation in Telecommunications: Are the Line-of-business Restraints Needed?*, 16 MANAGERIAL & DECISION ECON. 427, 433 (1995); Fred S. McChesney, *Empirical Tests of the Cross-subsidy and Discriminatory-access Hypotheses in Vertically Integrated Telephony*, 16 MANAGERIAL & DECISION ECON. 427, 433 (1995).

[7] Moreover, regardless of the type of regulation to which the LEC is subject, *a* is zero with respect to the allocation of *common* costs. Once incremental costs have been correctly attributed to a service, that service by definition is not being cross-subsidized by any other. *See, e.g.*, WILLIAM J. BAUMOL & J. GREGORY SIDAK, TOWARD COMPETITION IN LOCAL TELEPHONY 62 (MIT Press & AEI Press 1994). Thus, once incremental costs are directly assigned to unregulated services, there can be no remaining cross-subsidy concern with respect to the allocation of common costs.

telephony, is already rapidly approaching zero (if it is not there already) because competition in the local exchange has desiccated any reservoirs of profit with which to cross-subsidize entry into other markets. Third, AT&T's argument does not acknowledge (although AT&T surely understands) that the application of the Part 64 cost allocation rules to LECs subject to pure price cap regulation needlessly raises b. That is, it creates a material risk of deterring competitive entry by LECs into other markets, to the obvious detriment of consumers there. Fourth, AT&T does not consider the magnitude of Y, the loss in consumer welfare in the video market from deterring LEC entry. Contrary to the quarantine mentality of the cable-telco entry ban or the line-of-business restrictions under the Modification of Final Judgment, any expected harm to consumers in the LEC's regulated market must be weighed against expected benefits to consumers in the market that the LEC seeks to enter—which in this case is not an "unregulated" market at all, but rather a heavily regulated market that Congress and the Commission have long considered to be insufficiently competitive.

10. Alternatively, one might read AT&T's argument to suggest that the Commission could minimize Z—the administrative costs to public and private parties of enforcing, and complying with, the cost allocation rule—by applying the Part 64 cost allocation rules to LECs subject to pure price cap regulation. But that interpretation would simply introduce a fifth flaw in AT&T's reasoning: It is a false economy to lower the administrative costs of the cost allocation rule if doing so causes a or b to increase significantly and thus harm consumer welfare.

11. As an additional argument for applying the cost allocation rules to LECs subject to pure price caps, AT&T observes that the future may differ from the present: "As to those LECs that are not currently under a sharing obligation, such LECs' current decision to choose a price cap model that does not permit sharing does not prevent any of those LECs from later electing a different model