Act by preventing callers from accessing their OSP of choice. Entities caught using these devices should be subject to significant Commission forfeitures, in addition to any damages owed to OSPs.

XIV. CONCLUSION

Based on the foregoing, MCI respectfully requests that the Commission implement Section 276 of the Act as discussed herein.

Respectfully submitted,

MCI TELECOMMUNICATIONS CORPORATION

By: Mary J. Sisak

Mary J. Sisak
Donald J. Elardo
1801 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 887-2605

Dated: July 1, 1996

PAYPHONE COMPENSATION COST ANALYSIS

PREPARED FOR

MCI TELECOMMUNICATIONS CORPORATION

BY

HATFIELD ASSOCIATES, INC.

OCTOBER 10, 1995

PAYPHONE COMPENSATION COST ANALYSIS

Hatfield Associates, Incorporated (HAI) has been asked by MCI Telecommunications Corporation (MCI) to analyze the costs associated with providing consumers with access to interexchange carrier networks through privately owned payphones. Our analysis is based on a public cost study performed by New England Telephone in 1993. Using data contained in that study, along with other industry data, we conclude that the 25 cent per call charge proposed by the Federal Communications Commission ("Commission") in CC Docket No. 91-35 is too high. We estimate that the charge should be no greater than 8.3 cents per message.

GENERAL FRAMEWORK FOR ANALYSIS

The Commission has determined that private payphone owners ("PPOs") should be compensated for calls to interexchange carriers that do not generate revenue.[1] We start out with the assumption that the charges assessed to interexchange carriers by private payphone providers should be based on the competitive market model of competition. Under this model, regulation seeks to establish rates that would be set in a competitive market. In general, competitive market rates reflect economic costs. This model is widely accepted as a basis for regulation.[2]

There is no way to observe directly a competitive market price that can be used as a benchmark for these calls. Therefore, we use local telephone company payphone costs as a benchmark. The assumption is that these costs are the best available estimate of the rate that would be charged if the market were competitive. Using cost estimates as a proxy for the competitive rate is, of course, a standard regulatory tool. However, using a monopolist's costs as a proxy for a competitive rate obviously introduces a bias towards higher rates because actual competition would tend to drive down costs.

THE COMMISSION PROPOSAL

The Commission has proposed per-call compensation of 25 cents. This figure is derived from a set of benchmarks developed in 1992.[3] The first benchmark used by the Commission was one-half the interstate revenue requirement attributed to payphones by local exchange carriers ("LECs"). The Commission reasoned that "interstate access charges have generally been determined with reference to LEC costs, which should bear at least a rough relationship to PPO

---

[1] See Policies and Rules Concerning Operator Service Access and Payphone Telephone Compensation, Second Report and Order, CC Docket No. 91-35, released May 8, 1992.

[2] See William J. Baumol and J. Gregory Sidak, Toward Competition in Local Telephony, 1994, pp. 27-31 for a discussion of this model.

[3] See Second Report and Order, *supra.* note 1, paras. 16-41.

costs."[4] One problem with this analysis is that the interstate revenue requirements of LECs often do not reflect actual cost-causation because they are based on arbitrary jurisdictional cost separations rules. Moreover, these costs include both explicit and implicit subsidies. Finally, this interstate revenue requirement includes access charges that are paid by interexchange carriers for calls routed from private payphones to interexchange carriers through the LEC access network.[5] Basing compensation on the interstate revenue requirement amounts to double charging interexchange carriers. In any event, the direct estimate of LEC costs, provided below, provides a much better benchmark.

The second benchmark utilized by the Commission is the price of a 0- transfer call. The problem with this proxy is that it includes live operator costs, which are expensive. Therefore, the 0- transfer proxy overstates the costs PPOs incur in allowing interexchange carrier customers to originate calls. The New England Telephone ("NET") cost study used below to estimate compensation costs finds a substantial difference between the cost of a customer dialed operator call and an operator assisted call ($0.0593 v. $0.1841).[6]

The final benchmark proposed by the Commission in 1992 was AT&T commission payments for 0+ calls. Use of this benchmark for compensating PPOs is inconsistent with the Commission's specific finding that the level of compensation should not reflect the "opportunity costs" of initiating access code calls in lieu of 0+ calls that produce commissions from an operator services provider.[7]

Another problem with using 1992 proxies is that they are dated. The actual costs of payphone providers should be falling due to generally falling costs of telecommunications equipment.[8]

BENCHMARK PROPOSAL

The results of payphone competition do not approximate the results that application of the competitive market model would provide. Each payphone location is, essentially, a local

---

[4] See Second Report and Order, *supra.* note 1, para. 33.

[5] For example, these costs include some portion of loop costs and local usage, which will be recovered from access charges paid by interexchange carriers.

[6] See New England Telephone, New Hampshire Incremental Cost Study, p. 102.

[7] See Second Report and Order, *supra.* note 1, para. 31.

[8] According to a recent Wall Street Journal article, telecommunications equipment prices have been falling by 30 percent per year. See "Suppliers to Phone Firms Find Cord Cut," October 5, 1995, p. B3.

monopoly. Customers are often unable to use alternatives -- such as at an airport -- or can only do so at great inconvenience. In these cases, rents can be extracted from customers in the form of higher than competitive prices for long distance calls. Therefore, application of the competitive pricing model in the payphone market requires either a full cost analysis or development of benchmarks that can reasonably be applied to the payphone market.

The Commission has determined that individual PPO cost studies as originally proposed by MCI should not be required. In the absence of individual cost studies, some surrogate for costs must be found. As described above, the surrogates proposed by the Commission are flawed for various reasons. A benchmark not fully considered by the Commission is use of actual cost data for telephone company provision of payphone service.

One of the most thorough and well-documented cost studies for public telephone costs available on the public record was provided by the New England Telephone Company for 1993.[9] This study reports the costs that NET incurs to provide additional payphones. Since NET can provide phones at this cost, the numbers can be used as a competitive benchmark for PPOs. Data in the study were used to estimate the cost of a call. The estimate is derived in Table I.

TABLE I

1	Payphone Cost	300.39	NET study, p. 92
2	Capital Expense Factor	0.2136	NET study, p. 90, line 2
3	Capital Expense	64.16	line 1 * line 2
4	Maintenance	38.18	NET Study, p. 93 (coinless expense per phone)
5	Business Line	320.28	FCC 1994 Reference Book on Rates
6	Total Annual Expense	422.63	line 3 + line 4 + line 5
7	Total Phones	7,913	NET Study p. 91
8	Total Calls	40407545	NET Study p. 87 and p. 104
9	Calls/Phone	5106	line 8 ÷ line 7
10	Per Call Cost	0.083	line 6 ÷ line 9

Table I takes the cost of a payphone reported by NET (line 1), converts that cost to a capital expense (line 3) using NET's capital expense factor (line 2), adds NET's maintenance expenses (line 4) and then adds the nationwide average cost of a business line. The total annual expense (line 6) is then divided by the average number of calls per phone (line 9), resulting in a cost per call of 8.3 cents. The cost of the business line excludes message charges. The number of calls includes local sent paid, 0+, 0- and an estimate of access code calls. The number of access

[9] *Supra*, note 6.

code calls was assumed to equal the number of 0+ and 0- calls. All other types of calls, such as 800 service, are excluded from the total used here.

PPOs have reported substantially higher equipment costs than those in Table I. NET's equipment and installation cost for indoor coinless phones was used on the assumption that the extra expense of coin phones and coin phone maintenance is not required to deliver calls into the public switched network to reach interexchange carriers. Moreover, PPO phones may contain additional electronics not needed for the simple function of transferring calls to interexchange carriers. These additional costs are not appropriately included in compensation.

The estimate in Table I distributes the NET cost of providing a payphone over all of the coin sent paid and 0-/+ calls placed over the phone. The true incremental cost of using payphones to reach interexchange carriers is, of course, essentially zero. The equipment, maintenance and business line expenses would be incurred by payphone operators even if interexchange carrier customers placed no calls from PPO telephones. Stated alternatively, at 25 cents per coin call, the "revenue requirement" of $423 associated with each phone is recovered entirely from local coin sent paid calls (.25*3,874 = $968). Indeed, the cost of providing the payphone would obviously be recovered even if the coin call rate were substantially lower. Allowing PPOs to recover more than their actual costs results in excessive monopoly profits.

The estimate derived here is based on an average from experience in one state. PPOs would presumably be free to make individual cost of service showings if they believe the benchmark rates based on this average are incorrect.[10]

CONCLUSION

A better benchmark than the ones used by the Commission previously is available from the 1993 NET study. These results, or further analyses of other LEC payphone cost studies, should be used to set compensation. The estimates derived here are substantially lower than the 25 cent figure proposed by the Commission. The true incremental cost is virtually zero, while the fully distributed cost estimate derived here is 8.3 cents per call.

---

[10] The Commission used a benchmark analysis to establish regulated cable television rates, but allowed cable systems to make cost showings if they believed the benchmark was too low. See Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, 8 FCC Rcd 5631 (1993).

HATFIELD ASSOCIATES, INC.
International Telecommunications Consultants
737 29th Street, Suite 200
Boulder, Colorado 80303
(303) 442-5395

Statement of Qualifications

Hatfield Associates, Inc. (HAI) is an interdisciplinary consulting and research firm serving a wide range of clients in the telecommunications field. The firm was founded in February, 1982. In the more than one decade of its existence, the firm has provided consulting and educational services in nearly all aspects of the present and future telecommunications infrastructure, including local exchange networks, cable television systems, competitive access services, land mobile and personal communications, long haul terrestrial and satellite communications, data communications, and customer premises equipment

Principals of the firm include consultants with graduate degrees and decades of senior level experience in engineering, economics, business, and policy/regulation. HAI's services include, among others, regulatory filings and policy studies, engineering studies, expert testimony, market research, economic studies, "due diligence" support, business planning, education and system development.

Examples of recent consulting assignments include:

- Modeling the cost of providing local telephone service;
- Analyzing the potential for competitive entry into the local exchange telecommunications business, presented in a paper entitled "The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers";
- Testifying in several state proceedings on various aspects of competitive entry into local exchange and exchange access services;
- Assessing the technological and economic merits of various telephone companies' plans for offering video dialtone services;
- Authoring the "Telecommunications Technology" and "Utility Applications of Telecommunications" chapters, describing utility opportunities in telecommunications, of a major telecommunications report for the Electric Power Research Institute;
- Developing material on telecommunications technology for inclusion in a report on international telecommunications prepared by the Office of Technology Assessment of the U.S. Congress; and
- Providing telecommunications education to countries in Central and Eastern Europe.

MCI Telecommunications Corporation
1801 Pennsylvania Avenue N W.
Washington, D.C. 20006
202 887 2605

Mary J. Sisak
Senior Counsel
Regulatory Law

1/11/96

RECEIPT

January 11, 1996

RECEIVED
JAN 11 1996

Regina Keeney
Chief
Common Carrier Bureau
Federal Communications Commission
Washington, DC 20554

Re: CC Docket No. 91-35

Dear Ms. Keeney:

MCI Telecommunications Corporation (MCI) has maintained throughout this proceeding that payphone compensation should be based on cost. In its most recently filed comments, MCI submitted a cost study by Hatfield Associates, Inc. (Hatfield Study) which demonstrates that cost-based compensation would yield an amount of no more than 8.3 cents per call. The Hatfield Study is the only cost study on the record and it provides the best evidence of the true cost of providing access to interexchange carriers (IXCs) through privately owned payphones. To the extent that private payphone owners (PPOs) believe that the Hatfield Study does not accurately reflect their costs of providing service, they are free to submit their own cost data. The fact that they have not done so clearly suggests that they lack the ability to refute the Hatfield Study.

THE HATFIELD STUDY USES THE BEST AVAILABLE PAYPHONE COST DATA

The Hatfield Study is based on a New England Telephone Company (NET) payphone cost study. While some parties argue that the NET study is not an appropriate surrogate for private payphone costs because New Hampshire is a rural state and others challenge the Hatfield Study because it uses nation-wide averaged access line costs and New Hampshire specific costs for the other cost components, their contentions are without merit.

Although New Hampshire is essentially a rural state, it is not clear whether its status results in an over or an under-estimate of costs. For example, labor costs should be lower than in urban areas. However, the time and distance involved in service calls and collection may be higher. And, although nation-wide averages would have been preferable for all of the cost components in the study, these data were not available. However, nation-wide access line data were available and, therefore, were appropriately used.

In any event, the Hatfield Study is the only cost study on the record. Although some parties argue that an Illinois study estimates a higher cost for payphone compensation, this study is not part of the record in this proceeding and is proprietary. Therefore, the study cannot be tested and evaluated, nor can it be made the basis of a Commission decision concerning the level of payphone compensation. As noted previously, payphone providers who believe that the Hatfield Study does not accurately reflect their costs should provide their own cost data.

THE HATFIELD STUDY PAYPHONE INVESTMENT AMOUNT IS APPROPRIATE

Some parties argue that private payphones cost $800, not the lower depreciated cost used in the Hatfield Study. Such telephones purchased by PPOs, however, contain sophisticated electronics which are not necessary to transfer access code calls to interexchange carriers and they contain expensive hardware needed for coin collection. It would be inappropriate to require IXCs to pay for functionality not needed for calls placed by their customers. Thus, PPOs cannot expect to be subsidized by IXCs for high-cost telephones used to satisfy their other business objectives.

Moreover, the Hatfield Study is based on the cost reported in the NET study because that was the only cost data available. The undepreciated cost of an indoor coinless phone may serve as a proxy for the appropriate payphone cost, but even that cost may be too high if such phones contain sophisticated electronics for reading data imprinted on calling cards. Even if the excessive payphone cost of $800 were used in the Hatfield Study, the amount of compensation increases from $.083 to $.129 per call.

THE HATFIELD STUDY USES THE APPROPRIATE PAYPHONE COSTS AND, IF ANYTHING, MAY OVERSTATE PAYPHONE COSTS

Some parties argue that the Hatfield Study understates the cost of providing private payphones because it is based on indoor payphone costs. Most private payphones, however, are in airports, hotels and other controlled environments where maintenance costs are minimal. Therefore, the cost of maintaining indoor phones more accurately reflects the true cost incurred by PPOs. It would artificially inflate the cost of providing payphones to include the higher costs of maintaining outdoor phones.

The Hatfield Study correctly excludes the cost of coin collection because access code calls to alternative IXCs are not coin calls.

The Hatfield Study does not include commission payments because such payments reflect monopoly rents paid to premises owners. Cost-based pricing properly excludes these costs.

The Hatfield Study does not adjust costs for inflation. However, the study also does not adjust the NET study results for the productivity increases of five percent per year that the Commission

found appropriate in its recent Price Cap decision. Since inflation has been below five percent, the Hatfield Study would tend to overestimate costs.

In any event, PPO costs for maintenance and capital expense would have to be over nine times the costs reflected in the Hatfield Study to justify a compensation amount of $.25 per call.

THE RATE FOR LOCAL CALLS IS NOT AN APPROPRIATE SURROGATE FOR PAYPHONE COMPENSATION

Some parties argue that because $.25 is the rate for local calls made from payphones, it is an appropriate amount for compensation. The rate for local calls from payphones, however, recovers costs not incurred to provide access to IXCs. For example, this rate recovers the cost of terminating calls locally and IXCs terminate their own calls. Moreover, the New Hampshire data show that payphone charges provide a contribution to other intrastate services. Thus, under a true cost-based pricing approach, compensation in the amount of $.25 per call would be too high. Finally, the $.25 rate is typically a state-wide average that recovers the costs of low usage telephones and telephones in high-cost locations avoided by PPOs.

PAYPHONE COMPENSATION SHOULD BE NO MORE THAN 8.3 CENTS PER CALL

Payphone compensation in excess of cost would result in economic inefficiency. As demonstrated by the Hatfield Study, the total cost of installing and operating a payphone equipped to deliver access code calls is recovered from the revenues attributed to local coin sent paid calls. Thus, any Commission ordered compensation is profit for the payphone provider (PPOs <u>and</u> local exchange carriers, if the Commission extends compensation to them as requested) and a welfare loss for consumers. The magnitude of the potential social welfare loss can be demonstrated by estimating the excess profits that payphone providers would earn if they were able to collect compensation at the rate of $.25 per call. Assuming only five access code calls a day, $700 million in excess profits would go to payphone providers, with a corresponding welfare loss to society.

Moreover, because payphone providers compete with interexchange carriers in the provision of 0+ calls and, further, because they supply bottleneck access to their competitors, compensation above cost not only would provide them with monopoly profits, but also raise the cost of their competitors in the 0+ segment of the long distance market.

Thus, as demonstrated on the record and as supplemented by this letter, the criticism leveled against the Hatfield Study is without merit and that Study remains the best evidence on the record of the true cost of providing access to IXCs from private payphones. Accordingly, the Commission should adopt the findings of the Hatfield Study and impose a compensation amount of no more than 8.3 cents per call.

Sincerely,

Mary J. Sisak

cc: Mary Beth Richards
Mark Nadel
Anna Gomez