

One set of payphone service inputs that has heretofore largely not been supplied on a competitive basis involves local telephone services. Combined with the fact that these inputs are supplied by companies which also compete in supplying payphone services, the supply of local service inputs has been a prime focus for competition policy toward the payphone industry for several years. And this concern has culminated in several of the principal payphone provisions in the new Act, which mandates, *inter alia*, nondiscrimination and nonstructural competitive safeguards to ensure fair competition. We comment on these provisions presently. We remark that, notwithstanding simultaneous provision of local telephone and payphone services by LECs, regulatory policy has heretofore been sufficiently effective that payphone service competition has successfully evolved throughout the country and has become well-established in many states. Further perfection of competitive safeguards as contemplated under the Act should further enhance competition.

Before turning to the specific issues the Commission needs to resolve, let us briefly consider the issue of scale economies as a potential entry barrier. Brief consideration is all that presumably is required for, plainly, the overwhelming evidence of entry and successful market participation by firms operating on very modest scales in the payphone industry thoroughly belies the existence of significant economies of scale in the provision of payphone services. The absence of large economies of scale implies the economic and technical feasibility of entry at small scale. That, in turn, implies that the probability of competitive exchange difficulties on this score is minimal at best. Indeed, the incremental costs of payphone entry are likely to be exceedingly modest given apparent potential economies of *scope* with other economic activities. Other coin-service business operations (*viz.*, *e.g.*, candy or soft-drink dispensing machines) are naturally well-positioned to establish payphone routes. For a restaurant, bar, or other retail business operation with significant traffic (and, hence, potential

economic incentive), the incremental cost of installing a payphone service or privately-owned payphone are obviously quite low given the existence of an ongoing business operation.

C. Synopsis on Entry Conditions and Industry Structure

In the absence of any significant barriers to resource mobility in the payphone sector, it is not surprising that the industry's economic structure has become increasingly competitive in recent years. Some idea of the extent of competitive inroads can be gathered from RBOC data on the number of RBOC and IPP telephone stations that are deployed.¹¹ Note well that this type of count very likely substantially understates the actual economic inroads new competitors have made for two reasons: (1) the IPP count is based on the number of standard coin lines and alternate access lines billed to IPPs, which may significantly understate the actual number of IPP stations because many businesses

¹¹ The station count information is available only on a fairly aggregated basis and, as a consequence, masks a good deal of diversity within the IPP sector in terms of size, scope of operation and business strategy. There are several independent service providers of substantial size operating thousands of phones in multiple states. Some provide a traditional mix of services (*e.g.*, Peoples), while others supply a more limited range of services in high-usage locations. AT&T, for example, locates many of its payphones in airports and large hotels. There are a large number of small independents operating with more regional scope. Many of these are "Ma & Pa" operations consisting of little more than a single-person or single-family vending machine route. There are, in addition, some special-status suppliers like Hertz, the car-rental firm, which provides credit-card operated payphones in many of its rental cars. Finally, there are many "self-provider" payphone operators. This type of operation usually involves a small business (*viz.*, a restaurant or a barbershop) which has purchased a payphone and installed it on the business' premises. The unit gives the firm the benefits of a semi-public telephone (the firm can offer its clients telephone service, but does not have to pay any local usage charges) and can keep the coinbox revenues. Self-provision avoids the cost of coin-collection. Other services (*e.g.*, equipment maintenance and repair) can be acquired through a service contract.

There is an apparent discontinuity between small and large independent operations which may be accounted for by changes in underlying cost structures as an operation evolves from a small organization with only a few workers who know and trust one another, to a larger organization that must become more bureaucratic to cope successfully with monitoring and control issues. Controls over business operations, especially coin collection, may require managerial skills and equipment that create diseconomies of scale over mid-range operations. Only as firms reach a fairly substantial size may they economically rationalize investments in control systems and overcome these diseconomies.

simply attach payphone sets to business lines thereby rendering line count an inaccurate predictor of station count; and (2) the focus is on stations/lines deployed rather than revenues. As in other sectors of the telecommunications industry (*viz.*, long distance, local access), entrants have rationally concentrated their initial entry thrusts where the prospective revenue rewards are potentially greatest. At the same time, the RBOCs have historically placed many of their stations for other than solely economic reasons; for example, often placing stations to meet regulatory requests or perceived public service needs. The result is that station counts understate the amount of business incumbent telephone companies have lost to new independent payphone service providers.¹²

Tables 1 and 2 summarize the station data on an aggregate and regional-company basis. The aggregate data in Table 1 indicate that the independents now account for almost 30 percent of the aggregate Regional Public Telephone/IPP Station count.¹³ Table 1 also indicates that there has been a significant decline in the number of RBOC stations and a marked increase in the number of IPP

¹² Where information on revenues has been collected, it indicates substantially greater market penetration by new competitors. For example, within BellSouth territory (in the nine states of Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina and Tennessee), IPPs have achieved a 49.5-percent revenue market share by focusing on high-revenue stations. *See* BellSouth and Pacific Bell *Exparte*, Payphone Issues in an Evolving Competitive Environment, November 29, 1995.

¹³ For purposes of this calculation, we exclude semi-public payphones, which include sets installed and billed to the customer requesting the service. Under the Act, the term "payphone service" is defined to include, *inter alia*, semi-public pay telephones. While there is no necessary contradiction involved in including semi-public phones along with other payphones for purpose of defining the coverage of various statutory provisions, from an economic perspective there is an important distinction between semi-public phones and other types of payphone service. The former represent the sale of an input with remuneration for the line, while the latter typically involve the sale of service outputs in the form of calls with remuneration for the call services rendered. Semi-public payphone lines actually compete in a relevant market with payphone *sets* which permit small businesses to self-supply payphone service. Note well that a small price increase for payphone telephone calls would not lead *callers* to increase purchases of semi-public payphone lines. On conventional market-definition grounds, payphone service and semi-public payphone lines (which LECs also supply) do not reside in the same relevant economic market.

stations simply during the latter half of 1995. Table 2 presents a regional breakdown of the end-of-year 1995 data. Table 2 indicates that the independents have made significant competitive inroads in all the major regions, and have been particularly successful in the BellSouth, Pacific Bell and US West regions.

Summarizing our analysis of competitive conditions in the payphone industry, it seems to us that it would be extremely difficult to argue that competitive market failures in this industry segment are likely to present a truly significant concern for public policy. This is likely to be even more so the case on a going-forward basis as the industry commences operations on a fully subsidy-free basis and antidiscrimination and non-structural competitive safeguards are implemented.

In an industry operating environment where most relevant factors of production are generally supplied under conditions of effective competition¹⁴ and those which are not are available on the same terms and conditions to all service suppliers (*i.e.*, on a nondiscriminatory basis), and where all operational revenues reflect actual direct sales of services (*i.e.*, are subsidy-free), competitive market processes can be prudently relied upon to answer the traditional economic questions that need to be addressed in any market:

- What services should be produced?
- What inputs should be utilized to produce them?
- How should services be priced and inputs remunerated?

¹⁴ We have made previous reference to special, idiosyncratic circumstances in which particular factors (*viz.*, physical location sites) may be in limited supply.

Table 1
Regional Public Telephone/IPP Station Count*
As of June 30, 1995 and December 31, 1995

	RBOC			IPP/COCOT			Total RBOC and IPP/COCOT	RBOC as a % of Total	IPP/COCOT as a % of Total
	Coin	Coinless	Total	Standard Coin	Alternate Access	Total			
	(1)	(2)	(3) (1)+(2)	(4)	(5)	(6) (4)+(5)	(7) (3)+(6)	(8) (3)+(7)	(9) (6)+(7)
12/31/95	981,443	83,386	1,064,829	4,664	410,060	414,724	1,479,553	71.97%	28.03%
6/30/95	989,831	80,885	1,070,716	4,714	406,213	410,927	1,481,643	72.27%	27.73%

* Data do not include semi-public stations.

Source: Regional Bell Operating Companies.

Table 2
Comparative Regional Public Telephone/IPP Station Count by Region*
As of December 31, 1995

	RBOC			IPP/COCOT					
	Coin	Coinless	Total	Standard Coin	Alternate Access	Total	Total RBOC and IPP/COCOT	RBOC as a % of Total	IPP/COCOT as a % of Total
	(1)	(2)	(3) (1)+(2)	(4)	(5)	(6) (4)+(5)	(7) (3)+(6)	(8) (3)÷(7)	(9) (6)÷(7)
Ameritech	184,586	15,433	200,019	600	46,999	47,599	247,618	80.78%	19.22%
Bell Atlantic	158,862	10,869	169,731	0	58,699	58,699	228,430	74.30	25.70
BellSouth	126,091	12,902	138,993	422	77,905	78,327	217,320	63.96	36.04
Pacific Bell	96,899	12,401	109,300	3,535	63,676	67,211	176,511	61.92	38.08
NYNEX	148,163	8,991	157,154	107	63,709	63,816	220,970	71.12	28.88
Southwestern Bell	150,344	10,418	160,762	0	42,486	42,486	203,248	79.10	20.90
U S West	91,444	9,467	100,911	0	55,140	55,140	156,051	64.67	35.33
Total	956,389	80,481	1,036,870	4,664	408,614	413,278	1,450,148	71.50%	28.50%

* Data do not include semi-public stations.

Source: Regional Bell Operating Companies.

Currently in the payphone industry the answers to these questions are determined in significant part by a variety of government regulations, some of which incontrovertibly have the effect of limiting competition along significant dimensions. Thus, for example, regulation requiring dial-around capability reduces economic compensation and, consequently, the number of payphones that can be economically deployed. Restrictions on the RBOCs' ability to presubscribe their payphones to specific long-distance carriers limit these suppliers' ability to guarantee a long-distance service of good quality and, hence, to compete on the basis of differentiation in terms of service quality. It also limits their ability to compete effectively in the market for physical location sites and, as a result, limits the remuneration that site owners can expect to derive and the choices available to consumers. In each instance, regulatory restraints imposed to achieve particular, sometimes competitively oriented, objectives simultaneously limit competition along other important competitive dimensions.

Instead of having government attempt to optimize tradeoffs among manifold competing objectives, in our view a better strategy would be to allow competition in the marketplace to determine economically optimal tradeoffs. As long as competition is generally workable and effective, the presumption should be that it can do a better job of optimizing complex tradeoffs than well-intentioned, but necessarily somewhat inflexible regulatory arrangements. Thus, as regulation for competition in the payphone industry becomes fully rationalized, the proper course for government policy is to rely increasingly on market-mediated transactions among various input suppliers to set contractual terms and conditions. Competition and competitive regulatory rules should suffice to produce good outcomes in terms of industry performance. By the same token, given effectively competitive operating conditions, inartful intervention could easily have adverse consequences with perverse effects on performance. For example, compensation arrangements set on a rigid, noneconomic basis without reference to the actual economic organization of the business or regard to variations in underlying

economic realities might well entail significant, regulation-induced performance failures in the form of service degradation. Consequently, it is important in establishing arrangements for compensation policy to tread warily and to try to fashion policies that reflect rather than dictate or, worse, distort economic realities.

III. Public Policy Issues and the Principal Provisions of the Act

Heretofore the thrust of our discussion has been that, under a suitable scheme of regulatory governance, the payphone industry may be reasonably expected to operate successfully on a fully competitive basis. The new Act establishes the basic design features of a competitively supportive scheme of regulatory governance and assigns the FCC the primary responsibility for executing Congress' plan. To appreciate the salience of what is specifically contemplated, it is useful to step back to gain perspective on the public policy concerns which inform legislative reform in this area.

Historically, payphone services evolved naturally as integrated adjuncts of LEC network operations. Payphones were originally controlled by a human operator. Then, as improved electronics were developed, it became possible to control payphones using central office switches in place of human operators. This type of control required special programming in the central office switch and utilized electrical signaling techniques that were derived from the old electromechanical control techniques used with human operator-controlled phones. This use of the old signaling technology preserved much of the investment in older-vintage, "dumb" coin phones and associated systems. This allowed for an easy transition away from operator-controlled payphones, at the same time that it minimized the need for investment in new equipment — a technology evolution path that was "regulator-friendly." It did, however, implicitly restrict the types of new services that could be

offered to those which could be synthesized within the constraints imposed by the “dumb” payphone technology.

When legal barriers to competing payphone service provision were removed, new entrants into the payphone business (post terminal equipment registration) pursued a different technology strategy, one born of both convenience and necessity. The new entrants had no sunk investment in old-technology phones and they did not have access to the programming in the central office switch, but advances in microelectronic technology were making it possible to put computing power in the payphone units themselves. As in many other areas of computer and telecommunications technology, intelligence could increasingly be economically distributed at remote locations and no longer necessarily needed to reside at a central location. Moreover, as in other applications (cf. PBXs), the ability to distribute intelligence also meant additional flexibility in the kinds of new services which could be deployed. Thus, new “smart” payphones, which did not depend upon network infrastructure for control, were born. Our expectation is that as the industry evolves, there will likely be convergence, most probably on the smart-set solution, or alternatively, the network-based offerings will have to be significantly enhanced to allow them to compete successfully with the advanced capabilities of smart-set offerings.

The provisions of the Act grow out of two historical legacies, both of which may have made practical sense in the historical context in which they developed, but are problematical in the modern era of competitive payphone telephony. First, the cost of providing payphone service has historically often been recovered in part through charges for other services. Payphones have, at least historically, frequently been conceived as playing a significant role in achieving government’s universal service objective. To maintain the price of payphone service at low levels, part of the cost of the service was

recovered in other service charges. Similarly, part of the cost of payphone service is recovered in common line charges.

The Act formally prohibits a BOC from subsidizing its payphone service with revenues from exchange service or exchange access service. It furthermore instructs the FCC to prescribe regulations that discontinue the intrastate and interstate carrier access charge payphone service elements and payments, as well as all intrastate and interstate payphone subsidies from basic exchange and exchange access revenues.

There are two corollary adjustments which naturally flow from creation of the subsidy-free environment contemplated in the Act. To the extent that costs which were previously recovered in charges for other services or common-line elements are no longer supported in these ways, there need to be compensating adjustments in compensation arrangements (*i.e.*, prices for payphone services must be adjusted upwards) to ensure full cost recovery. At the same time, removal of subsidy support also necessitates a rerationalization of the scope and scheme of public payphone provision. The Act addresses each of these adjustment needs by calling for the FCC to establish a per-call compensation plan to ensure that all payphone service providers are fairly compensated for intrastate and interstate calls using their payphones, and to determine whether public interest payphones should be maintained and, if so, how to ensure their fair and equitable support.

Besides the issue of subsidies, there are also issues growing out of payphone service provision by BOCs on an integrated basis with telephone exchange and exchange access operations. The Act addresses these issues in two ways: (1) it prohibits a BOC from subsidizing its payphone service, or from preferring or discriminating in favor of its payphone service; and (2) it calls for the FCC to prescribe a set of nonstructural safeguards to implement the prohibitions against discrimination and cross-subsidization.

The Act's provisions regarding call compensation and BOC payphone service providers' right to negotiate with location providers to select and contract with carriers that carry interLATA calls from their payphones have significant implications for competition and the manner in which the competitive process operates in consumers' interest. Under terms of the MFJ, BOCs were prevented from offering interLATA long-distance service. As a consequence, their control over the quality and pricing of interLATA long-distance services provided through their payphones has been significantly attenuated. At the same time, competition for custom at particular premise locations by long-distance carriers and payphone service providers has focused largely on the percentage commission paid to the premise owner. Some long-distance carriers have offered high commission payments to premise owners or IPPs and then attempted to offset these high payments with high charges for long-distance service.

In some cases high charges for services at marginal locations might well be warranted and, where competition operates as an effective constraint, there is little reason to expect serious market failure to result from free competition for premise locations. Note, however, that constraints on BOC payphone operations do operate as a restraint on competition (limiting the BOCs' ability to "brand" their services effectively), and the government remedy that was adopted to cope with consumer complaints over long-distance overcharges created problems of its own. "Dial-around" creates a serious "free-rider" problem in economic terms. If non-payers cannot be effectively excluded from use of a service, economic theory predicts a tendency towards systematic underprovision of the service. Actual provision of the service by for-profit enterprises will only reflect their ability to appropriate rewards reflecting consumer valuation of the service they render. But dial-around significantly mitigates payphone service providers' ability to appropriate effectively rewards reflecting true valuation.

As we have remarked, the Act attempts to cope with this service-debilitating difficulty of inadequate compensation for services rendered by requiring fair compensation “for each and every completed intrastate and interstate call.” How the problem of compensation is handled will thus have important implications in terms of the extent to which the Act’s competitive objectives are actually realized.

IV. Public Policy Fixes

A. Nonstructural Safeguards and Asset Transfers

The Act instructs the FCC to issue nonstructural competitive safeguards no less stringent than those adopted in Computer Inquiry III (“CI-III”). The Act does not preclude BOCs from operating their payphone operations as separate subsidiaries, but clearly an important benefit of CI-III safeguards is that they permit BOCs to supply services as an integral part of the telephone company. CI-III safeguards permit the realization of potentially important economies of shared operations (lowering costs and avoiding wasteful duplication of effort) that would otherwise be foregone.¹⁵ Indeed, the Commission adopted nonstructural safeguards precisely on the basis of its recognition that the putative safeguard benefits of full separation were likely to be minimal given the reasonable effectiveness of nonstructural accounting safeguards and not likely worth the sacrifice of productive efficiencies full structural separation would inevitably entail. From an economic standpoint, it obviously makes little sense *to require the sacrifice of efficiencies* associated with shared resource

¹⁵ For a firm contemplating a spin-off or sale of a business unit, full structural separation may supply a convenient organizational arrangement affording transactional convenience. For such a firm, loss of economies of integrated operations is presumably not a decisionally-relevant factor — separation has advantages without offsetting disadvantages. For enterprises contemplating continuing joint operations, separation may pose meaningful disadvantages without any compensating advantages.

use within a business organization as a condition for allowing competition by that enterprise for the presumed purpose of enhancing economic efficiency. CI-III safeguards afford adequate protection without needlessly sacrificing economies from use of shared resources.

From an accounting standpoint, implementation of nonstructural safeguards simply entails a reclassification of some of the firm's assets from regulated accounts to unregulated accounts. Thus, payphone instruments will no longer be classified as part of the basic exchange telecommunications and exchange access services the BOCs are obligated to provide. The specific identity of required accounting adjustments will vary from company to company depending how accounts are currently organized, differences in cost allocation manuals and in allocations themselves, and the specific nature of the particular safeguard regime that any given company chooses to implement.

B. Call Compensation: General Discussion

1. Pitfalls in Establishing Suitable Compensation Arrangements

In a well-functioning, competitive market, consumers are generally able to avail themselves of a wide variety of services at prices that tend to reflect differences in costs of production arising because of product differences, variations in operating conditions, and variations in factor input prices. The market represents a kind of "spontaneous order" which is able to organize and encompass a great complexity and diversity of operations and varying conditions of supply and demand. It is very difficult for even the most well-intentioned regulatory administrative means to replicate the full set of market-mediated transactions in all its richness and complexity. Prudent policymaking will attempt to rely on competitive market processes as much as it can as soon as it can to achieve important public policy objectives.

Where administrative means must be relied upon, the consequences in terms of impacts on public policy objectives need to be carefully weighed. Economic theory predicts two likely conse-

quences resulting from substitution of government rate setting for market-mediated transactions: Government rate setting is likely to have important impacts on both the quantity and quality of the services offered to the public. We consider each impact in turn in the context of payphone services.

The costs of supplying payphone services are likely to vary for a variety of reasons. Costs of production are, for example, likely to vary in different regions of the country and within particular regions largely as a function (although not necessarily as a direct function) of population density. Even within a fairly circumscribed geographic area, the costs of operating a paystation might vary considerably as "wear-and-tear" factors vary. Demands for payphone services and for the use of particular machines are also likely to vary considerably. As we have noted, markets typically will automatically reflect these differences in supply and demand conditions and the prices established through market-mediated exchange will generally vary to reflect these differences.

In a perfectly competitive market, price is established at the *margin* where supply and demand intersect and where the incremental consumer valuation and the incremental cost of production are the same. When marginal costs of production rise with increases in the rate of output (*viz.*, in particular, the number of payphone stations operated per day in a particular relevant geographic market), a market price would reflect the cost of the marginal or most costly phone. If a regulator wished to mimic through the use of administrative means what the market would do, he or she would need to establish a set of compensation rates which accurately reflected the cost/value of the marginal phone in each relevant market. If the regulator were to set compensation on the *average* cost in all markets or in any individual market, and the marginal cost of the marginal phone in any individual market were higher than this average cost, the consequence of setting compensation at this level would be a *contraction* in the number of paystations (voluntarily supplied) in each market to the number of stations consistent with the compensation level established. If compensation were

established at levels in excess of the marginal cost of the marginal phone in a market, the result — given competitive rivalry and the absence of constraints on expansion of the number of phones deployed — would be an increase in the number of phones deployed. The output of phones would grow until the marginal cost of the marginal phone were consistent with the higher level of compensation.

The same type of analysis holds with respect to variations in demand across and within different markets. Recall that the market would set a rate where the marginal valuation and cost were identical. Suppose there are variations in demand (*viz.*, in simple terms, the number of calls per phone) and compensation arrangements are established such that (net of any demand stimulation effects) demand at the margin in a given market is less than the marginal cost of the marginal phone. The consequence will be a decline in the number of phones deployed. Similarly if compensation arrangements are such that (net of any demand-restriction effects) demand at the margin is greater than the marginal cost of the marginal phone, the consequence will be an increase in the number of phones deployed.

The regulator must thus carefully weigh the consequences of decisions with respect to appropriate compensation arrangements. *Given the mobility of resources to enter or exit the market, a prime effect of compensation policy will be on the number of phones that are economically deployed.*

As noted initially, to meet diverse consumer demands, a well-functioning market usually offers a variety of different service qualities at a variety of different prices to reflect differences in the costs of producing different products. Economic theory not only predicts quantity impacts deriving from regulatory decisions about compensation arrangements, but also quality impacts. In particular, economic theory predicts a “collapse” of product quality to levels consistent with the level of

compensation established.¹⁶ The economic logic underlying this prediction is simple: No supplier would voluntarily offer a product or service whose costs exceed the remuneration that can be expected at any given level of compensation. Similarly, no buyer could be reasonably expected to accept a quality of service lower than what the market supplies at any given level of compensation. It is in this sense that quality variations are forced to collapse to the level consistent with the administratively-determined level of compensation. In a freely-functioning competitive market, in contrast, a variety of prices are permitted to be established and price variations permit variations in service quality.

The implications of this latter analysis for payphone service are straightforward: Paystation equipment varies significantly in quality and functionality. Where compensation arrangements can vary to reflect differentiation in terms of service quality, a variety of different qualities of service might be expected. Some phones might offer a very basic service on a very primitive instrument for a low price; others might offer more elaborate service features via more sophisticated equipment at a higher price. There are seemingly innumerable ways in which the quality of payphone service might vary (Is the phone in an enclosure? Is it conveniently located? How frequently is it serviced? Does it offer useful and innovative service features? What is the provider's reputation for fair dealing, value for money, *etc.*). Under market organization or under administrative regulation that comes close to mimicking the market, a wide variety of services meeting a great diversity of consumers demands will be supplied. Administrative regulation that is inflexible and fails to replicate market-mediated transactions will limit diversity and consumer choice.

¹⁶ See, for example, Lawrence J. White, "Quality, Competition and Regulation: Evidence from the Airline Industry" ("One of the important losses from price regulation is the loss of product variety.") and the other essays in Richard E. Caves and Marc J. Roberts, eds., *Regulating the Product: Quality and Variety* (The Brookings Institution/Ballinger: 1975).

This analysis offers important lessons for the FCC as it undertakes to implement the Act's provision calling for fair call compensation to payphone service providers. A sound economic compensation scheme will be one which ensures the maintenance of satisfactory levels of payphone service in terms of station deployment in disparate market settings, and does not foreclose opportunities for beneficial service differentiation to meet diverse consumer needs.

2. A Suggested Approach for Transition to Market Governance

In our view, the best way to solve the matter of suitable call compensation arrangements would be to rely on the market to establish such arrangements. Under a market-based solution, a payphone service provider would deliver calls to a long-distance carrier only if the service provider and the carrier had a contractual agreement specifying the terms and conditions under which the call would be carried. Under TOCSIA, an administrative remedy is required. It may, however, be possible for such an administrative scheme to embody significant features of a market-based solution (*viz.*, rely on like market transactions to estimate suitable compensation, allow free negotiations to set terms that depart from the administratively determined rate(s), *etc.*).

Under the FCC's call compensation plan, it would make economic sense for compensation for credit-card, dial-around and 800 calls to flow from the network operator (who is paid for the service) to the payphone operator (who is otherwise not compensated). It is possible to conceive of alternative arrangements. For example, one could imagine a world where consumers paid a fixed amount to use a payphone regardless of the type of call placed (*viz.*, local, long-distance, 800, *etc.*), and then paid separately any additional charges levied by the network service operator. Such a policy is simple, but it would reduce the benefits of toll-free 800 and 888 numbers since calling these numbers from payphones would require coins or credit cards. A plan under which payphone service providers are compensated by network operators thus appears preferable.

As we have described in detail above, one key element of the public interest involved in establishing suitable compensation arrangements is maintenance of an adequate supply of payphones. The lower the per-call compensation rate is set, the more payphones are likely to become uneconomic and ultimately be withdrawn from the marketplace. Obviously, there is, at the same time, a sufficiently high level of compensation at which IXCs would be unwilling to carry the traffic.

One policy alternative would be to set compensation initially at a level consistent with maintenance of an acceptable level of service, and then afford carriers the freedom:

- (1) to carry calls at the administratively-determined level;
- (2) to refuse to carry calls at the administratively-determined level; or
- (3) to negotiate to carry calls at a mutually agreed-upon level.

This alternative approaches a market-based solution, but has some potential disabilities that need to be addressed. First, if compensation were set too high, some carriers and payphone providers might be unable to reach negotiated agreements quickly and service might suffer. Secondly, if a carrier refuses to carry a call, this may thwart the intent of TOCSIA. In particular, consumers who have been educated to dial-around to access their preferred carrier might find the altered environment confusing. These difficulties could be remedied by adopting a two-step process. The first step would be to set the compensation level sufficiently low (*e.g.*, at the level of *market* transactions today) that one could be quite confident in the industry's ability to function adequately using the administratively-determined compensation level. The FCC could also give the IXCs permission to refuse to carry calls if they felt the per-call compensation was excessive as well as permission to enter into negotiated contracts for compensation. The second step would be to establish an adjustment mechanism which would ensure the reasonability of the compensation rate over time. This approach would approximate a market solution for per-call compensation.

One possible concern with a market solution is that particular premises owners/administrators might be able to exploit consumers who lack good alternatives. It is possible to imagine that some location site suppliers would insist on payments that require the payphone provider to carry calls only at the maximum per-call compensation level and only carriers whose service charges were higher than the charges of most carriers might be able to afford to pay such charges. There are, however, some powerful countervailing market forces at work. First, consumers would be angered by such behavior and their anger could influence the location provider. Second, a large fraction of telephone calls are made to 800 numbers. If the carrier serving a particular 800 number were unwilling to pay the compensation required by the payphone operator, then customers using the payphone would not be able to call 800 numbers served by that carrier. If any of the big three IXCs were unable to reach an agreement with the payphone provider, the service from the payphone would be significantly compromised. Consumers would both complain and use the phone less. Which is simply to observe that the market can be a two-way street.

C. Call Compensation: Specifics

1. Dial-around Compensation

As we have noted, it will be very difficult for the Commission to develop administrative means to set compensation rates in a manner which closely mimics what the market would do in disparate circumstances. Market-mediated outcomes would likely be complex whereas administrative arrangements must of necessity be simpler or risk become unwieldy. Perhaps the most the Commission can expect to accomplish is a compensation regime which approximates in general terms what a freely functioning market would produce and is structured to incent a rapid transition to such a market.

In seeking to establish a suitable set of compensation arrangements, the Commission must take care to avoid establishing rates which fail to compensate fairly or, as we have noted, run the risk

of significant service deterioration. In this regard, we note that while the arrangements it establishes must provide for compensation on each and every call, it is important for the Commission to fathom that payphone costs are, for the most part, *not incurred on a per-call basis*. Some costs are driven by whether a particular call is placed, but costs are, more generally speaking, driven by the number of stations deployed, and costs of station deployment, servicing and maintenance are not primarily affected by whether a particular call is placed.

This industry “fact of life” has an important implication for establishing per-call compensation: Compensation arrangements *must recover more than merely the comparatively small costs incurred when a particular call is placed*. If they fail to do so, consumers will be trying to place calls through bare wire pairs to which payphones *used to be attached* (or *might be attached* given remunerative compensation). By way of analogy, note that at departure the marginal costs of a seat on a less-than-completely-full airplane are comparatively modest (*viz.*, the cost of a meal, an increment of jet fuel to carry a slightly heavier load, *etc.*). Obviously if compensation for air travel were generally set on the basis of such marginal costs, there would be very little air travel. Just as an airline must price its tickets to recover *all* of its costs and, in particular, the costs of its planes, maintenance equipment as well as airport slot and facility rentals (not to mention advertising and administrative overheads), so must a payphone service supplier receive compensation sufficient to cover the costs of its phone equipment, site location rentals and other productive inputs — *regardless of whether these vary according to whether a particular call is placed*.¹⁷ The fact that a rate covers very marginal costs

¹⁷ We note, in this regard, that rents paid for physical location sites are no less costs than payments for other inputs.

does not imply fair compensation by any stretch of the imagination, let alone sound economic principles.¹⁸

Instead of seeking reasonable “cost-based surrogates” for per-call compensation, whose existence is liable to prove illusory, the Commission should focus on “market-based surrogates” and the practical implications of variations in demand and supply in different market segments to establish suitable compensation arrangements. Fortunately, under current operating arrangements there exists a good surrogate for market-based compensation — indeed, it is not even a surrogate, but actually an authentic example of market-based compensation, one that the Commission concludes in its *Notice* constitutes “fair compensation.”¹⁹

In our view, the current compensation arrangements that have been worked out among IPPs/non-BOCs, presubscribed carriers and premise owners not only illustrate how market forces can be relied upon to produce efficacious results (“fair compensation”), but also a reasonable market-

¹⁸ The Commission at footnote 54 of its *Notice* remarks that freely-entered contracts between PPOs or non-BOC LECs and presubscribed IXC's likely recover “the marginal cost of the 0+ calls” and, therefore, there is fair compensation. The Commission cites lack of receipt of “any revenue to cover its marginal cost in originating the call” as raising an issue of fair compensation for dial-around calls. While compensation under freely-entered contracts is likely to recover marginal costs and the absence of compensation for dial-around calls implies failure to recover marginal costs, the fairness or economic efficiency of compensation turns on more than simply whether marginal costs are recovered. Subsidy-free payphone operations must recover all of their costs, not merely those few which vary with the placement of a marginal call. If the Commission mistakenly insists that recovery of marginal costs *of a call* suffices for fair compensation and sets compensation accordingly, a substantial degradation of payphone service is virtually certain. Per-call compensation must obviously recover costs that *do* vary on a per-call basis (*i.e.*, the marginal costs of the call). But the suitability of compensation arrangements turns on the economic viability of paystations as well as individual calls. If the Commission fails to get the economics right, it will almost certainly get the compensation wrong.

¹⁹ In a filing on behalf of the RBOC Payphone Coalition, Arthur Andersen has undertaken an empirical study of contracts between IPPs and IXC's, which can help inform the Commission's efforts to establish a suitable compensation package. *See Affidavit of Carl R. Geppert.*

based proxy that can serve as a starting point (“default rate”) for marketplace negotiations regarding compensation for dial-around calling. The Commission is far more likely to produce an economically sound compensation plan consulting the way in which the market is currently solving the type of problem it has been assigned to solve than by attempting to measure analytically suspect measures of “per-call” costs.

2. Coin Rates

Local and long-distance telephone calls are not the same economic good, and there is no reason to expect that varying basic conditions of supply and demand would produce identical rates for per-call compensation in freely-functioning markets. Indeed, identical rates of compensation would generally constitute a much larger proportion of the price of a local call compared to a long-distance call, and thus a much larger percentage increase in price. Thus, even if the elasticity of demand for long-distance payphone calling were significantly greater than the elasticity of demand for local payphone calling (a premise that is by no means obvious), equal per-call compensation would likely result in a substantial repression of local calling. This would occur simply because of the large percentage magnitude such a price increase would represent.

In his *Separate Statement re the Notice*, the Chairman of the FCC has expressed his reticence to disturb state decisions on local coin rates, reasoning that the impact of a low revenue stream, such as a reduction in the number of general payphones (the Chairman’s economics are good!), is primarily local.²⁰ The Chairman has asked for a demonstration why fair compensation cannot be achieved through the combination of revenues obtained from different services.

²⁰ Similarly, the Commission would presumably not (at least consistently) intercede in matters pertaining to the pricing of monopoly cable services, whose impacts are overwhelmingly local.

One potential reason why fair compensation may not be achievable involves the incentives of states under the new payphone industry arrangements. If states are afforded substantial freedom to regulate coin rates at whatever levels they wish, some state regulators might choose to set rates at very low levels after payphone assets have been removed from the regulated firm's books. State regulators might reason that the Commission would have to or would be likely to make up any shortfalls by increasing per-call compensation. If the number of general payphones *did* decrease, it would not necessarily be easy to determine which particular source of revenue was inadequate — all that would be apparent is the overall inadequacy of support. Certainly payphone service degradation might significantly affect the local population, but visitors (*i.e.*, vacationers, business travelers, *etc.*) would also be affected. Indeed, the latter are perhaps more likely to rely on payphone service to fulfill their communications needs.

There is certainly no need to attempt to recreate the jurisdictional separations process inside each payphone. Given the evolution of increasingly effective competition and the virtual absence of meaningful barriers to expansion of payphone capacity, coin rates can be market-determined. However, as long as coin rates remain regulated, there is some danger that they may be set at less-than-fairly compensatory levels.