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opposition to the application of CSX Corporation to acquire American Commercial Barge Lines, Inc., February 14, 1984 and April 19, 1984.

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Testimony on telephone rate structures before the Colorado Public Utilities Commission for Mountain States Telephone & Telegraph Company, May 27, 1983; the California Public Utilities Commission, for Pacific Telephone & Telegraph Company, August 18, 1983; the Missouri Public Service Commission, September 8, 1983; and Texas Public Service Commission, September 19, 1983, for Southwestern Bell Company.

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Testimony before the Ad Hoc Committee on Utility Diversification, National Association of Regulatory Utility Commissioners, May 6, 1982.

Testimony before Motor Carrier Ratemaking Study Commission, Orlando, Florida, April 2, 1982.

Testimony before the State of Connecticut Department of Public Utility Control on methods of regulating rates for basic television cable service, March 9, 1982.

Testimony before the Committee of Energy and Public Utilities, The General Assembly of the State of Connecticut on regulation of cable television, March 1, 1982.

Testimony before the Public Utilities Commission of the State of California, for Pacific Power & Light Company on methods of allocating aggregate revenue requirements, September 24, 1981.

Verified Statement, Interstate Commerce Commission, Ex Parte No. 347 (Sub-No. 1), "Coal Rate Guidelines-Nationwide," September 1981.

Testimony for the Department of Justice in the U.S. v. Standard Oil Co. (Indiana) et al. Civil Suit 40212, filed July 28, 1964.

(Rev. 12/96)

ATTACHMENT 2

**Reply Affidavit of
J. Gregory Sidak and Daniel F. Spulber**

**USTA Reply Comments
CC Docket No. 96-262
February 14, 1997**

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

In the Matter of)	
)	
Access Charge Reform)	CC Docket No. 96-262
)	
Price Cap Performance Review for Local Exchange Carriers)	CC Docket No. 94-1
)	
Transport Rate Structure and Pricing)	CC Docket No. 91-213
)	
Usage of the Public Switched Network by Information Service and Internet Access Providers)	CC Docket No. 96-263
)	

**REPLY AFFIDAVIT OF
J. GREGORY SIDAK AND DANIEL F. SPULBER**

J. Gregory Sidak and Daniel F. Spulber, being duly sworn, depose and say:

1. Our names are J. Gregory Sidak and Daniel F. Spulber. Sidak is the F. K. Weyerhaeuser Fellow in Law and Economics at the American Enterprise Institute for Public Policy Research and a senior lecturer at the Yale School of Management. Spulber is the Thomas G. Ayers Professor of Energy Resource Management and Professor of Management Strategy at the J. L. Kellogg Graduate School of Management, Northwestern University. A complete description of our professional qualifications appears in the affidavit that we filed on behalf of the United States Telephone Association (USTA) in this proceeding on January 29, 1997.

2. At USTA's request, we evaluate here the initial comments and expert testimony of various companies that (1) oppose a market-based approach to the pricing of interstate access, or (2) dispute the necessity of giving incumbent local exchange carriers the reasonable opportunity to recover their full economic costs of providing interstate access, or (3) assert that the Commission's failure to allow the incumbent LECs the reasonable opportunity for such cost recovery would not violate the Takings Clause

of the Fifth Amendment to the U.S. Constitution. In particular, we respond to the analysis of Professors William J. Baumol, Janusz A. Ordover, and Robert D. Willig, who have filed an affidavit on behalf of AT&T Corporation; the statement of Professor John E. Kwoka, Jr., on behalf of MCI Communications Corporation; and the comments of AT&T, MCI, the Ad Hoc Telecommunications Users Committee, and the Competitive Telecommunications Association.

3. We present this reply affidavit in our individual capacities, and not on behalf of the American Enterprise Institute, the Kellogg Graduate School of Management, or the Yale School of Management.

EXECUTIVE SUMMARY

4. In the thousands of pages of comments filed in this proceeding, the following paragraph contains the most remarkable assessment of the Commission's analysis of markets and competition in the provision of interstate access:

In sum, the Commission has its terminology backwards: The so-called "market-based" approach is not market based because no competitive access "market" yet exists. And the "prescriptive" approach is "market-based" because it represents the only mechanism by which to create genuine competition and insure competitive market-based prices.¹

This argument, advanced by AT&T, can be summarized in the slogan, "Regulation Is Competition." Such a proposition exemplifies what George Orwell, in his novel *1984*, called *doublespeak*.² Markets for interstate access that already exhibit dozens of rivals cannot be redefined as "nonexistent." Regulators do not make demonstrably competitive markets more competitive by regulating them more heavily. Nor, as AT&T urges, can the Commission's commitment to LEC price caps for interstate access be disregarded by euphemistically calling the repudiation of existing caps "reinitialization."³ Nor can the historic costs of providing network infrastructure, or the cost characteristics that inhere to such a network

1. Comments of AT&T Corp. at 7.

2. GEORGE ORWELL, *1984* (Signet Classic 1949).

3. Comments of AT&T Corp. at 22.

on a going-forward basis for the remainder of its useful life, be said not to have been “prudent” or “efficient” when asset-specific investments were made, or not to have resulted from a bargain struck between regulators and the LEC. Nor do the common costs of operating a local exchange network disappear by saying that a LEC is now in the business of selling elements rather than services, and that elements have few if any costs in common with one another. These are all examples of attempts to rewrite history and contort economic logic and terminology to produce results that would turn the sound application of economic principles on its head. They embody the sort of circumlocution and subversion of reason that has come to be described by the adjective *Orwellian*.⁴

5. In this reply affidavit we make four main points. First, a number of significant commenters—including AT&T, MCI, WorldCom, the Florida Public Service Commission, and the Ad Hoc Telecommunications Users Committee—advocate greater regulation of the market for interstate access. Second, those commenters ignore the adverse economic consequences for consumers and incumbent LECs that would result from the Commission’s imposition of TELRIC pricing for interstate access if such pricing were not accompanied by a competitively neutral and nonbypassable charge sufficient to meet the incumbent LEC’s shortfall in its ability to recover its full economic cost of providing service. Third, the opposing commenters do not understand the legal and economic basis for ensuring that the incumbent LEC receives a reasonable opportunity to recover its economic costs, nor do those commenters correctly comprehend what it means for a LEC to have received that reasonable opportunity. Fourth, the opposing commenters superficially toss around dismissive citations to takings cases, never giving the constitutional issues presented by this proceeding the analysis that they demand.

4. See PETER HUBER, *ORWELL’S REVENGE: THE 1984 PALIMPSEST* (Free Press 1994).

**I. TELRIC PRICING OF ACCESS
DOES NOT REFLECT ECONOMIC COSTS**

6. In their efforts to achieve lower interstate access prices for themselves, AT&T and other commenters argue the following:

- examination of access costs should be based on incremental costs of inputs rather than access services (for example, TELRICs rather than TSLRICs)
- the costs of only four important elements used to provide access should be considered, but not the many other relevant elements
- there should not be any share of joint and common costs of the incumbent LEC included in access pricing
- that the cost of the loop should not be included in access pricing
- that the Commission should “reinitialize” price caps at a lower level based on the TELRIC pricing methodology

On numerous grounds, the proposals of AT&T and other commenters rest on fallacious economic reasoning. We examine here the most common fallacies

A. TELRIC Pricing Revisited

7. Professors Baumol, Ordover, and Willig argue that “prices for exchange access elements must be set at forward-looking, long-run, incremental costs.”⁵ They clarify their meaning by stating that access prices will continue to be “distorted,” “unless the Commission embraces the TELRIC standard for access rates.”⁶ By returning to TELRIC pricing, AT&T takes an extreme position that differs from the Commission, which recognizes that prices must include a reasonable share of common costs. The Commission divides costs into incremental cost (TSLRIC or TELRIC) and common costs, and it proposes a definition of “economic cost” that consists of incremental cost plus a share of common cost:

The first condition we propose is that unbundled network elements be available at forward-looking economic cost, i.e., on the basis of the TELRIC of the network element . . . , plus a reasonable allocation of common cost. Unbundled elements provide a

5. Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig 7 ¶ 13, *attached to* Comments of AT&T Corp. [hereinafter Baumol-Ordover-Willig Affidavit].

6. *Id.* at 7 ¶ 14.

ubiquitous substitute for access service.⁷

As we have already pointed out in our earlier affidavit, the problem with TSLRIC- or TELRIC-based pricing generally is that it does not equal economic costs and therefore creates economic inefficiencies. It follows with greater force that simply pricing access at TELRIC, without any recovery of common costs, compounds the problems that we already described.

1. TELRIC Pricing Does Not Reflect the Incumbent LEC's Total Direct Costs

8. The incremental cost of production is of value to the firm when it makes decisions comparing incremental revenue with incremental cost. Because a multiproduct firm has shared costs and common costs, however, TELRIC pricing does not provide a complete picture of the firm's direct costs.

9. Certainly, there are circumstances in which TELRIC pricing equals the firm's economic costs of production. If the firm provides only one service, then the incremental cost and stand-alone cost of the service are equal, and incremental pricing provides an accurate estimate of the firm's costs of production. If the firm provides multiple services, but the services have no shared costs or common costs—that is, there are no economies of scope—then incremental-cost pricing provides an accurate estimate of the costs of production. Those circumstances do not describe the technology and cost of local exchange telecommunications, however.

10. If all of the firm's services were to be sold at their TELRICs, then the firm would not cover its total costs. The difference between a firm's total costs and the sum of that firm's incremental costs is equal to the firm's shared costs and common costs. Thus, under TELRIC pricing the firm would incur losses exactly equal to that remainder—that is, the firm's shared costs and common costs.

11. The firm's shared costs and common costs are precisely its economies of scope, which means that they are the firm's efficiency gains from jointly producing multiple services. To price without regard to those costs is to penalize a firm for its efficiencies

7. Notice ¶ 169.

12. Because TELRIC pricing fails to recover any of the incumbent LEC's shared costs or common costs, it interferes with the incumbent LEC's opportunity to earn a fair rate of return on its investment or even to recover its investment. That outcome violates section 252(d)(3), added to the Communications Act in 1996, which calls for the firm to recover its costs, with pricing that may include a reasonable profit.⁸ TELRIC pricing *guarantees* losses and thus is inherently confiscatory. A policy that required TELRIC pricing would therefore violate section 252(d)(3) and constitute a taking.

13. Some would suggest that the firm subject to TELRIC pricing can make up its losses elsewhere, perhaps from retail sales or from the "next fertile field" that the incumbent LEC may enter in the newly deregulated environment. Although appealing on the surface, such a suggestion requires that earnings from other services be sufficient to cover shared costs and common costs. Such an unfounded belief can easily fail to correspond to market conditions. Competition need not lower margins on those services identified by competitors in their unbundling requests; it is just as likely to do so on the remaining services. Indeed, with TELRIC pricing, competitors are most likely to purchase those services that would have a markup in a competitive market, so as to free-ride on the incumbent LEC. Competitive firms are able to stay in business when they recover common costs and shared costs through revenues above incremental costs. The market-allowed contribution of "other services" cannot be predicted *a priori*. What *is* certain is that a firm that does not cover its common costs and shared costs will not remain in business for very long.

2. TELRIC Pricing Subsidizes Entrants

14. Some proponents of TELRIC pricing may argue that prices set at TELRIC do not involve cross-subsidies, so that TELRIC pricing would rebalance rates. That claim is false. The incremental cost test for cross-subsidization requires that each service, *and each combination of services*, must cover its

8. 47 U.S.C. § 252(d)(3).