

The NPRM's apparent concern over call externalities is misplaced. Call externalities do not impart appreciable differences in market power over originating and terminating access. The reason is that the calling and called parties usually internalize the external benefits. Professor John R. Meyer of Harvard University and his colleagues have commented: "It can be argued that the call-related externalities can easily be internalized since, for instance, the parties to a call are generally either involved in a transaction or engage in reciprocal calling over a given period of time."³⁴

V. PLACING CEILINGS ON ACCESS PRICES TO PREVENT ANTICOMPETITIVE CONDUCT

Paragraphs 47 and 148 of the NPRM invite comment on arguments that access prices significantly above forward-looking economic (*i.e.*, incremental) cost are anticompetitive. These arguments anticipate the entry of incumbent LECs, or their long distance affiliates, into the provision of in-region, interLATA services. As described in the NPRM, these arguments have two parts. The first part asserts that when access charges exceed incremental costs incumbent LECs and their long-distance affiliates have an artificial competitive advantage. This artificial advantage, so the argument goes, stems from the fact that the true cost of access to the incumbent or its affiliate is the incumbent's incremental cost; while the cost of access for interLATA competitors is the price paid to the incumbent.

The second part of this line of argument contends that LECs could conduct a "price squeeze" if they sell both exchange access and in-region, interLATA services. Implicit in this part of the argument is the notion that incumbent LECs have not only the ability but also the incentive to engage in a such a squeeze. The incentive must lie in the profit produced from driving out established interLATA competitors or deterring potential entrants. One variation on the price-squeeze argument rests on a strategy called "raising rivals' costs." Another variation depends on manipulating the relationship between the

³⁴ John R. Meyer, *et. al.*, *The Economics of Competition in the Telecommunications Industry* (Cambridge, MA: Oelgeschlager, Gunn & Hain, 1980), p. 103.

prices charged for retail interLATA services and for the exchange access used to produce retail services.

Both parts of the foregoing argument are seriously defective. The notion that LECs have an inherent competitive advantage when selling both local exchange and access services rests on a common fallacy. It ignores the LECs' opportunity costs of foregone access revenues. Professor F. M. Scherer of Harvard's Kennedy School of Government explains the fallacy in this reasoning as follows:

. . . when a firm sells the same product both externally and to its own internal divisions, the true marginal cost of internal usage is the revenue foregone by not selling additional units to outsiders.³⁵

In terms of the LECs and their future in-region, interLATA operations, for every unit of access they use in their own operations or sell to their long-distance affiliates, they would sacrifice the margins over cost that they could earn by selling access services to their interLATA competitors. As an ingredient of a deliberate anticompetitive strategy, the foregone contribution would produce losses for Pacific Bell that it would have to recoup somehow.

Turning now to the price-squeeze part of the argument, incumbent LECs like Pacific Bell have neither the incentive nor the ability to engage in such anticompetitive tactics. Even if Pacific Bell possessed significant market power, it could not successfully squeeze competitors out of the industry. With no prospect of success, Pacific Bell and other incumbent LECs lack the incentive to attempt a price squeeze. In any event, existing safeguards are sufficient to prevent Pacific Bell from imposing a price squeeze on its future interLATA competitors. Moreover, ignoring the lack of incentive and the presence of safeguards, Pacific Bell could not execute a price squeeze because it lacks the requisite market power.

³⁵ F. M. Scherer, *Industrial Market Structure and Economic Performance*, 2nd. ed. (Chicago: Rand McNally, 1980), p. 305.

of what would occur with a price squeeze. Assume, for purposes of illustration, that the price of access is \$0.07, the cost to Pacific Bell of access is \$0.03, and therefore the contribution from access is \$0.04.³⁶ Assume further that the additional costs of the provision of interLATA toll service, in excess of the fee paid for access, is \$0.02. Therefore, the full cost of providing toll service to an IXC is \$0.07 + \$0.02, or \$0.09. If there are no cost savings from providing toll internally and Pacific Bell is equally efficient in its downstream toll activities, then Pacific Bell has a cost of providing interLATA toll which is also \$0.09.³⁷

In the example above, an anticompetitive price squeeze would require a price for interLATA toll which is less than \$0.09; however, such a price is irrational for Pacific Bell. Consider the level of contribution Pacific Bell obtains if it attempts a price squeezing price of, say, \$0.085 and captures some minutes which otherwise would have been provided through an established IXC. At the price of \$0.085, Pacific Bell's interLATA operations will receive a contribution level of a negative \$0.005 (-\$0.005), while Pacific Bell's exchange access operations continue to receive a contribution of \$0.04. The net contribution to Pacific Bell is $\$0.04 - \$0.005 = \$0.035$. However, if an established IXC had carried the call, the only sale would be the access sale, and the contribution obtained by Pacific Bell would be the \$0.04 obtained in contribution from its exchange access services. Pacific Bell would clearly be better off if it chose some price at or above \$0.09 and takes a chance of attracting some customers and generating some level of contribution above the \$0.04 in contribution from access. For example, a toll price above \$0.09 yields the opportunity for a contribution greater than \$0.04 for Pacific Bell while a price below \$0.09 drives contribution below the \$0.04 level.

In any event, bringing switched access charges closer to economic cost would not guard against anticompetitive price squeezes. As the NPRM seems to realize, an anticompetitive price squeeze arises as the result of the relationship between intermediate

³⁶ For convenience, all amounts are per conversation minute. The numbers chosen are purely hypothetical.

³⁷ Implicitly this assumes that there are not economies of vertical integration, coordination or marketing.

good prices and retail prices. The occurrence of a squeeze is not determined by the price of the intermediate good itself.

Professor Alfred Kahn and Dr. William Taylor have correctly and succinctly summarized the connection between the prospects for efficient competition and the level of access charges. Referring to access charges as "interconnection charges," users of exchange access like AT&T and MCI as "non-integrated rivals" and economic costs as "marginal costs," they reach the following conclusion about the level of interconnection charges:

... the *absolute level* of the charge is irrelevant to the ability of the non-integrated rival to compete with the LEC. That ability depends, rather, on the relationship or margin between the interconnection charge—whether high or low, monopolistic or competitive—and the prices at which the LEC offers the competitive service. This is another way of saying that what efficient competition requires is that the non-integrated rival not be subjected to a vertical squeeze, such as was one basis for the condemnation of the Aluminum Company of America (Alcoa) under the antitrust laws. The source of the squeeze was not the absolute height of the price at which Alcoa sold ingot to competing fabricators of sheet but the margin between its respective prices for ingot and sheet. It was the failure of that margin to cover Alcoa's own fabricating costs that made it impossible for equally efficient independent fabricators to compete. Whether the LEC's interconnection charge to its local competitors may properly exceed marginal costs, and if so by how much, is therefore essentially irrelevant to the preconditions for efficient competition (emphasis in the original; footnotes omitted).³⁸

VI. PRESCRIPTIVE APPROACH TO ACCESS REFORM

A. Estimating the Incremental Costs of Access Services

Section VI of the NPRM observes that AT&T and MCI have submitted computer models purporting to estimate the TSLRIC of retail services and the TELRIC of unbundled network elements.³⁹ Section VI also mentions that the Commission staff is completing an

³⁸ Alfred E. Kahn and William E. Taylor, "The Pricing of Inputs Sold to Competitors: Comment," *The Yale Journal on Regulation*, Vol. 11 (1994), pp. 228-229 (emphasis in the original; footnotes omitted).

³⁹ NPRM, ¶ 220.

analysis of the use of computer models in estimating incremental costs.⁴⁰ In addition, I should note that major LECs including Pacific Bell have sponsored similar models. These models have become known generally as cost proxy models. The proxy models include two versions of the Benchmark Cost Model ("BCM"), two releases of the second version of the Hatfield Model ("HM 2.2") and the Cost Proxy Model ("CPM"). The two versions of the BCM are the BCM1 and BCM2, and the two releases of the HM 2.2 are Release 1 ("HM 2.2.1") and Release 2 ("HM 2.2.2"). Pacific Bell, U S WEST and Sprint have recently sponsored a revised model known as the Benchmark Cost Proxy Model ("BCPM").⁴¹

For estimating costs as a reference for pricing switched access services, the various cost proxy models as they are configured today produce estimates that are inherently inferior to the estimates produced by the standard incremental cost methodology that LECs such as Pacific Bell use. While it is possible for LECs to err in constructing or implementing traditional incremental cost study methods, these traditional methods employ an approach superior to that taken in the cost proxy models. On the other hand, as detailed below, the methodology behind the best of today's cost proxy models, if not the specific results, may be suitable for estimating universal service subsidy requirements or for providing general cost "benchmark" information.

The inferiority of cost proxy model estimates for pricing purposes primarily stems from three sources. First, their various sponsors originally devised the models to estimate the incremental costs of basic local exchange service. The incremental costs of basic local exchange service are highly dependent upon geographic variables, such as customer density and terrain, because they are predominantly made up of local loop costs. Consequently, their sponsors rightly decided to build their models emphasizing the influence of geography and de-emphasizing the influence of other factors. Second, because of de-emphasizing the

⁴⁰ NPRM, ¶ 222.

⁴¹ Response of Pacific Bell, U S WEST and Sprint to the Public Notice of December 12, 1996, CC Dkt. No. 96-45, January 7, 1996.

influence of usage, the cost proxy models contain inadequate information on traffic characteristics so very important to determining the level of switched access costs. Third, the various cost proxy models were initially intended to estimate subsidy requirements independent of the company supplying the service.

The cost proxy models' focus on geographic determinants is inappropriate when estimating the incremental costs of switched access services. Switched access services are subject to significant economies of scale with respect to the volume of usage. As the volume of usage rises, the incremental costs of switched access services decline markedly. This dependency on the volume of usage is so strong that it overwhelms the effect of geographic influences. Hence, the design of the cost proxy models emphasizes cost determinants that have little or no impact on the incremental costs of switched access services.

As a result of the models' design, inadequate information regarding usage is included as an input. Because of the scale economies in switched access, reliable traffic forecasts are critical to estimating the incremental costs of such services. The engineering rules of thumb contained in the cost proxy models are insufficient to the task. Lacking accurate traffic forecasts or a design that realistically incorporates the impact of usage volumes, the cost proxy models are very likely to underestimate the incremental costs of switched access.

It is also extremely important to recognize that the various cost proxy models were originally devised to estimate subsidies, not compensatory prices. Hence, the models attempt to represent the costs of LECs differing greatly in size, using a different mix of technology, and serving vastly different geographic areas. The importance is that the technology choices and facility mixes embodied in the models often do not correspond to the actual choices and mixes of particular LECs. Technology choices and facility mixes have a significant impact on required investment levels, especially for providing customer access. For example, the impact of these choices is reflected in the selection of the crossover point for use of electronic facility provisioning and in the placement costs which the companies incur (e.g., burying cable in some densely populated areas may be

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considerably more costly than placing aerial facilities). When estimating costs for pricing purposes, the economically preferred method is to reflect as closely as possible the actual choices faced by engineers in placing relevant facilities.

In summary, when the objective is obtaining a cost reference for pricing access services, accurate traffic forecasts and company-specific cost information are required, and traditional LEC incremental cost studies should be performed. When obtaining more general cost information about the need for subsidies in particular geographic areas is the objective, proxy models may provide a cost effective way to obtain such information.

B. TSLRIC Pricing Methodology

When discussing its prescriptive approach to access pricing, the NPRM's Section VI seeks comment on rules designed to drive interstate access rates to TSLRIC levels.⁴² I take this request to mean that the Commission wants comment on rules forcing the prices of access services to equal TSLRIC. Promulgating such rules would be an enormous mistake. First, as I have already discussed, incumbent LECs must recover common line costs through access charges, unless the Commission increases the SLC. Second, incumbent LECs must also recover unattributable shared and common costs throughout the full array of their services, including exchange access, unbundled network elements and other interconnection services. Finally, incumbent LECs must recover through access and interconnection charges the costs that they have prudently incurred in fulfilling their public service obligations, including depreciation reserve deficiencies and stranded costs.

Traditional total service long-run incremental cost ("TSLRIC") estimating procedures result in shared and common costs which cannot be attributed to individual services. For LECs like Pacific Bell, the amount of these shared and common costs is very significant. Although total element long-run incremental cost ("TELRIC") methodology may attribute a greater amount of these costs, there is no doubt that there will still be a

⁴² NPRM, ¶ 222.

significant amount of shared and common costs which will not be directly attributable to network elements. The actual amount of unattributable shared and common costs will depend on how network elements are defined.

The greater the efficiencies of sharing facilities and costs, the larger the shared and common costs of the firm, and the greater the need to set prices in excess of TELRIC.⁴³ In other words, such increased efficiencies will reduce incremental costs but increase shared and common costs. However, these shared and common costs must be recovered for a firm to remain in business.

The increased efficiencies from sharing facilities and costs is desirable for the firm and society. However, these costs must be recovered from the services which the firm provides, including intermediate services. Prices for intermediate services no higher than TSLRIC do not allow for the recovery of the shared and common costs which are beneficial to society and are not consistent with the competitive process.

Competition tends to drive prices to a point where all valid business costs are just recovered. Shared and common costs are valid costs of business. When competition drives prices toward costs, these shared and common costs are a component of the costs a provider must recover, even in the most competitive of markets.

In a competitive environment, every product must be allowed to make a sufficient contribution to help recover the shared and common costs of the firm. Many firms strictly offer business-to-business services, i.e., they only offer intermediate products or services to other firms and do not sell to end-users.⁴⁴ Many of these firms may have substantial shared

⁴³ The efficiencies due to sharing facilities and costs in the provision of multiple services are sometimes called economies of scope. This is similar to, but may be distinct from, the concept of economies of scale which reflects cost savings from large scale production of a particular (a single) product or service.

⁴⁴ Catalogs and directories exist for "business-to-business" products and services; many of these products are used as components or inputs to produce products for final consumers. Some of the firms which are largely or completely intermediate-products firms are obvious and well known such as Intel, Boeing, McDonnell-Douglas, U.S. Steel, Alcoa Aluminum, or Peabody Coal. However, many other firms which one might consider as final goods producers, such as Beatrice Foods, Detroit Diesel, Kellogg, Phillip Morris, Proctor & Gamble, or Frito Lay, provide relatively few, if any, products to end users. These firms rely on other firms to actually provide products to end users. Certainly, any firm which only provides intermediate services must recover all of its shared costs from those intermediate services.

and common costs which must be recovered from the prices of the intermediate products or services which they sell to other firms. In general, firms in real markets selling intermediate services have shared and common costs which must be recovered through the prices of the intermediate products or services which they sell to other firms. It is obvious in these instances that providers must obtain a sufficient contribution from each intermediate service or they will be unable to continue in business.

VII. TRANSITION ISSUES

A. Recovery of Embedded Costs

Firms in competitive industries may, at any point in time, price services above, below, or equal to their embedded costs or historical costs. Competitive firms will always price services at or above forward-looking incremental costs, but the degree to which prices exceed incremental costs will be based on market considerations at the time.

Clearly, firms on average must recover their historical costs and earn a normal accounting profit (a zero economic profit). No firm would willingly enter an industry or produce a particular product if it expected that it would not recover its investment. Competitive market forces often cause some firms in an industry to sustain losses and go out of business. At the same time, other firms in the industry may earn above-average accounting profits (positive economic profits). In fact, competitively determined prices cover the full costs of the *least* efficient surviving firm in the industry. This marginal firm will just barely earn a zero economic profit and stay in business in the long run.

"Profit" is by nature a residual concept. It is what is left over after all costs have been paid; it is the margin by which total revenues exceed total costs. On average, firms must expect to earn at least an average accounting profit, or firms will not enter an industry or remain in it. In other words, on average firms must recover their historical costs.

Logically, to take regulatory action which would preclude a firm from recovering its historical costs would seem to require a significant probability that under different circumstances the firm would have been allowed to earn a profit much greater than average. In particular, it would seem that one must carefully consider a regulatory policy which precludes recovery of historical costs, when absent regulation, the firm would have a reasonable opportunity for recovery of such costs.

B. Recovery of Depreciation Reserve Deficiency

Both the harm caused by using prescribed depreciation lives to set rates and the impractical nature of such a practice in a competitive environment can be best understood by examining past practices with respect to depreciation policy. In a monopoly environment with telephone companies subject to rate of return and revenue requirement forms of regulation, such a practice was useful in maintaining low basic exchange rates. For example, think of the prescribed depreciation life as a "time payment plan" for a monopoly telephone company's capital investments. Long time payment plans imply low annual or monthly payments, while short time payment plans involve higher annual and monthly payments. So long as there was no effective competition, and so long as the time payment plans were completed, the revenue requirement process would assure that the local telephone company would receive both a return of and a (prescribed) return on its capital investments. Regulatory accounting practices insured that this would be the case by allowing for depreciation reserve deficiencies.

A depreciation reserve deficiency is represented by the undepreciated portion of an asset at the time that the asset is taken out of service or is no longer useful. If depreciation lives were prescribed to be longer than the useful life of the asset, the undepreciated portion of the asset was left in the rate base. Thus, the regulated books of the local telephone company would consider the reserve deficiency to be a (financial) asset of the company on which earnings would still be allowed in a revenue requirement. This would be true even if the asset were no longer useful or even continued to exist. Indeed, at the time of divestiture AT&T's reserve deficiency was well over \$20 billion. This means that

depreciation lives had been prescribed to be excessively long on average at that point in time.

The problem with continuing this practice today is that it may be both anticompetitive and unsustainable in a competitive environment. The practice is potentially anticompetitive because the local telephone company would be underestimating its costs when using excessive prescribed depreciation lives. By overestimating depreciable lives, and hence underestimating costs, rates may appear to be in excess of costs and yet be anticompetitively low (as compared to prices reflecting economic depreciation lives and economic costs). The practice is unsustainable because competitive marketplaces set prices based on the cost of competitive entry (using current and forward-looking technologies) rather than book costs carried over from incorrect previous depreciation practices. In the end, a firm must survive by receiving positive cash flows which exceed the negative cash flows of the firm. Properly prescribed economic depreciation lives match the expenditure on a capital asset with its opportunity to receive net revenues (revenues in excess of the operating and maintenance expenses associated with the capital item). This compels competitive firms to use economic depreciation lives in setting competitive prices. So should it compel the Commission in this instance.

C. Stranded Cost Recovery

Stranded costs are those costs which incumbent LECs incurred under past regulatory pricing and entry policies, but whose recovery may be precluded from the ensuing competition in the local exchange market. The costs of stranded investments are a result of the franchise monopoly agreement under which Pacific Bell and other incumbent LECs operated for most of their history. In order to keep basic rates inefficiently low, depreciation lives were artificially extended beyond the economic lives of the investments. Furthermore, regulators ensured that the rate of return experienced by Pacific Bell and other incumbent LECs did not exceed near riskless levels. Hence, the return promised to investors was not allowed to be large enough to compensate for the risk of long

depreciation lives. These factors served to maintain low telephone rates and to accomplish public universal service objectives.

However, the introduction of competition into the local exchange market requires that depreciation lives be adjusted to properly reflect economic lives going forward. Also, as explained below, the future cost of capital will increase. These represent very real costs which Pacific Bell will incur with the onset of competition. There is a need to compensate Pacific Bell for its present unrecovered costs.

Failure to allow recovery of stranded costs will increase the risk of investing in incumbent LECs like Pacific Bell for two reasons. First, the credibility of the Commission will be questioned and cause investors to be wary of future commitments made by the Commission. Second, the financial viability of Pacific Bell and other incumbents will be hindered thereby causing investors to demand a higher return in order to invest. This leads to either an unnecessary increase in the cost of capital or a shortage of investment funds available to the incumbent LECs that the Commission regulates.

It is important to note that in the end consumers must absorb any resulting economic inefficiencies. Such inefficiencies will be manifested in higher prices, poor quality of service, and lack of innovation.

It should be recognized that stranded costs are essentially a form of common cost and should be treated as such. Recouping stranded costs can be considered part of the common costs to which the price of access and interconnection services supplied by Pacific Bell to competitors can appropriately contribute or even cover completely.⁴⁵

An economically appropriate means to recover the costs of stranded investments is a markup on the prices of exchange access services and unbundled network elements. In doing so, incumbent LECs operating in both the local and interLATA markets will be charging competitors the same price for intermediate services which they implicitly charge

⁴⁵ Baumol, William J. and J. Gregory Sidak, *Transmission Pricing and Stranded Costs in the Electric Power Industry*, Washington D.C.: The AEI Press, 1995, page 147.

themselves. The primary benefit is that a markup on access services and unbundled network elements is competitively neutral and will promote the competitive process.

VIII. PRICING ACCESS AND UNBUNDLED NETWORK ELEMENTS

Perhaps the most significant issue arising in the NPRM concerns the Commission's prior decision that entrants into the local exchange market need not pay access charges when using unbundled network elements to supply exchange access services.⁴⁶ The NPRM implicitly recognizes that unbundled network elements are substitutes for access services.⁴⁷ Inexplicably, however, the NPRM refuses to acknowledge that charging considerably less for unbundled network elements than for access services will encourage uneconomic entry.

This refusal violates a fundamental economic principle. Where two goods or services are close substitutes, the difference in price between the two should equal the difference in incremental costs. Violating this principle causes buyers to make incorrect decisions in comparing the value that they place on the two goods or services with the opportunity cost to society of the resources used to produce them.⁴⁸

The danger in keeping unbundled network element prices further below access prices than justified by the incremental cost differential is that IXCs will inefficiently substitute unbundled network elements for access. The more the price differential exceeds the cost differential, the more substitution of unbundled network elements for access will occur, and the greater will be the economic harm. This will not only misallocate scarce economic resources but also deprive Pacific Bell and other incumbent LECs of their opportunity to cover shared and common costs and earn a reasonable profit. As a result,

⁴⁶ NPRM, ¶ 54.

⁴⁷ NPRM, ¶ 157.

⁴⁸ William Vickrey, "Current Issues in Transportation" in Neil W. Chamberlain (ed.), *Contemporary Economic Issues*, rev. ed., (Homewood, IL: Irwin, 1973), p. 231.

incumbent LECs such as Pacific Bell will have insufficient earnings to maintain existing facilities, expand capacity for growth and invest in new telecommunications technologies.

IX. CONCLUSION

In conclusion, I cannot emphasize enough the importance of relying on the market forces unleashed by the Act to govern access prices. The Act contains prescriptive measures intended to give competitors open access to the local exchange networks of Pacific Bell and other incumbent LECs. These open access standards are working successfully as evidenced by the number of comprehensive interconnections arrangements Pacific Bell has entered into through voluntary negotiation and mandatory arbitration. The Commission should not make pricing flexibility for access services contingent upon satisfying any additional standards, metrics or tests. All that is necessary for granting access pricing flexibility is recognition that these arrangements are in place and being used.

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January 29, 1997

ATTACHMENT - B

ALJ/MCK/sid

Dawson, Castle, Sawyer, Discher,
Blak, Ruiz, Day (for distribution)
File 90678. 15

Mailed

AUG 07 1996

Decision 96-08-021 August 2, 1996

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Rulemaking on the Commission's)
Own Motion to Govern Open Access)
to Bottleneck Services and)
Establish a Framework for Network)
Architecture Development of)
Dominant Carrier Networks.)

R.93-04-003
(Filed April 7, 1993)

Investigation on the Commission's)
Own Motion into Open Access and)
Network Architecture Development)
of Dominant Carrier Networks.)

I.93-04-002
(Filed April 7, 1993)

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In its April 17 and May 24 reply comments, Pacific has vigorously defended its cost studies, arguing that they were the best that could be prepared under the circumstances:

"Our cost studies were done in a hurry and, while they are of generally high quality, the documentation isn't perfect. Even though they weren't delivered to the parties in a shrink-wrap package with a four-color brochure, they represent quality work conducted by a quality team of cost experts. They comply with the consensus cost principles, and with the mainstream economic literature on long run incremental costing. In terms of the substance of the cost studies, we need make no apology whatsoever." (Pacific's 4/17 Comments, p. 2.)

Allowing for the rhetoric on both sides, we have concluded that Pacific has the better of the argument on this threshold issue. While we are ordering substantial downward adjustments to the cost estimates in Pacific's studies (as indicated below), our own extensive analysis of the studies -- conducted by our staff over a period of four months -- convinces us that Pacific's studies adequately conform to the TSLRIC principles we have adopted and can, therefore, be used as a basis for setting prices. We base this conclusion not only on our own analysis, but on Pacific's willingness during the cost study process to admit error where an error could be demonstrated. In addition to the adjustments we are ordering herein, Pacific has agreed to correct approximately \$235 million of errors.

B. Has Pacific Improperly Characterized as Shared or Common Costs, Expenses That are in Fact Service-Related?

One of the largest generic criticisms the Coalition has made of Pacific's cost studies is that these studies improperly treat expenses that should be considered BNF- or service-related as "shared" or "common" costs, in violation of the costing principles set forth in Appendix C of D.95-12-016. The Coalition argues that Pacific has two incentives to mis-assign expenses in this way.

"The reason that the monthly volume sensitive costs of residential RCF service are higher than the equivalent costs of business RCF is that residential RCF customers call Pacific's business office (i.e., sales and marketing expense) and repair center (i.e., repair expense) much more frequently than do business customers. Frequently these calls are by customers requesting information about the service. . . . In addition, despite the Coalition's assertions that Pacific's TSLRIC studies involve 'expense allocations,' the identifications of the RCF sales and marketing expenses and repair expenses come from the company operating reporting systems." (Id. at para. 53.)

2. Discussion

At heart, the Coalition's attack on Pacific's expense assignment process seems rooted in a gaming theory. The Coalition reasons that if Pacific has an incentive to game (e.g., to understate BNF costs in order to keep price floors low), then it must necessarily have done so. We reject this argument for the reason stated by Pacific in its April 17 reply comments:

"The Coalition's proof of gaming consists of identifying an incentive to game, combined with a result that would be consistent with gaming. In all these cases, however, the cost study result is also consistent with gaming not having occurred." (Reply Comments, p. 9.)

As Pacific has noted, it has some important reasons not to overstate shared and common costs, even though such a step would theoretically make possible lower price floors for its products. Pacific states:

"[M]argins in this industry are such that running up against a price floor is not a serious concern for most services. What is of real concern to us is the uncertainty around whether costs in the shared/common bucket can ever be recovered. By their definition, shared/common services cannot rationally be allocated to any particular service. How to set prices when shared/common costs exist is

the big issue for the hearings this [summer]. Intervenors will argue that no shared/common costs should be included in the prices of their favorite wholesale products." (Id. at 8.)

After examining all of the Coalition's examples of alleged mis-assignment of operating expenses by Pacific, we have concluded that the Coalition overstates the problem, and that most of Pacific's expense assignment decisions appear reasonable. However, we also believe there is a substantial probability that approximately \$145 million in operating expenses have been incorrectly assigned. These expenses are covered by the function codes set forth in the Pacific CRD. As to them, we will order further analysis.

Further analysis is required because we do not believe that Pacific has furnished an adequate justification for its treatment of the expenses represented by these codes as "shared family" costs. With respect to these expenses, Pacific has not demonstrated that the costs would be avoided if the services were not furnished, which -- as the Coalition notes -- is the basic test for a volume-sensitive cost. Moreover, it appears from our own examination of the tracking codes related to these function codes that in some cases, the tracking codes can be assigned to specific services. As to them, Mr. Scholl's argument that tracking codes provide project specificity rather than product specificity does not appear to hold true.

In view of these doubts, we will direct Pacific to review the function codes set forth in the CRD and to submit an advice letter pursuant to General Order (G.O.) 96-A concerning this review within 14 days after the effective date of this order. In addition to the function codes listed in the CRD, Pacific is directed to review all functions codes and loadings related to trouble reporting (i.e., 611 functions). In its advice letter, Pacific should either assign the function codes and loadings directly to services, or document fully why they should not be so assigned.

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Decision 96-10-066 . October 25, 1996

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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Rulemaking on the Commission's Own
Motion into Universal Service and to
Comply with the Mandates of Assembly
Bill 3643.

R.95-01-020
(Filed January 24, 1995)

Investigation on the Commission's
Own Motion into Universal Service
and to Comply with the Mandates of
Assembly Bill 3643.

I.95-01-021
(Filed January 24, 1995)

- (See Appendix F for List of Appearances.)

Universal Services 95-01-020
Dawson, Castle, Sawyer, Discher,
Day, Scarborough (for distribution)
File 91865. 15

b. Discussion

The August 5, 1996 proposed decision suggested that the CPM use the Commission approved depreciation lives established in D.95-11-009. The proposed decision's rationale was that a distinction should be drawn between the provisioning of residential basic service, and the rapid turnover of equipment associated with building a state of the art network for every conceivable telecommunications service. For that reason, an adjustment to the CPM of \$245 million was proposed.

The proposed decision's resolution of this issue generated many comments. The LECs and others argued that the use of longer lives was inconsistent with the CCPs and D.96-08-021, and that the use of longer lives would cause the high cost areas of the state to retain older, less advanced equipment, while the low cost areas would enjoy state of the art equipment. AT&T argued that the incumbent LECs never sought to change the Commission approved depreciation lives, and have failed to submit any evidence to support the shorter depreciation lives. AT&T also argues that the proposed decision correctly noted the distinction between a network designed to supply universal service, and a state of the art telecommunications network.

In deciding that the shorter lives should be adopted for purposes of the OANAD proceeding, the Commission stated that the depreciation lives adopted in D.95-11-009 reflected the previous regulated monopoly environment, and that the longer lives are difficult to justify in an environment of local exchange competition.

We will likewise adopt the CPM's use of shorter lives for depreciation in this proceeding. Such an approach is consistent with what we have done in OANAD, and reflects the forward looking costing principles. It is also consistent with AB 3643's principle that incentives be used "to promote deployment of advanced telecommunications technology to all customer segments."

that they are not presently receiving residential basic service through any other telephone company will be adopted, and CSD and the Telecommunications Division shall convene a workshop to discuss ways in which the self certification process in GO 153 can be adapted for use with the CHCF-B.

70. An adjustment to the CPM estimate to spread the cost of the drop over two pairs instead of one should not be made.

71. An adjustment to the A & B cable cost of \$48 million should be adopted due to Pacific's revision of this cost.

72. An adjustment to the A & B conduit costs should be made in the amount of \$40 million.

73. An adjustment to the feeder and distribution cable sizes should not be adopted.

74. An adjustment to the CPM estimate to extend the cut-off of copper feeder to 12,000 feet should be adopted. This change results in a \$78 million reduction to the estimated subsidy.

75. The proxy cost model should be reasonably consistent with the practices adopted in the OANAD proceeding.

76. The 76% fill factors that were adopted in OANAD for feeder and pair gain should be adopted, and Pacific's distribution fill factors should be used.

77. The adopted fill factor adjustments result in a \$64 million reduction in the estimated subsidy.

78. The economic life depreciation method should be used because it is consistent with: the forward looking cost principles; what we have done in OANAD; and AB 3643.

79. GTEC's switch reordering proposal should not be adopted at this time.

80. GTEC's adjustment to the outside plant factor in the CPM estimate should be adopted.

81. The adoption of the adjustment to the outside plant factor results in an adjustment to the estimated subsidy of \$37 million.

CERTIFICATE OF SERVICE

I, Colin R. Petheram, hereby certify that copies of the foregoing "Comments of Pacific Telesis Group" were served by first class US mail, postage paid, upon the parties on the attached service list this 18th day of February, 1997.



Colin R. Petheram

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