

Bell Atlantic
1300 I Street, NW, Suite 400 West
Washington, DC 20005
202 336-7893
FAX 202 336-7922
E-Mail: marie.t.breslin@bell-atl.com

Marie Breslin
Director -
Government Relations - FCC

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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Mr. James Casserly
Legal Advisor - Commissioner Ness
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

XOCKET FILE COPY ORIGINAL

Re: CC Docket 96-128, Pay Telephone Reclassification and Compensation

As a follow-up to our discussion yesterday, attached are excerpts from the Coalition's reply comments that address the Massachusetts incremental cost study. Also attached is a copy of Bell Atlantic's Opposition to Sprint's request that we be required to make the study public.

Please call me or Michael Kellogg if you wish to discuss this material or have any other questions regarding the payphone remand proceeding.

Sincerely,

Marie Breslin

Attachments

cc: William Caton

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The Commission therefore was entirely correct when it concluded that "a cost-based compensation standard could lead to a reduction in payphones by limiting PSP's recovery of its costs, and this result would be at odds with the legislative purpose of Section 276 [to] 'promote the widespread deployment of payphone services to the benefit of the general public.'" Recon. Order, 11 FCC Rcd at 21267, ¶ 66. Nowhere do the interexchange carriers even attempt to respond to this appropriately-supported record conclusion.

Second, as the Commission also has recognized before, cost-based compensation poses obvious administrative difficulties and could well turn this otherwise competitive industry into a highly regulated one. As the Commission has explained, market-based methodologies "impos[e] minimal regulatory burdens on small new entrants." FCC Br. at 49. In contrast, cost-based methodologies would require industry participants to follow regulatory accounting rules,²¹ and would embroil the entire industry in an unending series of periodic rate recalculations. The Commission therefore was correct to reject the costs of such a methodology as "completely disproportionate to any benefits offered by [the] approach." Second Report and Order, Policies and Rules Concerning Operator Services Access and Pay Telephone Compensation, 7 FCC Rcd 3251, 3256, ¶ 32 (1992) ("Second Report and Order"). Once again, the interexchange carriers respond to these concerns by ignoring them.

1. *Sprint's Bellwether Approach Is Inconsistent with Section 276 and Would Be Harmful to Consumer Welfare*

Rather than address the Commission's reasons for rejecting a regulatory costing approach, Sprint attempts to resurrect the methodology by dressing it in competitive clothing. In particular,

²¹ Recon. Order, 11 FCC Rcd, at 21266, ¶ 66 ("it would be particularly burdensome to impose a TELRIC-like costing standard" -- or any cost-based standard -- "on independent [PSPs] who have not had previous experience with any costing systems"); Second Report and Order, 7 FCC Rcd at 3255-56, ¶ 32 (similar conclusion).

Sprint promotes a "bellwether" approach under which "the default rate [w]ould be based on the costs of handling non-coin calls by an efficient payphone provider." Sprint Comments at 6; see generally Sprint Comments at 6-8. Based on this theory, Sprint urges the Commission to set per-call compensation based on the per-call cost calculated in a single cost study performed by New England Telephone ("NET") for the Commonwealth of Massachusetts. Id. at 8-11.

The argument is flawed from its fringes to its core. For one thing, Sprint plucks its chosen result from the study without even bothering to explain the methodology employed. The reason for this is clear. Because of state regulatory rules, NET was required to submit an incremental cost study, which by definition omits large fixed, joint and common costs which otherwise should be included. See Andersen Remand Reply Report at 2-3. It is thus flatly wrong to assert that the study examined "total costs," AT&T Comments at 12 (emphasis in original), or to claim that NET had an incentive to include "every conceivable" cost in its study, id. at 12-13; see Sprint Comments at 9. State requirements mandated that NET exclude non-incremental costs that, for per-call compensation purposes, should be included.

Indeed, relying on the NET incremental cost study is particularly inappropriate, as the Commission has expressly rejected such a methodology for per-call compensation purposes. As the Commission explained, it is wholly inappropriate to rely on a methodology -- like that used in the Massachusetts incremental cost study -- "under which a carrier is compensated only for the incremental cost of providing each service individually without a reasonable allocation of common costs." Recon. Order, 11 FCC Rcd at 21268, ¶ 69 (emphasis added); see Report and Order, 11 FCC Rcd at 20576, ¶ 68 ("We conclude that use of a purely incremental cost standard for all calls could leave PSPs without fair compensation for certain types of payphone calls.").

Such an approach "would not allow the carrier to recover the total costs of providing all of the services." Recon. Order, 11 FCC Rcd at 21268, ¶ 69.

Even if reliance on incremental cost were permissible -- and it surely is not -- Sprint nowhere explains why an estimate of the incremental costs of providing service in Massachusetts should be used to determine compensation for PSPs that operate in rural West Virginia or Nebraska, where costs are higher and call volumes are lower. The statute requires the Commission to ensure that all PSPs are "fairly compensated" for "each and every call" made using their payphones. See 47 U.S.C. § 276(b)(1)(A). Nowhere does it state that the Commission can fulfill this obligation by offering compensation that is probably not adequate even in Massachusetts as the rate for PSPs located in higher cost, lower volume areas throughout the nation.

Indeed, because regional cost differences can be extreme, relying on cost estimates for a single state is singularly inappropriate. For example, compared to Massachusetts, nearby Vermont exhibits vastly higher per-call costs. Vermont line charges are *over double* those in Massachusetts, while Vermont call volumes are lower. Andersen Remand Reply Report at 3-4. Indeed, higher line charges than those borne by Massachusetts PSPs are common throughout the country; the average charge in BellSouth's region is 75 percent higher than the Massachusetts rate. Id.

Similarly, many regions exhibit lower call volumes, which also tends to increase per-call costs. Again, an examination of PSP costs in New England states alone proves this. Payphones located in New Hampshire carry only 70 percent of the average call volume of payphones in Massachusetts, and payphones located in nearby Maine and neighboring Rhode Island respectively average only 53 percent and 61 percent of the volumes in Massachusetts. Id. at 3-4.

As a result, if Sprint had selected nearby Maine rather than Massachusetts as its "bellwether," the resulting cost per-call would have more than doubled.

The results of the Massachusetts incremental cost study thus are wholly unrepresentative of national costs. Among Coalition members, the average cost per call ranges up to \$.34 for all calls, and is in the range of \$.30 per call on average. Andersen Remand Report at 13 n.14; 1996 Andersen Report at 10. Independent PSPs have submitted average cost figures of \$.45 per call. See Coalition Remand Comments at 27 & n.14. Not one Coalition member reported regionwide costs as low as those reported by the Massachusetts incremental cost study. Andersen Remand Reply Report at 4.

Consequently, using the Massachusetts incremental cost study as a "bellwether" to set per-call compensation rates would produce insufficient compensation and trigger widespread removal of payphones, especially in rural areas with higher costs and lower volumes. This may be consistent with Sprint's interests, but it is not consistent with the public's interest or Congress's express command. To the contrary, it would directly conflict with the Commission's obligation to "promote widespread deployment" of payphones. 47 U.S.C. § 276(b)(1)(A).

It was precisely because of these considerations that the Commission decided to avoid reliance on a cost-based model and rely on market-based proxies instead. As the Commission explained, "a cost-based compensation standard could lead to a reduction in payphones by limiting a PSP's recovery of its costs, and this result would be at odds with the legislative purpose of Section 276 [to] 'promote the widespread deployment of payphone services to the benefit of the general public.'" Recon. Order, 11 FCC Rcd at 21267, ¶ 66. Instead, the Commission selected a "market-based approach" that would accommodate the "likely cost variations" from region to region and "payphone to payphone." Id. at 21268-69, ¶ 71. Sprint's

attempt to saddle the entire nation with cost recovery that would not even be sufficient in Massachusetts only underscores the wisdom of the Commission's choice.

2. *The Commission Appropriately Rejected Marginal and Incremental Cost Models as Inconsistent with Section 276 and Basic Economics*

Many of the carriers argue that marginal or incremental costs should be the basis for determining per-call compensation. See, e.g., LCI Comments at 5-6; CompTel Comments at 12; C&W Comments at 7. Under their theory, access code and subscriber 800 costs should not bear any of the joint and common costs associated with the payphone. For example, CompTel boldly asserts that "the existence of a payphone can be regarded as a given for the purposes of determining per-call compensation." CompTel Comments at 12. Likewise, Sprint argues that the Commission should prescribe a per-call compensation amount of zero, contending that the only costs created by dial-around and subscriber 800 calls are the "de minimis per-call costs of the additional wear and tear on the handset and the keypad." Sprint Comments at 4; see also LCI Comments at 6; CompTel Comments at 13.

The Commission, however, already has flatly rejected this approach. Recon. Order, 11 FCC Rcd at 21268, ¶ 70 ("a compensation rate of \$0 would not be in accord with our responsibility under the statute to ensure fair compensation for all payphone calls."); id. at 21268, ¶ 69 (rejecting incremental cost approach); Report and Order, 11 FCC Rcd at 20576, ¶ 68 (same). And the Commission's rationale was indisputable. Because a marginal cost approach does not allow PSPs to recover the joint and common costs which constitute a majority of all payphone costs, Recon. Order, 11 FCC Rcd at 21268, ¶ 69, it would give interexchange carriers a free ride at the expense of PSPs. It was precisely to end this free ride, and to replace no compensation with "fair compensation," that Section 276 was enacted.

Moreover, since a marginal cost approach does not allow for the recovery of joint and common costs, adopting such an approach would result in the removal of thousands of payphones. Indeed, as one of the interexchange carrier's own expert has explained, reliance on marginal cost in an industry with high fixed costs is not a recipe for fair compensation. It is instead a "recipe for bankruptcy." Strategic Policy Research, Critique of Hatfield Cost Analysis at 3 (attached to the 1996 Reply Comments of BellSouth (FCC July 15, 1996) (quoting Professor Baumol)) ("SPR Reply"); see also Comments of the APCC at 11 (FCC July 1, 1996) ("APCC 1996 Comments").²²

3. *The Commission Correctly Rejected TSLRIC and Similar Methodologies*

Several commenters advocate the use of TSLRIC, WorldCom Comments at 4; Comments of the Telecommunications Resellers Association at 18-19, or similar measures of "forward-looking, direct costs," LCI Comments at 7; CompTel Comments at 13 (same). But the Commission already rejected those models and -- despite vigorous appeals²³ -- the Court of Appeals has not disturbed the Commission's conclusions.

²² Sprint and MCI also argue, as they did before, that the Commission calculated PSP costs at \$.11 in 1992. See Sprint Comments at 10 & n.10; MCI Comments at 3. But the Notice of Proposed Rulemaking they rely on expressly states that the calculation that produced the figure was only an "example" and declares that the Commission was "not proposing" the figure as an appropriate rate. Report and Order and Further Notice of Proposed Rulemaking, Policies and Rules Concerning Operator Service Access and Pay Telephone Compensation, 6 FCC Rcd 4736, 4747-48, ¶ 44. Indeed, the Commission ultimately chose a rate in the range of \$.40 per call instead. See Second Report and Order, 7 FCC Rcd at 3257 ¶ 40. Nowhere do Sprint and MCI explain why the Commission's "example," which was rejected in 1992 in favor of a \$.40 rate, should suddenly be considered an accurate estimate of costs in 1997.

²³ Joint Brief of IXCs at 30 (contending that the FCC's "decision to treat deregulated rates as surrogates for costs" was flawed); id. at 36 ("the FCC's reasoning in rejecting TSLRIC is unsupported by the record, contrary to the FCC's other determinations, and thus arbitrary and capricious").

Indeed, the Commission's decision to reject these approaches was not only well-supported in the record, but undeniably correct. See, e.g., Recon. Order, 11 FCC Rcd at 21266-68, ¶¶ 66-69. As explained above, each of these cost-based approaches must rely on industry-wide averages and, as a result, simply cannot account for variations in costs and volumes from payphone to payphone and region to region. See id. at 21267, ¶ 66, 21268, ¶ 71; pp. 18-19, supra. Moreover, focusing on costs would mean a giant step backwards for this industry, which would be transformed from a highly rivalrous industry with multiple competing participants into an industry full of rate-regulated utilities. Recon. Order., 11 FCC Rcd at 21266, ¶ 66; p. 19, supra. It also would be a step backwards for the Commission, embroiling it in endless and complicated regulatory rate proceedings. See p. 19, supra. Even, before that process begins, the Commission will have to resolve disputes over the relevant model to define cost recovery. And, as the cost studies submitted by the participants in this proceeding demonstrate, there are as many ways of calculating costs as there are grains of sand on the beach.

In addition, to the extent these models -- like a pure marginal and incremental cost approach -- ignore joint and common costs associated with the provision of payphone service, they would be both inappropriate and unwise. As the Commission previously recognized, "a TSLRIC standard under which a carrier is compensated only for the incremental cost of each service individually without a reasonable allocation of common costs . . . would not allow the carrier to recover the total costs of providing all of the services." Recon. Order, 11 FCC Rcd at 21268, ¶ 69. As a result, they would neither provide "fair" compensation for each and every

payphone call nor "promote the widespread deployment of payphone services." See *id.* at 21267, 21268, ¶¶ 66, 69.²⁴

D. The Carriers' Cost Estimates Are Fatally Flawed

Consistent with their attempts to minimize per-call compensation through the use of inappropriate methodologies, various carriers have put into the record distorted cost estimates in order to "prove" that subscriber 800 and access code calls cost very little to originate. Neither these estimates nor the methodologies used to derive them have any validity.

1. *Reliance on the New England Telephone Cost Study Is Inappropriate*

Seizing on the results of the same incremental cost study Sprint relied upon for its fatally flawed "bellwether" approach, several commenters argue that the cost of originating calls is less than \$.16 or \$.17 per call. See ITA Comments at 6; Sprint Comments at 8-11; AT&T Comments at 12. But, as explained above, it is wholly inappropriate to rely on the results of this single Massachusetts incremental cost study to set a default rate for the entire nation. See pp. 21-23, *supra*. Indeed, as Arthur Andersen explains, far from being representative of costs, the results of

²⁴ Without addressing this analysis, or any other, some carriers assert that a TELRIC methodology would be best. But the Commission gave a particularly detailed set of reasons for rejecting the TELRIC methodology. In addition to the above reasons, the Commission explained that TELRIC was designed to "enable competitors to take advantage of an incumbent monopolist's 'economies of scale, scope, and density, and thus rapidly to acquire potentially bottleneck elements that they cannot promptly supply themselves.'" FCC Br. at 50 (quoting *Recon. Order*, 11 FCC Rcd at 21267, ¶ 67). Unlike local exchange facilities, payphones cannot even conceivably be construed as bottlenecks, and there are no significant economies of scope or scale. *Recon. Order*, 11 FCC Rcd at 21267, ¶ 67. Moreover, TELRIC can only be applied efficiently where there are few joint and common costs. For dial-around, subscriber 800, and all other payphone calls, however, almost all costs are joint and common. *Ibid.* This renders TELRIC particularly difficult and inappropriate to use for payphones. *Ibid.* Because these carriers offer nothing to controvert those conclusions or findings, there is no record (or any other) basis for reconsidering rejection of the TELRIC methodology.

that study are lower than the regional results for any Coalition member, and unrepresentative of even states in the New England region. Id.; Andersen Remand Reply Report at 3-4.

Moreover, the study does not even reflect the full costs for *Massachusetts*. As also explained above (see pp. 19-21, supra), the study does not look at "total costs" as AT&T asserts (at 12-13), but rather looks only at incremental costs, i.e., the cost of meeting an additional increment of demand. It thus omits significant fixed, joint, and common costs. See p. 20, supra. The Commission already has indicated that, for per-call compensation purposes, relying on incremental costs alone is wholly inappropriate and understates the compensation to which PSPs are "fairly" entitled. Ibid. (citing and quoting Recon. Order, 11 FCC Rcd at 21268, ¶ 69 and Report and Order, 11 FCC Rcd at 20576, ¶ 68).

2. *AT&T's Cost Study Offers a Wholly Unrealistic Estimate of Total Costs*

Advancing what purports to be a direct cost methodology, AT&T argues that per-call costs are as small as \$.11 per call. But AT&T's "study" -- which does not show AT&T's actual costs per call as a PSP but rather at the costs of a hypothetical PSP -- is riddled with flaws. Indeed, the errors are so numerous that these Comments discuss only a select few; Arthur Andersen addresses the remainder in its Remand Reply Report (at 4-10).

The Costs of Providing A Payphone. AT&T begins by seriously underestimating the costs of providing a payphone. For example, AT&T assumes that a \$225 phone that it has used on occasion could be employed to provide coinless calls. See Robinson Affidavit at ¶¶ 5, 9, 20 (attached to Comments of AT&T). But of AT&T's 29,000 payphones, only 5,500 -- a small fraction -- are of the type AT&T uses for its "study." See Andersen Remand Reply Report at 5-6.

DPU requires that public utilities seeking rate increases submit incremental cost studies.³ Indeed, in case after case, and for service after service, the Massachusetts DPU has required Bell Atlantic to submit incremental cost studies.⁴ And that is precisely the type of study Bell Atlantic submitted there.⁵

A. Sprint Should Not Be Allowed To Avoid the DPU Protective Agreement by an Appeal to the Commission.

Sprint's motion is a collateral attack on the DPU's procedures. As Sprint concedes, it was the DPU that placed Bell Atlantic's study under seal. And it was pursuant to the DPU's procedures that parties reviewing the submission are barred from using it in any proceeding other than the one in Massachusetts.⁶ If Sprint believes that the seal on the study should be broken and that the study should be used for proceedings other than the one for which it was prepared, then Sprint should address that request to the Massachusetts DPU. It should not ask this Commission to over-ride that state agency's confidentiality procedures (and undermine the confidentiality that the DPU guaranteed Bell Atlantic) without so much as petitioning the state agency for relief first.

Sprint nowhere in its motion addresses the effect that unsealing that study, and using it in this proceeding, would have on the substantive policies which caused the DPU to put the study

³ *Investigation into IntraLATA and Local Exchange Competition in Massachusetts*, DPU 94-185-A, at 6 (March 31, 1997) ("March 31, 1997, DPU Order").

⁴ *See id.* at 9; *Petition for New England Telephone and Telegraph Company d/b/a NYNEX for an Alternative Regulatory Plan for the Company's Massachusetts Intrastate Telecommunications Services*, DPU 94-50, at 205-206 (1995); *Investigation into IntraLATA and Local Exchange Competition in Massachusetts*, DPU 94-185, at 15-16 (Aug. 29, 1996) ("Aug. 29, DPU Order").

⁵ Reply Comments of the RBOC/GTE/SNET Coalition at 20 (Sept. 9, 1997); Reply Report of Arthur Andersen at 2-3 (attached to Coalition Reply Comments).

⁶ Sprint Motion at 1-2 (study confidential and could be obtained "only by agreeing to restrict its use to that DPU proceeding").

It is indisputable that Massachusetts required Bell Atlantic to submit an incremental cost study. In no uncertain terms, the Massachusetts DPU has stated that “it is appropriate to use *LRIC [long-run incremental cost] as a basis for determining the prices and price floors for NYNEX’s competitive services.*”⁸ As a matter of firm policy, the DPU requires incremental cost studies when examining rates for competitive and so-called “monopoly” or “essential” services alike.⁹ This cannot be a surprise to Sprint, which is a regular participant in Massachusetts DPU proceedings.

Because the Massachusetts cost study looks only to incremental costs, it is irrelevant to this case. The Commission has rejected any measure of compensation based on incremental costs. As the Commission explained, and explained repeatedly, it is inappropriate to rely on a methodology — like that used in the Massachusetts incremental cost study — “under which a

⁸ March 31, 1997, DPU Order, at 6 (emphasis added); *see id.* at 9 (“*LRIC [long-run incremental cost] is the appropriate basis for determining prices . . . for NYNEX’s [competitive] services*”).

⁹ *See id.* at 9 (“*In Local Competition, we found that TSLRIC was the appropriate methodology to use to determine prices for NYNEX’s monopoly/essential services, for computing price floors for monopoly services, and for measuring subsidies, and that LRIC was the appropriate methodology to use to determine prices and price floors for non-essential services*”); *Petition for New England Telephone and Telegraph Company d/b/a NYNEX for an Alternative Regulatory Plan for the Company’s Massachusetts Intrastate Telecommunications Services*, DPU 94-50, at 205-206 (1995) (“*For those services where NYNEX controls an essential input for a competitor’s offering of a competing service, in order to prevent anti-competitive pricing, the proper price floor for NYNEX’s own rate element shall consist of the relevant wholesale rate that at least one competitor pays to NYNEX in order to offer the service, and NYNEX’s marginal cost of related overhead. For all other services, in order to prevent cross-subsidization, the proper price floor shall be the marginal cost . . .*”); Aug. 29, 1996 DPU Order at 14 (“*[T]otal service long-run incremental cost [TSLRIC] is appropriate to use as a basis for determining the prices of NYNEX’s monopoly/essential services . . .*”).

C. A Firm's Costs Are Competitively Sensitive Information and Should Not Be Disclosed to the Firm's Competitors.

The Massachusetts DPU protects the cost study for good reason — few pieces of information are as competitively sensitive as a firm's costs. For example, this study contains a break-down of Bell Atlantic's investment in its payphone business in Massachusetts, as well as details of its operating expenses, including commissions paid to premises owners. Courts and regulatory agencies recognize the highly proprietary nature of such information and do not release one firm's cost data to its competitors. Sprint has suggested no reason why the DPU's procedure is wrong in this case or why the information in the Massachusetts study is not of the sort that should be kept confidential.¹³

2. IF THE COMMISSION REQUIRES BELL ATLANTIC TO PRODUCE ITS DATA, IT SHOULD REQUIRE AT&T AND SPRINT TO DO LIKEWISE.

If the Commission were to consider compelling the production of the Massachusetts cost study, then it should also require AT&T and Sprint to submit their actual costs and call volumes for inspection and review by the parties. Although both those carriers offered scattered bits of "data" concerning their costs in running their payphone businesses, neither submitted any complete studies, and both intentionally distorted the results. AT&T, for example, used an average cost per phone of \$225, even though the vast majority of its phones cost many times that amount. Indeed, AT&T excluded not only the costs of its most expensive payphones (its extremely fancy and undoubtedly very expensive Phonetel 2000), but also all its overhead and administrative expenses. Moreover, AT&T further depressed its per-call cost estimates by

¹³ If the Commission were to require production in this proceeding, it should also be under a protective agreement.

CERTIFICATE OF SERVICE

I, Mary Liz Hepburn hereby certify that on this 26th day of September, 1997, a copy of the foregoing Bell Atlantic "Opposition to Sprint's Motion to Require Production of a Confidential Cost Study and Conditional Cross-Motion for Production of Payphone Cost Data from Sprint and AT&T" in CC Docket No. 96-128 was served on the party listed below by first class U.S. mail, postage prepaid.


Mary Liz Hepburn

Mr. H Richard Juhnke
Sprint Corporation
1850 M Street, NW
11th Floor
Washington, DC 20036