estimate demand elasticities, the Commission declined to take account of differences in price elasticities.[1]

4. None of the Commission's criticisms undermines the conclusions I reached. First, contrary to the Commission's suggestion (¶ 66), customers who make access code calls would be expected to display less price sensitivity than average toll customers since these customers are likely to have higher income and to be more frequent business travelers than the average toll customer. Both factors would lead to decreased price sensitivity. For this reason, the use of overall toll elasticity was conservative.

5. But even assuming that demand for access code calls is more price sensitive than demand for toll calling generally, the Commission improperly disregarded my analysis. This conclusion follows because the Commission failed to realize that even if the demand elasticity is far higher than I estimated, the dial-around and subscriber 800 price set by competition would continue to exceed the competitively determined coin rate. Using the elasticity I estimated for coin calls of -0.663 (¶ 20), I now demonstrate that if one increased the estimated demand elasticity from -0.723 (First Decl. ¶ 21) to -1.24, the dial-around and subscriber 800 rate would still exceed or equal the coin call rate.[2]

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1. The long distance price elasticities that I used are well-documented in the literature and are almost always used by economists in doing economic analysis of long distance markets. A recent paper in the literature is W. Taylor and L. Taylor, "Post-Divestiture Long-Distance Competition in the United States", American Economic Review, 83, 1993; and a recent textbook is L. Taylor, Telecommunications Demand in Theory and Practice, 1994, ch. 6. In a recent book R. Crandall and L. Waverman, Talk Is Cheap, 1995, p. 162, state, "The Consensus estimate of the market elasticity of demand for long-distance service is about -0.7." Note that this value is approximately the demand elasticity I used in my first declaration. An interesting econometric fact is that the estimated long distance price elasticity has not changed by a significant amount in the last 20 years despite a significant decline in long distance prices: this indicates a constant elasticity demand curve, a conclusion with which Crandall and Waverman agree. Id. p. 161, fn. 68).

2. In a recent draft report the "E Group" has estimated an elasticity of demand for payphones (not for coin calls) of -0.31 ("Economic effects of Excessive Compensation Rates to Pay Telephone Providers," pp. 9-10). This elasticity is not directly comparable to my estimated elasticity of coin calls

6. The calculation is done as follows: in ¶ 29 of my first declaration I found the marginal cost of a local coin call to be $0.04 and the marginal cost for dial-around and subscriber 800 calls to be $0.05. I now use the elasticity for coin calls of -0.663 to solve for the derived demand elasticity for dial-around and subscriber 800 calls that would lead to competitive per-call compensation of $0.35 after applying the markup over marginal cost. This elasticity is -0.685. I take the ratio of this elasticity to the weighted average elasticity of -0.398 that I calculated in ¶ 27 of my first declaration and find out how much the long distance elasticity could increase above the -0.723 I used in the first declaration and still find a dial-around and subscriber 800 rate of $0.35. The result of this calculation is a value of -1.24 or an increase of 71.5% (in magnitude) over the value of -0.723 that I used in the first declaration. Thus, so long as the long distance elasticity is smaller (in magnitude) than -1.24, the dial-around and subscriber 800 rate would exceed the coin call price. If the long distance elasticity were -1.24 the regulated rate would equal the competitively determined coin call price.

7. It is virtually impossible that the appropriate market long distance price elasticity is as high as -1.24, because a value this large would imply that price was being set by an unregulated monopolist in long distance markets.[3] Thus, for any credible value of the long distance

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which is the relevant parameter. Furthermore, the estimate of -0.31 is biased towards zero (i.e., it is too small in magnitude) because the authors do not take account of the well known simultaneous equation problem which must be taken into account when estimating demand curves. This problem has been known since the 1940's when it was discovered by T. Haavelmo, who received the Nobel Prize in economics for his discovery.

3. The decision also states that the data I used "probably overstate[]" the current average price for an access code call. Second Report and Order ¶ 66. Although the Commission bases this conclusion on no data, I can lower the price of the dial-around calls by a significant amount and still reach the same conclusion. Instead of using $2.16 for the average price of a dial-around long distance call as I did in ¶ 24 of my first declaration, I will assume that the average price is 20% lower, $1.73. Under this assumption the minimum value of the demand elasticity decreases (in magnitude) from -1.24 to -1.21. The reason this very small change occurs is that dial around calls are only 1/3 of the blended rate (as I explained in ¶ 27 of my first declaration).

elasticity used in the calculation, even for an increase of 50% over the value I used, the finding would continue to be that the dial-around and subscriber 800 rate would exceed the competitive coin call rate of $0.35 per call. The Commission's disagreement with my elasticity estimate for long distance thus fails to justify its finding that the regulated rate should be less than $0.35. A pricing formula that takes demand elasticities into account is the efficient economic method for rate-setting and is commonly used by firms in competitive markets when joint and common costs are significant.[4]

8. This calculation demonstrates the risks of imposing too low a regulated default rate for dial-around and subscriber 800 calls. If the regulated rate is set below the price that would be established in a competitive market, a less than efficient supply of payphones will result since marginal payphones will be removed.[5] The Commission recognized this possibility, but mistakenly claimed that an IXC might agree to a higher compensation rate than the default rate. Second Report and Order ¶ 28. If only a single IXC existed, then the Commission could be correct that the single IXC would negotiate a higher rate to assure placement of the payphone since the IXC would earn a profit. However, in the presence of numerous IXCs, no single IXC is likely to agree to a higher rate because that IXC would be at a competitive disadvantage to other IXCs who will "free ride" from the placement of the payphone, because the other IXCs will pay the lower regulated

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Thus, no change in my conclusions follows if the average price of a dial-around call is decreased by 20% or even more. Thus, the Commission's comment here was not based on correct economic analysis. Again, an elasticity as high as -1.21 would be an incredible outcome.

4. This calculation also demonstrates that the criticism of Dr. Warren-Boulton for AT&T is not applicable. He again would have to find such a large demand elasticity for dial-around and subscriber 800 calls as to be incredible (i.e., greater than -1.0 in magnitude), especially when it is recognized that the demand elasticity for business customers is likely to be less than the overall elasticity used in my calculations for reasons that I discussed above in ¶ 4.

5. See ¶¶ 30-32 of my first declaration for a further discussion of this outcome.

rate.[6] To the contrary, an IXC can secure a lower rate than the regulated rate by threatening to block calls from a particular payphone. Because of the asymmetrical form of regulation which forbids a PSP from blocking an IXC's calls, but allows an IXC to block payphones calls, the likely bargaining outcome will be too few payphones, unless the Commission sets the default rate at (or above) the economically efficient level.

II. Regulated Rates Based on Avoided Costs

9. I agree with the Commission decision that if demand differences are to be ignored, a rate calculated based on avoided costs is superior to either an average cost or TSLRIC determined rate. An avoided costs approach, since it is based on the competitively determined coin call price, takes different costs and volumes of calls in different regions into account.[7] An average cost approach would result in the elimination of marginal payphones with below average volumes or above average costs and would thus lead to too few payphones as I discussed in my first declaration. First Decl. ¶¶ 36-38. Similarly, if an average TSLRIC calculation were done, marginal payphones would again be removed as I discussed previously. First Decl. ¶¶ 39-41. Only if TSLRIC calculations were done for each individual payphone so that the regulated rate could be set for each payphone depending on specific volume and cost information, would a TSLRIC approach avoid this problem. However, the administrative burdens of regulation here would be so large as to make this approach impractical. Furthermore, the rates would need to be constantly revised as economic conditions changed (e.g., increased use of mobile phones leading to decreased use of payphones). Use of a market determined

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6. This situation is similar to the public good problem where no single consumer can be excluded, and no consumer has an economic incentive to pay for use of the public good. Public goods have been studied extensively by economists, e.g., P.A. Samuelson and W.D. Nordhaus, Economics, 12th edition, 1986, p. 713.

7. An avoided costs approach has long been used in electricity regulation. See, e.g., F.C. Schweppe et. al., Spot Pricing of Electricity. Boston, 1988, p. 75. Schweppe et. al. point out that avoided costs calculations should be based on competitive prices.

competitive price as the basis for the regulated rate is a much better policy, because the market adjusts to changing economic conditions without any needed external intervention.

10. The basic economic factor which recommends the use of avoided costs is that marginal payphones will not be eliminated so that an efficient supply of payphones will result (except to the extent that demand elasticities are not accounted for). Congress intended for payphone deregulation to lead to an efficient supply of payphones without cross subsidy; the avoided costs approach to regulated rate setting will come closest to this competitive outcome. Furthermore, use of avoided costs leads to an efficient allocation of calls among calls types. Because competing call types will contribute equally to joint and common costs, the PSP is indifferent between different call types so that no perverse economic incentives arise for the PSP to favor any given type of call.

11. Use of the competitively determined local coin rate on which to base the avoided costs calculation is a proper economic approach because market forces will determine the price of marginal payphones. Note further that since the local coin rate is the lowest priced call offered in the market with the lowest contribution to the fixed and common costs of the payphone, basing the avoided costs on the local coin rate is conservative. Use of other call types such as 0+ calls in an average price together with local coin calls would lead to a higher avoided costs estimate for the regulated rate.

12. Given this economic analysis, the avoided costs approach the Commission has adopted is superior to average cost approaches or the TSLRIC based approach recommended by AT&T and MCI. Avoided costs pricing will lead to a more efficient supply and wider availability of payphones -- as Congress intended. Only a demand elasticity based approach is more efficient than an

avoided costs approach.[8] Basing the regulated rate on a competitively determined price allows the market to determine the supply of payphones which is consistent with a competitive outcome.

III. Problems with the Commission's Avoided Costs Approach

13. The avoided costs approach chosen by the Commission to set the regulated rate is the best of the cost based approaches since it uses the competitively established local coin rate as its basis. However, economic analysis reveals a number of significant problems with the Commission's application of the avoided costs approach, which I now discuss.

A. The Coin Mechanism and Coin Box are Not Avoided Costs

14. The idea of an avoidable cost is that it is not a necessary cost for the production of a good or service. In the payphone application it has been established that the coin mechanism and coin box cannot be avoided except by eliminating the payphone. Market evidence establishes that coinless payphones are not an economically viable solution. A study by Arthur Andersen indicates that less than 2% of public payphones outside of inmate institutions are coinless. Given that the removal of the coin mechanism would lead to a higher rate for dial-around and subscriber 800 calls, designation of the coin mechanism as an avoided cost will lead to an economically inefficient outcome for marginal payphones. The avoided costs methodology is designed to lead to a cost efficient outcome, but the Commission's approach will lead to a cost inefficient outcome because PSPs will not supply payphones that they would have otherwise supplied. In the absence of the coin payphones, either a coinless phone with higher costs and prices will result or no payphone will be supplied.

15. The Commission states that a PSP would not install a coin payphone instead of a coinless payphone unless the additional coin traffic would at

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8. The avoided costs approach would be similar to the demand based approach if the demand elasticities among call types were similar.

least cover the additional costs of a coin mechanism. Second Report and Order ¶ 52. This reasoning provided the basis for the decision that the "coin mechanism should be attributed to coin traffic." However, this reasoning is in error because the Commission's own analysis of costs demonstrates that instead of installing a coinless payphone where the coin mechanism costs would not be covered, a PSP would install no payphone at all because it would not be economical to do so. The cost study provided by Arthur Andersen confirms this result. Indeed, market outcomes demonstrate the error in the Commission's reasoning because very few coinless payphones are observed (apart from inmate institutions). When the primary way to avoid a cost is to avoid offering the service altogether, the cost cannot be considered avoidable.

16. The above analysis demonstrates that the coin mechanism benefits both coin callers and coinless callers; IXCs should be required to pay a proportionate share of the coin mechanism costs, without which no payphone would be available. The cost of the coin mechanism is not "avoided" simply because the user does not take advantage of it; it is still there, and the expense of providing it must be incurred, even when a particular user makes an access call or subscriber 800 call. Otherwise, in situations where a marginal coin payphone is not economically viable because the regulated rate does not include the coin mechanism, no payphone at all will be supplied because the coinless payphone is higher cost and will also not be economically viable. Thus, dial-around callers receive a benefit from the existence of the coin mechanism, i.e., the provision of a payphone, so that the coin mechanism becomes a common cost -- without it the dial-around customer would have no payphone to use. By treating coin mechanism costs as avoidable, the Commission gives the IXCs a free ride for their traffic. Since the Commission has determined that the payphone market is competitive, this free ride represents a tax on PSPs which will lead to a decreased supply of payphones from the efficient level.[9]

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9. The Commission apparently recognizes these points when it rejects AT&T's cost model. Second Report and Order ¶ 45. The Commission states that average coinless payphone costs and volume would lead to a rate of $0.38 per

17. Lastly, even if the coin mechanism were an avoided cost (which I disagree with), the Commission decision recognizes that the coin mechanism is not a marginal cost, but rather a fixed incremental cost. Second Report and Order fn. 140. I agree with this conclusion since no marginal costs are created with additional coin calls with respect to the coin mechanism. Thus, the avoided cost should be based on an average payphone, not a marginal payphone. Otherwise, the discount on access calls will be too great, and the IXCs will receive a windfall gain because, on average, more than the actual cost of the coin mechanism will be deducted from the coin call price.[10] This amounts to a tax on PSPs for IXCs benefit. Only average avoided costs should enter the calculation; not an amount greater than the average avoided costs.

B. The Decision Makes a Mistake with Respect to ANI ii Costs

18. The Commission commits a fundamental mistake with respect to increased costs created by ANI ii digits. The Decision approach is inconsistent with its handling of coin costs. The Decision recognizes the fact, and it is undisputed by the parties, that ANI ii is used only for dial-around and subscriber 800 calls. ANI ii is the mechanism used to ensure that PSPs get paid on dial-around and subscriber 800 calls. Without these calls, ANI ii would not be used. Thus, ANI ii costs should be paid by dial-around and subscriber 800 calls, as the Commission Decision recognized: "Our general

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call while a marginal payphone would lead to an even greater per-call cost. Indeed, using the Commission's estimate of 143 dial-around, subscriber 800, and other coinless calls at a marginal payphone location and AT&T's estimate of monthly costs for a coinless payphone, $76.85, used by the Commission in ¶ 45, yields a per call cost of $0.54. This again demonstrates that coinless payphones would not be economically viable in many locations.

10. An example might be useful here. Suppose an avoided cost is $10 and the number of units sold at a marginal location is 500. Dividing $10 by 500 gives $0.02 which is the form of the calculation made in the Decision. However, assume over all locations that the average number of units is 600. Multiply $0.02 by 600 gives $12. Thus, on average the avoided cost is too high and on average the IXCs are receiving $12 in avoided costs rather than the correct amount of $10 in avoided costs. The IXCs would be receiving a windfall gain of $2 per month or 20%. This outcome is inconsistent with the principles of avoided costs methodology. The correct calculation is to divide the actual avoided cost by the average number of calls, $10/600 = $0.167. Otherwise, the IXCs receive a windfall gain based on a tax of PSPs.

approach is to start with the market rate for local coin service ($0.35), and subtract costs directly attributable to coin calls and add costs specific to access code and subscriber 800 calls." Second Report and Order ¶ 42 (emphasis added). However, the Commission erred when it failed to attribute ANI ii costs only to access code and subscriber 800 calls. Instead, the Commission attributed the costs of ANI ii to all calls, including coin calls.

19. The Commission's mistake occurs in ¶ 57 of the Second Report and Order where in its discussion of ANI ii the Commission estimates the extra cost of ANI ii to be $5.50 per month. The decision then divides the $5.50 per month by the "low traffic location number of calls, 542, [which] would equal approximately $.01 per call." However, in ¶ 50 the Commission states: "Accordingly, we use this number, 542, as the total number of calls that would be made from a low traffic location." (emphasis added). Since coin calls have nothing to do with ANI ii costs, the correct procedure is to use the number of low traffic dial-around and subscriber 800 calls.[11] If the estimates of ¶ 50 are used, one starts with 147 dial-around (access code) and subscriber 800 calls and reduces it by 20.68% to calculate 116 calls at a marginal location. Dividing $5.50 per month by 116 leads to a calculated ANI ii cost per call of $0.0474. Thus, the Commission needs to increase its regulated rate by 3.74 cents per call (4.74 - 1.0 used in the Decision) to correct its mistake.[12] This correction represents a significant amount to marginal payphones, and if the mistake is not corrected an inefficiently low supply of payphones will be the result.

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11. The calls at a marginal location are used here because, by definition, a marginal payphone location has no economic rent. If the number of calls at an average location were used, a phone at a marginal location would begin to lose money since it would not cover the additional ANI ii cost. A PSP would then eliminate the previously marginal phone because it would now be losing money. Thus, my calculation here is not inconsistent with my calculation with respect to the avoided cost of the coin mechanism (¶ 17 above), because in the earlier calculation no marginal decision was being made. The IXCs should only receive credit for the average avoided cost, not an amount greater than the average avoided cost.

12. If an average payphone were used for the calculation, the correction would be $5.50/147 - $0.01 = $0.027.

IV. Conclusion

20. Economic analysis demonstrates (and the Commission agrees) that a competitive firm uses demand elasticities in determining its prices as a markup over marginal costs to cover its fixed and common costs. This approach would lead to a regulated rate for dial-around and subscriber 800 calls of more than the competitive coin rate of $0.35 unless the long distance price elasticity were incredibly high. If demand considerations are not used, the avoided costs approach best approximates the results that would be seen in a competitive market. Methodology based on average costs or average TSLRIC calculations will lead to an inefficiently low supply of payphones. Price and quantity are set at the margin in competitive markets.

21. I largely agree with the Commission's avoided costs approach. Three major disagreements exist: (1) the coin mechanism should not be treated as an avoided cost because coinless payphones have higher per-call costs than coin phones and are economically inefficient as market evidence demonstrates. (2) The per-call avoided cost of the coin mechanism, because it is not a marginal cost, should be based on an average number of coin calls; otherwise, the adjustment will be too large for a non-marginal payphone and could lead to an inefficient tax on PSPs for the benefit of IXCs. (3) The Commission has made a fundamental mistake in attributing part of the costs of ANI ii to coin calls when ANI ii is used only by dial-around and subscriber 800 calls.

J. A. Hausman 25 Nov 1997

Jerry A. Hausman

CERTIFICATE OF SERVICE

I hereby certify that on this 1st day of December, 1997, I caused copies of the foregoing RBOC/GTE/SNET Coalition's Petition for Reconsideration to be served upon the parties on the attached service list by first-class mail.

Marilyn R. Leeland

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FEDERAL COMMUNICATIONS COMMISSION
Implementation of the Pay Telephone Reclassification and
Compensation Provisions of the Telecommunications Act of 1996
CC Docket No. 96-128, Second Report and Order

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