

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Implementation of the Pay Telephone)
Reclassification and Compensation)
Provisions of the Telecommunications)
Act of 1996)

CC Docket No. 96-128

COMMENTS OF
THE AMERICAN PUBLIC COMMUNICATIONS COUNCIL

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SUMMARY

In Payphone II, the court of appeals considered the Commission's redetermination of "fair" compensation for payphone service providers ("PSPs"), pursuant to Section 276 of the Communications Act, for "dial-around" calls made from their payphones. The court expressly recognized that "a market-based rate – as opposed to a cost-based rate – could satisfy the statutory fair compensation requirement." However, the court found that the Commission had not adequately explained "why a market-based rate for coinless calls could be derived by subtracting *costs* from a *rate* charged for coin calls." The court faulted the FCC for failing to expressly find that costs and rate converge. The court also faulted the FCC for failing to go through "the steps of connecting this premise [that costs and rate converge] with its reasoning in the Second Report."

The first missing piece identified in the court's opinion is a finding as to whether rate and costs converge in the local coin market. APCC's economic consultants, John Haring and Jeffrey Rohlf's of Strategic Policy Research, conducted a study of payphone competition that demonstrates that the payphone market is competitive and that therefore rates and costs do converge. According to Haring and Rohlf's, the payphone industry is characterized by low economic barriers to entry, with thousands of competing firms having entered the payphone industry since competition was first permitted.

Further, alleged "locational monopolies" do not prevent rates from converging with costs. The supply of physical location sites for payphones is not a serious barrier to competition. There are numerous product substitutes and alternatives available to payphone callers, including cellular and PCS phones and the option to place the call at a

different time – for example, after returning home or reaching one’s office – using residential or business telephone equipment. Even in airports – the “paradigm” “locational monopoly” – local coin rates are at \$0.35 or less for local calls.

The fact that the local coin-drop rate, after being deregulated, has stabilized around 35 cents, a rather modest increase over the previously capped and subsidized rate of 25 cents, further indicates that the payphone market is competitive.

Using a market-based rate as a “proxy” for costs is a far better approach than “cost-of-service” ratemaking. The Commission has already explained in its Order on Reconsideration in this proceeding a number of reasons why it is not desirable or feasible to try to set the payphone rate based strictly on costs. In addition to those reasons, there is another reason why a strictly cost-based rate is not desirable or feasible for dial-around compensation: Most of the costs of payphone service are fixed costs. The per-call cost, for those costs is highly sensitive to the number of calls made from a payphone. The compensation set by the Commission will itself have a major effect on the supply of payphones, and therefore on the number of calls per payphone and the per-call cost. The supply of payphones will attempt to adjust to equalize rates and costs at the rate set by the Commission. But each change in the supply of payphones changes the volume of calling, and hence the cost per call, at payphones setting off another cycle. Thus, a cost-based compensation amount is inherently unstable.

A market-based approach avoids most of the basic disadvantages of cost-of-service ratemaking in this context – e.g., the difficulty of correctly assessing costs and the need to continually revisit cost determinations. In addition, a market-based approach enables the

Commission to avoid the destabilizing effects produced by cost-based ratemaking in this context. Further, unlike a randomly selected rate, a market-based ratemaking approach enables the Commission to ensure that the rate is fair and meets the Congressional objective of wide deployment of payphones.

A market-based approach using the local coin rate as a starting point can be justified based on the following reasoning:

1. The bulk of the costs that must be recovered are joint and common costs;
2. The market is competitive; therefore rates generally reflect costs;
3. The rate for the most common type of call, the local coin call, is a reasonable first approximation of the average cost per call, and therefore of the average cost attributable to each dial-around call;
4. By adjusting that rate for differences in marginal costs attributable to each type of call, the Commission can arrive at a better approximation of the average cost that would be recovered from each dial-around call in a freely functioning market.
5. An even better approximation could be developed by further adjusting the local coin rate for differences between the elasticity of demand in the local coin market and the elasticity of demand that would prevail in the dial-around market if it were free to function. However, the Commission found it had inadequate evidence to make this estimate earlier in this proceeding. Therefore, it chose to rely on an equal per-call allocation of joint and common costs to both types of services. While this cost allocation decision can be questioned, it is the same type of cost allocation decision that must be made in pure cost analysis. Therefore, it is just as permissible here.

The Commission also seeks comment on “the reasonableness of adjusting the local coin rate for cost differences between providing coin and coinless calls as a market-based mechanism for deriving fair compensation for coinless calls.” In setting a market-based

rate, a number of avoidable cost adjustments should be modified in order to produce a more accurate rate. First, the Commission should add back the 3.1 cents that was subtracted from the compensation rate as a coin mechanism cost differential. Second, the Commission should add to the local calling rate an allowance for dial-around uncollectibles and collection fees and expenses. The Commission disregarded evidence submitted by APCC indicating dial-around uncollectibles, fees and expenses will average 4.3 cents per call, an estimate since validated by experience with collections on per-call compensation. Finally, the Commission incorrectly calculated the add-on adjustment for ANI digit upgrade costs.

There are no market imperfections that detract significantly from the validity of the local coin rate as a market-based surrogate for coinless calls. Locational monopolies are not a factor. Limitations on the use of pennies in payphones will resolve through market mechanisms. Any upward pressure on local rates resulting from their linkage to per-call compensation can be addressed by correctly calculating the avoidable cost between the market determined local coin rate and the per-call compensation rate. In any event, there are two additional “market checks”: (1) the ability of IXCs to block calls in the event that they or their subscribers do not want to pay the compensation rate that applies to a particular payphone; (2) the fact that the amount of the per-call compensation charge is already passed through to many end users and can be passed through to callers of 800 subscriber numbers.

While the local coin rate, as a market rate, provides a better starting point than cost-of-service ratemaking, it is not the best market-based approach. The Commission’s use of

the local coin rate as the starting point has resulted in understatement of the costs properly allocable to dial-around calls: the Commission's "avoided costs" adjustment under-allocated costs to dial-around calls, the Commission made no adjustment for the relative elasticities of demand of dial-around and coin calls, and the deregulated coin rate is the lowest of several market-based rates that could be valid proxies for per-call compensation.

The Commission can avoid this unfair result and the need for avoided cost and elasticity analysis by choosing one of these other market surrogates – the 0+ commission level, the 0- transfer rate, or the sent paid toll call surcharge – as the per-call compensation rate. The Commission should reexamine these alternatives, including the use of blended market surrogates as well as or in lieu of local coin rate levels, as the baseline benchmark for calculating dial-around compensation.

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**COMMENTS OF
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The American Public Communications Council (“APCC”) hereby files the following comments in response to the Commission’s Public Notice, DA 98-1198, dated June 19, 1998 (“Public Notice”), seeking further comment on certain issues raised by the decision of the U.S. Court of Appeals for the District of Columbia Circuit in MCI Telecommunications Corporation v. FCC, slip. op. (D.C. Cir., No. 97-1675, May 15, 1998)(“Payphone II”).

I. THE COURT OF APPEALS DECISION

In Payphone II, the court of appeals considered the Commission’s redetermination, on remand from a prior court of appeals decision,¹ of “fair” compensation for payphone service providers (“PSPs”), pursuant to Section 276 of the Communications Act, 47

¹ Illinois Public Telecom. Ass’n v. FCC, 117 F.3d 555 (D.C. Cir. 1997) (“Payphone I”).

U.S.C. § 276(b)(1)(A), for “dial-around”² calls made from their payphones. The court remanded the Commission’s Second Report and Order, 13 FCC Rcd 1778 (1997), for further proceedings. The court expressly recognized that “a market-based rate – as opposed to a cost-based rate – could satisfy the statutory fair compensation requirement.” Payphone II at 6. However, the court found that the Commission had not adequately explained “why a market-based rate for coinless calls could be derived by subtracting *costs* from a *rate* charged for coin calls.” *Id.* at 5 (emphasis original).

The court noted that the FCC had found (1) that payphone costs are primarily “joint and common costs that are shared by the different types of calls made by means of a payphone,” and (2) that “each call placed at a payphone should bear an equal share of joint and common costs,” but ruled that these findings alone did not explain why a market-based rate for dial-around calls could be derived from a market-based rate for local coin calls. *Id.*

The court suggested that “the Commission’s reasoning may have depended on the premise that the market rate for coin calls generally reflects the costs of those calls.” *Id.* The court noted that this premise would be “valid in a competitive market in which costs and rate converge.” *Id.* However, the court faulted the FCC for failing to expressly find that costs and rate converge. This omission was important, the court added, because, even though the court earlier upheld the Commission’s conclusion in the First Report and Order, that “market forces generally will keep [local coin calling] prices at a reasonable level” (Payphone I, 117 F.3d at 562), in the court’s view it did not necessarily follow that

² In these comments, we use the term “dial-around call” to refer to any call that meets the Commission’s criteria for per-call compensation under Section 64.1300(c) of the Commission’s rules, i.e., any call for which the PSP is not compensated by a coin deposit or pursuant to a contract with the carrier to which the call is routed.

“coin call rates converge with costs.” *Id.* at 6.³ The court also faulted the FCC for failing to go through “the steps of connecting this premise [that costs and rate converge] with its reasoning in the Second Report.” *Id.*

II. OVERVIEW

The Commission seeks comment on how to fill in the two missing links identified in the court’s opinion: (1) “whether the local coin rate reflects competitive market conditions and the extent to which costs and rate converge in the coin call market;” and (2) whether, and how, it is possible to reason from the fact that costs and rate converge to the conclusion that the local coin rate, adjusted for differences in the costs directly attributable to local coin calls and dial-around calls, can serve as a “market-based mechanism for deriving fair compensation for coinless [dial-around] calls.” Public Notice at 2.

The answer to both questions is “yes.” First, payphone rates do converge with costs. Available evidence shows that the Commission’s deregulatory policy is working, and that competition is strong in the payphone market in general, and the local coin market in particular. As a result, payphone rates reflect economic costs, and economic (supra-competitive) profits cannot be gained.

Second, the fact that rates converge with costs can reasonably be used to derive a market-based rate for dial-around calls. Indeed, a rate-making approach that utilizes an appropriate market surrogate, such as the local coin rate, is the most effective and appropriate way to set fair dial-around compensation rates. Other market-based surrogates, such as 0+ commission rates, are also available.

³ The court stated that the Commission had earlier “acknowledged . . . that, because of locational monopolies and incomplete information endemic to the payphone market, the coin call rate may potentially diverge from coin call costs.” *Id.* at 6, citing Report and Order, 11 FCC Rcd 20,541, ¶¶ 13-16 (1996) (“First Report and Order”).

III. THE PAYPHONE MARKET IS COMPETITIVE

The first missing piece identified in the court's opinion is a finding as to whether rates and costs converge in the local coin market. The Commission seeks comment on "competition in the payphone market since the deregulation of payphones and the impact of deregulation on the local coin rate," and in particular on "whether the local coin rate reflects competitive market conditions and the extent to which costs and rates converge in the coin call market." Public Notice at 2.

APCC's economic consultants, John Haring and Jeffrey Rohlfs of Strategic Policy Research ("SPR"), have conducted a study of payphone competition. See Declaration of John Haring and Jeffrey H. Rohlfs, Strategic Policy Research (July 13, 1998) ("SPR"), attached to these comments as Exhibit 1. They reaffirm the Commission's finding, in the First Report and Order, that the payphone industry is characterized by low economic barriers to entry, noting that literally thousands of competing firms have entered the payphone industry since competition was first permitted. SPR, ¶ 8. Haring and Rohlfs add that most of the inputs used in payphone services are competitively supplied in well-organized markets, with equipment components, business information and technical support readily available. Id.

Further, Haring and Rohlfs also find that the supply of physical location sites for payphones is not a serious barrier to competition. SPR, ¶ 11. Indeed, a recent survey by the Southwest Regional Office of Consumers Union -- an organization that went to court to oppose the deregulation of local coin rates -- found that more than 30 percent of the pay phones in the vicinity of Austin, Texas were within *visual range* of another provider's payphone. Consumers Union, Southwest Regional Office, Public Policy Report Series #6, May 1998, "More than Pocket Change: Making Cents of the Cost of a Pay Phone Call" at

13.⁴ Even where there is currently no alternative payphone within “visual range” of another provider, there are likely to be alternative payphones nearby which can be rather easily discovered. SPR, ¶ 11. Moreover, there is almost always the potential for additional competition. Alternative payphone sites generally are readily available nearby and will be used if the incumbent provider tries to extract a “premium” profit. *Id.*

Haring and Rohlfs also find that there are numerous product substitutes and alternatives available to payphone callers. *Id.* With continuing market penetration of wireless equipment,⁵ and continually dropping air-time rates for cellular/PCS calls, Cellular/PCS unquestionably provides a major competitive alternative to payphone service.

Another alternative for payphone users is the option to place the call at a different time – for example, after returning home or reaching one’s office – using residential or business telephone equipment. *Id.* While payphone service can be priced higher, on a per-call basis, than comparable residential or business service because it reflects the convenience factor of having a phone immediately available while “on the move,” the price of payphone service is constrained by the caller’s ability to postpone the call and use lower-priced residential or business service.

Finally, even in mass-transit facilities such as airports and train stations, where access to alternative sites might be more constricted, the owners of the facilities tend to be highly sensitive to complaints about unreasonable charges from consumers whose price

⁴ Consumers Union also found that “Of the payphones in visual range of one another, nearly all charge \$0.35 for a local call.” *Id.* Consumers Union interpreted this as evidence of a *lack* of competition. However, the relatively uniform prevalence of a particular local coin calling rate is better interpreted as evidence that the market has moved to a market-equilibrium price that reflects underlying costs and demand without the possibility of supra-competitive profits. See SPR, ¶¶ 14-18.

⁵ SPR, n.7 (wireless market penetration is 23 percent and is growing at an annual rate of 25 percent).

expectations are formed by experiences at more competitive locations. SPR, ¶ 10. As a result, even payphones in airports and train stations are generally priced at or near the prevailing market rate (currently 35 cents per local call).⁶

The fact that the local coin-drop rate, after being deregulated, appears to have stabilized around 35 cents, a rather modest increase over the previously capped and subsidized rate of 25 cents, further indicate the competitiveness of the payphone market. The Consumers Union study does not cite a single case where a local drop rate exceeds 35 cents.⁷

Furthermore, after an initial reaction to the rate increases necessary to bring rates to cost, the deregulation of local coin rates has not led to complaints about local coin rates. In the First Report and Order, the Commission expressly ruled that any state that finds that payphone competition is not working in that state, either in general, or in specific areas, may present its evidence to the Commission and petition for appropriate relief, including partial or total deregulation of local coin rates. First Report and Order, ¶ 61. To date, no state has filed such a petition. To APCC's knowledge – at least after the initial reaction of

⁶ See Declaration of James Kelly, III, attached to these comments as Exhibit 2.

⁷ Consumers Union also found that 51 (32%) of the 166 payphones surveyed, and 87% of the independent payphones, offered long distance coin rates that are lower than those offered at Southwestern Bell payphones. These payphones offer a flat rate of 25 cents per minute to call anywhere in the United States. All the unusually high prices cited by Consumers Union involved operator services – services that account for only about 5% of all payphone calls. See Comments of APCC, filed August 26, 1997, Att. 4 (data showing that only 36 out of 713 calls per payphone per month are 0-, 00-, or 0+ calls). Unlike coin services, operator services are characterized by delayed billing and lack of immediate price information. The Commission has separately addressed the operator service pricing issue in CC Docket No. 92-77.

Thus, while Consumers Union recommends that the Commission revisit its conclusion that the payphone market is competitive, that recommendation is not supported by Consumers Union's own findings on pricing of coin service.

callers to the long-overdue rate change that occurred immediately after deregulation – there have been virtually no complaints filed regarding local coin rates in any state or the FCC.

In sum, developments to date fully support the Commission’s conclusion that the post-deregulation payphone market is competitive, and that “only normal rates of return can be sustained.” SPR, ¶ 4. Consequently, in the payphone market, average rates are approximately equal to average cost. SPR, ¶ 20.

IV. THE LOCAL COIN RATE, ADJUSTED FOR VARIABLE COST DIFFERENCES, IS A VALID PROXY

The Commission also seeks comment on “the reasonableness of adjusting the local coin rate for cost differences between providing coin and coinless calls as a market-based mechanism for deriving fair compensation for coinless calls.” Public Notice at 2. It is entirely reasonable for the Commission to use local coin rates, adjusted for differences in the variable costs of local coin calls and dial-around calls as a proxy for the costs that would be recovered from dial-around calls in a freely functioning market.

A. The problem faced by the Commission is not a traditional monopoly service ratemaking problem

The ratemaking problem that the Commission must solve here is far from the typical monopoly service ratemaking problem. In the traditional setting of cost-of-service ratemaking, all the services of the regulated entity were subject to rate-of-return regulation. The Commission’s task was to ensure that rates for regulated services were “cost-based,” primarily to ensure that the regulated entity did not earn a supracompetitive profit on its services considered as a whole, by recovering more than its total costs including a reasonable rate-of-return.

Here, the Commission's task is quite different. The rates for the majority of payphone calls are *nonregulated*. Since October 7, 1997, there has been a deregulated, freely functioning market for local coin calling service. As discussed above, the Commission's predictions that local coin calling rates could be safely deregulated and that the resulting coin calling market would be competitive are fully justified.

In this otherwise freely functioning payphone market, there is one service – dial-around calling – for which the market is not free to function. Section 226 of the Act requires that payphone providers allow dial-around calls, even if they receive no compensation from the interexchange carrier (“IXC”). Because PSPs do not have the option of refusing to deliver dial-around calls to IXCs, they cannot freely negotiate with IXCs to determine a market price for dial-around calls. Thus, the Commission's task is to prescribe a rate for one service – dial-around calling – that is subject to regulatory restrictions in an otherwise freely functioning market.

In these circumstances, the most appropriate way to determine an “administered” dial-around rate is to use a method that is most likely to ensure that the resulting dial-around rate approximates the rate that would be set by a fully functioning market. If the market for dial-around calling were free from regulatory restrictions, the rates for all the major payphone services, including dial-around calling, would be directly set by the market. As a result, all payphone rates, including the dial-around rate, would reflect a market-driven allocation of the underlying costs. The resulting dial-around rate would be fair, because it would be negotiated by a “willing buyer and a willing seller” in a freely functioning market. First Report and Order, ¶ 52. Therefore, the ratemaking method to be chosen by the Commission should be designed to approximate the rate that would be set in a freely functioning market.

Significantly, however, it is also important for the Commission to find a ratemaking method that will ensure that the dial-around compensation rate stays at an appropriate level despite changes in market conditions, including changed conditions brought about by the rate setting process itself.

B. Cost-of-service ratemaking is not feasible or appropriate for dial-around calling

In the payphone industry, where most costs are fixed and most calls are subject to market rates, traditional cost-of-service ratemaking will not work well to arrive at a fair rate for dial-around calls.

The Commission has already explained a number of reasons why it is not desirable or feasible to try to set the payphone rate based strictly on costs. Order on Reconsideration, 11 FCC Rcd 21,233, ¶¶ 67-69.

Trying to apply cost-of-service regulation to rates in a competitive market is very difficult under any circumstances, because of the inherent uncertainties in measuring costs and because market dynamics change so rapidly that regulators must continually revisit their calculations of costs.⁸ In the context of per-call payphone compensation, as the Commission has previously noted, cost-of-service regulation poses even more difficult problems, because so many of the costs are fixed joint and common costs.

In the local competition proceeding, the Commission was determining the cost incurred by monopoly suppliers in providing a single element or facility, which shared relatively few common costs with other services. Even so, the task of cost-of-service

⁸ As long ago as 1981, this Commission recognized that attempting to apply cost-of-service regulation to firms that lack market power imposes cost that “can have profoundly negative implications for consumer welfare.” Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, Further Notice of Proposed Rulemaking, 84 FCC 2d 445, 449 (1981).

ratemaking proved daunting. Here, by contrast, a cost-based approach would face the task of determining and allocating, for a highly competitive industry, the very large portion of joint and common costs that are shared among several services using the payphone. Order on Reconsideration, ¶ 69. As a result, the cost-of-service rate-making process is even more potentially arbitrary and prone to misallocation with resulting distortion of the marketplace.

In addition to the reasons already given, there is another reason why a strictly cost-based rate is not desirable or feasible for dial-around compensation. As noted above, “cost-based” prescription of a *per-call* rate is unusually difficult in a competitive payphone market, because most of the costs of payphone service are non-traffic-sensitive “fixed” costs. These costs can be estimated on a per-payphone basis. However, in order to use this estimate to derive a per-call rate, it is necessary to divide the fixed per payphone costs by the number of calls per payphone. SPR, ¶ 20. For example, if fixed payphone costs average \$210 per payphone per month, and there are 600 calls per payphone per month, then per-call costs will be \$.35 per call. However, if there are 700 calls per payphone per month, per-call costs drop to \$.30 per call. And if there are only 500 calls per payphone per month, per-call costs increase to \$.42 per call. The number of calls per payphone is highly dependent on the quantity of payphones deployed. Id.

The compensation set by the Commission will have a major effect on the supply of payphones, and therefore on the number of calls per payphone and the per-call cost. Whatever “cost-based” compensation rate is set by the Commission, that rate will affect the payphone market and the supply of payphones. Id. If the rate happens to be exactly equal to the rate that provide exactly enough incentive to maintain the existing supply of payphones, and market conditions did not change, then the rate might continue to be a “reasonable” cost-based rate. However, if the rate was either more or less than the rate

that would maintain the existing supply of payphones, or if market conditions independently changed, then the rate would not continue to be a “reasonable” cost-based rate. Furthermore, the prescribed “cost-based” rate would affect the supply of payphones in ways that would severely distort the whole ratemaking process and create an unstable environment.

For example, if the Commission determines that costs are averaging \$150 per payphone per month, and that call volumes average 600 calls per month, the Commission would set a “cost-based” rate of \$.25 per call. But if the Commission miscalculated costs or volumes, or if market conditions changed, then the 25-cent rate would not be reasonable. For example, suppose the optimal dial-around rate for maintaining the existing supply of payphones was \$.30 cents per call. Then the 25-cent rate would be 5 cents too low. As a consequence, payphone providers would be unable to recover their average costs, and some payphones (those with relatively low call volumes) would be removed. This would reduce the number of available payphones, without proportionately affecting total demand to make calls from payphones. As a result of the removal of lower-volume payphones, *and* the redirection of callers to a smaller number of payphones, per-phone call volumes would increase. SPR, ¶¶ 21-22.

The market impact would in turn distort subsequent “cost-based” rate-making. With more calls, the estimated cost per call would be reduced. For example, if calls increased to 700, cost per call would fall to about \$.21 per call. Therefore, in a subsequent proceeding, the Commission would have to reduce the rate to \$.21 per call in order to maintain a “cost-based” rate. This in turn would cause further removal of payphones, further increases in call volumes, and further reductions in average cost per call. Id.

If the Commission erred on the high side in setting the initial rate, a similar distortion would be produced, but in the opposite direction. The number of payphones would increase, calls per payphone would drop, and costs per call would increase, thereby triggering a need for further rate increases.

Accordingly, pure cost-based rate-making is inappropriate for purposes of setting a per-call rate in a competitive payphone market where most of the costs are fixed. The need to derive a usage-sensitive (per-call) rate to recover primarily non-usage-sensitive costs means that traditional cost-of-service ratemaking will produce a rate that will be correct only by accident, and only for a moment. Worse, over time cost-of-service ratemaking will produce market instability due to the spiraling cycles of payphone removal (or alternatively, excessive payphone deployment) that result from setting the initial “cost-based” rate too low (or too high). Such market distortions would defeat the Congressional objectives of widespread payphone deployment and fair payphone compensation.

C. By linking the dial-around rate to a market rate, the Commission can provide a fair rate of dial-around compensation that produces optimal payphone deployment

Using a market-based rate as a “proxy” for costs is a far better approach than “cost-of-service” ratemaking. A market-based approach avoids most of the basic disadvantages of cost-of-service ratemaking in this context – e.g., the difficulty of correctly assessing costs and the need to continually revisit cost determinations. In addition, a market-based approach enables the Commission to avoid the destabilizing effects produced by cost-based ratemaking in this context. Further, unlike a randomly selected rate, a market-based ratemaking approach enables the Commission to ensure that the rate is fair and meets the Congressional objective of wide deployment of payphones.

As discussed above, the Commission could try to use cost-of-service ratemaking to take a “snapshot” of average per-call costs. However, the “snapshot” would be, at best, a static reflection of market conditions at one particular time. As market conditions changed, the snapshot-based rate would cause market distortions, and repeated recalculations of a “cost-based” rate would lead to a harmful “vicious cycle” of rates spiraling up or down.

By using a market-based rate such as the local coin rate,⁹ the Commission avoids these difficulties, and ensures that, over time, the “administered dial-around” rate continues to approximate what would be the rate in a freely functioning market.¹⁰

As shown by Haring and Rohlfs, under conditions of differentiated competition such as prevail in the payphone market, when competitive equilibrium is reached, total revenues will equal total costs (including the cost of capital). Therefore, the average price of a call will be equal to the average cost of a call. Because local coin calls are by far the most common type of call made from a payphone, the Commission not unreasonably chose the local coin call as a starting point for estimating the average cost of a call.¹¹

⁹ Other market-based measures could be chosen. In Section V below, APCC discusses some market-based approaches that have significant advantages over the local coin rate. Nevertheless, a local-coin-rate-based approach is superior to any cost-based approach.

¹⁰ Even in the context of “just and reasonable” ratesetting for common carriers, courts have repeatedly endorsed comparable rate analogies as appropriate ratemaking devices. See, e.g., San Antonio v. United States, 631 F.2d 831, 836-37 (D.C. Cir. 1980), clarified, 655 F.2d 1341 (D.C. Cir. 1981); Burlington Northern, Inc. v. United States, 555 F.2d 637, 641-43 (8th Cir. 1977). Market rate-based approaches are even more clearly appropriate in the instant context, where rates are being set for a competitive industry, and where the standard is *not* the traditional “just and reasonable” standard of common carrier regulation, but is instead a “fairly compensated” standard. See, e.g., Amusement and Music Operators Association v. Copyright Royalty Tribunal, 676 F.2d 1144 (7th Cir. 1982) (upholding the Copyright Royalty Tribunal’s decision to raise the compulsory license fee for jukeboxes from \$8 per box to \$50 per box, based on “marketplace analogies”).

¹¹ However, as discussed in Section V below, the other types of payphone calls for which market prices have been established are priced higher than local calls. Thus, the choice of the local coin call alone as the starting point biased the result downwards.

As Haring and Rohlf's point out, the logic of the Commission's market-based approach using the local coin rate as a starting point can be summarized as follows:

- i. The bulk of the costs that must be recovered are NTS costs;
- ii. The market is competitive; therefore rates generally reflect costs;
- iii. The rate for the most common type of call, the local coin call, is a reasonable first approximation of the average cost per call, and therefore of the average cost of a coinless call;
- iv. By adjusting that rate for differences in marginal costs attributable to each type of call, the Commission sought a better approximation of the cost that would be recovered from each dial-around call in a freely functioning market; and
- v. An even better approximation could be developed by further adjusting the local coin rate for differences between the elasticity of demand in the local coin market and the elasticity of demand that would prevail in the coinless [dial-around] market if it were free to function. The Commission found, however, that it had inadequate evidence to make this adjustment. It, therefore, chose an equal per-call allocation of NTS costs to both types of services.

SPR, ¶ 42.

Thus, there is a multi-faceted relationship between the local coin rate and the dial-around rate. First, as noted above, the bulk of the payphone costs that must be recovered through payphone rates are fixed joint and common costs. Because the market is competitive, prices reflect costs. And because local coin calls are the bulk of the calls made from payphones, the local coin rate is a reasonable first approximation of average per-call costs. By adjusting the local coin rate to account for differences between the marginal (or "avoidable") costs that are solely attributable to local coin calls and dial-around calls respectively, the Commission can arrive at a better approximation of the per-call costs that would be recovered from dial-around calls if the market were free to function.

Another step that the Commission could take to further improve its estimate of a market-based dial-around rate is to adjust the marginal-cost-adjusted local coin rate to account for differences in market demand for local coin calls and dial-around calls. In an earlier phase of this proceeding, evidence was presented by the RBOC Coalition indicating that the demand elasticity of dial-around calls (that would exist if the market were free to function) is greater than the demand elasticity of local coin calls. That evidence was disputed by AT&T. Ultimately, the Commission declined to make any findings regarding demand elasticities, and effectively assumed that the elasticities were approximately the same, resulting in an equal per-call allocation of fixed costs to each type of call. APCC questions whether this assumption is warranted, and urges the Commission to reconsider the evidence as to elasticity. See SPR, ¶¶ 44-47.

However, it is important to recognize that the question of allocating fixed, or non-traffic-sensitive (“NTS”) joint and common costs is present whether the Commission undertakes a purely cost based ratemaking approach, as the IXCs have urged, or whether the Commission undertakes a market-proxy-based approach – which it has undertaken, and to which it should adhere. In both cases the question is ultimately the same: what is the proper allocation of joint and common costs not between the various classes of calls using a payphone? The Commission’s use of an equal per-call cost allocation, similar to a fully distributed cost methodology, is an accepted ratemaking technique. The technique is no less valid in a market-based approach than in a cost-based approach. Switching to a purely cost-based approach would raise the same cost-allocation issue, and the Commission would not have any better basis to resolve it than it has under the market-based approach. Moreover, the allocation method actually chosen – an equal per-call cost allocation – is

clearly far superior to the allocation method (zero allocation of joint and common costs to dial-around) advocated by some IXCs.

In short, the Commission's decision to avoid undertaking a demand elasticity analysis does not mean there is no valid link between local coin rates and dial-around rates. It merely means that the Commission adopted a simplifying assumption in order to make the link. Significantly, if the Commission had credited the RBOCs' evidence, it would have found a lower demand elasticity for dial-around calls, resulting in a higher rate.

D. The avoidable cost adjustments should be modified in order to produce a more accurate market-based rate

APCC's pending petition for reconsideration pointed out that, in implementing its market-based rate-setting method, the Commission made a number of mistakes that require reconsideration.¹²

1. Coin mechanism costs

As explained in APCC's petition for reconsideration, the Commission incorrectly determined that the portion of fixed payphone costs that relates to the payphone's coin mechanism should be attributed solely to local coin calls, and not to dial-around calls. The Commission's economic rationale for this determination incorrectly assumes that a PSP first decides whether to put in a payphone at all, based on expected revenue from coinless calls alone, and that only after cost-justifying a coinless payphone based on coinless calls does the PSP consider whether the additional costs of a coin mechanism are justified by the revenue from "additional coin traffic." APCC Petition at 9-13.

¹² Petition of APCC for Partial Reconsideration, filed December 1, 1997 ("APCC Petition"). APCC hereby explicitly incorporates by reference the arguments in its petition for reconsideration.

This model is inconsistent with the reality of the payphone industry. In reality, few if any locations can support coinless payphones from coinless revenue, and PSPs rely on revenues from all calls -- coin and coinless -- to support fixed costs of payphones with coin and coinless capabilities. Therefore, the Commission should add back the 3.1 cents that was subtracted from the compensation rate as a coin mechanism cost differential. *Id.* See also SPR, ¶¶ 43-44.

2. Dial-around collection costs and uncollectibles

Second, the Commission incorrectly refused to add to the local calling rate an allowance for dial-around uncollectibles and collection fees and expenses. The Commission disregarded evidence submitted by APCC indicating dial-around uncollectibles, fees, and expenses will average 4.3 cents per call. *Id.* at 14-15.

In fact, experience to date with per-call compensation indicates that this estimate of collection costs and uncollectibles may be substantially understated as applied to the more complex per-call compensation system. In the payment cycles for the per-call compensation period, beginning with the fourth quarter of 1997 ("4Q97"), the percentage of submitted ANIs disputed by AT&T and MCI is equal to or greater than the dispute rates that occurred under the Section 226 flat-rate compensation plan. See APCC Petition for Partial Reconsideration, Attachment 1. Non-payment rates for Worldcom and Sprint for the first quarter of 1998 are substantially higher than those for AT&T and MCI.

Moreover, with respect to the ANIs that are accepted for payment, IXC's are showing erratic per-call payment patterns. For example, MCI chose to pay on a per-call basis in 4Q97 and the first quarter of 1998 ("1Q98"). MCI's initial call counts for 4Q98 were as follows: October – 6.8 million; November – 11.3 million; December – 11.4 million. Although per-call compensation did not officially begin until October 7, the

subtraction of six days from October does not account for the major shortfall in the call count for this month, especially since call volumes are typically substantially higher in October than in November and December.

For 1Q98, similarly erratic patterns emerge when MCI's call counts are compared with AT&T's. MCI tracked 9.2 million calls in January, 7.9 million in February, and 9.5 million in March. By contrast, for the 40,000 phones for which AT&T paid on a per-call basis in 1Q98, AT&T tracked 1.1 million calls in January, 1.7 million in February, and 2.1 million in March. Thus, MCI's call counts dipped in February, while its counts in January and March were about the same. By contrast, AT&T counted only half as many calls in January as in March, while February's count was in between. There is no apparent reason why these two carriers should have such dramatically different call count patterns. Therefore, the disparity in call count patterns suggests that a substantial volume of calls are "dropping through the cracks," thereby increasing the amount of uncollectible compensation that occurs in a per-call system.

An additional major collection problem has resulted from carriers' efforts to avoid payment for calls that terminate on reseller switches.¹³ Months after the due date for its 4Q97 payments, MCI informed APCC that a substantial portion of its 4Q97 payments were related to calls routed through MCI's network to debit card providers and other switch-based resellers. Therefore, MCI unilaterally "credited" itself with a 26% reduction in its 4Q97 payments, and deducted that amount (about \$2.64 per phone per month, or 9.3 calls worth) from its 1Q98 payments. APCC has no ability to audit MCI to ensure the accuracy of its determination that 26% of its 4Q97 calls were routed to switch-based

¹³ In the Order on Reconsideration, the Commission moved the "toll gate" upstream by requiring that compensation for calls routed to switch-based resellers be paid by the reseller rather than by the facilities-based carrier.