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Before the  
**FEDERAL COMMUNICATIONS COMMISSION**  
Washington, DC 20554

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Implementation of the Pay Telephone	)	
Reclassification and Compensation	)	
Provisions of the Telecommunications	)	CC Docket No. 96-128
Act of 1996	)	
	)	DA 98-1198

**REPLY COMMENTS**

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## SUMMARY

The comments demonstrate that, largely because payphones are locational monopolies, economic costs and rates do not converge in the payphone market. Rather, local coin rates reflect the monopoly price and include monopoly site rents. Accordingly, subtracting coin costs from the coin rate does not approximate the cost of a coinless call and, therefore, it would be irrational to set compensation for non-coin calls in this manner.

Because competition in the payphone market will not work to keep rates reasonable, a regulatory approach is necessary to set a fair compensation rate for subscriber 800 and access code calls, if compensation is carrier-pays. The default compensation rate should be determined using a cost-based approach that relies on costs and quantities that are consistent with a market where multiple firms compete for the patronage of consumers. MCI's cost study, submitted with its Comments, achieves this goal and demonstrates that the cost of using a payphone to place a non-coin call is between \$0.08 and \$0.12 cents per call.

The adjustments to avoided cost requested by the LEC Coalition and APCC should be denied. Coin specific costs, such as the coin mechanism and coin box, are avoidable costs and should be recovered from coin calls. Flex-ANI upgrades are not solely for the purpose of payphone compensation and, therefore, should not be part of the compensation amount at all. If, however, the Commission includes this cost in the compensation amount, then it should be allocated to all calls from payphones because ANI ii digits will be transmitted with every call. Also, the LEC Coalition's estimates for payphone compensation collection and uncollectible amounts are unreliable and should be rejected.

Finally, APCC's alternative market-based approaches should be denied.

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554**

<b>In the Matter of</b>	)	
	)	
<b>Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996</b>	)	<b>CC Docket No. 96-128</b>
	)	
	)	

**REPLY COMMENTS**

MCI Telecommunications Corporation (MCI) hereby replies to the comments submitted in the payphone remand proceeding.<sup>1</sup>

**I. ECONOMIC COSTS AND RATES FOR COIN CALLS DO NOT CONVERGE**

In MCI v. FCC,<sup>2</sup> the Court required that, on remand, the Commission determine whether costs and rates converge in the local coin call market. The comments of MCI and others demonstrate that, largely because payphones are locational monopolies, economic cost and rates do not and will not converge. Nothing in the comments, including those of the RBOC/GTE/SNET Payphone Coalition (LEC Coalition) and the American Public Communications Council (APCC), demonstrates otherwise.

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<sup>1</sup> Public Notice, CC Docket No. 96-128, DA 98-1198, released June 19, 1998.

<sup>2</sup> MCI v. FCC, No. 97-1675, slip op. (D.C. Cir. May 15, 1998).

There is no dispute that “competition” in the payphone marketplace is between payphone service providers (PSPs) to be selected by the location provider as the provider of payphones on the premise. PSPs “compete” for this ability by promising to pay the highest commission to the premise owner. In this “competition-for-the-field,” the “winner” obtains the exclusive monopoly right to serve a market. Because the “competition” is for the exclusive right to serve a payphone site, PSPs operate in a monopoly fashion in order to generate incomes sufficient to win franchises from site owners by offering the largest commission. This process renders a price that equals not the cost of production, but the monopoly price, which includes monopoly site rents.<sup>3</sup> The interaction of location monopoly at payphone sites and the ability of premise owners to “auction off” the right to serve that monopoly, creates an incentive for the PSP to raise rates, including the local coin rate, rather than lower rates under the constraint of competitive forces. Accordingly, the payphone market lacks the characteristics of competition that drive rates to costs<sup>4</sup> and, therefore, the market forces in the payphone marketplace do not lead to “competitive prices.”

The conclusion that payphone sites are locational monopolies is supported by the E GROUP’s findings that competition for site locations is driving up commissions and, as a consequence, coin rates-- and its analysis that wireless services and other payphone locations are poor substitutes for a specific payphone’s services. The fact that some LECs have increased local coin rates by forty-percent since the deregulation of those rates-- from 25 cents to 35 cents-- in a number of existing (and, thus, already profitable) payphone locations, supports the thesis that

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<sup>3</sup> MCI Comments, E GROUP Study at 4.

<sup>4</sup> *Id.* at 11.

individual payphone sites are locational monopolies. The LECs' own statements -- that they have increased their payphone coin rates to pay competitive commissions to property owners<sup>5</sup>-- also demonstrates that payphones are locational monopolies and that competition, or the lack thereof, cannot be relied on to keep prices in line with economic costs. Further, payphones are locational monopolies when analyzed in the context of the Department of Justice's Merger Guidelines because there is no product of sufficient substitutability-- not cellular phones and not even nearby payphones-- to constrain price increases.<sup>6</sup>

The LEC Coalition and APCC largely assume that the local coin call payphone market is competitive because there is free entry by PSPs into the payphone business,<sup>7</sup> thus confusing "free entry" with competition where prices approximate cost. They fail, however, to meaningfully address locational monopolies.<sup>8</sup>

Although Haring and Rohlfs acknowledge that payphones are differentiated by location and that payphones in different locations may not be regarded by callers as perfect substitutes for one another,<sup>9</sup> they conclude that any attempt to exploit a locational advantage "is likely to prompt

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<sup>5</sup> *Id.* at 6.

<sup>6</sup> MCI Comments, E GROUP Study at 8-10.

<sup>7</sup> For example, Kahn refers to the market rate as "putatively competitively determined", although he admits that he has not conducted a study of the payphone market sufficient to conclude that it is effectively competitive. (LEC Coalition Comments, Declaration of Alfred E. Kahn at 9; 2)

<sup>8</sup> The declarations submitted by the LEC Coalition and the APCC are refuted in the E GROUP Reply attached hereto.

<sup>9</sup> APCC Comments, Declaration of John Haring and Jeffrey H. Rohlfs at 4.

a swift supply response” because “[n]earby locations will find it worth their while to make space available and thereby undercut the ability to extract any significant locational premium.”<sup>10</sup> This is not likely, however, because payphones located only very short distances apart are not substitutes for each other.<sup>11</sup> Thus, even assuming a nearby location might allow the placement of a new payphone, it would not create downward pressure on the rates at the first payphone. In fact, since the motivation of the premise owner is to extract as much commission as possible, there is no reason to expect a new phone ever to create downward pressure on local coin rates.<sup>12</sup>

In addition, because the rate for local coin calls must be rounded to the nearest coin denomination that the payphone accepts and because payphones do not render change, rates in the local coin market will not accurately reflect the cost of such calls. The LEC Coalition and APCC argue that this limitation will not lead to rates higher than cost because rates will be rounded down as well as up and, therefore, on average, coin rates will equal cost. This argument, however, presumes that the payphone market is competitive and that payphones are not locational monopolies, which, as demonstrated, is not the case. Accordingly, there is no evidence to suggest that a payphone owner would ever set a rate below the cost of providing service.

Accordingly, the rate for a coin call cannot be used as the starting point for the cost of a

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<sup>10</sup> *Id.* at 6.

<sup>11</sup> MCI Comments, E GROUP Study at 8-10; E GROUP Reply at 7.

<sup>12</sup> Professor Hausman acknowledges as much when he argues that even for those few payphones that might be locational monopolies, PSPs would not earn above-normal profits because the location owner would capture all such profits. (LEC Coalition Comments, Declaration of Professor Jerry A. Hausman at 12, n. 14).

coinless call because the coin call rate does not reflect cost and, therefore, subtracting cost differences between the two types of calls does not approximate the cost of a coinless call. Thus, it is irrational to set compensation for non-coin calls by subtracting coin costs from local coin call rates. In MCI v. FCC, the Court found this to be a fundamental weakness in the Commission's approach.

The ability of carriers to block calls does not cure this defect. As found by the Court in Payphone I, the ability of carriers to block calls from overpriced payphones "does not save a default rate that is inexplicably tied to a local coin rate."<sup>13</sup>

Moreover, as demonstrated in the E GROUP's Reply, the ability to block is not an efficient way to establish a market discipline on pricing because blocking calls, in effect, drives entities out of the market.<sup>14</sup> In addition, the entity blocking and the person placing the call are not the same. Therefore, while the caller may be willing to pay the cost imposed by the PSP to make the call, the 800 subscriber making the blocking decision may not, thus unnecessarily frustrating the caller's ability to make the call.

In any event, the ability of carriers to block is limited because of the lack of nationwide payphone coding digits as a result of the waivers granted by the Common Carrier Bureau. Moreover, even when coding digits are available, selective blocking cannot be effectively implemented unless the Commission mandates certain parameters, which the Commission has

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<sup>13</sup> Illinois Public Telecommunications Ass'n v. FCC, 117 F.3d 555 (Payphone I), clarified, 123 F.3d 693 (D.C. Cir.), petition for cert. filed on other grounds, 66 U.S.L.W. 3458 (U.S. Dec. 29, 1997) (No. 97-1072).

<sup>14</sup> E GROUP Reply at 3.

not done.<sup>15</sup>

## II. A COST-BASED APPROACH WOULD PRODUCE "FAIR COMPENSATION"

As demonstrated by MCI, the default compensation rate for subscriber 800 and access code calls should be determined using a cost-based approach that relies on costs and quantities that are consistent with a market where multiple firms actively compete for the patronage of consumers. MCI's cost study,<sup>16</sup> which calculates the entire cost to provide an additional payphone, including usage costs associated with an average number of coin and coinless calls, demonstrates that the cost of a coin call is between \$0.11 and \$0.16 per call and the cost of a non-coin call is between \$0.08 and \$0.12 cents per call.

The LEC Coalition and APCC argue against a cost-based approach for a number of reasons. APCC argues that cost of service ratemaking will not work well to arrive at a fair compensation rate because "most costs are fixed and most calls are subject to market rates."<sup>17</sup> The LEC Coalition argues that a cost-based approach would impose wasteful regulatory burdens contrary to the intent of Congress; it would result in an inaccurate and contentious rate; it would create perverse incentives for PSPs to raise costs; it would require the Commission to adjust rates over time; and it would limit the recovery of PSP costs in high cost, low volume areas, thus

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<sup>15</sup> For a discussion of the parameters needed, see MCI's Reply Comments, CC Docket No. 96-128, 91-35, September 11, 1997 at 12.

<sup>16</sup> See, MCI Comments, MCI Payphone Cost Study at Exhibit 2.

<sup>17</sup> APCC Comments at 9.

leading to a reduction in the number of payphones.<sup>18</sup>

These arguments are without merit. As an initial matter, market based rates are superior to regulated rates where there is effective competition that keeps rates reasonable. As demonstrated, there is no such competition in the payphone market. Therefore, assuming carrier-pays compensation, a regulatory approach is necessary to set a fair compensation rate for 800 and access code calls.

Contrary to the LEC Coalition arguments, the Commission does not need to conduct a full-blown cost proceeding to establish a fair compensation rate. It could simply rely on the cost study submitted by MCI in its comments. In addition, since there is a market for PSP equipment and services, publicly available data on the cost of these items is readily available and is the basis of the data in the MCI cost study. Thus, the Commission does not need to rely on individual company data and, therefore, there would be no incentive for PSPs to artificially increase their costs.

As for APCC's argument that most costs are fixed and a regulated approach requires an accurate determination of call counts and the LEC Coalition argument that the Commission would have to adjust prices over time, the Commission's current approach requires the calculation of avoided cost. Thus, the current approach also has the problem of dealing with fixed cost and determining call counts, and it could require Commission review in the future.<sup>19</sup> It

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<sup>18</sup> LEC Coalition Comments at 4-7.

<sup>19</sup> Once implemented, a cost-based compensation mechanism would not need to be continuously recalculated, and, thus, should not be administratively burdensome, because most payphone costs do not vary based on usage and the number of calls from payphones is increasing. Accordingly, if anything, the cost per call should decrease.

is not clear why these problems are any worse with MCI's recommended cost-based approach.

Finally, the 1996 Act and the Commission's payphone orders provide for subsidized public interest payphones where a payphone could not otherwise be supported because of high cost and/or low volumes. Since Congress specifically provided for public interest payphones, it cannot be argued that the general requirement for "fair" payphone compensation was intended to subsidize non-economical payphones.

### III. THE LEC COALITION AND APCC AVOIDED COST ARGUMENTS ARE INCORRECT

The LEC Coalition and APCC incorrectly argue for a number of adjustments to the Commission's avoided cost approach. Specifically, they argue that the capital cost of the coin mechanism is not an avoidable cost because a PSP would not place a phone without a coin mechanism. Thus, there should be no offset to the local coin rate for the costs associated with the coin mechanism in calculating compensation for access code and subscriber 800 calls.

Coin mechanism and coin box costs, however, clearly are only used in connection with coin calls and, therefore, because they are not common to all functions of the payphone, they are avoidable costs. This is not changed by the fact that it may be more profitable for PSPs to offer payphones that can be used to place coin and coinless calls. Thus, these costs must be attributed to the cost causer and recovered from coin calls.<sup>20</sup>

APCC and the LEC Coalition also argue that the cost of Flex-ANI upgrades should be assigned to access code and subscriber 800 calls only, not all calls, because the upgrades are

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<sup>20</sup> E GROUP Reply at 6-7.

solely for the purpose of per-call compensation and tracking on subscriber 800 and access code calls. This contradicts earlier statements by the LEC Coalition that some LECs are implementing Flex ANI upgrades to comply with the Commission's requirement in the originating line screening proceeding. Moreover, that proceeding clearly establishes that unique payphone ANI ii digits assist PSPs in preventing charges for fraudulent calls and are not for the sole purpose of payphone compensation. Accordingly, there should be no adjustment in payphone compensation for Flex ANI.

If, however, the Commission includes this cost in the compensation amount, then the cost of implementing payphone digits should be apportioned to all calls from payphones because ANI ii digits will be transmitted with every call from a payphone. Using the LEC Coalition estimate for Flex ANI costs of \$1.17-\$2.45 per line per month and an estimate of 700 calls from payphones per month, the per-call cost of Flex ANI is only \$.00167-\$.0035 per call. Moreover, PSPs will only incur this cost for one or two years, when the full cost of implementing Flex ANI will have been recovered. Therefore, if there is an adjustment, it should be eliminated from the compensation amount once it is no longer imposed on PSPs.

The LEC Coalition also argues that its members have incurred costs to administer the collection of payphone compensation and since the cost of collecting coins is treated as an avoided cost, the incremental administrative collection costs associated with payphone compensation must be included in the compensation amount. For example, the LEC Coalition members allegedly have implemented new systems designed to create payphone compensation invoices, account for cash receipts and reconcile internally generated call counts with those produced by carriers; and they have hired new staff to maintain these systems and administer the

invoicing, collections and reconciliation processes. The LEC Coalition members allege that these expenses range from \$100,000 to \$2.2 million for the eight and one-half months ended December 31, 1997. On a per-call basis, this expense amounts to \$0.0005 to \$0.008 per call.<sup>21</sup>

As an initial matter, no underlying documentation is provided to support these alleged expenses and the mere fact that the expense varies among the RBOCS, GTE and SNET-- all large carriers-- from \$100,000 to \$2.2 million suggests that these numbers are not reliable. Also, it is not clear why PSPs must incur these costs to collect payphone compensation. The Commission imposed all costs of tracking compensable calls and making compensation payments on paying carriers. Thus, if the Commission also includes such an expense in the compensation amount, paying carriers would have to pay collection expenses twice-- their expense as required by the Commission's order and the PSPs' expense.

The LEC Coalition also alleges that per-call compensation uncollectibles will range from 3 to 10 percent of total expected per-call compensation revenue, or \$0.009 - \$0.028 per call. This percentage is based on bad debt percentages used by Coalition members in their 1997 financial statements and their bad debt percentages being used in their 1998 projections modified "to focus exclusively on amounts related to carriers which refused to remit 4th quarter, 1997 PCC payments and who have not raised any objection to their obligation to pay based upon regulatory issues."<sup>22</sup>

Again, there is no underlying documentation provided which would allow interested

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<sup>21</sup> LEC Coalition Comments, Report of Arthur Andersen on Per-Call Compensation at 5-6.

<sup>22</sup> *Id.* at 6.

parties or the Commission to verify the accuracy of these statements. In addition, it appears that the modified LEC data only represents a period of less than one full quarter. Accordingly, the LEC Coalition's conclusion cannot be deemed reliable or representative.

#### IV. THE ALTERNATIVE MARKET-BASED APPROACHES SUGGESTED BY THE APCC DO NOT PRODUCE "FAIR COMPENSATION"

The Commission must reject the arguments of the APCC to establish a market-based rate for subscriber 800 and access code calls based on other surrogates such as commission payments for 0+ calls, the rate for LEC 0- transfer service, and the sent paid toll call pay station charge.<sup>23</sup> The Commission has already rejected the use of these surrogates and there is no reason to revisit that decision now. In any event, 0+ commissions clearly are not an appropriate surrogate for compensation for access code and subscriber 800 calls because it represents the value to the carrier of being the monopoly provider of 0+ service from the phone and in receiving calls from customers in addition to the carrier's presubscribed customers. Just like the PSP pays locational monopoly rents to the premise owner, the presubscribed 0+ carrier pays monopoly rents in the form of high 0+ commission payments to the PSP. There is no basis for allowing the PSP to collect monopoly rents from access code and subscriber 800 calls, regardless of the surrogate used to determine these rents.

In addition, to use 0+ commissions as a surrogate would be contrary to the goal of the Telephone Operator Consumer Service Improvement Act of 1990, which sought to protect consumers from excessive 0+ rates by requiring aggregators to allow consumers to dial-around

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<sup>23</sup> APCC Comments at 27-29.

the 0+ carrier. As stated by operator service providers in CC Docket No. 92-77, high operator service rates are caused, in part, by the high commissions OSPs are required to pay to PSPs to be the monopoly provider of 0+ service. If the Commission requires carriers to compensate PSPs for access code and subscriber 800 calls like 0+ calls, then consumers could ultimately be charged the same excessive rates for access code and subscriber 800 calls as they are charged for 0+ calls.

The LEC transfer service rate and the sent-paid toll call surcharge also cannot be a surrogate for the cost of providing access to access code and subscriber 800 calls. The LEC transfer service rate, as a regulated rate, purportedly represents the cost to the LEC of transferring a call to another carrier. There is no such transfer with an access code or subscriber 800 call and, therefore, this rate cannot be a surrogate for access code and subscriber 800 compensation. And, the sent-paid toll call surcharge is imposed when the customer places a toll call from a payphone using coins, which clearly cannot be a surrogate for the cost of providing access to non-coin calls any more than the cost of local coin calls is an appropriate surrogate.

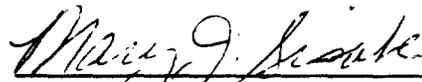
## V. CONCLUSION

In its Comments and Reply Comments, MCI has demonstrated that local coin rates and costs will not converge in the payphone market, largely because payphones are locational monopolies. Thus, the observed rate for coin calls includes monopoly rents, which are not economic costs and should not be included in a prescribed compensation amount for subscriber 800 and access code calls. Accordingly, the Commission cannot devise a market-based rate for coinless calls based on the observed rate for coin calls minus coin costs.

Rather, a carrier-pays compensation mechanism must be based on economic cost. The Commission can, and should, determine a fair cost-based compensation rate from the cost study submitted by MCI.

Respectfully submitted,

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Dated: July 27, 1998

# **ATTACHMENT**

## Payphone Compensation: A Reply to Comments

*T. Randolph Beard, Robert B. Ekelund Jr., and Richard P. Saba\**

*My, look at the Emperor's new clothes!  
There's never been anything like them!*<sup>1</sup>

### I. INTRODUCTION

"[W]ithout explanation, the Commission merely declared itself 'confident that market forces will keep payphone prices at competitive levels.'"<sup>2</sup> This statement, made by the Court in its remand of the Second Order, encapsulates the reasoning behind the rejection of the Commission's second attempt at a "market based" payphone compensation rate. This same criticism is no less applicable to the four declarations filed on behalf of the payphone industry by Drs. Becker, Kahn, Hausman, and Haring and Rohlfs. These declarations provide no evidence, either conceptual or empirical, that competition in the payphone industry offers any competitive discipline on local coin rates. Yet, these economists' support of the "market based" approach of the Commission rests solely on the foundation of this competitive discipline. The Court already has rejected any approach to determining a compensation rate that simply assumes competition, "especially because the Commission itself has suggested that the assumption may not be accurate."<sup>3</sup> Returning to the Court with little more than assertions about competition in the payphone industry will be as unsuccessful now as in the past.

In addition to incorrect assertions about competition in the payphone industry, the declarations submitted by Drs. Becker, Kahn, Hausman, and Haring and Rohlfs suffer from several other flaws, both as a group and individually. We discuss these flaws in the following sections. First, in Section II, we discuss some general topics that appear somewhat uniformly in both the comments and economic declarations. In Section III, we provide specific comments on the each of the four economic declarations submitted on behalf of the payphone industry. Conclusions are provided in Section IV.

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<sup>1</sup> Hans Christian Andersen, The Emperor's New Clothes.

<sup>2</sup> See Court Remand, MCI v. FCC, May 15, 1998 (143 F.3d 606); Commission cited at Second Order, ¶ 118.

<sup>3</sup> *Id.*

## II. General Issues

### 1. NATURE OF COMPETITION

The concepts of competition in the payphone industry proffered in the declarations of Becker, Haring and Rohlfs, Hausman and Kahn ("declarations") all differ in detail and, indeed (as we show below) are contradictory. However, all of the declarations agree on one critical point: all confuse free entry in the payphone business with competition in its conventional sense. Furthermore, all the affiants' arguments rest on the assumption that the recent forty percent increase in coin rates is the result of competitive market forces and, as such, reflect the social cost of payphone calls. Dr. Becker, for example, concludes that the "avoided cost" methodology proposed by the FCC is "reasonable" because the framework approximates the value that would arise in a competitive market.<sup>4</sup> Dr. Hausman, in a similar vein, argues for the avoided cost approach, "since it is based on the competitively determined coin call price" (p. 7).

As shown in our original report, the payphone industry is not competitive. Thus, any scheme based on the present rates prevailing in the payphone market is inherently flawed. As we argued in our previous filings, the prevailing coin rates contain economic rents to site owners that cause prices to overstate the true costs of service. These prices represent transfers from consumers of payphone services to site owners through competitive rivalry for the best site locations. This circumstance implies that observed coin prices actually incorporate locational monopoly rents – rents which, from society's perspective, are not a social cost. For the most part, the problem of locational monopolies in the payphone industry has been ignored. And, when the question is broached, it is dismissed on an erroneous classification of the market, which fails to draw a clear distinction between the market for payphone locations on the one hand and the market for payphone services on the other. The former has all the characteristics of the classic locational monopoly, while the latter is populated with a large number of providers. The affiants base their claim that the industry is competitive on the large number of PSPs competing for a limited number of good payphone sites. This sort of competition will not restrain coin prices, and will in fact increase them. These payphone prices cannot be used to correctly calculate "competitive" dial around compensation rates.

Affidavits supporting the claims of the payphone industry based on the assumption of competition are therefore irrelevant if the FCC desires to approximate

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<sup>4</sup> Becker, further, in a discussion of this so-called competitive situation in payphone services, suggests an analogy to hair stylists in order to illustrate "how competitive markets function under similar production and cost conditions." In that example, Becker uses the textbook assumptions of the perfectly competitive model. We fully agree with Becker's analysis of that market if there are no monopoly elements to be considered. The problem is that the analogy posits no locational monopoly input considerations – an essential characteristic of the payphones industry.

a truly competitive rate for 800 and dial around compensation. Observed coin rates do not and cannot reflect the true opportunity costs of providing service. A prudent and logical approach to establishing a competitive level of compensation must necessarily establish the probable level of relevant economic costs using a bottom-up cost calculation.

## 2. CALL BLOCKING AND MARKET POWER

Blocking, the ability of some 800 number hosts or interexchange carriers to refuse to accept calls from designated payphones, is often portrayed by advocates of high or unrestricted dial around compensation levels as an important and useful mechanism to establish market discipline in dial around pricing. As in the case of terminating access charges, dial around calling is sometimes initiated by one party but paid for by another. Just as the recipient of an unwanted person-to-person call can decline to "accept the charges," a business with an 800 number can decline to pay for calls from payphones with "outrageous" payphone compensation rates.

In an immediate sense, the "blocking" option is identical to that oft cited, and court rejected, defense of monopolies everywhere: one is not required to buy.<sup>5</sup> A firm offering 800 service can decline to "buy" calls, just as the customer of a cable television monopoly can decline to buy service. Certainly, neither Congress nor the Commission disregards market power in the cable television industry simply because thirty to forty percent of households do not subscribe to (i.e., block) cable television service. This feeble defense of high prices is familiar to students of the early days of the Sherman Act and has been repeatedly and soundly rejected.

The effects of a reliance on blocking to discipline prices do not appear very attractive. First, blocking is merely the ability of an 800 site provider to escape imposition of high costs by fleeing the market, so to speak. To what, though, do they flee? Since consumers cannot possibly know in advance which payphones are blocked by which companies, the 800 site's choices are either to frustrate their customers or else to pay monopoly prices.

In addition, increases in dial around costs will presumably lead to both increased blocking and abandonment of 800 service by some businesses. Many customers who call 800 numbers do not buy anything, while actual buyers "pay freight" for the others. However, those who can call, whether they purchase something or not, enjoy an "option value": they could buy, and might do so under other circumstances. Yet, the site provider does not capture these values. With high compensation rates, these values are destroyed as 800 numbers dwindle. Thus, as

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<sup>5</sup> See P. Asch, Industrial Organization and Antitrust Policy, New York: Wiley, 1983, ch. 12 and 13, for a fascinating history of early defense to antitrust charges in U.S. courts.

with any network, elimination of sites reduces the value of the remaining system to its users.

### 3. RELATIONSHIP BETWEEN COIN AND COINLESS CALLS

The degree to which the demands for coin and dial around calls are independent is an important issue no matter which position one takes on the appropriate coinless compensation mechanism. If the price of one service (e.g., coinless calls) affects the demand for the other (e.g., dial around calls), then any price change for one service will affect the quantities consumed of both services. This relationship is important because it will affect the degree to which coinless calls are a competitive alternative to coin calls.

It is an old observation in industrial economics that the degree to which one service is a substitute for another depends on their prices, among other things. To see the relevance of this for payphone regulation, it is only necessary to note that consumers can make local calls with a calling card. In fact, it has become increasingly common for payphones to advertise to customers that a collect or calling card call can be made for local as well as long distance calls.<sup>6</sup> While the use of a coin alternative to local calls is often an issue of convenience (a lack of coins, for example), coinless calls could also serve as a substitute for coin calls as the price for coin calls increases.

In general, interexchange carriers charge intrastate long distance rates for any intrastate call, whether local or long distance. If intrastate rates are low enough, the per minute average price multiplied by the number of minutes could be less than the coin rate, particularly if very high coin rates emerge under deregulation.<sup>7</sup> Absence of a set-up fee for calling card calls -- a feature of some carriers' calling plans -- makes this substitution more probable. If one believes coin rates will continue to rise while intrastate access rates continue to fall, this phenomenon takes on increasing significance.

While it is attractive to think that such coinless calls could act as a competitive brake on rising local coin rates, any possibility of such a beneficial effect clearly depends on the level and type of dial around compensation. The Commission's

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<sup>6</sup> For example, an advertisement on a payphone in the District of Columbia reads "Out of Change? Use Your Calling Card or Call Collect to Place Local & Long Distance Calls... (Payphone at the 1900 block of M Street NW)."

<sup>7</sup> History has shown that payphone operators, whether regulated or not, are willing and able to charge extremely high rates for services, particularly operator assisted long distance services. As we noted in our previous report, one payphone operator in Georgia attempted to charge \$1.75 for a three minute local call (Independent Pay Phone Operator Loses Contract to Serve Summer Olympics, Communications Daily, July 9, 1996). In this case, occurring prior to the deregulation of local coin rates, the Georgia Commission disciplined the payphone operator.

"market based" approach, where the dial around compensation rate is only a few cents off the prevailing local coin rate, excludes the possibility of coinless calls competing with local coin calls whether the local coin rate is \$0.35 or \$1.75. Ironically, tying coinless compensation rates to the coin rate in such a fashion helps preserve coin rates at monopoly levels.

#### 4. COMPENSATION AND NUMBER OF PHONES

The economists supporting the coalition's position argue that increases in the coin rate will increase the number of payphones. No evidence supporting this position is provided. Their argument is based on the assumption that the regulated rates were set below the rate that would obtain in a competitive market. However, the empirical evidence indicates that increases in the local coin rate have led to little, if any, increase in the number of payphones.<sup>8</sup> And, since the number of coinless calls are a fraction of the total number of calls placed from the average payphone, the effect of an increase in the coinless compensation rate would be even smaller.

In addition, as we point out in an earlier filing, the empirical evidence suggests that the increased benefits to consumers from increases in the number of payphones arising from higher prices is more than offset by a transfer of consumer surplus to site owners.<sup>9</sup> The report found that in an "average state" a ten percent increase in the price of a payphone call results in a loss of about \$77 in consumer surplus for each existing payphone per year, yielding a net \$5,500 consumer benefit loss per new payphone obtained. Given the recent forty percent increase in many coin rates, the total consumer welfare lost due to increases in payphone rates dramatically underestimates the actual losses. Given these findings, it is difficult to reconcile above cost compensation rates with the Act's requirement that compensation be "to the benefit of the general public (§ 276(b)(1))."

One might argue, as Haring and Rohlfs did in their declaration, that even though a price represents a monopoly rent, it still plays an important economic function: the allocation of a scarce resource to its most valued use.<sup>10</sup> (The transfer of consumer surplus to the site owner, as mentioned above, still obtains.) This however, is much different from the role prices play in a competitive market. Competitively determined prices not only facilitate the allocation of a good to its most valued use but also induce changes in the supply in response to changes in the price. As we argued in our earlier filing, a forty percent increase in coin prices, from

<sup>8</sup> See Economic Effects of Excessive Compensation Rates to Pay Telephone Providers (filed with the FCC on October 7, 1997, FCC Docket No. 96-128) and A Study of Payphone Market Organization and Compensation (filed with FCC on July 13, 1998, FCC Docket No. 96-128).

<sup>9</sup> See Economic Effects of Excessive Compensation Rates to Pay Telephone Providers.

<sup>10</sup> See Declaration of John Haring and Jeffrey H. Rohlfs, July 13, 1998, page 11.

\$0.25 to \$0.35, has a large monopoly site rent component, and we found no statistically significant effect on the change in the number of payphones from coin price deregulation.<sup>11</sup> It is possible to argue that sites not profitable under competitive returns might be profitable if monopoly rents could be earned, and that more of these sites would be developed if the monopoly rents increased. But increasing the number of sites does not necessarily mean an increase in the number of payphones or the number of calls, nor does it imply that there will be an increase in consumer welfare.

### III. Specific Replies to the Declarations

#### 1. KAHN

Professor Kahn's declaration, like that of the other RBOC/GTE/SNET payphone coalition experts, is based on the proposition that payphone markets are competitive. We have briefly discussed here, and in detail in our earlier reports, that the type of competition present in the payphone industry does not lead to competitive coin prices.

Further, Professor Kahn makes several specific suggestions that deserve comment here. Professor Kahn argues that, "the commission's adjustment of the local coin rate for avoidable cost was economically erroneous in at least one critical respect: if the facts are as I have been informed, coin mechanism capital costs should not be treated as avoidable costs of coinless calling" (Kahn, p.2). Professor Kahn argues that, because most payphones would not be installed in the absence of coin calling sales, capital costs associated with the coin mechanism itself should be partially paid for by users making coinless calls. This is completely incorrect.

Professor Kahn confuses two entirely separate questions. First, given market demands, what type of equipment/product offering is profit maximizing for the PSPs? Second, how should the costs of terminal equipment be recovered? By restating Professor Kahn's argument in a more transparent fashion, it is clear that coinless call patrons should not pay costs caused solely by coin patrons, despite the fact that it is more profitable for PSPs to offer phones that can do both. For example, restaurants ordinarily serve both food and drink. There are costs common to both products (e.g., the premises), and costs incremental only to food (e.g., the stove) or drinks (e.g., the soda fountain). Now, it is probably true that there are virtually no restaurants that offer only food, or only drinks. This is a result of market demand conditions, common costs and the like. Yet, by Professor Kahn's argument, this implies that, under competitive conditions, drink patrons should pay extra charges to amortize the stove, which they don't use. One presumes that, likewise, food

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<sup>11</sup> See A Study of Payphone Market Organization and Compensation, page 11.

patrons should help pay for the soda fountain, and so on. This is plainly incorrect, and violates the basic principle of cost causative pricing. The set of products actually offered by a business is endogenous and reflects profit opportunities. Costs, however, must be attributed, so far as possible, to those who occasion them.

As with many of the other payphone coalition affiliates, Professor Kahn argues that free entry by PSPs is equivalent to competition in its usual economic sense, so that observed prices approximate costs. Unfortunately, the rate of site rents, and the obvious incentive of site owners to sell a monopoly franchise to a PSP, implies that free entry will not cause prices to be driven to social costs. Coin prices will reflect monopoly site rents, which are not social costs. In order to sustain Professor Kahn's position, it would be necessary to show that the typical geographical scope of a payphone's (or bank of payphones) market ordinarily overlapped other payphone geographical markets sufficiently to impose competitive price discipline. The small absolute cost of even a monopoly priced coin call suggests, however, that these markets are likely to be very small. The inability of consumers to observe prices at a central location (i.e., imperfect information), and the incentive of site owners to offer monopoly locations to PSPs, further reduce the probable size of these markets. Thus, Professor Kahn's analysis rests on a competitive premise that seems improbable.

## 2. BECKER

Professor Becker, despite a primary reliance on the raw conclusions of the traditional (textbook) competitive model to calculate 800 and dial-around compensation, does mention the possibility of particular market imperfections within the payphone industry. Among these "complications" (p. 4), he cites the possibility of imperfect information among consumers. Certainly, payphone users do not ordinarily know payphone prices at other locations. The costs of doing so, as is revealed in search models described by Becker in other contexts, would be "too high" to engage in search. Payphone prices, moreover, are a small portion of the consumer's budget.<sup>12</sup> These considerations do in fact add a monopoly characteristic to the payphone market.

But the monopoly characteristics of the payphone industry also extend to the supply side of the market. Thus, Becker admits (p. 9, n. 6) that payphones differ "perhaps because of locational differences" and that "profits and margins" will only be driven to zero across different services at the marginal payphone. Becker misses the fact that such locational differences constitute an important part of the reason why, in general, normal profits are expected for all payphones. The inframarginal profits collected by firms with superior locations are transferred to monopoly site

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<sup>12</sup> Generally speaking, the smaller the percentage of income expenditures on a particular good are, the less sensitive the consumer will be to price changes for that good (i.e., the more inelastic will be demand).

location owners. This arises due to the rivalrous "competitive" bidding process for sites. Thus, a monopoly location element will be embodied in coin rates charged consumers when coin prices are not regulated. For this reason, coin rates cannot be used as a proxy for true opportunity costs of payphone services.

### 3. HAUSMAN

Professor Hausman's statement, as in other declarations, considers the element of location. He argues that "relatively few" locations are plausible candidates for locational monopoly, although he admits (p. 12, n. 14) that "to the extent that such behavior did occur, PSPs would not earn above-normal profits since the location owner would capture all such profits through its agreement with the PSP." While admitting that locational monopoly sometimes exists, Dr. Hausman concludes that (unconstrained) airport authorities or truck stop owners might want to "set the local coin rate at the prevailing competitive rate (p. 12)" and notes a similarity to an airport fast food restaurant.

Hausman's arguments, however, are fatally flawed. First, the allegation that locational monopoly is rare is unsupported and unsupported empirically. Clear testimony refutes the notion that rent transfers are exclusively at the "best" locational sites. Secondly, the rivalrous process of competition for sites will depend on the expected revenues from coin phone operation in a particular location. The amount of rents transferred to the site owner will depend on that expectation. Third, while the site owner might have the ability to restrict coin prices at his or her location, he would have little incentive to do so.<sup>13</sup> Since only one PSP would ordinarily be franchised to serve customers in a single market site, and since demand is presumably price inelastic for payphone services, price increases would be transferred into rent enhancement to the location provider.<sup>14</sup> There is little reason to expect that the latter is not a profit maximizer. Hausman's observation that locational rents are capitalized in "some cases" has far more general applicability. The evidence, some of it presented in our previous study, is that "commissions" are a very significant monopoly element in coin prices at all but marginal locations.

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<sup>13</sup> An early discussion of the "altruistic" monopolist was provided by Alfred Marshall, where he concludes "...it would seldom happen that the monopolist can and will treat £1 of consumers' surplus as equally desirable with £1 of monopoly [profit]." See, Alfred Marshall, Principles of Economics (1920) (at (in the original text) V, xiv, 7).

<sup>14</sup> Prices for food and beverages at airports are typically very high due to the site rent paid by vendors to the airport. These prices may also reflect an actual competitive situation (pizzas vs. hamburgers vs. chicken, etc.) – a competition that does not obtain for payphones.