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August 27, 1998

EX PARTE OR LATE FILED

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, D.C. 20554

NOTICE OF EX PARTE PRESENTATION

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AUG 27 1998
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: CC Docket No. 96-128

Dear Ms. Salas:

On August 27, 1998, Albert Kramer and Robert Aldrich of this law firm, representing APCC, met with Greg Lipscomb and Milton Price of the Enforcement Division staff and Craig Stroup of the Industry Analysis Division.

We discussed generally the views stated in APCC's Comments, filed July 13, 1998, and Reply Comments, filed July 27, 1998, and record submissions of other parties. The points made are fully described in the attached summary of the record, which was handed out at the meeting.

Sincerely yours,

Robert F. Aldrich

Robert F. Aldrich

RFA/nw
Enclosure
cc: Greg Lipscomb
Milton Price
Craig Stroup

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EX PARTE PRESENTATION

AMERICAN PUBLIC COMMUNICATIONS COUNCIL

CC DOCKET NO. 96-128

REMAND OF THE FCC'S SECOND REPORT AND ORDER

SUMMARY OF RECORD
ON PAYPHONE COMPENSATION ISSUES

I. THE PAYPHONE MARKET IS COMPETITIVE

- The Commission previously found that the payphone market would be competitive enough to allow deregulation of the local coin rate. This finding was specifically affirmed by the court of appeals.

- Two years ago, the Commission offered to provide exemptions from local coin deregulation if a state provides evidence demonstrating that "market failures" in a particular state prevented market-based rates. First Report and Order, 11 FCC Rcd at 20572, para. 61. To date, no state has attempted such a demonstration.

- Virtually all parties agree with FCC's finding that there is intense competition among payphone service providers ("PSPs"). Low entry barriers have allowed thousands of suppliers to enter the market. In this competitive market, it is clear that payphone rates reflect costs incurred by PSPs.

- But some parties now advance the theory that each payphone *location* represents a monopoly, and that "monopoly rents" extracted by *location providers* from these "thousands of monopolies" prevent effective payphone competition. These claims are rebutted by the record.

A. Locational Monopoly Theory Has No Foundation

- Several distinguished economists find no significant "locational monopoly" barriers to payphone competition.

  - Haring and Rohlfs: "[C]allers usually possess a large number of effective substitute alternatives to a particular payphone. . . . the supply of physical location sites should thus not properly be regarded as a serious competitive barrier." Haring and Rohlfs Dec., paras. 11-12.

  - Hausman: "Market experience to date demonstrates the competitiveness of payphone markets. . . . Relatively few locations are likely to be plausible candidates for such locational monopolies." Hausman Dec., paras. 20-22.

  - Kahn: The argument that "*every* payphone location is a monopoly . . . is surely absurd: while travelers passing through an airport may have no feasible alternative . . . that can certainly not be true of payphone users in almost all other conceivable circumstances." Kahn Reply Dec. at 6.

- The mere fact that a commission is paid to a location owner does not show that the location is a monopoly. Commissions are no more indicative of monopoly power than any other rental payment. Like other rents, commission payments reflect the market value of space vis-à-vis other competing uses.

- IXCs and paging companies refute their own "locational monopoly" theory by supporting a market-based "caller pays" approach to compensation. If a market-based "caller pays" approach is viable, then locational monopolies must not be posing significant barriers to competition producing reasonable, market-based "caller pays" rates.

B. Locational Monopoly Theory Ignores Reality

- Callers have numerous competitive options:

  - *Nearby payphones.* A Consumers Union study found that 30% of payphones are in *visual range* of another company's payphones. Where nearby payphones are outside visual range, they can be readily discovered. And if a payphone's price increases beyond competitive levels, additional payphones will be added at currently unfilled locations.

- *Wireless telephones.* A substantial percentage of callers have this alternative. Wireless penetration is 23% and growing at 25% annually. There is no reason to believe wireless users are insensitive to price differences between payphone calls and wireless calls.

- *Temporal alternatives.* Most payphone calls are not emergency calls. High prices would encourage non-emergency callers to defer calls to another time when they can be made from home, workplace, or a different payphone location.

- *Changing routines.* Many callers are repeat users of payphones near their homes, shopping areas, workplaces, or commuting routes. These callers are likely to change their routines to avoid higher-priced payphones.

♦ There is no reason to doubt that callers, PSPs and location owners are aware of and sensitive to these alternatives.

♦ From the location owner's perspective, payphones are one element in the location owner's overall product mix. A convenience store will not risk deterring customers for magazines, cigarettes, etc. by overcharging for payphones.

C. Pricing Evidence Contradicts Locational Monopoly Theory

♦ IXCs argue that payphones must not be competitive, because local coin rates increased after deregulation. But the rate increase shows only that rates were held artificially low by regulation.

♦ In fact, the relatively uniform 35-cent rate is further evidence of a competitive market. If a significant portion of locations were monopolies, major differences would be evident between "monopoly" and "competitive" rates. The relative prevalence of the 35-cent rate indicates that the market is imposing a ceiling on rates.

♦ Even in airports, the "paradigm" "locational monopoly" repeatedly cited by IXCs, the facts in the record establish that rates have not risen above the competitive 35-cent level.

- Because rates are competitive, rates approximate cost. Competition doesn't have to be perfect, it only has to be effective. With effective competition, rates will reflect economic costs.

II. IN A COMPETITIVE INDUSTRY WHERE ONE SERVICE IS SUBJECT TO STATUTORY CONSTRAINTS ON MARKET PRICING, THE MARKET RATE FOR ANOTHER SERVICE WITH SHARED COSTS PROVIDES A GOOD STARTING POINT FOR SETTING THE STATUTORY RATE

A. Prescribing Dial-Around Compensation Is Unlike The Commission's Traditional Regulatory Tasks

- The Commission correctly allowed rates for most payphone services to be set by the market. But it found that one payphone rate – the dial-around compensation rate, could not be set by the market, because PSPs are not free to negotiate with IXCs regarding the delivery of such calls.
  - Section 226(c) prohibits blocking of access code calls
  - Even apart from Section 226, the Commission has indicated call blocking is generally prohibited as an unreasonable practice. Telecommunications Research and Action Center v. Central Corp., 4 FCC Rcd 2157 (Com. Car. Bur. 1989).
  - PSPs are effectively prevented from blocking subscriber 800 calls (even if technically permitted to do so) because it is not practical to differentiate all subscriber 800 numbers from all 800 number access codes.
- Thus, the Commission must regulate rates for one service in an industry that is otherwise competitive and subject to market rates.

B. Cost-Of-Service Ratemaking Would Be Inadequate And Counterproductive

- Recognizing that cost-of-service ratemaking can't keep up with continually changing telecommunications markets, the Commission has consistently sought to move away from cost-of-service ratemaking and to rely on markets to regulate rates. In the competitive payphone market, cost-of-service ratemaking would be step backwards and inconsistent with the Commission's settled policies.

- Payphones have high fixed joint-and-common costs; market changes affecting the supply of payphones and the number of calls per payphone dramatically affect fixed costs per call.

    - Repeated attempts at cost-of-service ratemaking would cause cycles of instability in response to market changes that increase or decrease average call volumes at payphones.

    - The IXCs claim that this problem is inherent in cost-of-service ratemaking – but if so, that is exactly why market-based rates are preferable.

    - Contrary to IXCs' claims, pure cost-of-service ratemaking (without any reliance on market rates as a starting point) presents far worse problems than the avoidable cost calculations used in the Commission's market-based approach.

        (1) the costs involved in avoided cost ratemaking are much smaller, so any distortions will be far less significant;

        (2) properly implemented, the only avoidable costs considered are variable, i.e., volume-sensitive costs. *Variable costs per call* are not dramatically affected by changes in the number of calls per payphone. By contrast, *fixed* costs, which make up the bulk of the costs that must be estimated in a pure cost-of-service approach, will vary dramatically *on a per-call basis* due to changes in the number of calls per payphone. Thus, it is the comprehensive cost-of-service approach, which tries to estimate fixed costs, that threatens cycles of instability due to changes in the supply of payphones and the number of calls per payphone.

- The advantages of cost-of-service ratemaking – preventing excessive profits – aren't applicable here. Even IXCs do not seriously claim that the *PSPs* are earning monopoly rents. In any event, as demonstrated above, the local calling rate does not include any monopoly rents.

- Moreover, because the payphone market is competitive, rates will always reflect costs. Even if the dial-around rate is set "too high," payphones will be added by new or existing competitors until all economic profits are eliminated. Thus, a rate set "too high" will not result in "windfall" profits. It will only result in a greater number of payphones, or a different relationship among the rates for various payphone services, than would result in a fully functioning market. On the other hand, if the rate is set too low, the number of payphones will be lower than would result from a freely functioning market, contrary to the statutory mandate for "widespread deployment of payphone services".

C. Using A Market-Based Payphone Rate As A Starting Point Ensures That The Dial-Around Rate Reflects Costs And Avoids The Pitfalls Of Cost-Of-Service Ratemaking.

- The market rate, suitably adjusted for cost differences, will provide a cost-based proxy for the rate that cannot be set by the market – i.e., the dial-around rate. Such a rate will be "cost-based" because competitive market rates reflect costs.

- As the market rate changes, the dial-around rate is periodically recalculated (and under the Commission's approach, is automatically recalculated) to reflect the market changes. As a result, the market-based approach has several key advantages over a cost-of-service approach:

  - Unlike the cost-of-service approach, the market-based approach automatically tracks changes in the market that affect the supply of payphones, call volumes, and fixed costs per call.

  - The market-based approach avoids cost calculation mistakes, relying on market competitors to correctly calculate their costs when setting market rates.

  - The market-based approach avoids cycles of instability that afflict cost-of-service ratemaking.

  - In fact, the market-based approach is self-correcting. If the dial-around rate is "too high," additional competitors will come into the market, causing a reduction in market rates and therefore a reduction in the dial-around rate that is tied to market rates.

- Market rates that deserve consideration for this purpose include:

  - Local coin rates

  - Sent-paid toll rates

  - 0+ rates

- Ideally, the dial-around rate would be set by mimicking the results of the market. In a freely functioning market where all payphone rates are market-based, the rate for each type of call would be set to recover marginal (avoidable) costs of that type of calls plus an appropriate allocation of joint and common costs.

- Ideally, dial-around rates would be set as a function of all three market rates. The Commission chose a simpler approach that relies on just one market rate – the local coin rate. Significantly, the rate chosen by the Commission is the lowest of the three. Any bias in the Commission's choice of a market-based proxy is a bias in favor of lower dial-around rates.

- Further, to mimic the market exactly the Commission would determine (1) the avoidable costs associated with each type of call, and (2) an allocation of joint and common costs based on relative elasticities of demand for each type of call, and would adjust the existing market rate to reflect these factors. The Commission found that the former could be determined, but not the latter – even though the RBOCs presented persuasive evidence that the elasticity of dial-around calls is lower than the elasticity of local coin calls, resulting in allocation of more joint and common costs to dial-around calls than to local coin calls. In choosing not to rely on this evidence, and setting the allocation of joint and common costs on an equal per-call basis for both types of calls, the Commission again chose the approach that results in a lower rate for dial-around calls.

- The finding that relative elasticities cannot be determined does not at all invalidate the market-based approach. It only means that the allocation of costs resulting from the market-based approach will not perfectly mimic the results that would occur in a freely functioning market. (The same imperfection, and many more, apply to a cost-of-service approach.)

D. Local Coin Rate Is Related To The Dial-Around Rate On The Supply Side

- The court of appeals questioned how local coin market is related to the dial-around market, such that the rate established in one market, with cost adjustments, could be a proxy for the rate established in the other market. As shown above, the payphone market is competitive, with no significant "locational monopoly" element. Therefore, rates reflect costs.

- There is a close supply-side relationship between the local coin rate and the dial-around rate. The same payphone is used for both types of calls, and the costs involved are primarily fixed joint and common costs. The bulk of the costs attributable to each service are joint and common costs shared by both services.

- The relatively small portion of costs that are not shared can be identified, estimated and added or subtracted from the local coin rate to arrive at a useful proxy for the costs per call attributable to dial-around calls. Tying the dial-around rate to the local coin rate and adjusting for avoidable cost differences ensures that the dial-around rate does not include any costs not attributable to dial-around calls, but does include an appropriate allocation of fixed costs.

- Thus, there is a clear relationship between local coin calls and dial-around calls on the supply side, because the same equipment is used and the bulk of the costs are shared by both types of calls. While there may or may not be differences between the two markets on the demand side, the close relationship on the supply side makes the local coin rate a valid market-based benchmark for ensuring that dial-around compensation is based on attributable payphone costs.

- In summary, the market-based approach is superior because (1) market rates are a better indicator of overall costs than attempts to apply cost-of-service ratemaking to an entire competitive industry; and (2) a cost-based approach will not adjust to market changes, including changes induced by the Commission's rate prescription. As noted above, a market-based rate will automatically adjust the dial-around rate, in the appropriate direction, in response to market changes that produce increases or decreases in the supply of payphones. By contrast, a cost-based rate will produce exactly the opposite of the desired market approach.

E. The Market-Based Approach Is Subject to Effective Market Control

- IXCs claim that a market-based carrier-pays approach is invalid because the IXCs cannot control whether a call is made from a payphone.

- The Commission's market-based approach ensures that there is market control of the rate by tying it to the local coin rate. The result is a market controlled rate.

- IXCs can exercise direct control by blocking calls from excessively priced payphones. The information necessary for creating targeted call blocking is available. Because the uniform default rate does not expire until October 1999, IXCs have ample time to prepare before any need to deploy blocking capabilities will arise.

- IXCs can pass dial-around compensation costs through to their subscribers, many of whom are able to control placement of calls.

    - Calling card customers and prepaid card users that are billed for payphone surcharges on access code calls can directly control the use of their cards.

    - Many subscriber 800 calls are placed by employees of the 800 service subscriber. For example, truck drivers place huge volumes of subscriber 800 calls to trucking companies from truckstop payphones. These subscribers can directly control their employees use of payphones to make such calls.

    - Other subscribers to 800 numbers, e.g., paging companies or auto rental companies, are in a position to exercise indirect control, if there is an economic reason to do so, by passing through payphone surcharges to customers in the form of extra service charges.

III. THE COMMISSION SHOULD NOT ADOPT CALLER PAYS

- The Commission's rejection of a caller pays approach was upheld by the court of appeals. There is no reason to revisit that decision.

- No party provides a basis for reconsidering the Commission's conclusion that it would be burdensome to force callers to acquire and deposit coins to make 800-number calls from these payphones.

- Callers have an expectation that they will not have to deposit coins for these calls. Access code users would be billed twice – once for a coin deposit and once for calling card charges.

- Section 226(c)(1)(C) of the Act prohibits PSPs from collecting advance payment for access code calls unless they collect advance payment for calls to the presubscribed carrier – i.e., 0+ (and even, presumably, 0-) calls. Thus, the statute appears to prohibit coin deposits on dial-around calls unless coin deposits are collected on *all* coinless calls.

- Even if not directly applicable to compensation under Section 276, Section 226(e)(2)(prohibiting the Commission from considering advance deposit compensation for access code calls) and 228(c)(7)(prohibiting carriers from assessing callers a charge for 800-number calls) express a clear Congressional preference against exacting compensation directly from callers for these types of calls.

- As noted above, there are other methods than caller pays by which the Commission can ensure adequate market discipline of the compensation for dial-around calls.

- The only consumers and users to comment oppose caller pays. This is a "carrier-friendly" solution, not a consumer-oriented one.

- Transaction costs would increase under caller-pays. A large percentage of dial-around callers are business callers who would need to be reimbursed by their employers. Thus, coin deposit requirements would increase administrative costs by shifting call tracking responsibilities to individual employers and employees.

IV. THE PER-CALL COMPENSATION RATE NEGOTIATED IN 1994 BETWEEN APCC AND AT&T IS NO MARKET-BASED RATE.

- PSPs were no freer to block dial-around calls in 1994 than they are today.

- AT&T had no legal obligation, and no reason to agree, to pay more than its prescribed share of FCC-mandated access code compensation, amounting to about $3.50 per payphone per month.

- In light of these constraints, the negotiations were focused on the establishing the feasibility of per-call payments, not on increasing AT&T's total dial-around payment.