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October 2, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

In re Matter of the Pay Telephone Reclassification and Compensation Provisions
of the Telecommunications Act of 1996, **CC Docket No. 96-128**

Dear Ms. Salas:

The attached Declaration by Professor Jerry Hausman was prepared on behalf of the RBOC/GTE/SNET Payphone Coalition. The Declaration addresses certain points made by Professor William Baumol in an affidavit submitted with AT&T's Reply Comments (filed July 27, 1998). In addition, the Declaration reviews existing and new empirical evidence that proves that the market for local coin calls is competitive.

The Declaration's main points are as follows:

- Professor Baumol concedes that the avoided cost approach, in appropriate circumstances, is a valid, market-based, rate-setting technique. He thus refutes any concerns that avoided cost pricing entails subtraction of "apples from oranges."
- Professor Baumol also agrees that Ramsay pricing would constitute an appropriate rate-setting technique in this context; Professor Hausman has shown in past declarations that Ramsay pricing for any plausible range of demand elasticities supports a per-call compensation rate greater than the local coin rate.
- Professor Baumol's approach to payphone pricing appears to rest on the notion that property owners should receive zero rent for the placement of payphones -- a contention that ignores the fact that alternative economic uses exist for the space in which payphones are placed.

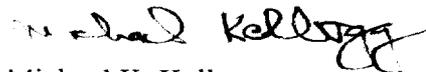
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Ms. Magalie Salas
October 2, 1998
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- Professor Baumol cannot explain the fact that payphone pricing is generally uniform. If locational monopolies existed, one would expect payphone prices to vary from location to location depending on traffic, payphone usage, demand elasticity, and other factors. Only if there were a "grand cartel" among all PSPs would one expect uniform pricing in the absence of competition. Given the number of payphone locations, providers, and ease of entry into the payphone market, such a cartel would be virtually impossible.
- Professor Baumol's analysis depends on the assumption that consumers will be ignorant of the typical price of a local coin call. That assumption is wrong. Consumer awareness of the payphone rate also explains why a PSP in a relatively low volume location does not reduce the coin price below the rate charged at a relatively high volume location: the price decrease will cause other nearby PSPs to cut their prices, and the price cutter will lose more revenue from the cut in price than it will gain from the increase in volume.
- Perhaps most important, Professor Baumol ignores the significance of demand elasticity data. It is well known that a monopolist always sets prices high enough to cause the demand elasticity to exceed 1.0 in magnitude. Data that is already in the record of this proceeding shows that the price elasticity of demand for local coin calls is -0.663 -- well less than 1.0
- Professor Hausman analyzes new data from 10 Bell Atlantic states that confirm that the price elasticity of demand for local coin calls is less than 1.0. Data from those state shows demand elasticities ranging from -0.53 to -0.82, with a weighted average for all ten states of -0.635.

One original and one copy of this letter are being submitted to you in compliance with 47 C.F.R. § 1.1206(a)(2) to be included in the record of this proceeding. If you have any questions concerning this matter, please contact me at (202) 326-7902.

Sincerely,



Michael K. Kellogg

cc: Don Stockdale, Jr.
Bill Rogerson
Greg Lipscomb
Glenn Reynolds

Milton Price
Jerry B. Duvall
Lawrence E. Strickling
Patrick DeBraba

Tom Power
Paul Gallant
Jim Casserly
Kevin Martin
Kyle Dixon

Declaration of Professor Jerry A. Hausman

I, Jerry A. Hausman, do hereby declare as follows:

1. I am MacDonald Professor of Economics at the Massachusetts Institute of Technology in Cambridge, Massachusetts, 02139. I submitted previous declarations in this proceeding dated August 25, 1997, November 18, 1997, and July 13, 1998.

2. In this declaration I reply to the affidavit of Prof. William Baumol, submitted July 27, 1998. I discuss the points of my agreement and disagreement with Prof. Baumol. Most important, I identify the fundamental mistake made by Prof. Baumol when he concludes that the coin rate is not established by a competitive market outcome.

I. Areas of Agreement between Prof. Baumol and Myself

3. Prof. Baumol agrees that the avoided cost (top-down) approach can "in certain circumstances" (pp. 1-2) be a correct approach. Of course, he does not agree that the coin rate provides a correct starting point for the top-down calculation, a point to which I will return subsequently. Prof. Baumol does not claim that the bottom-up price calculation has any inherent economic or computational advantage over the top-down approach; he views them as equally complicated (p. 15). Most importantly, Prof. Baumol does not claim that the avoided cost approach entails "subtracting apples from oranges", as the Circuit Court feared.¹ Instead, he claims that the starting point of the calculation is incorrect.

4. Prof. Baumol agrees with me that the use of demand elasticities to set prices as markups over marginal costs, the Ramsey method of pricing, is the correct approach (p. 15). He states that the practical use of the Ramsey method is limited here, requiring constantly updated information on demand elasticities for each pertinent service. However, Prof. Baumol fails to consider the actual range of plausible demand elasticities.

¹ MCI Telecom. Corp. v. FCC, 97-1675slip op., p. 5 (D.C. Cir. May 15, 1998).

Had he done the analysis, he would have found, as I demonstrated in my declaration of November 18, 1998, that when differences in demand elasticities between coin calls and dial-around and subscriber 800 calls are taken into account, the Ramsey price for dial-around and subscriber 800 calls would be higher than for coin calls due to the lower derived demand elasticities for the dial-around and subscriber 800 calls. Hausman Decl. ¶¶ 5-7. While disagreement may exist over the precise values of the demand elasticities, a very large adjustment can be made in the demand elasticity estimates that I used in my calculations with the result that the dial-around and subscriber 800 price set by Ramsey pricing exceed the Ramsey determined coin rate. So long as the long distance elasticity is smaller (in magnitude) than -1.24, the Ramsey dial-around and subscriber 800 rate would exceed the Ramsey coin call price.² Thus, AT&T's witness, Prof. Baumol, has agreed that Ramsey pricing would provide the best approach, and Ramsey pricing for a plausible range of demand elasticities leads to the conclusion that the dial-around and subscriber 800 rates should exceed the coin rate, even if it is also determined by Ramsey principles or through a bottom-up calculation that takes account of demand factors.

5. Also, Prof. Baumol agrees, at least to some extent, that PSPs benefit only by a small amount (if at all) from what he considers to be excessive pricing of payphones (pp. 10-13). He states that "the benefits of excessive pricing, while going in part to the more efficient PSPs, can be expected to accrue in large part to the landlords" (p. 12). Since in a competitive industry more efficient firms earn a higher return, the moral of Prof. Baumol's story is the landlords are the "villain of the piece" since they are the cause of what he sees as excessive pricing. PSPs will compete away any supra-competitive returns since the landlord can cause the PSPs to compete with each other for the opportunity to locate in a given building.³ Thus, PSPs are competitive, but it is the exercise of monopoly power by landlords that create the problem.

² It would be incredible that the appropriate market long distance price elasticity could be as high as -1.24, because a value this large would imply that price was being set by an unregulated monopolist in long distance markets. Thus, for any credible value of the long distance elasticity used in the calculation, the finding would be that the dial-around and subscriber 800 rate would exceed the local coin call rate.

³ Prof. Baumol's theory does suffer from the following rather fundamental problems. If landlords can extract most (or all) of the profits from the payphones, why would it be economically rational for PSPs to want deregulation and market based pricing? Instead, the LECs would be expected to seek the "shelter" of their PUC and be "guaranteed" a normal return to their investment with a regulated coin price. Currently,

II. Areas of Disagreement between Prof. Baumol and Myself

“All Property is Theft” (Pierre Joseph Proudhon, 1809-1865)

6. Suppose that Prof. Baumol is correct and landlords are earning monopoly rents from the excessive prices for payphones. What is the “correct” rent that landlords should receive for the use of their property? According to Prof. Baumol, the answer appears to be zero rent, since he never mentions the idea that property owners should receive payment for the use of their property. Similarly, the MCI “Payphone Cost Study” (July 13, 1998) includes no payment to the property owner. I believe that it has been an agreed to principle in the U.S. (and most of the rest of the world since 1989) that property owners must be rewarded for the use of their property. Certainly, an opportunity cost exists for the property owner allowing a payphone to be deployed since a news kiosk, restaurant, or soda machine could similarly be producing the monopoly rents that Prof. Baumol ascribes to payphones.

7. How would most economists make a start on determining the appropriate amount of rent? They would look to the market. Using Prof. Baumol’s example (p. 17), compare a payphone in a building on the corner of 43rd Street and Second Avenue in New York City (NYC) to a payphone in the Sony (formerly AT&T) building on 55th and Madison in NYC. The latter building rents for much more on the ground floor because of location and higher traffic levels. Economic analysis would conclude that Sony should

under Baumol’s theory, they are being whipsawed by greedy landlords who are extracting profits and causing higher prices and less profit for LECs, who would otherwise benefit from a uniform price, set by the regulators. PSPs must also be acting irrationally under Prof. Baumol’s theory since he states that “few of the PSPs will benefit in the long run.” (p. 2). Prof. Baumol’s claims also imply that state regulators are derelict in their responsibilities. Despite having regulated payphones (in most states) for decades, state regulators have “sat back” and let the coin payphone price increase to excessive levels without taking back regulatory control of payphone prices. I doubt that landlords have nearly the political clout with state PUCs that NYC taxi medallion owners have with their regulators. As has been shown this year, taxi owners can go out on strike while landlords do not have a similar credible threat with state PUCs. Lastly, Prof. Baumol’s taxi example is not applicable to the payphone situation. The New York City government has limited the number of taxi medallions which artificially inflates their value by limiting supply. No similar limitation exists on the number of payphone locations, so payphone supply can increase in response to increased demand. This increased supply will limit the value of a payphone in any given location,

receive a higher rental payment for the use of its building; however, Prof. Baumol would pay Sony the same amount as the other building--zero.⁴ I do not see how a "bottoms up" calculation of the type Prof. Baumol favors will lead to the placement of very many payphones in commercial buildings, contrary to Congressional legislation. Even if rent were included in the bottoms up calculation, I expect it will be quite difficult to determine the appropriate level of rent for each commercial building in the U.S.⁵

8. However, the market outcome of a \$0.35 coin rate (in most places) is the competitive outcome. It is a fact that locations differ by their amounts of traffic, payphone usage and in their demand elasticities. Now in any model of monopoly pricing, an economist would expect to see the coin rate of payphones differing based on these factors (especially the demand elasticity). If a bodega and a news store are located next to each other in a residential area of NYC, the demand elasticity at each location would be quite high given that a user can walk next door and get a lower price, if it exists. Thus, holding other factors equal, the coin rate should be considerably lower for these types of stores than the rate set in airport where few choices exist, apart from a wireless phone. Yet we observe the price to be quite uniform at \$0.35. Now if a grand "cartel or some other collusive arrangement" (Baumol, p. 6) exists, a uniform price outcome might be possible. But the outcome would be quite unlikely given the millions of locations for payphones in the U.S. the large number of PSPs, and the ease of entry into the payphone market. Thus, the empirical evidence is inconsistent with the claim that landlords are charging monopoly prices for the use of payphones on their premises. The data are inconsistent with the claim of location monopoly.

contrary to the situation for taxi medallions.

⁴ Indeed, one might conclude from Prof. Baumol's analysis that the market for office space is quite uncompetitive with excessive rents being charged in midtown Manhattan. If two equivalent skyscrapers were built, the building at 55th and Fifth would rent for much more than the same building at 37th and Sixth. The price difference arises from the greedy landlord who owns the more expensive property. A bottoms up calculation of the type recommended by Prof. Baumol would lead to the same rent being charged at both locations.

⁵ Once the realization is made that rent must be paid to property owners, it follows that intra-premise PSP competition would not significantly affect the coin rate charged as Prof. Baumol implies (p. 6). Landlords would set a level of rent high enough to recover their opportunity cost, and the competing PSPs would need to charge a high enough price to cover the rental cost.

9. Instead, I believe that Prof. Baumol's claim (p. 7) that consumers do not know the usual price for a coin rate call is wrong: to the contrary, a significant proportion of the population knows the typical price of a coin call on a payphone. A typical price exists for most payphones—usually \$0.35 in most geographic areas. If a PSP attempts to charge above \$0.35, say \$0.50, most consumers will realize that if they go to an alternative payphone in a different location, they are very likely to find the coin rate to be \$0.35. Of course, only a small proportion of potential payphone users need to decide not to use the payphone if the PSP attempts to charge \$0.50 because of the relatively low marginal cost of a payphone call compared to the price.⁶ These marginal customers will discipline the pricing behavior of the PSP, because price discrimination that targets infra-marginal customers is impossible with payphones. Thus, the presence of a near uniform price and customer knowledge demonstrate the presence of competition in payphone provision.

10. Customer knowledge of the payphone rate also explains why a lower volume landlord does not decrease the price of his payphone to say \$0.25 to capture more volume. The landlord cannot gain enough in volume to offset his loss in revenue in the calls that are currently being made, so the strategy will not be profitable. Given that customers have knowledge about the coin price, the price decrease will cause other nearby payphone providers to decrease their prices and given the overall market elasticity of payphones being less than one (in magnitude), the price cutter will lose revenue and also have greater costs. Thus, the incremental profit from the payphone will decrease. Unless a cartel forms, which is extremely unlikely, competition will keep prices the same except in exceptional locations where no nearby competition exists.

11. I now turn to the fundamental mistake in Prof. Baumol's analysis. Prof. Baumol is claiming that landlords are exploiting their locational monopolies. By having only one PSP in each location (Baumol, p. 6), the PSP will set a monopoly price and the

⁶ The relatively low marginal cost is not a signal of lack of competition. The fixed and common costs for payphones are significant. Thus, as in most areas of telecommunications, price must exceed marginal cost

landlord will take back the monopoly rent, according to Prof. Baumol. It is an elementary result in economics that a monopolist always sets the price high enough to cause the demand elasticity to exceed 1.0 (in magnitude). Otherwise, the monopolist is not earning maximum profits.⁷ Yet the empirical evidence in this proceeding unambiguously demonstrates that the market demand elasticity is less than 1.0 in magnitude. In my declaration of August 25, 1997, I estimated the demand elasticity for the coin rate to be across a sample of states to be -0.663 , an elasticity that is significantly below 1.0 in magnitude.

12. The previous data that I used to estimate the local coin call price elasticity of -0.663 was based on U S WEST data. I have recently received data from Bell Atlantic, which increased its local coin rate from \$0.25 to \$0.35 in a number of states in 1997. Using recent demand data to estimate the price elasticities leads to the following estimates: New Hampshire -0.60 , Maine -0.82 , Vermont⁸ -0.68 , District of Columbia -0.63 , Delaware -0.60 , Maryland -0.65 , New Jersey⁹ -0.68 , Pennsylvania -0.60 , Virginia -0.58 , West Virginia -0.53 . The weighted average elasticity estimate of all the price changes is found to be -0.635 . Thus, the further empirical evidence demonstrates that in all 10 Bell Atlantic states the price elasticity is less than one in magnitude, which demonstrates an absence of monopoly pricing. Furthermore, the weighted average estimate of -0.635 from the Bell Atlantic states is very close to the estimate from the U S WEST states, which is -0.663 . The empirical evidence demonstrates quite strongly an absence of monopoly pricing in the coin rates.

13. The only evidence that any long distance carrier has put forward on the demand elasticity confirms the lack of monopoly pricing. MCI submitted a study by the

to allow for a normal return to investment.

⁷ See, e.g., D.W. Carlton and J.M. Perloff, Modern Industrial Organization, Scott, Foresman, 1990, p. 103: "Therefore, a common observation is that monopolists never operate on the inelastic portion of their demand curve. That is, monopolist always profit more by changing prices until they reach the elastic portion of their demand curve". The elastic portion of the demand curve occurs when the demand elasticity equals or exceeds 1.0 in magnitude. Prof. G. Stigler wrote: "It follows immediately that since no monopolist will willingly operate where marginal revenue is negative, he will never willingly operate where demand is inelastic. Theory of Price, Macmillan, 4th ed., 1987, p. 197.

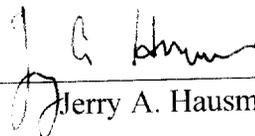
⁸ The coin price in Vermont increased from \$0.10 to 0.35

“E Group” which estimated an elasticity of demand for payphones of -0.31 , an estimate even further away from the 1.0 standard for monopoly pricing.¹⁰ Thus, all the demand elasticity evidence entered in this proceeding is consistent with competition in the provision of payphones and inconsistent with the locational monopoly position of Prof. Baumol and AT&T. The data contradict Prof. Baumol’s monopoly payphone claim.

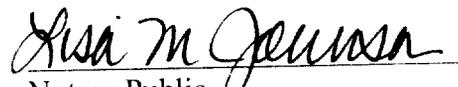
Even an economic theorist needs to look at the data—otherwise he will never find his lost wallet as in the parable that Prof. Baumol relates about the drunkard on 44th Street (p.17).

⁹ The coin price in New Jersey increased from \$0.20 to \$0.35.

¹⁰ E Group, “Economic Effects of Excessive Compensation Rates to Pay Telephone Providers”, pp. 9-10. As I stated in my declaration of Nov. 18, 1998, I believe this study has econometric problems. Nevertheless, MCI submitted the study, presumably because they believe it made a valid estimate.


Jerry A. Hausman

SUBSCRIBED AND SWORN to
before me this 1st day of October, 1998.


Notary Public

LISA M. JOHNSON
Notary Public
Commonwealth of Massachusetts
My Commission Expires
March 11, 2005