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October 19, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

Re: Ex parte - CC Docket No. 96-128, Payphone Compensation

Dear Ms. Salas:

On October 16, 1998, Richard H. Rubin (AT&T), Len Sawicki (MCI WorldCom), Mary Sisak (MCI WorldCom), Jim Smith (Excel), Tiki Gaugler (Qwest/LCI), Dick Juhnke (Sprint), Rachael Rothstein (Cable & Wireless) and I met with Kathyrn Brown, Chief, Common Carrier Bureau; Donald Stockdale, Jr., Associate Bureau Chief, Common Carrier Bureau; Glenn Reynolds, Counsel to the Common Carrier Bureau Chief; Richard Cameron, CCB Office of the Bureau Chief; Greg Lipscomb, CCB Enforcement Division; and Craig Stroup, CCB Industry Analysis Division. During the meeting, this group reviewed their positions of record in the above-mentioned docket. The attached document formed the basis for the discussion.

Two copies of this Notice are being submitted to the Secretary of the Commission in accordance with Section 1.1206(a)(2) of the Commission's rules.

Very truly yours,

Brian W Masterson

Attachment

cc: K. Brown
D. Stockdale, Jr.
G. Reynolds
R. Cameron
G. Lipscomb
C. Stroup

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PAYPHONE COMPENSATION-
AN IXC PERSPECTIVE

October 1998

Payphone Compensation - The Problem

- Current Commission rules force carriers and consumers to pay PSPs excessive amounts for the use of payphones to complete dial-around and toll-free calls
  - Current $.284 rate represents an increase of hundreds of millions of dollars in new "access" costs for carriers, which must be recovered from customers
- The D.C. Circuit has found the Commission's market-based approach for calculating payphone compensation is arbitrary -- twice
- A new solution is required to satisfy the law and serve consumers

Basic Facts About Payphones

- 2.2 million payphones
- 75% of payphones owned by LECs, 25% owned by Independent Payphone Providers (IPPs)
- 70% of payphone calls are coin calls - rates are deregulated
- PSPs receive substantial revenue from commissions on 0+ calls
- Payphones handle about 3 billion dial-around and subscriber 800 calls per year
- PUCs are not seeing a need to implement public interest payphones

Industry Structure: Competition Is Only For Locations

- Payphone "competition" takes the form of PSPs competing to pay the highest amount of commissions to site owners -- not on offering low-cost service to consumers
- LEC PSPs have raised prices for local coin calls as a "competitive" response to IPPs' payment of higher commissions
  - U S WEST Press release, March 2, 1998 (price for coin calls raised to 35 cents because "[t]he only way to [pay higher location commissions] is to charge a competitive price to end users")
  - Bell Atlantic statement, July 2, 1998 (the "need to pay competitive commissions and charge competitive prices drove [the] increase")

Industry Structure: Consolidation Among PSPs

- Significant consolidation is occurring in the PSP industry, both among LECs and IPPs
  - Bell Atlantic acquired NYNEX and seeks to merge with GTE
  - SBC acquired Pacific and seeks to acquire Ameritech
  - Davel (an IPP) is making major purchases among IPPs

Industry Structure: No Competition for Callers

- There is no competition for callers at the point of sale
- Competitive payphones do not sit side-by-side. Why?
  - In nearly all cases, PSPs have an exclusive right to provide payphones at a location
    - PSPs' exclusive placement rights stem from location owners' legal right to control the use of their property
    - Regulators cannot affect these property rights, and location owners have contractual and economic incentives to disallow side-by-side competitive phones

Payphone Compensation History

- Commissions on 0+ calls began with the advent of payphone "equal access" in the late 1980's
- IXC payphone compensation for dial-around calls (only) started in 1993 with a rate of $6.00 per phone per month, for IPP phones only
- Section 276 of the Telecom Act broadened the scope of payments to include 800 "subscriber" traffic and LEC payphones

FCC Orders

- First Report and Order and Order on Reconsideration
  - Set a $.35 rate, to be tracked and paid by IXCs
  - Attempted to adopt a "market-based" rate equal to the assumed market price for local coin calls
  - Ignored cost differences between coin and coinless calls
  - Overturned by the Court as "the epitome of arbitrary and capricious decisionmaking"
  - Court stated that the prospect of call blocking cannot substitute for a reasonable default rate

FCC Orders

- Second Report and Order
  - Another attempt at a "market-based" rate
  - Set compensation level at $.284 per call
  - Again started with the local coin rate, and attempted to make adjustments between costs for coin and coinless calls
  - Promptly rejected by the Court as arbitrary and unsupported, because it lacked evidence that
    - Coin and coinless markets are similar
    - Costs and rates for local coin calls converge

Flaws in the Market-Based Analysis Cannot Be Cured

- The caller pays-based local coin market is not the same as a carrier pays-based market for coinless dial-around and subscriber 800 calls
- Different buyers (callers and carriers) face different market dynamics
  - Callers can costlessly choose not to make a call
  - Carriers have significant impediments to blocking
    - D.C. Circuit's first order recognized that callers could not complete calls, leading to consumer inconvenience and dissatisfaction
    - Implementation costs
    - Foregone profits

Flaws in the Market-Based Analysis Cannot Be Cured

- Cost data in the record amply demonstrate that prices and costs for local coin calls do not converge, so that avoided cost analysis cannot be used in this case

Flaws in the Market-Based Analysis Cannot Be Cured

- Use of a "floating" compensation rate linked to the local coin rate would wreak havoc
  - Creates significant economic uncertainty for carriers and consumers
  - Provides PSPs with enormous incentives to manipulate the local coin rate to increase total payphone receipts
  - Carriers cannot implement payments to PSPs or optional blocking for consumers without real-time access to massive amounts of data and huge additional infrastructure costs
  - A bad choice regardless of the compensation mechanism selected

Commission Alternatives

- No market-based approach based on the local coin rate is sustainable
- There are only three other possibilities:
  - Calling Party Pays
  - IXC Market Surrogate
  - Properly Developed Cost-Based Rate

Calling Party Pays

- Calling Party Pays has many advantages
  - A purely market-based mechanism
  - A direct market analog to the local coin market
  - The most deregulatory solution
  - Makes payphones similar to other types of aggregator phones
  - No need to set a compensation rate
  - Avoids need to resolve future disputes between PSPs and carriers
  - Not precluded by Section 226

Cost-Based Compensation Rate

- In the absence of a market-based approach, a cost-based approach is necessary
- Prior Commission attempts at a cost-based analysis cannot be sustained
  - The Second Report and Order's limited recognition of cost data was incorrectly based on the higher costs of the minority IPPs, not the lower costs of the larger and more cost-efficient LECs

Cost-Based Compensation Rate

- IXCs submitted cost data that show that the actual cost of coinless calls is \$.06-\$.12 per message
- LEC data on the record for the Second Report and Order produced a cost of no more than \$.101-\$.169 per message, based on information from Sprint and NYNEX (Mass)
- Subsequent data submitted on the Second Remand all show costs in the same range, which is substantially below the current 28.4 cent rate
  - SBC data
  - MCI cost study
  - NY PSC data on BA (NY)

Cost-Based Compensation Rate

- Consumers would be significantly harmed by a rate that rewards PSPs for inefficiency
- A cost-based rate should rely only on the costs of efficient providers
  - Any other standard would be inconsistent with longstanding Commission precedent
  - Significantly simplifies the process for setting a cost-based compensation rate
- Given that the costs of payphone operation do not appear to be increasing (and indeed are declining), the rate adopted here could reasonably be fixed for at least two years

Other Issues

- Promptness is important - consumers and the industry have been waiting for two years for final and sustainable rules
- The rate established here should be retroactively applied back to the beginning of the compensation period, with appropriate true-up for all parties

Conclusion

- A new paradigm for payphone compensation is required
- The Commission cannot establish a "market-based" compensation rate that is linked to the local coin rate
  - Any continued attempts to do so defy both logic and fact
  - All such efforts will unfairly reward PSPs at the expense of consumers