EX PARTE OR LATE FILED

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November 19, 1998

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

RE: Ex Parte – CC Docket 96-128
Implementation of the Pay Telephone Reclassification and
Compensation Provision of the Telecommunications Act of 1996

Dear Ms. Salas:

On November 17, 1998, Mr. David Robinson, Mr. Stephen Levinson and I, all representing AT&T, met with Mr. Craig Stroup, industry economist with the Industry Analysis Division, Common Carrier Bureau to discuss the above-captioned docket and the attached presentation material.

We reviewed with Mr. Stroup the evidence that the current charge for coin calling – the supposed starting point for a "top down" calculation of the appropriate price for coinless calls – cannot be assumed to be set at a competitive level. Consequently, the proposed coinless price derived by this method is indefensible and excessive. Pursuant to this discussion, we provided a copy of a declaration by Professor of Economics William J. Baumol of New York University concerning the basis for an more appropriately calculated competitive rate.

In addition, we provided leave-with information to Mr. Stroup regarding a March 24, 1997 Bell South filing to the North Carolina Public Utilities Commission regarding the most reasonable coinless payphone calling center subsidy rate. Contrary to the position that monopoly local exchange carriers have made before this federal regulatory body, the North Carolina filing indicates that Bell South advocates, in effect, a coinless PCC rate of 16.1 cents per call. Further, we discussed the untenable assertion made by SBC last month to the Commission that its own "Project Quintet" study regarding the projected costs of payphone operations – prepared in 1994 and provided by SBC to the FCC -- was now somehow inoperative.

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

Sincerely,

Attachments

cc: Mr. Craig Stroup, FCC
Mr. Peyton L. Wynns, FCC
Mr. Glenn T. Reynolds, FCC
Ms. Dorothy T. Attwood
Mr. Lawrence E. Strickling

Declaration of William J. Baumol

I, William J. Baumol declare that

1. I am professor of economics at New York University, located in New York City, 10003. I have previously provided an affidavit in this proceeding dated July 27, 1998.

I. Purpose of the Declaration

2. This declaration is a reply to the declaration of Professor J.A. Hausman, filed October 2, 1998, which is, in turn, a reply to my previous affidavit. In particular, I show that his argument in support of the supposed competitiveness of coin telephone rate setting is not valid. Thus, the current prices for coin calling, the proposed starting point of the "top down" calculation of the appropriate price for coinless calls cannot simply be assumed to be set at a competitive level. Consequently, the proposed coinless price derived by this method is indefensible, and is, indeed, very probably excessive.
3. I will deal in particular with three assertions by Professor Hausman: first, his assertion that the elasticity of demand estimates for coin telephone calls demonstrate that their price is competitive; second, his claim that competitiveness is also demonstrated by the alleged uniformity of prices of coin calls throughout the U.S.; and, third, his attribution to me of the view that "the correct approach" to determination of the markup over marginal cost for the pricing of coinless calls is Ramsey pricing, with the conclusion 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..."

II. Crucial Role of the Right Choice of Base for a Top-Down Calculation

4. Professor Hausman implies that I agree with him on many fundamentals, notably on the validity of the avoided cost approach and that I am merely claiming that "...the starting point of the calculation is incorrect." But this is only an attempt to get around the heart of the issue by trivializing it. If one starts off a top-down calculation from a grossly incorrect initial number one is certain to get an answer that is surely incorrect. Saying that I accept the remainder of the LEC's avoided-cost approach is like saying that, apart from the fact that Bluebeard murdered his wives, I know nothing to his discredit.

5. For just this reason, the issue of competitiveness of setting of coin call price is crucial for our discussion. I agree with Professor Hausman that, in general, *if a price were in fact set at a competitive market level* it would be an appropriate starting point for a legitimate top-down calculation.[1] On the other hand, I am confident that he will agree with me that if that price is well above the competitive level the resulting top-down calculation will yield an inappropriate and excessive price figure. This must be so, because if an appropriate number is subtracted from an excessive number, the result will patently also be excessive.

[1] Of course, even if one somehow determines the competitive market price for coin usage, it does not follow that subtraction of just any number that appears to represent avoided cost is legitimate.

6. The misunderstanding that is entailed in Professor Hausman's interpretation of my affidavit is that he implicitly takes all prices either to be perfectly competitive or perfectly monopolistic, *with no possibility that real prices will fall anywhere in between.* Thus, if he can show that actual prices are not those that would yield maximum profits to an absolute monopolist, it follows in his artificial world of only two possible outcomes, that the one postulated alternative – effective competition -- must be the state of reality.[2]

III. Demand Elasticity, Perfect Monopoly Prices and Reality

7. Professor Hausman chides me for forgetting my elementary economics. He reminds me of the textbook proposition that a monopolist will fail to maximize its profits if it selects a price at which elasticity of demand is less than unity. For at such an inelastic demand level of price an increase in price must, by definition, result in a relatively small decline in sales volume, thereby raising the firm's total revenue, while reduced output simultaneously cuts its total expenditure on production. This is all trivially true. But it is equally irrelevant.
8. No one ever claimed that the suppliers of coin-telephone service are the pure monopolists of economic theory. Nor has anyone claimed that they succeed in

[2] I must mention that professor Hausman surprises me by some of his interpretations of my views. He asserts that to me the landlord is the "villain of the piece" (his term). He implies I believe "All Property is Theft." He takes me to believe that if landlords have monopoly power the local telephone companies must have none. And he infers that I want landlords to receive none of their legitimate rent payments. This is all a bit silly. There are no good guys and bad guys in the story -- all the players in the piece are seeking to promote their own interests, which is neither vice nor virtue. Whether or not the landlords possess market power, the PSPs patently do possess market power, as I am sure Professor Hausman will not be willing to deny. As owner of some property I am prepared to assert under oath that I did not steal it, and to credit others with the same limited degree of virtue. Will not Professor Hausman join me in recognizing that any monopoly component of rent – any payment to landlords above the competitive rent level does *not* promote economic efficiency but, on the contrary, impedes it?

maximizing profits. His elasticity figures, even if they are reasonable approximations to reality, do prove that these suppliers have not attained *the maximal profits of a pure monopolist.* But it is a clear non sequitur to claim that this proves the opposite – that coin-call prices are at the level they would be in a fully competitive market. There can be plenty of room for abundant monopoly profits between the competitive price level and that which maximizes monopoly profit. For validity of the proposed top-down price calculation of the coin-call providers it is hardly enough to show that these prices do not *maximize* monopoly profits. Rather, it is necessary to show *that they provide no monopoly profits at all.*

III. The Alleged Uniformity of Coin-Call Prices

9. Professor Hausman does not leave his arguments at this. To show the competitiveness of coin-telephone pricing he observes "...the price to be quite uniform at $0.35." He concludes "...the [uniform price] 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. The data are inconsistent with the claim of location monopoly." (Hausman *Declaration* at 4).

10. But the fact that in a competitive market prices will be uniform (absent differences in costs) does not, as we know, imply the converse. The syllogism: "competitive prices are uniform, payphone prices are uniform, therefore payphone prices are competitive" has no more validity than the textbook examples of elementary courses in formal logic. It is reminiscent of "humans have eyes, fish have eyes, therefore all fish are human."

11. Uniformity of price can occur in many ways and not only through a vast and pervasive conspiracy, that is, Professor Hausman's straw man that he erects so that it can easily be knocked down. For example, prices can be driven toward uniformity by a tradition that evolved under a previous regulatory regime. Or it can be imposed by current regulation or by fear of regulatory intervention if prices get out of line. Or given the FCC's endorsement of 35 cents as "the" market price, firms dependent for their future on the good will of that agency might well show a remarkable propensity to cluster about that price. I am informed by persons in a position to be well acquainted with the circumstances that this scenario is not too far from the facts.

12. But the claim that prices are "quite uniform" is itself a bit disingenuous. In New York and Rhode Island a substantial proportion of calls are priced at 25, not 35, cents. This is, of course, a result of regulatory intervention. But that only underscores my point – that in a set of regulated markets uniformity of price merely can mean that local regulatory authorities tend to mimic one-another's decisions, and has little to do with competitiveness of markets. And that is not all. In various places where price is ostensibly uniform at 35 cents, that amount buys very different quantities of service. It can range in a significant share of cases from 4 minutes for 35 cents (nearly 9 cents per minute) to 10 minutes for 35 cents (3.5 cents per minute) – hardly uniform prices. And one cannot simply reject reports of acquaintances, which I hear repeatedly, that they found themselves forced, at a constrained location such as an airport, to pay 70 cents or some other bizarre figure for a local call. If this is interpreted by the payphone service providers as uniformity, one may well wonder what degree of dispersion they require to accept as non uniformity.

IV. Digression on Ramsey Pricing

13. Professor Hausman at one point goes even further and tries to co-opt me into support of the conclusion that access payments for coinless calls should be even higher than the prices of coin service. He starts off from my support of Ramsey pricing theory, for which I offer no apology and undertake no retraction. Since regulators, for good reason, have shied away from tying themselves to this theory, his deduction from my position on this matter has little immediate significance. I will therefore take little space to deal with the issue. But it is worth taking note of the non sequitur enlisted here. "...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." (*Declaration* at 2).

14. The words "derived demand" give away the flaw in the logic. As is well known, Ramsey analysis does tell us that when prices set at marginal costs do not permit the firm to cover its total costs, then prices have to be marked up above the marginal cost levels. Moreover, *in certain special circumstances* the markups for the firm's different services that best serve economic efficiency will be inversely proportioned to each service's elasticity of demand. But the analysis also tells us that *these markups should apply* ***only*** *to final products of the firm. Those* markups should not apply to inputs or components of final product. This is roughly because that amounts to double counting – a markup of both final products and components that will lead to an excessive final price. Or a markup of one input alone will lead to inefficient input

substitution – use of less suitable inputs whose prices have not been marked up. But Professor Hausman recognizes that the demand for payphone use by dial-around or 800 calls is demand for only an input of a more substantial final product – the entire calls themselves. That is what economists mean when they say the demand for one product is *derived* from the demand for another. The demand for steering wheels is derived from the demand for automobiles. And the case for Ramsey markups of steering wheels or other components is to put it mildly, questionable.

V. The Realities of Competitiveness of the Markets for Payphone Services

15. It is surely time to cease exaggerations, one way or the other, about competitiveness of payphone services provision. The markets are neither perfectly competitive nor fully monopolized. Their prices are distorted by a history of regulation, continuing regulatory intervention or its threat, and the inability of *very significant sets of consumers* to take advantage of the existence of a multiplicity of suppliers. We can easily provide real examples of situations that are inherently ripe for competition and others in which it plainly does not prevail. In the impoverished neighborhoods of an inner city, if many residents cannot afford to subscribe to a telephone they will, of course, turn to a payphone when one is needed. Moreover, in such a neighborhood, if one supplier attempts to charge excessive prices this may soon become known and repeated users will vote with their feet to select alternative payphones. In contrast, at an airport, where most users do not know where less expensive payphones are located, and where time is often the most pressing consideration, the competitive scenario is likely to be a fairy tale.

16. Moreover, even in the inner city, where the ability of users to pick and choose will tend to make prices *uniform*, they need not make the prices *competitive*. Low incomes in a neighborhood may make entry unattractive even if entry barriers are low. And regulatory intervention can distort prices further, and may, arguably, bring them above competitive levels.

17. The bottom line, then, is this. Mere assertion of competitiveness is no substitute for evidence, let alone proof. Moreover, there is plenty of evidence that the sale of payphone services is subject to all sorts of competitive imperfections. And evidence that the prices are not as high as a theoretical pure monopoly could extract is no basis for the conclusion that monopoly rents are totally absent from payphone prices. There is every reason to agree that as a starting point for a top-down calculation current prices are not quite as absurd at the price of a textbook monopolist would be. But it is quite another matter to deny that they probably are still substantially excessive. All of these problems could be avoided, as I have already explained, if the Commission were to establish a competitive rate using a properly calculated bottom-up approach.

Date: 12 Nov 98

ADDITIONAL RBOC COST INFORMATION

- MARH 24, 1997 BELL SOUTH FILLING TO NORTH CAROLINA P.U.C. ON PAYPHONE SUBSIDY

- BELL SOUTH INTRASTATE PAYPHONE COSTS FOR 15, 883 PAYPHONES WAS $20,484,000 OR $107.47./PHONE (OPERATIONS, ACCESS, DEPRECIATION, COMMISSIONS)

- AT & T ESTIMATED "GROSS UP" (BASED ON BELL SOUTH'S DATA) TO RELECT TOTAL COSTS (INTA/INTER) IS: $25,633,153 OR $134.64 MO/PHONE

- IF COMMISSIONS OF $4,918,000 WERE REMOVED TOTAL EXPENSE WOULD BE: 20,745,153 OR $108.84 MO/PHONE

  @478 CALLS=$.227/CALL
  REMOVING COIN RELATED COSTS OF $.066 (FCC 2ND ORDER)
  YIELDS COINLESS P.C.C. OF $.161/CALL