

RECEIVED

NOV 01 1999

57-96:00

DOCKET FILE COPY ORIGINAL
An Alternative Analysis of Marketing Expenses Related to the Calculation of USF Support

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

CC: 96-45

In 1996, ETI, on behalf of the National Cable Television Association, analyzed, among other things, the component of universal service support associated with non-plant-related expenses. The following analysis and attached spreadsheets provide an alternative analysis of the treatment of advertising expenses as they relate to the calculation of universal service support.

Marketing expenses encompass three categories. Two of these categories (Account 6611 (Product Management) and Account 6612 (Sales)) remain unchanged from the estimates made by Susan M. Baldwin and Lee L. Selwyn in the August 1996 analysis entitled, *Converging on a Cost Proxy Model for Primary Line Basic Residential Service: A Blueprint for Designing a Competitively Neutral Universal Service Fund*. The August 1996 study disallows the Sales account in its entirety because, based on the information available, the "activities in this account do not support basic residential service" (at 31). This rationale continues to apply. The August 1996 study recommends an inclusion of 16% of product management expenses, and the underlying rationale for this inclusion continues to apply, although as indicated in the August 1996 study, the factor of 16% does not include an explicit provision for business lines. This alternative analysis focuses on the third category of marketing expenses: Account 6613: Product Advertising. This analysis updates the August 1996 analysis to reflect new SOCC data and to take account of the fact that eligible telecommunications carriers (ETCs) are *required* to advertise their local exchange services.

The analysis starts with the Product Advertising (Account 6613) component. The New England Telephone Cost Study (COSS) used in the original analysis separates this account into four components: Business, Residence, Public, and Other Services. (The Massachusetts Cost of Service Study for New England Telephone as filed in November of 1992 is the basis of the analysis because it is non-proprietary, and includes a narrative that describes the costs encompassed.) This analysis assumes that single-line business and primary residence lines are the only lines which the Universal Service program will subsidize. As such, this analysis estimates the share of residential lines that are considered primary lines and uses this factor of 84.35% for "product advertising - residence". This can be altered if there is more accurate information available concerning primary versus secondary residential lines. The share of total business lines that are single-line business lines was estimated to be 7.8%. Based on the descriptions in the COSS, the other two categories of Product Advertising do not apply to universal service.

Thus, as the attached tables demonstrate, the analysis produces a factor of 8.09% of total Marketing Expenses if Single-Line Business lines are included and 7.83% if they are excluded. However, both of these factors substantially overstate a reasonable proxy for applicable advertising expenses because:

- They include the aggressive marketing associated with the sale of vertical services. The source data does not permit disaggregation between advertising

No. of Copies rec'd
List ABCDE

2

associated with basic local exchange service and advertising associated with vertical services. In 1992, the study year, it is highly probably that the vast majority of advertising concerned the sale of additional lines and the sale of discretionary services.

- Although the analysis excludes a *proportional* amount for the sale of second lines, marketing is likely to be *disproportionately* related to the sale of additional lines.

This analysis is case-specific to one company, in one state, and for a year that precedes the Telecommunications Act of 1996, and thus precedes any competitive forces which may exist for local exchange services. One could argue that the specific consequence of focusing on a study from 1992 is to underestimate the amount of advertising expenses related to Universal Service. This is due to the fact that carriers must now compete for basic local exchange customers and that ETCs are *required* to advertise their local exchange services for the express purpose of Universal Service. Relevant advertising presumably did not occur in 1992. However, greatly offsetting this consequence is the fact that most marketing expenses for basic local exchange services still focus, for the most part, on vertical services such as Call Waiting and Caller ID, which are not encompassed in the Universal Service program.

Table 1: Because this table reflects 1998 SOCC data, and because product management as an overall percentage of total marketing expenses has apparently increased, the result of updating the original analysis is to increase the total percentage from 4.4% to 5.25%. As noted in the August 1996 study (at page 30), 16% is biased upward.

Table 1
ETI August 1996 Analysis of Marketing Expenses for Computing USF
Updated to Reflect 1998 SOCC Data

Line No.	Account No.	Item	All Reporting LECs		
			As Filed (000s omitted)	Percent (Upper Bound)	Partially Corrected (Upper Bound)
257	6611	Product Management	1,666,529	16.00%	266,645
258	6612	Sales	2,611,045	0.00%	0
259	6613	Product Advertising	803,998	0.00%	0
Total Marketing Expenses			5,081,572	5.25%	266,645

Sources: Preliminary Statistics of Common Carriers 1998, Table 2.9.

For justification of the "Upper Bound" estimates see Baldwin, Susan M. and Lee L. Selwyn. *The Cost of Universal Service:*

A Critical Assessment of the Benchmark Cost Model, August 1996, at 30-31.

The original table can found in the August 1996 analysis at Table App - 3A, at 34.

Table 2
Analysis of Marketing Expenses for Computing USF
Revised to Include an Allowance for Advertising
(Includes Single-Line Business Lines)

Line No.	Account No.	Item	All Reporting LECs		
			As Filed (000s omitted)	Percent (Upper Bound)	Partially Corrected (Upper Bound)
257	6611	Product Management	1,666,529	16.00%	266,645
258	6612	Sales	2,611,045	0.00%	0
259	6613	Product Advertising	803,998	18.00%	144,681
Total Marketing Expenses			5,081,572	8.09%	411,325

Sources: Preliminary Statistics of Common Carriers 1998, Table 2.9. See Table 4a for derivation of 18% estimate.

For justification of the Product Management and Sales "Upper Bound" estimates see Baldwin, Susan M. and Lee L. Selwyn. *The Cost of Universal Service: A Critical Assessment of the Benchmark Cost Model*, August 1996, at 30-31.

The original table can found in the August 1996 analysis at Table App - 3A, at 34.

Table 3
Analysis of Marketing Expenses for Computing USF
Revised to Include an Allowance for Advertising
 (Excludes Single-Line Business Lines)

Line No.	Account No.	Item	All Reporting LECs		
			As Filed (000s omitted)	Percent (Upper Bound)	Partially Corrected (Upper Bound)
257	6611	Product Management	1,666,529	16.00%	266,645
258	6612	Sales	2,611,045	0.00%	0
259	6613	Product Advertising	803,998	16.35%	131,475
Total Marketing Expenses			5,081,572	7.83%	398,120

Sources: Preliminary Statistics of Common Carriers 1998, Table 2.9. See Table 4b for derivation of 16.35% factor.

For justification of the Product Management and Sales "Upper Bound" estimates see Baldwin, Susan M. and Lee L. Selwyn. *The Cost of Universal Service: A Critical Assessment of the Benchmark Cost Model*, August 1996, at 30-31.

The original table can found in the August 1996 analysis at Table App - 3A, at 34.

Table 4a
Illustrative Analysis
Massachusetts Cost of Service Study
(Includes Single-Line Business)

Account		Illustrative ILEC	Upper Bound	Total Factor
6613	Product Advertising	\$20,302,230		18.00%
6613.1	Product Advertising - Business	\$4,275,050	7.80%	\$333,454
6613.2	Product Advertising - Residence	\$3,935,938	84.35%	\$3,319,964
6613.3	Product Advertising - Public	\$313,361	0.00%	\$0
6613.4	Product Advertising - Other Services	\$11,777,881	0.00%	\$0

Source: *Massachusetts Cost of Service Study* ("COSS"), 12 Months Ended November 30, 1992, Book IV of VI, New England Telephone.

Table 4b
Illustrative Analysis
Massachusetts Cost of Service Study
(Excludes Single-Line Business)

Account		Illustrative ILEC	Upper Bound	Total Factor
6613	Product Advertising	\$20,302,230		16.35%
6613.1	Product Advertising - Business	\$4,275,050	0.00%	\$0
6613.2	Product Advertising - Residence	\$3,935,938	84.35%	\$3,319,964
6613.3	Product Advertising - Public	\$313,361	0.00%	\$0
6613.4	Product Advertising - Other Services	\$11,777,881	0.00%	\$0

Source: *Massachusetts Cost of Service Study* ("COSS"), 12 Months Ended November 30, 1992, Book IV of VI, New England Telephone.

Table 5
Percent Share of Total Local Exchange Lines for
Residential Primary Lines and Single-Line Business Lines

Residential Lines	Share
Primary	84.35%
Secondary	15.65%

Source: FCC, CCB, *Trends in Telephone Service*, February 1999, Table 20.4

Business Lines	56,900,690	Share
Analog Single-line	4,440,558	7.80%
Analog Multi-line	45,514,505	79.99%
Digital	6,945,627	12.21%

Source: Preliminary Statistics of Common Carriers 1998, Table 2.10

MASSACHUSETTS
COST OF SERVICE STUDY
12 Months Ended November 30, 1992
BOOK IV OF VI



New England Telephone

A **NYNEX** Company



**CONVERGING ON A
COST PROXY MODEL FOR
PRIMARY LINE BASIC RESIDENTIAL SERVICE**

**A Blueprint for Designing a
Competitively Neutral Universal Service Fund**

Susan M. Baldwin
Lee L. Selwyn

August 1996

 **ECONOMICS AND TECHNOLOGY, INC.**

ONE WASHINGTON MALL • BOSTON, MASSACHUSETTS 02108

Furthermore, where expenses in a given account are disproportionately incurred in order to serve business customers or for additional lines,² expenses should be adjusted accordingly.

Analysis of selected accounts illustrates that a disproportionate amount of the expenses are associated with services other than primary residential lines

Account 6611: Product Management

The Massachusetts COSS describes this account as including “costs incurred in performing administrative activities related to marketing products and services.”³ Of the approximately \$46-million in expenses associated with this account in Massachusetts, a vastly disproportionate amount, i.e., 84% of the total costs, is related to market management and planning for *business* customers.⁴ The remaining 16% is related to market forecasting and rates and tariffs for all customer classes and also to market management and planning for residential customers. It is unlikely that all of these efforts are required for universal service (e.g., it is not readily obvious that “costs incurred to identify, quantify and plan for customer requirements for new or changed communications services” supports universal service). Therefore, the *upper bound* that should be associated with this account is 16%.

Account 6612: Sales

According to the Massachusetts COSS, “[t]his account contains the pay and other expenses primarily of personnel engaged in performing the functions of canvassing for new business or for changing or renewing existing service.”⁵ Of the five organizations associated with this account, only the Administration and System Group Sales organization potentially performs functions that may possibly be related to universal service (because the description of the activity includes the activity of satisfying customer requests for service). However, an examination by customer class of this account indicates that only 7.3% of the entire account is assigned to the residence class and that the expenses assigned to the residence class do not concern the Administration and System Group Sales organization, but rather are related to activities in the Direct Marketing/Direct Response Center, which

2. For example, ILECs may have undertaken targeted marketing campaigns in order to encourage customers to subscribe to additional line service.

3. *Id.*, Book IV of VI. Tab H1, at 1.

4. *Id.*, at 3.

5. Tab H1, at 22.

Appendix 3A: Analysis of Selected LEC Expense Accounts

concern the sales and fulfillment of service orders for supplemental services.⁶ Since the activities in this account do not support basic residential service, we have excluded the entire account. Although this analysis is based upon a Massachusetts COSS, it is nonetheless difficult to envision any sales activity by ILECs associated with *primary* line basic local exchange service.

Account 6613: Advertising

As described in the COSS, “[t]his account includes expenses incurred in commercial advertising activities in developing and implementing promotional strategies to stimulate the purchase of products and services.”⁷ There is nothing in the account description to suggest that any of the advertising is of an instructional nature. This amount should be removed entirely because advertising is not necessary for primary basic local exchange service. Therefore this account should be entirely eliminated in the calculation of a forward looking cost factor for primary residential basic local exchange service.

Account 6621: Call Completion Services

This account covers expenses associated with helping customers place and complete calls, except for directory assistance (e.g., quoting rates, etc.).⁸ These expenses are entirely associated with the provision of operator services and thus belong in the cost factor only if operator services are encompassed within the scope of the universal service being costed. Approximately two-thirds of these expenses are assigned to the coin class, however, so even if operator services are being encompassed in a cost model, the expenses should be scaled back significantly from the total shown. In the Massachusetts COSS, approximately 15% of the total account is assigned to the residential class.⁹ We set this amount at zero because the inclusion of operator expenses should be made explicitly and should reflect the fact that the expenses are disproportionately associated with pay telephones.

6. *Id.*, at 21. Furthermore, 42.3% of the expenses in this account are associated with the provision of Centrex, a competitive service. *Id.*, at 24.

7. Mass. COSS. Book IV of VI, Tab H-1, at 33.

8. COSS, Volume IV of VI, Tab H2, at 1.

9. Most likely few of these operator services are provided in connection with local calls so arguably the entire account should be eliminated from the calculation of a revised cost factor for basic local exchange service.

Appendix 3A: Analysis of Selected LEC Expense Accounts

Account 6622: Number Services

Approximately half the expenses in this account are assigned in the Massachusetts COSS to the residential directory assistance category.¹⁰ This account includes expenses incurred in preparing, compiling and disseminating listings through directory assistance or other means, and relates to handling calls for local and toll directory assistance and non-published number requests, among other things. The Massachusetts COSS does not distinguish requests for directory assistance relating to local calls from those relating to toll calls. Furthermore, in many states, ILECs receive revenues for those calls made in excess of a DA allowance, and also receive revenues for non-published listings.¹¹ Thus, it would be misleading to include the substantial expenses associated with directory assistance unless the revenues are also included. Therefore we have excluded this expense figure.

Account 6722: External Relations

The COSS indicates that the majority of this account relates to corporate advertising, public relations, investor relations and regulatory/government relations. NYNEX allocates approximately half of these expenses to the residential class.¹² For the purpose of a forward-looking cost study, however, none of these activities support primary residential basic local exchange service and therefore this entire account should be eliminated for the purpose of determining relevant expenses.

Exclusion of unrelated non-plant-related costs brings the BCM2 results much closer to those previously presented in the original BCM and in other cost analyses

Table App-3A below shows that the total illustrative expenses for Tier 1 LECs is \$7,192,621,000, or approximately \$50 per line.¹³ Furthermore, extrapolating from an examination of the Massachusetts Cost of Service Study suggests that at most 2.1% of these

10. *Id.*, at 14.

11. Even in Massachusetts, which is one of only a few states with a DA allowance as high as 10 calls, the estimated revenues from directory assistance is anticipated to exceed the costs associated with fulfilling certain legislated requirements (e.g., providing a relay service and E-9-1-1 service). Massachusetts D.P.U. 91-68. *Investigation by the Department on its own motion, released July 12, 1991.*

12. Tab I2, at 20, 22.

13. Tier 1 LECs serve 137,975,749 lines. *Statistics of Common Carriers, 1993/1994 Edition, Table 2.10.*

Appendix 3A: Analysis of Selected LEC Expense Accounts

expenses might be considered relevant to the provision of basic local exchange service.¹⁴ The table below does not purport to summarize all expense accounts that may be associated with the provision of basic local exchange service but is included in order to illustrate the type of supporting documentation that is conspicuously absent from the BCM2.

The Massachusetts Cost of Service Study was presented at a level of detail sufficient to permit the kind of account-specific analysis that is presented here. Unfortunately, however, the BCM and BCM2 cost support is too aggregated to permit a similar account-specific examination at the national level. But the absence of detail *that is within the control of the ILECs and that could have been provided* should not be permitted to foreclose appropriate and accurate regulatory review. The pervasive use of companywide averages or aggregates as being representative of the costs properly *caused* by basic primary residential exchange access lines (the current universal service baseline) produces a systematic bias in which the costs of this service are consistently overstated. It would be a monumental error to permit such consistently overstated costs to drive national or state telecommunications policy. Before federal or state regulators can make decisions as to the appropriate components of cost factors, it is critical that the ILECs be required to provide account-specific information with narratives and explanations of the purposes of the accounts, so as to permit service-level disaggregation. Furthermore, expense information needs to be provided separately for (a) primary residential basic local exchange service and (b) additional residential exchange service and business service.

14. For runs of the BCM2 that include business lines, the expense factors should clearly reflect some expenses associated with providing basic local exchange service. However, the expense factor should not reflect the disproportionate level of expenses caused by activities such as marketing, advertising, and sales. The legitimate expenses are those associated with providing basic local exchange service.

Appendix 3A: Analysis of Selected LEC Expense Accounts

Table App-3A Illustrative Analysis of Non-Plant-Related Expenses (000s omitted)					
			All Reporting LECs		
Line No.	Account No.	Item	As Filed	Partially Corrected (upper bound)	Percent (upper bound)
257	6611	Product Management	\$958,201	\$153,312	16.0%
258	6612	Sales	\$1,934,013	0	0
259	6613	Product Advertising	\$600,470	0	0
260	6610	Total Marketing Expenses	\$3,492,684	\$153,312	4.4%
261	6621	Call Completion Services	\$734,690	0	0
262	6622	Number Services	\$2,201,208	0	0
270	6722	External Relations	\$764,039	0	0
		TOTAL	\$7,192,621	\$153,312	2.1%
<p>Note: Selected accounts shown for Tier I LECs. Sources: Statistics of Common Carriers, 1994/1995, Table 2.9; Massachusetts NYNEX Cost of Service Study, 12 Months Ended November 30, 1992.</p>					