



JACK SHREVE
PUBLIC COUNSEL

STATE OF FLORIDA
OFFICE OF THE PUBLIC COUNSEL

c/o The Florida Legislature
111 West Madison St.
Room 812
Tallahassee, Florida 32399-1400
850-488-9330

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September 24, 1998

Blanca S. Bayo, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Re: Docket No. 980000A-SP

Dear Ms. Bayo:

Enclosed for filing in the above-referenced docket are the original and 15 copies of the Summary of Remarks by Dr. Marvin H. Kahn on behalf of the Citizens of the State of Florida.

Please indicate the time and date of receipt on the enclosed duplicate of this letter and return it to our office.

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Sincerely,
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Charles J. Beck
Deputy Public Counsel

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10600 SEP 24 88
FPSC-RECORDS/REPORTING

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Procedures and Operative)
Dates for Study on Fair and Reasonable)
Basic Local Telecommunications Rates)

Special Project No: 980000A-SP
Filed: September 24, 1998

SUMMARY OF REMARKS

BY

DR. MARVIN H. KAHN

On Behalf of the Citizens of the State of Florida

Jack Shreve
Public Counsel

Office of the Public Counsel
c/o The Florida Legislature
111 West Madison Street
Room 812
Tallahassee, Florida 32399-1400

(850) 488-9330

Attorney for the Citizens
of the State of Florida

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FPCC-RECORDS/REPORTING

SUMMARY OF REMARKS BY DR. MARVIN H. KAHN

ON BEHALF OF OFFICE OF PUBLIC COUNSEL

Introduction

House Bill 4785 required the Commission to study and report on existing relationships among the costs and charges for various telephone services and to also report on conclusions as to fair and reasonable local exchange rates. Indeed, this is not the first instance in which commissions in general or this Commission in particular has addressed this set of questions. It can be argued that commissions have addressed these questions in every rate case. To be sure, however, the industry landscape today is different, or at least hopefully so, from what it was several years ago. First, enormous efforts are being asserted to open this market so that, hopefully, competition will be the norm rather than the exception. In that same context, public policy questions with regard to universal service have to be addressed in the matter consistent with the competitive market rather than with one dominated by monopoly and regulation.

As indicated, the question raised by the legislature is to identify a set of rates for local exchange services that are "fair and reasonable." We are here to report on our proposed approaches and some preliminary findings in that regard.

We define a fair and reasonable rate structure as one that is "subsidy-free." It follows from economic theory and common sense that a rate structure is subsidy-free and, therefore, fair and reasonable, if all rates are above their respective incremental costs and below their stand-alone costs. If a rate structure is subsidy-free, then each of the services provided benefits from the joint production process -- even at the price level for each of the other services. In other words, if the current rate structure is found to be subsidy-free, then the prices charged for each of services involved benefits from the joint production process, even at the current prices for each of the other services.

In undertaking this investigation, we are mindful that this Commission has already addressed the question of the reasonableness of a rate structure and the appropriateness of the stand-alone cost methodology in that context. Specifically, in Docket No. 860984-TP, the Commission investigated the reasonableness of local exchange rates, intrastate toll rates and intrastate access rates, from a fair and reasonable perspective. In that proceeding, the Commission concluded that there was no cost justification for a rebalancing of rates, but that instead, the existing rate structure was reasonable. In support of its conclusion in that regard, the Commission relied extensively on stand-alone cost information.

In what follows, I will first describe briefly three costing processes we anticipate undertaking in this proceeding and comment on the assistance that they will provide the Commission and its Staff in its endeavor. I will then provide some rather general conclusions on these matters. The approaches we propose in this regard are:

- stand-alone cost using embedded cost data
- stand-alone cost using incremental cost data
- incremental customer cost investigation.

Embedded Stand-Alone Cost Study

A stand-alone cost study is one that identifies the cost of producing one or more services without including the benefits of economies of scope or joint production with other services. Stand-alone cost estimates can be determined for an individual service, for instance, or even conceivably for the total complement of services offered.

Using the stand-alone method, the incremental costs of a service or group of services is calculated by: first determining the stand-alone cost of a group of services which includes the service in question; then calculating the stand-alone cost of the same group, but excluding the service or services in question; and, finally, comparing those two stand-alone cost estimates. The incremental cost of the service or services in question is simply the difference between those two stand-alone cost estimates.

A benefit of the stand-alone costing procedure is that one does not have to make any assumption with regard to costs being directly attributable, shared or common with regard to any one or combination of services. Questions with regard to that are determined analytically by the stand-alone cost process. Costs that are shared or common find their way into the stand-alone

costs of multiple services. Costs that are direct find their way into the stand-alone cost study only if the service ... at the costs are directly attributable to are included. The incremental costs determined through a stand-alone costing procedure include only the costs directly attributable to the service(s) in questioned.

Given that the Commission earlier relied on embedded stand-alone cost information, it should be viewed as reasonable to provide additional information in that regard. This is not to suggest that embedded cost information is determinative, but simply that it provides a contribution to the Staff and the Commission in addressing this issue.

BellSouth has indicated in responses to data request served by Public Counsel that embedded cost information on several of its services is currently available. Our intention is to draw on that information to conduct the stand-alone cost analysis.

The stand-alone cost procedure will simply identify a group of services that rely on similar equipment for its provision. This will be local, toll and access, primarily. Based on the cost information provided, the intent will be to construct a stand-alone cost for this family or aggregation of services, given that they rely on very similar facilities. The stand-alone costs for local and toll will then be calculated separately. The result will be stand-alone costs for the two groups of services, as well as the incremental costs of each. With that information available, questions with regard to whether rates for local and toll services in general, (including access) are reasonable at current levels, based on the stand-alone cost analysis, can be determined.

Incremental Cost Analysis

As noted, stand-alone cost information is not, in our view, determinative. Indeed, incremental cost information should be used as the primary input as to the question as to the reasonableness of current rate structures. BellSouth has provided incremental cost information in this proceeding to the Staff and it is also generated incremental cost information in its recent generic TELRIC investigation. That information, we believe, can be used to structure stand-alone incremental cost information, on a forward looking incremental basis. The basic questions and approach will be identical. Using these data, a network designed to provide local, toll and access functions will be developed. In a TELRIC sense, a reasonable allocation of shared and common costs to this network will be necessary. Then, the stand-alone costs for the local component and the toll component will be determined separately.

Incremental Customer Cost Study

While the previous two analyses focused on local exchange rates in general, we propose in this instance to also provide information with regard to residential rates, *per se*. In that regard, it is necessary to recognize that in a competitive market, it is likely that the relationship between cost and rate for any individual service may be less important than the relationship between costs and rates for a bundle of services to a customer. This is especially true with regard to the residential customer. As it applies to residential customers, the administrative cost of shopping

for individual telephone services from different suppliers may be sufficiently great so that "one stop shopping" becomes the norm.

If that is the case, then it will be the customer, and not the service that becomes the incremental unit. In other words, the relevant scope for an incremental analysis with regard to the residential customer is the customer, and not an individual service. If BellSouth is successful in retaining a residential customer, BellSouth will retain all services taken by that residential customer. To compare the revenues and costs for residential services, it is appropriate to compare the total revenue from all services taken by that customer that accrue to BellSouth with the total costs of providing all such services to that customer. The complement of services that are relevant includes local basic, vertical services, intrastate toll, intrastate access and interstate access.

General Observations with Regard to Stand-Alone Costs

As I indicated, the Commission earlier received evidence on the stand-alone costs of providing local, toll and access services and concluded that the rate structure at that time was subsidy-free. Since that time, there have been numerous changes to rates, charges and costs incurred by the telephone company. However, those changes have all been in the direction of making the results found at that time even more compelling today. (We are preparing charts and overheads or handouts that can be used in this context)

First, consider that since the Commission reached its earlier determination that rates were subsidy-free, rates for residential local service had been virtually unchanged. As shown in Chart No. 1, rates in (several) BellSouth's cities have remain virtually unchanged over the last ten years. Indeed, rates for TouchTone, which is now available to all residential customers, have been eliminated. Even factoring this into the analysis, as has been done on Chart 1, shows that rates for local exchange services have been relatively flat, though indeed slightly downward in trend.

While rates for local services have been relatively unchanged, the same cannot be said for toll or access charges. Chart 2 reveals the trend in intrastate toll rates over the last ten years in Florida.

Chart 3 reveals rates for carrier switched access charges (either LS1, CCLC, or some combination thereof).

Charts 4 and 5 go to the cost incurred by BellSouth. To paraphrase BellSouth in testimony provided before the Louisiana Public Service Commission, one thing you can be certain with regard to telephone is that the cost of providing service today is less than the cost of providing it yesterday. Chart 4 provides the trend in BellSouth total factor productivity. This measure of total factor productivity is that adopted by the FCC in its productivity investigation in CC Docket 94-1. Using those methods, we have updated the information to provide the most current available. Also shown are trends in BellSouth labor productivity and capital productivity

Chart 5 presents information on the costs incurred by BellSouth. BellSouth's costs have increased less than the rate of inflation generally realized. Moreover, when the rate of productivity advance it has experienced is recognized, then the result is that the unit costs incurred by BellSouth in producing the various goods and services offered has declined steadily over this time period.

What does the above information indicate with regard to the expected results of a stand-alone cost study if one were done using current information? The data relied upon by the Commission in its earlier investigation suggested that rates were subsidy-free. Since that time, BellSouth's costs have trended decidedly downward. If the prices in place at that time were to remain in place today, rates would even be further above costs than they were at that earlier time. Rates for local exchange service were found not be below cost or to be benefitting from subsidy then. So with costs even lower today, they clearly would not be below cost today. Rates for access and toll services were found to be below their stand-alone costs then. Rates and charges for toll and access services have trended decidedly downward since that time. Hence, it is reasonable to conclude that the charges for these services today still remain below stand-alone costs. In short, the available evidence suggests that rates and charges today are more likely to be subsidy-free than they were during the earlier investigation.

I thank you for the opportunity to be here today, and I am available to answer any questions that you may have.