BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

SPECIAL PROJECT
NO. 980000A-SP

In Re: Fair and reasonable residential basic local telecommunications rates.

DAY 1
AFTERNOON SESSION

IN RE:	Staff Workshop
CONDUCTED BY:	Anne Marsh
DATE:	Thursday, October 1, 1998
TIME:	Commenced at 8:30 a.m. Adjourned at 4:15 p.m.
PLACE:	Betty Easley Conference Center 4075 Esplanade Way Room 148 Tallahassee, Florida
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P R O C E E D I N G S

MS. MARSH: Okay. Let's go ahead and get started again. Our next speaker is Mark Calnon.

MR. CALNON: Thank you. Good afternoon, the scope of my comments today cover three main topics: Background in the current environment; GTE's contribution analysis that was submitted earlier and attached to my prefiled comments; and then the role of that contribution analysis in the PSC's investigations, both this phase for fair and reasonable rates, as well as the cost model phase that is upcoming.

The key messages are that the contribution analysis supports the legislature's concern regarding the existence of implicit subsidies in current rates. It identifies the major sources: Multi-line business rates, switched access, intraLATA toll, vertical features.

Another key message is that the fair and reasonable rates are consistent with and cannot be isolated from universal service analysis. This is not simply an evaluation of a move, say, from $15 a month for basic rates to $20 a month or something higher for basic rates. There are much more complex interactions. We've got to understand the relationships between other rates that currently support universal service, where they are now, where they may move to over time and the impacts that they will have in conjunction with any changes in a determination about what might be fair and reasonable. Given these interactions and tradeoffs, I'd make the strong recommendation that the report that goes into the legislature include and reflect to as great an extent as possible the scope of these interrelated issues.

If we look at background -- and I apologize, the shading here is not that strong, but I'll work with the pointer. If we stand back and look at current rate relationships, what we see quite simply is disorientation. If we look in total, we've got total costs that are covered by the combination of intrastate revenues and interstate revenues. In total, the revenues generated from the provision of service are sufficient to cover costs. If we look beneath that aggregate level analysis and to adopt some terminology that will be used in the upcoming phases, if we look at supported services, those services that will be the object of public policy issues in terms of what might be an affordable level, if we look -- so single line business rates and residential rates. If we look at the rate to cost relationships for those services, what we see is that current revenues cover just a fraction of cost, and there is a shortfall that is produced there. If we look over at unsupported services, those I just mentioned areas, the incentives don't exist today. The costs are high. The prevailing rates are low. There is not a sufficient signal to competitors to enter and compete in the provision of basic access.

If we look at unsupported services, basic switching and hauling of traffic, the presence of that surplus, the presence of those implicit subsidies creates very strong incentives for arbitraging this current set of rates or cream skimming, taking advantage of this disorientation.

The costs are not high. The costs are not the reason that the prices are high. The prices are high to create the level of surplus. So in this status quo what we have is insufficient incentives to enter and compete in the rural areas. We also have a threat to the current set of implicit subsidies. Currently the surpluses exist and they are able to manage the necessary level of support.

As entry occurs, in the major metropolitan areas for the large business customers and those subsidies are competed away, they are eroded, that creates the appearance of competition, but it's a form of competition that is damaging because the support is no longer in the system. The end result to that is ultimately upward pressure on basic rates.

So the implications that are borne out by the primarily -- multi-line business, switched access, intraLATA toll and vertical features -- what we see is a significant surplus generated where current revenues are well in excess of costs. The aggregate balance that I mentioned earlier is realized because the surpluses are able to offset the shortfall that are for supported services.

And, again, a complex web of implicit subsidies, and we've got to look not just as service levels, but we've also got to look at this flow of implicit support from several dimensions: Urban versus rural, where in the lower cost urban areas rates are highest; in the higher cost rural areas, rates are generally lower. So there is an urban/rural dimension to this web of implicit support.

We saw data this morning on usage and features priced with contribution margins maybe in excess of a thousand percent compared to basic service covering possibly half of its cost, at least residential and single line business. And, again, then, from a customer flow, business versus residential services.

The key message in terms of the current environment is that these implicit subsidies are not sustainable. If we go back two slides to the picture we were looking at, what we can see if we look at supported services here and think about competition in the rural contribution analysis, rate rebalancing to competitive market levels for non-supported services is key. Within that context of rebalancing, fair and reasonable determinations focus on the price for basic service paid by customers; and as I mentioned before, we've got to stay focused on those tradeoffs and take not a focused or narrow view of this but a broader view where we are considering the impacts of rebalancing on all rates.

In terms of identifying the flows of support and starting to get a gauge on where this leads us, what we are doing is making a comparison for both supported and unsupported rates -- unsupported services between the rates that exist today and the rates that would exist absent a public policy goal of promoting universal service. So a service is being supported if a current rate is set at a level that is below its market rate. Conversely, a service is providing support if it's set at rates that are above the rate that would exist -- the competitive market rate that would exist absent the goal.

It's important to focus on unsupported services as well as supported services. We can look at basic local service in itself, make revenue and cost comparisons, and they are very important and it's insightful to do that. We can also look at all the unsupported services and get a feel for the manner in which the current mechanism is providing for that shortfall between revenues and costs on the local side.

In that end, consistency is important, looking between wholesale and retail rates considering UNEs as well as -- unbundled network elements -- as well as retail rates and affordable rates for basic service and the costs associated with providing basic service. And so prior findings of economic costs from UNE proceedings are relevant to this, and a proper relationship between wholesale and retail is critical.

If we turn now to the contribution analysis, revenue to direct cost comparisons were made on the initial submission July 31st, revenue to economic cost. Again, as I mentioned earlier, what we want to compare are current rates to rates that would prevail absent the public policy goal of universal service. To that end you want to consider not only direct costs but also common costs. So with my testimony on the 24th of the month, the contribution analysis was updated to reflect reasonable allocations of common costs.

From this data several conclusions emerge. I mean the level of disorientation that exists in rates is confirmed, very consistent with what we saw from Sprint this morning. Revenues from residential service alone fall short of costs by over three hundred million dollars, and to set up some of the linkages with the cost model phase that is upcoming, this shortfall is a conservative estimate of funding requirements for three key reasons: Costs are aggregated to a rate group level -- I'll come back to that in a minute -- local measured service was excluded from the analysis -- just the unlimited use residential service was considered in the cost and charges in the contribution analysis -- and single line business services were included in the contribution analysis, but they are excluded in the calculation of that 328 million shortfall. And, again, single line business would also be considered a supported service. So we want to -- it's important; I'll come back to this -- to keep the differences between what we can use the contribution analysis for and how it relates to the cost model phase.

Again, let's kind of restate the goal or the objective here. In the top panel coming across, we've got our current system, and total costs are recovered but through a very disoriented rate schedule where shortfalls on the supported services side are made up for with surpluses on the unsupported services side. The end state, or the goal we are trying to realize here has the costs of supported services covered now through a combination of universal service funds and the revenues paid by customers, and that universal service funding mechanism would in marked contrast to the current set of implicit supports be designed and implemented on a competitively neutral and, therefore, sustainable fashion where all providers of telecommunications services would contribute.

So in effect, the surpluses here (indicates) are transformed into an explicit universal service fund, and the rebalancing that was talked about earlier today where rates for those toll and vertical access multi-line business rates, those rates would be reduced down to levels that are more consistent with their levels of costs.

COMMISSIONER JACOBS: So you would look at each one of those elements that contribute to the subsidy? Much attention has been focused on access, but you will look at each of them?

MR. CALNON: Oh, that's right. Access is most definitely a significant component of the current funding mechanism, but it is not the only component, so I think it's very important, as you point out, to recognize that the offsets need to be taken in a way that reflects the current funding mechanism.

COMMISSIONER JACOBS: So you have vertical services as one of those major items that contributes to the subsidy presently?

MR. CALNON: That's right.

COMMISSIONER JACOBS: There would be some -- Would it be an equal -- Would the reductions be equivalent, or would there be some formalized how you do that?

MR. CALNON: If we sort of envision a fully sufficient fund where all implicit subsidies would be removed, then it wouldn't necessarily be equal or proportionate; but to the extent that features are marked well in excess of their costs, they would be rebalanced down as would toll, as would access. So to the extent that there is implicit support in each of those, if you look at the contribution analysis, everything is not at eight or 900% now for those services, and 50% of cost for basic. Some markups are higher than others, and so the reductions wouldn't necessarily be proportional to one another but would reflect their current mix.

COMMISSIONER JACOBS: Would there be an effort to reach some proper maximizing price, I would assume, because those elements go into some kind of competitive marketplace?

MR. CALNON: Well, those services whose margins are greatest today are subject to the greatest levels of competition, features through telephone equipment versus taking them from the supplier, alternatives to switched access and toll bypassed for the multi-line business customers. So in a sense, the rebalancing to more proper cost levels -- I mean to the question that was raised this morning, you know, why would we want to do this since it's establishing proper price signals and encouraging competition? The answer was, it's to stop the bleeding. And so in that sense, I don't know if profit maximizing is the right characteristic or the right description, but it certainly does maximize the preservation of the support mechanism.

MS. BUTLER: Hi, I'm Melinda Butler. I'm a little bit confused. It was a couple of pages back, and you were talking about which services being supported and which service supports.

MR. CALNON: Okay.

MS. BUTLER: And there was a statement on the page that said a service is providing support if the current price is greater than the market price.

MR. CALNON: That's right.

MS. BUTLER: And that's the one that is confusing me because it was my understanding that the services that you were talking about earlier, some of your colleagues were talking about earlier that were providing support were the non-basic services; is that correct?

MR. CALNON: That's right. And when I say it's providing support --

MS. BUTLER: Right.

MR. CALNON: -- providing support to basic service.

MS. BUTLER: Right. I understand that part.

MR. CALNON: Okay.

MS. BUTLER: And you were just saying that those non-basic services tend to be the ones that are more competitive; is that correct?

MR. CALNON: That's right.

MS. BUTLER: Okay. Then the part that I'm confused about is that if they are more competitive than if you are charging above the market price, you aren't -- you are not revenue maximizing, are you?

MR. CALNON: No, I think that's right, and the reason is, those services are marked up high today because those are the implicit supports, the only source of funding that allows basic rates to stay where they are.

MS. BUTLER: But what I don't understand is this: From the perspective of a company, if you were to lower the price of the non-basic services in the competitive environment today, you would, in fact, then have more revenue for support, would you not? And what is preventing you from lowering the price of the non-basic services?

MR. CALNON: It is most likely the case that lowering those rates, certainly in a situation where competition exists, it may not actually increase the level of revenues or contributions, but it may limit the erosion of those supports. It's not the case for many services that lowering their price actually increases volume to such an extent that total revenues grow. But confronted with a competitive situation in a major -- in downtown Tampa, responding to the competition and lowering prices is necessary to just try and preserve the support that is there. The offsets --

MS. BUTLER: I think that, I think that -- I'm sorry to interrupt. But I think that what you're saying is, is hinging upon whether or not it's currently at the market price because, if it's above the market price, then I believe by definition, if you lowered it to the market price, then you would have an increase in revenues.

MR. CALNON: I don't think that necessarily follows. More lowering the prices, I think, would definitely increase sales; but with highly averaged rates, if prices are lowered to all existing customers and then the incremental stimulation or attention is small relative to the total base of customers, then that impact might be lower revenues in total. They may be higher relative to the alternative of doing nothing where competition would then take the business.

MS. BUTLER: Okay. That's very helpful. I think I understand what you're saying now.

MR. CALNON: As we pivot off of that, the key constraint on keeping those non-basic rates high is that basic rates are where they are.

MS. BUTLER: Okay. Thank you.

MR. CALNON: Right?

MS. BUTLER: Thanks.

MR. CALNON: So what our goal is, is to create this transformation from the current set of implicit supports to what for supported services would be a combination of revenues paid by the customer and support drawn from a fund, sufficiency to cover their costs, and then with those implicit burdens off loaded from unsupported services, their prices more closely approximate their costs. And if we go back to the comment I made earlier about an insufficient incentive to enter and compete in the rural areas and the customer impacts and economic development impacts that are associated with that, that problem has been solved in that the portable level of universal service funding and the price paid by customers is now sufficient to cover costs, so rural -- potential entrants for rural areas will see appropriate compensation. We've also eliminated the uneconomic arbitrage opportunities that exist for unsupported services, and so that transformation has preserved or transformed the current level of implicit funding to the explicit fund. So you've got reasonable cost to rate relationships for both unsupported services and supported services.

Taking a little closer look at the residential component of the contribution analysis, just for the five rate groups for GTE, the first column is average revenues per line. The second column is average costs, and as I mentioned earlier, the contribution analysis was presented at a rate group level. As you move into the cost ng phase for universal service, you'll be looking at wire center level of detail, and there is much greater cost variation that at an individual wire center than you would see at a rate group level. So just to sort of expose that variation underneath the rate centers, I've shown the high and low wire centers for each of those rate groups.

COMMISSIONER GARCIA: Okay. So you're saying that your lowest cost for providing service is 29.99?

MR. CALNON: That's correct.

COMMISSIONER GARCIA: And I'm sorry, I might have missed your earlier part, but is that where you think rates have to be taken to?

MR. CALNON: No, not necessarily. If we go back -- Actually the next slide we'll see that. If that's the measure of cost in that wire center, then -- and we'll link to affordability in a minute. What is important is that the combination of the price paid by the customer and whatever level of funding is established, that the sum of those two properly address their costs.

COMMISSIONER GARCIA: But the slide showed cost -- Your least cost line was $30?

MR. CALNON: That's right.

COMMISSIONER GARCIA: And you're saying that would support that -- That's where it should be at, the revenues should take, if it's costing you 30 --

MR. CALNON: As you --

COMMISSIONER GARCIA: I understand. I understand what you're doing.

MR. CALNON: Okay. As we move into the cost model phase of this --

MR. OCHSHORN: Mr. Calnon, Ben Ochshorn, Florida Legal Services. I have a question or two about this chart. Your average cost numbers are considerably higher than the ones you first submitted on July 31st for these five groups, so what is the reason for the difference?

MR. CALNON: As I mentioned earlier, the July submission was direct cost only.

MR. OCHSHORN: Okay.

MR. CALNON: For purposes of addressing universal service and making comparisons to where the prices would tend to be absent a public policy goal with where they are now, it's necessary to bring common costs into those. So I've adjusted the direct-cost-only estimates and included a reasonable allocation of common, and those are reflected here.

MR. OCHSHORN: Okay. The other question I had about this chart is that in your July submissions your company calculated average revenue as the tariff rate plus the subscriber line charge. Is that how average revenue is calculated here?

MR. CALNON: Yes, actually I believe it was tariffed rates, subscriber line charge, and an average of the ECS revenues as well. And these average revenues are those total dollars simply expressed on a per line basis.

MR. OCHSHORN: Okay. A question I'd have is does this calculation include second line charges? As I followed your submission, you are calculating average revenue as being simply for the primary line, but if somebody has more than one line, they pay a lot more than the tariff rate for a single line.

MR. CALNON: I would -- I did not change in any way the base of the lines that were used in the July 31st, so I would need --

MR. OCHSHORN: So the answer is this calculation does not include revenues from second lines?

MR. CALNON: I would need to check that. If they were not included in July 31st, they were not included now. I'm just not sure of whether or not they were in July 31st.

MR. OCHSHORN: Okay. Thank you.

MR. CALNON: So the basic relationship that emerges, a properly sized fund will capture the difference between current regulated rates, if we were to make those calculations today, or whatever a rate would be determined affordable going forward, that difference would be captured. So to the prior question of was I -- were we advocating that $30 necessarily be charged? No, but it's also not necessarily the case the current rates will be those going forward. So whatever that difference is would determine the level of funding requirements. If we are at a wire center by wire center basis, making that calculation and then coming back to total company.

The fund will be undersized, and then the proper competitive signals we discussed earlier be distorted if either costs are ignored or revenues overstated. Again, more issues that are into the next phase.

COMMISSIONER DEASON: I have a question on your first bullet point there. Are you equating market rates with costs?

MR. CALNON: Yes. I mean if -- I think the best, for individual services, the best estimation of where prices would tend to in a competitive market is to look at cost; but I would note that it's not only direct cost but direct cost plus a reasonable allocation of common that would provide a gauge for market prices. That's why I adjusted the data submitted at the end of July to reflect common costs for purposes of this discussion.

COMMISSIONER GARCIA: Shouldn't it just be embedded costs, I mean what it actually cost you as opposed to the market rates?

MR. CALNON: I'm sorry, could you --

COMMISSIONER GARCIA: Following Commissioner Deason's point, I mean should it be the market rates? Is that what determines the price, or shouldn't it be your costs so that you can cover your costs, not what the market would dictate? Because I'm sure if you raise the rate a hundred dollars, you might not have 93% penetration, but 83 would put you probably in a better position. So it shouldn't be what the market -- it should be your cost.

MR. CALNON: That's correct, and these are forward-looking estimates of the direct costs, but then the adjustment I made to those direct costs was to be consistent with actual costs; so I think I agree with your point.

COMMISSIONER DEASON: But you're assuming a competitive model under which prices would tend to approach cost, plus a reasonable profit.

MR. CALNON: That's right.

COMMISSIONER DEASON: Any cost I assume there is a profit margin built in, and I use the term cost.

MR. CALNON: In the direct cost and then a common cost recovery, and I think that's the appropriate basis for identifying what the current level of flows would be.

COMMISSIONER DEASON: And so I assume you're saying that would work in both directions. For those services which are now subsidized, the rates should go up to approach cost, and for those services which are providing the subsidy, they should go down?

MR. CALNON: Absolutely. The rebalancing is central to this message.

COMMISSIONER DEASON: And they should also approach cost?

MR. CALNON: That's correct.

COMMISSIONER DEASON: But we have in the proposal, at least as it was presented earlier today, is the rate rebalancing and a rate -- revenue neutrality approach. Do you endorse that as well?

MR. CALNON: Yes, if we can go back one or two slides here. I mean through this chart we are not changing the overall level of costs for the firm. All right, what we are showing is that these surpluses here, right, they migrate to a permanent explicit universal service fund, and then the large revenue column here is rebalanced down.

COMMISSIONER DEASON: So you're assuming that your current revenues are equal to your costs?

MR. CALNON: Yes.

COMMISSIONER DEASON: Do we know that as a fact?

MR. CALNON: I think current revenues provide --

COMMISSIONER DEASON: Are they equal to your cost?

MR. CALNON: I think they provide a reasonable --

COMMISSIONER DEASON: Cost plus a reasonable profit.

MR. CALNON: Right.

COMMISSIONER DEASON: Do we know that, that as a fact that that's the current situation, your current revenues do that?

MR. CALNON: I think they provide a --

COMMISSIONER DEASON: Or would you have to go to the legislature and just say, The first assumption is current revenues are equal to these companies cost?

MR. CALNON: I think current revenues provide a reasonable approximation to cost. I don't know -- I mean you said do we know that with certainty.

is by no means the case that establishing such a fund creates in any way found money. It's really just a transformation of the fund that exists today to a fund that makes more sense and is more consistent with an open competitive market.

MR. OCHSHORN: Mr. Calnon, you keep mentioning a competitive market price. Are you aware of any residential service market that is competitive now that we could look at to see what the prices are?

MR. CALNON: I think the level of competition for residential markets is very limited. I think the reason is, as the previous chart was showing, the current level of compensation relative to the cost that is incurred isn't sufficient incentive to enter and compete.

MR. OCHSHORN: So right now the area isn't a competitive market for residential service that you are aware of, and so this discussion is theoretical about how a competitive market would function; is that correct?

MR. CALNON: I think we are using estimates of cost in the establishment of funding through a universal service mechanism that would be portable to try and gauge what level of compensation would be necessary to foster a more robust competitive market.

MR. OCHSHORN: In a competitive market in which exchange carriers have to file tariffs and then offer the service to whoever applies for it, why wouldn't competitors offer as low a basic rate as they could in order to get subscribers and then make their money on vertical services?

MR. CALNON: I think the answer to that, if you start to work through that, as a planning exercise, what you would quickly confront is the realization that it may look like potentially the level of total revenues would be sufficient to cover total cost, the risk of your -- the risk to that supplier of not providing those high-priced services to create the offsets is pretty high. So the analysis would, I think, come back to, on a stand-alone basis: Do the rewards for providing basic service compensate for the cost?

MR. OCHSHORN: Well, there is certainly a risk as far as opening a business and entering a market, but the competitive markets that I can think of in businesses other than local telephone service do generally operate with a low initial rate or charge or whatever to get somebody interested in your product, and then you make your money on repeat business and extra services and things like that.

MR. CALNON: And I think those businesses would also enjoy the sort of flexibility to learn from the market in terms of if they price something too low expecting follow-on business to be strong and it doesn't materialize, I think they are with a pretty high level of flexibility able to react and adapt to that.

MR. OCHSHORN: Okay. Thank you.

MR. CALNON: Just to reiterate, I think the fund from this basic relationship, the funding will be under sized if costs are ignored or revenues are overstated. I think that is where we wrapped up.

If we look now at just, reasonable and affordable rates, I think we can take this basic relationship that is shown here on a per line basis, but where we have got costs that are in total covered by the combination of the basic rate and the support that is paid -- and I think it's helpful to look at affordability in the context of where do we want to draw this line? What is the split we want to have between the price paid by the customer and the level of funding that would be required? To the earlier point of do prices need to move all the way up to cover their cost? The answer is, no, but there are, as I think several of the other presenters will show over the next three days, significant benefits to be realized by moving the level of basic rates higher, reducing the level of funding that would be required while still recovering costs. So affordability looks from the consumer's perspective and sets to draw that line. Just and reasonable focus in total on the combination of the basic rate, the funding that's there and the sufficiency of those two against the level of cost.

To illustrate some of the interactions I've been talking about, the key message here is not to look in a vacuum, not to approach affordability as an issue of, say, a $10 rate moving towards $20, or without looking at the potential offsets and the total bill impact. If we sort of envision an explicit universal service surcharge and consider rebalancing rates that remove the implicit support that exists today -- I've just prepared some hypothetical data to show these interactions, and I'll talk through the first couple of columns. If we assume that basic rates are $15, the other two assumptions down here in the notes, and I apologize for the quality of this slide, but I've assumed that 50% of the current bill above and beyond the basic connection is rebalanced down; and if you recall the level of the contribution margins from this morning that the other companies have put in, 50% may, in fact, be a conservative level given how much support --

COMMISSIONER GARCIA: I'm sorry, you've lost me completely. I have no idea what you're talking about.

MR. CALNON: Okay. I'm just making a hypothetical, and I'm going to focus on the first column right now.

COMMISSIONER GARCIA: Okay.

MR. CALNON: And I just want to look at those tradeoffs between two things. A customer who would spend $15 a month would be in a position to receive no benefits, because they are not consuming toll or access or verticals. If we are in a world where rates are rebalanced and as the second note points out there is, say, a 20% surcharge, universal service surcharge, I just want to come down that column and find the bill impact for that customer whose bill is $15 on average. So they start out at $15. They are not consuming any of those things whose prices come down, so there is no benefit realized, yet they are subjected to a 20% tax, the universal service surcharge.

COMMISSIONER GARCIA: Got you.

MR. CALNON: So the bill would go to $18, a 20% increase for that customer. If we step to a $20 a month customer, they are consuming -- you know, they've got their basic rate at $15 and then there is $5 of additional, either features or toll or long distance, if their prices fall in half, they would receive a $2.50 credit, if you will. Their new bill would be 1750. Which would assessed a 20% surcharge. The net of those two things would be a $21 bill. Their bill is a dollar higher than it was before, or roughly 5% higher.

If we go one more step out with greater levels of usage and feature and long distance, now there is $10, the difference between 25 and 15 in their consumption bundle, that generates a $5 credit when those prices are reduced. The surcharge now would be $4. Their net bill impact is a dollar lower. And so I think the key point here is to recognize that as use increases, for whatever mix it would be, features, long distance, toll, that at reasonable levels of consumption beyond --

COMMISSIONER GARCIA: Should that type of direct offset be required by any legislation that the legislature considers?

MR. CALNON: Direct offset in the form of a credit?

COMMISSIONER GARCIA: A pass-through. I don't know. You can call it a credit as long as it shows up somewhere, not necessarily on the bill but that the customer gets it back. Is that what GTE proposes?

MR. CALNON: I think for those services that the Commission has jurisdiction over, toll and verticals, those reductions and their impacts are -- can be handled directly through the prices. The issue that is drawing a lot of attention in the industry is the reductions that would come from switched access to the IXCs and then what is the manner in which and the extent to which the IXCs would make that pass-through, and there is discussion of using surcredit mechanism for the IXC portion given that those are tariffs that are beyond the control of state commissions.

I think if you look at, say, the structure of a toll tariff today with several distance bands and some pretty high rates out in the longer distance bands, the credit approach for the intrastate tariffs may make -- may not be as desirable as directly simplifying the rate structures given the levels of cost and consolidating some of the rate elements, but certainly it's --

COMMISSIONER GARCIA: So you would propose a rebalancing of the intraLATA? Not a rebalancing. I guess you'd subsidize them to some degree. You would sort of just group them in a much more simplified manner ard equalize the costs. The longer tolls and the shorter tolls would come closer together.

MR. CALNON: We would need to look at all the rate elements, for example, that would be in the toll tariff, all the distance bands, if first and additional are still there, and day, evening night. You would want to look at those relative to their underlying cost and probably try and at the end of the day have a simpler more cost-reflective structure that may not have anywhere near the level of rate elements that the tariff would have today.

And, again, these are just hypothetical numbers. I think 50% is, given the level of contributions, is possibly easily realized. The 20% surcharge is important. What is critical, and it ties to this morning's discussion, we want to -- it's very important to understand the customer base that would sit in the low usage categories. Certainly reasonable levels of use and higher will see net benefits from this, so I think the focus is properly placed on the low-use customers in understanding to as great a degree as possible the demographic and socio-economic attributes that those customer would have. A simple example would be, some fraction of that low-use segment would probably be second homes and seasonal homes; and I think it's a much different public policy perspective of that $3 impact than it would be for an elderly or a low-income or a fixed-income household.

So I think what this sets up, just, again, with illustrative data, and other presenters have Florida-specific data over the remaining days of these workshops, but it sets up I think a strong argument for focusing and targeting; and that helps in the setting of an affordable rate on average and then the creation or the establishment of target programs where the possibility of a detrimental impact would exist if the affordable rates moved higher.

COMMISSIONER DEASON: Could you backup?

MR. CALNON: Sure.

COMMISSIONER DEASON: The level of your universal service fund surcharge, that would be dependent upon the amount of rate rebalancing that takes place; is that correct?

MR. CALNON: That's right, and --

COMMISSIONER DEASON: And what are you assuming here, no rate rebalancing?

MR. CALNON: Well, the first note there identifies the level of rebalancing, and since different mixes of toll and vertical and long distance would produce different answers, I just lumped it all into one category and let it be a dollar amount above and beyond the $15 basic amount. And so I have assumed that a very significant, by cutting those rates in half by, that a very significant amount of rebalancing is occurring.

The 20% number in terms of the level of surcharge, several factors that go into determining what that number would ultimately be, the aggregate level of funding required within the state, if it would be a state level surcharge, and you've also got -- and the reason 20% is less than 50% I think is you've got all telecommunications providers participating in the fund going forward, not just the rates for those services above and beyond basic. So with the broadest possible assessment base that would come in beyond just the local incumbent providers, but long distance, wireless, I mean the full scope of telecommunications services being the base against which the funding needs of the state are assessed. So you've got a lot of details in actually putting substance to those numbers. I just, you know, used illustrative numbers to try and frame the impacts.

COMMISSIONER JACOBS: I'm sorry, I have a quick question. In your, in the list of services that you listed as non-supported, you did not include multi-line residential in there. Is that reflective of the idea that you don't anticipate that those are non-supported?

MR. CALNON: Multi-line residential?

COMMISSIONER JACOBS: Yeah, separate line and residences.

MR. CALNON: I think in terms of supported services I would consider all residential and single line business as the supported services.

COMMISSIONER JACOBS: Okay. That answers my question.

MR. CALNON: A couple of comments on the linkages to the cost model phase -- and the cost and charges here I'm referring to the contribution analysis -- just to compare a couple of differences that will be important as the Commission works through. In looking at supported services and unsupported services, for the contribution analysis, we used GTE's ICM model. As we look over into the cost model phase, given the need to use proxy models there, GTE supports the use of the BCPM. So there is a different cost model, and that is looking at supported services. In the cost model phase GTE presents an analysis of the level of funding that exists in rates today. For purposes of identifying that we use the permanent UNE rates that are in place and take those as a statement about the economic costs of the underlying switching and hauling functionality and use those to compare to current retail rates.

In terms of the scope of the analysis, as I mentioned earlier, residential and business access here, excluding message rate service, switched access toll, and selected verticals that were identified for the cost -- for the contribution analysis into the cost model phase, res. and single-line business are studied, multi-line bs., state, interstate access, all vertical services identified as those that current provide support.

The level of averaging, we are at a rate group in the data presented here with my testimony, and I'm saying here that it includes netting; and a business example will make that clear. If we are in rate group five, there would be a certain relationship. Say, on average revenues cover costs for single line business in a certain rate group, but down at a wire center level, there would be pluses and minuses. There would be wire centers whose revenues would be greater than costs. There would be wire centers whose costs would be greater than revenues. As you go through the cost model phase and start to look at alternative fund sizes, that example is what I mean here netting, net averaging, above cost and below cost, netting in an example to, say, be equal.

On the USF side, you will look at data at the wire center level, and there will not be netting. If you go from one wire center where costs are greater than revenues, that identifies a support requirement. If you go to the next wire center where revenues may exceed costs, that is another form of implicit support. Just the same as switched access and intraLATA toll, you don't count the positive against the negative there. I think it's more proper to consider that positive as another target for rate rebalancing. So in the sizing calculations that will come out there, you are looking wire center by wire center and just capturing the negative differences, not offsetting those with wire centers whose revenues may be greater than costs. Just a few of the differences that I think will help put the cost and charges or contribution analysis into a proper perspective, as you move into the next phase.

COMMISSIONER DEASON: Well, when you go into the next phase and there is no netting, what does that do to the company's over revenue level?

MR. CALNON: I don't think -- it doesn't have an impact on the revenue levels. What it does is if you looked at costs and charges for business services, there might be a slightly positive relationship between revenues and costs in aggregate. Yet when you look through the wire center level detail, you will identify, USF support requirements. The reason being, high B1 rates in the metropolitan areas that may be well above their costs, those should be identified and rebalanced down to appropriate levels, just as a PBX trunk would come down, just as toll would come down. So what you'll identify is larger business funding requirements without netting than you would see if you just reviewed the more aggregated contribution analysis that comes from the companies.

COMMISSIONER DEASON: So those --

MR. CALNON: I think the overall level of rev -- I'm sorry, the overall level of revenues wouldn't change, it's just identifying a more proper split between the level of funding that is needed and the rate rebalancing that would be appropriate, a mix issue, not a level of revenues issue.

Conclusions. From the consumers' perspective, we are looking at affordability in as broad a possible context, considering all the rebalancing that will occur. From a supplier's perspective, just and reasonable, focusing on a reasonable opportunity to recover costs, linking retail rates and universal service. A key issue is as alternative levels of affordability are considered, as was discussed this morning, the link to the rate -- the linkage to the rate the customer will pay is essential. It doesn't make sense to say that $25 is affordable, to use that number for purposes of sizing the fund, but to not -- but to leave current rates where they are. We'll see in a second that there is a gap that is created there that -- because we have used something for a policy reason but not actually charged it. Also, wholesale and retail rates need to be linked and establish consistency across resale, unbundled element rates and retail rates.

So just visually, again, in terms of charging the affordability -- charging whatever rate is determined to be affordable, if a higher rate is deemed affordable, but it's not charged, then you'll size your funding requirements from the higher level, you'll not be charging it, and there is a gap that is created. If something is truly determined to be affordable for the average consumer recognizing the need for targeted programs, then that's the rate that should be charged. That's the point beyond which funding requirements would be necessary.

In terms of an aggregate link from the providers point of view, reconciling the attributes of the cost proxy models with actual costs, if this is sort of the basic set of relationships between costs, revenues and funding levels to the earlier point from Commissioner Garcia, the forward-looking costs, to the extent that they might create a completely different view than currently exists, that needs to be reconciled as well. And that concludes my presentation.

COMMISSIONER DEASON: Could you define for me what the proxy model cost estimate is supposed to do?

MR. CALNON: What it's supposed to do? In your next phase, that's the basis for identifying support requirements, but I think what I've tried to point out is it's important to complement that investigation with estimates of the level of funding that's currently in play as well as the aggregate level of cost.

COMMISSIONER DEASON: Isn't that supposed to approximate the cost or identify the cost of what an efficient provider could come into the market and provide this service.

MR. CALNON: Yes, subject to some fairly aggressive assumptions in terms of the network is built, in effect, overnight. It's built to known levels of demand. I think there are some very strong assumptions in there, and the level of inputs into those models are also extremely important to focus on. I think Bert Steele next week can extend that discussion farther.

COMMISSIONER DEASON: Well, the difference between cost and the proxy model cost estimate, that difference that you define as gap, how do we know how much of that is differences, as you characterize as utopian, and those differences which are in your current cost structure perhaps inefficiencies or efficiencies yet to be gained when we go to a competitive model.

MR. CALNON: That's a very good question. I think the point of reconciling those is to -- is tc look to what might be reasonable differences and the likelihood that those actual costs will be realized in the marketplace over a reasonable planning horizon and not just sort of the result of, you know, the algorithms in the model and the inputs that are fed to it. So, again, it's just sort of a broader perspective to take those model outputs and evaluate them in light of several other relevant pieces of information, both in terms of the overall level of cost for the company in total and funding requirements when we look at basic service alone.

COMMISSIONER DEASON: Have to exercise a great deal of judgment; is that correct?

MR. CALNON: I think that's appropriate.

MR. OCHSHORN: Mr. Calnon, I have a few final questions. Your presentation has discussed a lot of possible ramifications for the future in the residential market if current rates are left where they are. Do you feel that your company would be harmed if rates for all of your telecommunication services were left where they are today?

MR. CALNON: Most definitely. I think --

MR. OCHSHORN: I --

MR. CALNON: I'm sorry.

MR. OCHSHORN: Go ahead.

MR. CALNON: I think as we pointed out earlier, the level of disorientation, the imbalance that exists with the competition that exists today, the current implicit funding mechanism is being eroded.

MR. OCHSHORN: And how does this harm your company?

MR. CALNON: The ability to continue to offer basic service at current rates is predicated currently on the ability to generate the surpluses, if you will, from the other services. As those surpluses are eliminated, pressure will exist for basic rates to go up, potentially, without sufficient action on the universal service front to and through a level that may be determined to be affordable. So I think what is critical is to not wai: for competition. That's too late. The competition that exists today is inefficiently, artificially incented, given these high margins, and it's thwarted in the rural areas. So I think it's critical to move to establish the universal service fund. That gets the proper balance.

MR. OCHSHORN: Okay. Well, I would agree with you to establish the universal service fund, although that could be a federal or a state level as far as who does that.

If your company were able to petition this Commission to have its basic rates changed and any other rates adjusted, if there was a substantial change in circumstances, would that opportunity address your company's concerns that you've raised in your presentation?

MR. CALNON: If we were allowed to petition the Commission to rebalance?

MR. OCHSHORN: Or to change your rates based upon substantial change in circumstances.

MR. CALNON: I think the policy of universal service goes beyond any one company, so I don't know that it's completely solved by that hypothetical. I think, if this is another variation on your question, I think the proposal we heard this morning has a lot of very sound attributes to it. It recognized the link to charge the rate that is determined to be affordable. It put a transition plan out which has a reasonable time horizon probably. Too long, I think, would have jeopardies. The certainty that would be created by a gradual phased-in approach benefits consumers. I think it would provide enough information to entrants to, you know, be able to form and implement their business plans. So I think that sort of straw man and what I was talking about today is the solution.

MR. OCHSHORN: Could your company adequately pursue or obtain this solution through a petition to the Commission to have your rates, your basic rates raised, or do you need some measures in addition to that?

MR. CALNON: In that the level of cost for basic service is, if not on average, at least in the most rural areas, well beyond what would be a reasonable affordability range; and, therefore, USF system is necessary. I think the answer to your question is, no, the petition by itself doesn't get the job done.

MR. OCHSHORN: Because you would, in addition, need to address the DUSF issue?

MR. CALNON: I think USF is central to the solution here, and I'm not sure procedurally the nature of your question.

MR. OCHSHORN: Oh, okay. The reason I'm asking is that current -- as you know in Florida and I realize you are from out of state, but in 1995, we allowed companies to get out of rate regulation if they wanted to and go to price regulation. And the 1995 law provided that if at any time there was a substantial change in circumstances from when the Act went into effect that a company could petition the Commission and request an increase in rates based upon those changed circumstances, and so that's why I was trying to see whether you felt based on your economist's perspective here whether that remedy would be sufficient or not.

MR. CALNON: Not in and of itself, no, I don't think it would be.

MR. OCHSHORN: But it would be, you feel, in combination with looking at the USF issue?

MR. CALNON: Yes, I would think so.

MR. OCHSHORN: Okay.

MR. CALNON: I mean the finding that might come out of here, an implementation plan behind that finding, coupled with the establishment of a fund and then the corresponding rate reduction, I think those are --

MR. OCHSHORN: Okay. That's fine, because that is basically our position too at Legal Services. We represent low-income people, and we feel that the remedy that is in the law now is combined with work on these USF issues and seems to be a perfectly adequate way to address any substantial changes in circumstances where you may have to adjust rates due to competitive pressures or whatever, so thank you.

MR. CALNON: Thank you.

MS. MARSH: We need just a minute to set up for the next speaker. We are considerably ahead of schedule, so unless the court reporter or the commissioners need a break, I'd suggest we just kind of break in place while we get set up. My thinking was that since we were ahead of schedule some people might just want to get finished, but some people do want to take a break.

COMMISSIONER DEASON: 15 minutes.

(BRIEF RECESS TAKEN)

MS. MARSH: We are ready to get started again. Okay, we are ready to get started again. The next speaker is Bill Dunkel, and Tom Regan, I think, will also be speaking, so we are ready to start.

MR. DUNKEL: Thank you, Anne. A funny thing happened to me this morning on the way over here, I came out of the hotel, and I was looking for a taxi cab; and as I was out there, there was also another person from GTE and one from Southern Bell -- BellSouth. And all three of us were looking for a cab, and we are going to the same location, so we decided instead of taking three separate cabs we would just take one cab.

As I was riding along, I noticed the gentlemen from BellSouth had his calculator out and he was doing some sort of very complex calculation. The gentleman from GTE had a laptop computer out and was also doing a very complex calculation. So when we arrived here the taxi cab meter said $30. Well, the gentleman from BellSouth was the first one out, and he said, well, according to my calculations, because of the additional weight of one more passenger, this cab burned five cents more gasoline than it would have burned had there been only two passengers. In addition, the tire wear and a few other items were also slightly higher, so in total this trip cost ten cents more because of the weight of a third passenger than it would have cost had we made the same trip with only two passengers. Now this is the only cost that I am responsible for because all of the other costs would have occurred anyway because of the other two passengers; however, I will make a very generous 30% contribution to joint and common. So he reached in his pocket and came up with 13 cents, handed it to the driver, picked up his bags and left.

Well, the driver looked at the coins in his hand, looked at the meter that said $30, but he didn't say anything.

The next person out was the gentleman from GTE. He said, No, that last calculation was totally incorrect.

When the wind drag is considered, it's actually eight cents additional cost caused by an additional passenger, and this is the only cost I'm responsible for. All of the other costs of the trip would have occurred anyway because of the other two passengers, so my cost is eight cents; however, I will pay a 20% contribution to joint and common. So he reached in his pocket, came up with a shiny dime, handed the dime to the driver, picked up his bags and left.

The driver still said nothing. He Looked at the coins in his hand, looked at the meter, but said nothing.

Well, I was the last one out of the cab, so I thought about it a while. I said why not. So I got out my calculator. I calculated the additional cost of one additional passenger, and it was nine cents. And I was very generous, I included a 40% to joint and common. So I came up with 14 cents or 13 cents, handed it to the driver.

He looked at the coins in his hand, looked at the meter that said $30, and then he looked in the back of the cab, and there were no more passengers in the cab. At that point he reached underneath his seat and came up with a baseball bat. He said, I heard what the first gentleman said, and it sounded pretty good when he said it. I heard what the second gentleman said, and it sounded pretty good when he said it. I heard what the third gentleman said, you, and it sounded pretty good when you say it, but somebody owes me $30; and since you are the last one in the cab, I guess it's you. So the moral of the story is, when you are doing incremental pricing, don't be the last one in the cab.

Okay. Much of what we are doing in this case is the same. It's doing incremental pricing for your service, and then leaving someone else as the last one in the cab. One question -- one thing I would like to point out is there has been a question about motivation, why would the telephone company want to have a revenue-neutral rate restructure? What is the benefit to them? Well, the answer is it benefits them by allowing them to impede competition.

Competition for utilities is nothing new. Back in the 1800s before railroads were regulated, there were four railroad lines that ran from New York to Chicago. And the prices there were very competitive and, therefore, the prices were very low. There was only one railroad line that ran from New York to Buffalo, New York City to Buffalo. That was a monopoly service. The price there was very high. As a matter of fact, a lot of times it was cheaper to ship something from New York City that went through Buffalo to Chicago than to ship something from New York City that stopped at Buffalo. So a utility unregulated will price competitive services extremely low and monopoly services very high. This is in their interest. It allows them to impede competition, or get an unfair advantage over competition, but it's not in the public interest; and, in fact, it was this discriminatory type of pricing that led to regulation of the utilities.

Regulation of the utilities is supposed to make rates where there is a monopoly similar to the rates that would exist where there is competition. What you are seeing in this filing and in filings all over the country are utilities asking to be allowed to lower the rates where they have competition and raise the rates where they have monopoly power. There is nothing wrong with them proposing this. This is in their stockholders' interest. It's something they should propose since they have a responsibility to their stockholders; however, it is not in the public interest, and that's the difference.

Now you'll hear all of us talking about cost loop cost. Let's explain why. BellSouth's investment in loop facilities is 55% of their total investment in anything. That's why everyone talks about the loop cost. A very common technique, if you want to make the cost of a service look low, is to do the cost excluding the loop cost. When you exclude the loop cost, there is not much cost left. If you want to make the cost of a service look high, you do the cost including the loop cost. You'll end up with a big number that way. A very common trick commonly used in presentations to regulators.

Now all of these problems, such as the people sharing the cab or the rent in a restaurant, for example, almost all industries deal with a common cost or a fixed cost that is it not caused by any one service but it's an overhead or common or joint cost of some sort. And there are very well-accepted ways of properly recovering these costs. There is actually a three-step process that regulators recognize. The first is you establish a range. The lower part of the range is called the incremental cost, and we won't get into too great of details; but basically what you do in incremental cost is you take the minimum possible allocation of the joint and common cost. Now the minimum possible allocation is zero, so the TSLRIC or floor is a cost that includes none of the joint and common costs. Now that is your lower level. You don't stop there, but that is the minimum.

Now there is another extreme. The maximum possible number is a hundred percent of those costs, so you do that, and it's called a stand-alone cost. You price it as to what it would cost to build a system to provide only one service. For example, if you build a system to provide toll service, the cost of that system gives you stand-alone cost of toll. This gives you the ceiling. So you have a floor that includes none of the incremental costs or none of the joint or common costs. You have a ceiling that includes all of the costs of the facility needed to provide that service. The proper price is between those two extremes.

If you are between those two extremes, it is a subsidy-free price. If you're priced below the incremental cost, that service is receiving a subsidy. If you're priced above the stand-alone, you're paying a subsidy. If you are between those two, you are neither receiving or paying a subsidy. It's a subsidy-free price.

Now if you would like to perhaps understand a little bit of these theories, let's take an example. Let's say you owned a business and you were going to build a parking lot and the business next to you is also going to build a parking lot and your parking lot would cost you a hundred thousand dollars and this business came over and said, Let's go together and build one parking lot and we'll share it. And they said, I would like your share of that to be a 150 thousand. Now if you can build your own for a hundred thousand, you are certainly not going to go in on a shared lot and pay 150 thousand; that is above your standard cost. If you were offered that, you simply wouldn't do it unless you were trying to subsidize that other person for some reason, it was your brother-:n-law or something like that. So the stand-alone cost is the maximum. No one in a free market would pay more than stand-alone because they would simply not share any more; they would build their own system.

The floor, the incremental floor, this is the cost that is incurred and not counting any shared or joint and common cost, so this is the cost caused just by that service even if they contribute zero to the shared cost. And, again, if you are priced below that, you are not even covering the cost that you very directly caused. So if you are priced below that, you are receiving a subsidy.

The actual pricing is between these two services. And, interestingly, in competitive markets the actual pricing is between these two extremes. For example, if you ran a fast food restaurant, if you -- You would calculate your incremental cost of a hamburger by taking the price of a bun, the price of the meat, the labor to cook it, that type of thing, and that would give you your incremental cost of a hamburger. You could do the same thing for the french fries and the soft drink, et cetera. That doesn't include any of the rent.

Now a lot of people will tell you in a competitive market that prices go to TSLRIC, but that is not true. If you priced your soft drinks and your french fries and your hamburgers all at incremental cost, at the ends of the month you couldn't pay the rent because it's not part of the incremental cost of a hamburger or a soft drink or anything else. So if you did that you would go bankrupt.

So in a competitive market, the price will be a price that will cover all the costs. It will cover the incremental cost of the service, the TSLRIC of the service, plus it will cover a share of the joint and common cost. You have to price the french fries and the soft drinks, et cetera, to cover the rent at the end of the month. If you don't, you are out of business.

So this basically, what is called an allocated cost or a cost that covers the TSLRIC plus a share of the joint and common cost is what occurs in competitive markets; and if someone tries to tell you competitive markets are priced at TSLRIC, that is simply not true. There is a name for the companies that price everything at TSLRIC, it's called bankrupt.

Now because of this -- By the way, this is a hypothetical telephone company. Later in our actual filings, we'll put in some costs for real telephone companies. They all have the same pattern all across the country.

THE COURT REPORTER: I'm having a hard time hearing you.

MR. DUNKEL: Basic exchange service is priced above its incremental cost. It's priced below stand-alone. The same is true for toll and access. And let's just run through -- We do have a schedule here, but I'd like to run through some of the costs.

COMMISSIONER CLARK: Mr. Dunkel, why don't you move that over there so you are speaking into the mike.

MR. DUNKEL: Okay. I was afraid the staff couldn't see it then. Thanks for the suggestion though.

MS. MARSH: We have got a lapel mike if you think that would work better.

MR. DUNKEL: Yes, that would be fine. Sure.

MS. MARSH: Okay.

MR. DUNKEL: Let's go through the TSLRIC of toll service. The TSLRIC of toll service is really only additional cost caused by usage. You need more switching equipment, interoffice equipment and things like that if you are carrying toll calls than if you don't. That is a fairly small number.

Now let's talk about the stand-alone of toll service. If you were to build a system that was providing only toll service and not shared with any other service, what would you need? Well, if you are going to place a call from a business, you need a loop going from that business to the switching equipment because the business has to pick up their phone and place a call, a toll call. You need the switching company. You need interoffice facilities, and if they are calling a residence, you need a loop from the switching equipment to the residence in order to terminate the toll call.

So if you built a system that did nothing but provide toll, you still need the loop cost at both ends. The loop cost is part of the stand-alone cost of toll service, the same as switched access. Switched access is a service the LECs provide to interexchange carriers, like AT&T. AT&T will bring a call to perhaps downtown Miami, but going from there to the customer premise, they use the LECs' facilities. And, again, for the LECs to offer that service to the toll carriers, they need loops that go to all the premises. So part of the stand-alone cost of toll service includes the loops.

Local service is exactly the same story. The stand-alone cost of local service includes the cost of the loops because, if you are going to have local service, you have to have a loop. If you build a system that was only for local, you need the loop cost. The incremental cost of local service does not include the loop because if you build a system that was providing a number of services and stopped providing local while still providing toll, you would not eliminate the need for the loop. You would eliminate some cost of local switching, the local part of local switching costs. You might eliminate a few billing costs, but that is all you would get rid of.

As a matter of fact, the Washington commission looked at all this and they said in their state that if the company eliminated local basic service, they would lose $14 in revenue and $4 in costs, and that's about right. If you think of what costs would go away if you dropped local service while you kept everything else, it's pretty minimal.

So this is really the structure for all companies and almost all companies -- well, every company I've ever looked at, the revenues for basic exchange are between their ceiling and floor, which is where they should be; and for toll and switched access, revenues are between the ceiling and floor, which is where they should be.

Now we have a problem. There are -- it's in the company's shareholders' interest to convince commissions or legislatures to raise the rates for basic exchange service and to reduce the rates for competitive services, such as toll or switched access. And they've got cost studies that will give them costs like this, but the problem is they want to convince someone that these rates are too low.

Now if you look at this map very carefully, if you wanted to be able to say that residential rates are below costs, can you find something on there that makes that a true statement? Well, sure you can. There is a stand-alone cost. If you look at the stand-alone cost, you can honestly say residential basic rates are below stand-alone costs. You might not -- you might want to drop the word stand-alone and just say residential basic is below cost because the stand-alone might cause someone to go to a dictionary and find out what you are talking about. So if you were trying to convince someone that residential rates were below cost, this is the cost you would refer to.

Now let's say it's in your company interest to convince these same people that toll rates are above cost. Okay, well, if you were consistent, you would refer to the stand-alone cost for toll, right? I mean that is consistent. I use stand-alone costs for residential basic, let's use stand-alone for toll. But that doesn't give me the result I wanted if I'm trying to get toll rates down. So all I have to do for toll service is talk about that cost.

So for stand-alone -- or for basic, the cost I talk about is the stand-alone that includes a hundred percent of the loop cost. For toll the cost I talk about is the incremental cost that doesn't include any of the loop costs. I can then make all sorts of graphs and charts and say, you know, this service is priced 50% below its cost, this one is priced two hundred percent above its cost. The only difference is I'm using a different definition of cost. One of them I'm putting all the loop costs in, the other one I'm not. This simple little trick is the basis for many of the filings and documents you'll see in this case. Not my documents, by this way.

Now let's get to the issue of why someone would argue that this cost, the loop cost, is the cost of basic exchange service only. Well, there are several arguments given for that, but they can easily be refuted. We have handed out a little card here, and the first purpose of this card -- On one side it's called "The test for cost mislabeling." There are a lot of problems of someone calculating a stand-alone cost and calling it an incremental cost or vice versa. So any cost you see, I would like you to really realize whether it's a floor or a ceiling cost; and in telephone service, the key cost is a loop cost, so you can usually tell just by looking at the loop cost.

If the cost you are given includes a hundred percent of the loop cost, that's the maximum possible loop cost you can include; that's a ceiling. If the cost includes none of the loop costs, that's the lowest possible allocation you can put in; that's the floor. The reasonable price should be below the ceiling and above the floor. So if someone gives you a cost study that's got a hundred percent of the loop cost, you should immediately think, the right price is below that number. If someone gives you a study that has got zero percent of the loop costs, you should automatically think, the right price is above that number.

Now let's get to the argument of whether the loop cost -- the cost that includes the loop, which is properly a stand-alone cost, can be called a TSLRIC; and you will see this called TSLRIC in many cases. This Commission has defined what TSLRIC means. They did so in a -- we've got the docket number in the handout we have given you. And this Commission found that TSLRIC is defined as the cost to a firm, both volume sensitive and volume insensitive, that will be avoided by discontinuing or incurred by offering an entire product or service holding all other products or services offered by the firm constant. This is page 4 of our handout here.

So you can use this test to see if the loop cost is part of the TSLRIC of basic exchange service. If you're providing all the products of the firm, you've got a loop cost for that. If you dropped basic local exchange service from the products you provided but continued to provide toll service and all other services, you did not avoid the cost of the loop. You will still need a loop to get toll calls to and from premises. The cost of the loop is not part of the cost of basic exchange service, not part of the TSLRIC of basic exchange service.

Here is another fact that is not well known: Toll and switched access benefit from the provision of basic local exchange service. If the companies did not provide basic local exchange service, the rates for toll and access would be much higher than they are today. The reason is, basic exchange service pays for a part of the cost of the loop. If you didn't provide basic exchange service, then toll switched access and vertical services, the other services, would themselves have to pay a hundred percent of the cost of the loop. So toll, vertical and switched access services are priced lower today than they would be if you got rid of basic exchange service because basic exchange service supports a part of the cost loop.

Now let's deal with the claim that some parties make that will say the loop cost is caused entirely by basic exchange service. I think there was a gentleman from GTE who said that what causes loop cost is the telephone company's prediction that customers in a new development will subscribe to telephone service and they said that's what causes the loop cost. Well, let's see if we believe this.

Let's pretend we are all telephone company executives and a subdivider comes in and talks to us, and he offers us the opportunity to provide service in a new subdivision, and we'll assume it's entirely up to us whether we do it or not or whether we let some CLEC do it; and let's just pick some numbers. Let's -- I think we had a witness earlier today that said the average residential total revenues, total telephone revenues were $62 a month. For my example I'll just use $30 a month.

Let's assume that your market department did an analysis and they found out or they concluded that you would collect $30 in revenues per line average from the subdivision if you put facilities in, and they found out that the costs of the services other than the loop costs were $5, so you would make $25 net revenue other than loop costs. And they found out that it could cost you $15 per loop to put the facilities in, so you would get $25 additional revenue, $15 cost, it's a good deal.

Now if I told you this $30 in revenue is comprised of $10 in toll -- or, I'm sorry, $10 in local, 3.50 SLC, $5 vertical, $6 state toll and state access and $6 interstate toll and access, or whatever adds up to 30, that would not change your decision. You would not say, well, I can get $10 of local revenue and the loop costs 15, therefore, I won't do it. That would be an illogical decision. What you would say is, if I can get $30 of revenue, 25 after all other costs and the loop costs 15, I will do it. Any rational decision making as to whether to put a loop in or not, looks at all the revenues that would be generated, not just revenues from basic local.

So don't believe that it's basic local that causes a loop cost. The loop costs are caused by all services that are expected to use that loop. And residential basic is just a small part of the revenues that are generated by loops.

Let's deal with another claim. Some claim that you should raise basic exchange rates to make residential service more attractive to CLECs, more attractive to competitors. That, again, does not make sense. A competitor thinking about going into an area is going to look at all the revenues they could generate, not just basic exchange. They would look at basic exchange, switched access revenues, caller ID revenues, call waiting revenues. Whatever they thought they would collect, that's what they would think about. It would make just as much sense to say that you should increase the price of switched access service, that would also make residential more attractive to a competitor because, if he could put facilities in a subdivision, then that competitor would get whatever switched access revenues the IXCs paid in order to connect toll traffic to or from those premises.

COMMISSIONER GARCIA: But the fact that they don't have a choice.

MR. DUNKEL: Who doesn't have a choice?

COMMISSIONER GARCIA: Well, let's say we make your came computations and the subdivision is a loser, but they still have to provide the service. Let's say it's the -- somewhere between there their LRIC cost and total cost.

MR. DUNKEL: Okay. If all the revenues that were generated by the subdivision were less than the cost of the loop, then it would be a loser, and that would be a candidate for some sort of universal service fund. But that is not just the revenues from basic exchange. If all the revenues still didn't cover the cost, then I wouldn't do it if I as an LEC and I had a choice, nor would a CLEC, nor would any one else; so you would need a universal service fund to help that out, or else you would to have to charge very high rates for either access, caller ID or local service. Somewhere in the package you would have to charge higher rates, okay.

COMMISSIONER GARCIA: Okay.

MR. DUNKEL: Let's deal with another issue that has come up. Some people say, well, now there is something called an unbundled loop rate, and that means you can no longer talk about recovering or sharing the cost of the loop. That's not true. The customers that subscribe to the unbundled loop rate are the CLECs, not the end users. The unbundled loop rate should cover the full cost of the loop, but then the CLEC uses that loop to provide a family of services; and the CLEC spreads the cost of the unbundled loop over the family of services it provides. It might recover 50% of that loop cost in its basic exchange, 25% in interstate access, et cetera; so it will spread the cost just like everyone else.

Another argumentative I've heard is that you should recover all of the costs of the joint and common loop or the shared loop from basic exchange service because not everyone subscribes to caller ID or not everyone makes toll calls, et cetera. Well, first of all, this is not -- In the real world competitive markets, the services that are optional are used to cover a part of the shared costs. If you go to the fast food restaurant, not everyone that comes in there orders French fries. Yet French fries are priced to cover a part of the rent. The fact that it is a competitive market does not mean soft drinks or French fries or whatever are priced in incremental cost. All of them are priced to cover a part of the rent.

And the fact that your contribution from different customers may vary is also something that exists in the competitive market. There are people that go into a fast food restaurant, buy just a hamburger and a glass of water. They probably made a fairly small contribution to the rents. Someone else that comes in that buys the Big Mac and the big soft drink and the large fries and an apple pie, they make a larger contribution to the rent. The fact that there will be residential or telephone customers, some of who will make a less contribution to rent than others, is not abnormal; that is what exists in competition.

COMMISSIONER JACOBS: Part of the argument that I think I've heard is that those contributions are very disproportionate, that on one end you have these huge contributions and on the other end, you have a very small, if -- a zero contribution at all, a negative contribution.

MR. DUNKEL: Sure.

COMMISSIONER JACOBS: How do you handle that?

MR. DUNKEL: Okay. Those cost studies are done using the double standard we just talked about. The cost of toll they show you is the cost of toll including no part of the loop cost. The cost of local they show you is the cost of local including a hundred percent of the loop cost. If you do it on the same standard, if you say the cost of local including no part of the loop cost, you are going to have, you know, a hundred, two hundred percent, three hundred percent contribution. If you do vertical services or toll the way they do local and say, okay, your cost is the cost including a hundred percent of the loop, since you share the loop and you need the loop to be provided, you are going to have a negative two thousand percent contribution. Your cost is here (indicates), your revenues are there (indicates).

So when they give you a cost, that's what I'm telling you, they give you two different costs. It's not costs by a standard definition. If you use the standard definition, if you use this (indicates) for basic and this (indicates) for toll, both are producing a couple hundred percent contribution. If you use this (indicates) for basic and this (indicates) for toll, both are producing negative whatever, hundred percent, you know, negative hundred percent contribution. Just don't -- you know, don't let them switch the standard on you, that's all I'm asking.

Now let's go to the customer who is a basic exchange customer, they make no toll calls. I think we had a slide earlier that said 94% of the people make toll calls, but let's take the extreme. Let's say the person who never makes a toll call. Well, of course they still receive toll calls. A telemarketer will call and try to sell them a credit card, so that's still -- And that generates revenue for the LEC, by the way. When a toll call comes into a premise, the LEC gets a carrier common line charge for incoming traffic as well.

But let's pretend there is a customer who absolutely has never made a toll call and they've never received a toll call, they don't have caller ID, they don't have anything, so the company gets ten to -- well, with the SLC they may get 13 or $14 of revenue. You will hear it argued that that one extreme customer means you should raise the rates for basic exchange because that one extreme customer is not covering supposedly its cost.

Well, this is wrong for two reasons: First of all, in competitive markets you don't price on the extreme. If you ran a grocery store and your clerk was ringing up a jar of pickles and they dropped it, you might have to get a second jar of pickles for that one transaction; but you don't price every jar of pickles to cover the cost of two jars of pickles. You would say on the average 1% of them get broken, so on the average I'll price it an extra 1% to cover breakage, but you don't use the worst case, you use the average. That's the difference.

Secondly, in the telephone business, when they tell you the cost of an individual loop is $15, that is an allocated cost. If you get into what the costs really are. If you are running a wire down the street, cutting the trench costs you something like $5 a foot. Once you've dug the trench, if you put a 25-pair cable in, that's about 50 cents a foot; 50-pair cable, dollar a foot. So the cost of running the trench is the big cost.

Now you can take that cost of the trench and spread it all over everyone and say the cost is $15 a month or whatever, but it's really not. If you could identify in advance the people in the subdivision that would take only basic exchange service and decide not to serve them, you would have lost because you did that. You would still have to dig that trench at $5 a foot. Maybe you could put in a little bit smaller cable and save 50 cents a foot, but in all you might save -- and you could save the drop. So you might save, let's say, $3 a month by not serving that customer, but you would lose their 15 or $14 basic exchange revenues.

So if you are putting facilities in a subdivision, you are better off putting in facilities to serve everyone, even those -- the few people who would have basic only, okay? So when you see the cost of this customer is $15, no, it's not. The cost of that one customer is probably about $3, but there is also a trench cost; and if you allocate that to everyone, then the cost goes up. But if you didn't serve that customer, you wouldn't get rid of that trenching cost. You are still going to have to pay the $5 a foot no matter what.

One final item or a few final items, Doctor Taylor advocated what he called inverse elasticity. He said we should have a higher markup for the lower elasticity services and a lower markup for the higher elasticity services. Well, the only problem with this is that if you have a monopoly service, that automatically has a lower elasticity. Elasticity means people can react or not react to a change in price. For example, if you had the only grocery store on an island and your brother was the dictator and he prohibited anyone else from selling food on that island, that would be a monopoly, and it would be very price inelastic. If you doubled your price, people would still buy food from you. You have a monopoly power, and that makes it inelastic. If you had a supermarket where there is a dozen other supermarkets right around you and you doubled your prices, people are not going to buy from you. So when you see inelastic, think monopoly services.

So what Doctor Taylor is proposing very simply is that you should charge higher rates, higher markup, higher contribution where the company has monopoly power; lower rates, lower markup, lower prices where the company has competition. This is in the company's interest; it's not in the public interest. It's the kind of thing regulation was established to prevent.

The robber barons in the railroad industry in the 1800s didn't use the term inelastic or elastic, but they knew if they had monopoly power over somebody, they could extract higher prices. And that's what was in their interest; it's not in the public interest. Calling abuse of monopoly power inelastic pricing doesn't change what it is at all.

A few last issues, the affordability issue has come up. It was stated that there are low-income customers who make toll calls, who have caller ID, call waiting, et cetera. That may be true, but the percent -- but the number of toll calls that low income and elderly make is lower than average, so please do not believe that you can raise basic exchange rates and lower toll rates and that the elderly or low income will come out equal, they will not. They make relatively few toll calls compared with the average, so if their basic rates go up and toll rates go down, they lost in that transaction; they did not stay even. Of course you're also talking about lowering business rates, so if you raise residential basic and lower business rates, that's not going to benefit the elderly either. They lost as far as their rate goes on that transaction as well.

On affordability, I think a fact that is not well known is BellSouth in Florida last year disconnected 230 thousand customers, residential customers for non-pay. That's at present rates, so please do not let anyone tell you that present rates are affordable for everyone. 7% of their customers were disconnected for non-pay last year.

COMMISSIONER CLARK: Can you respond to whether that was, what happened really was them overextending themselves on toll calls? Do you know? Would it --

MR. DUNKEL: I haven't seen a study in this state. I have seen studies from other states that said that the interexchange calls were a significant factor. The billing for AT&T, for example, was a significant factor. However, the FCC in many states are now moving to prevent disconnection of local service if you don't pay your toll bill, and what that is doing is making it now really the local bill only, hopefully in the future, that will be the key to forcing people to disconnect. I don't know if you've done that in this state, but I certainly urge you to do so if you have not.

COMMISSIONER CLARK: Well, then how relevant is that figure if it is, in fact, a result of over extension on toll? How relevant is that to your point about local services?

MR. DUNKEL: It is relevant -- okay, first of all, we have surveys that in the past have asked people who do not have telephone service what kept them off, and the two most common answers are the connection charges and the basic local rates. So the people that don't have phone service, those are the two charges that they worry about the most, that keep them off.

For toll service, first of all, if you want to you can get toll limitation services, a lot of company offer that.

COMMISSIONER CLARK: Well, let me ask you this, what would be the more, I guess I want to say -- not relevant, but the one you would put more credence in, is what people say keeps them off or what your evidence shows keeps them off? In this sense --

MR. DUNKEL: I understand.

COMMISSIONER CLARK: -- you know, if someone asked me --

MR. DUNKEL: I understand.

COMMISSIONER CLARK: -- I would say, well, the rates are too high; but in reality I'm not on is because I'm not paying my toll bill.

MR. DUNKEL: I would hope that this Commission and other commissions would make a service available whereby you could get basic exchange service and not be disconnected for not paying toll; that is my first answer. But second of all, the surveys have said that it's basic exchange rates that is most important to keeping these people off the network. Now --

COMMISSIONER CLARK: I guess I have a -- I get concerned about that because I know when I answer surveys, it's not necessary --

MR. DUNKEL: Right. I know.

COMMISSIONER CLARK: You know, I say, well, yeah, that's what I think; but when it actually comes down to saying are you going to buy this product, somehow it's a whole different ball game.

MR. DUNKEL: Okay. Well, I'd ask you to do is change the rules in Florida if you haven't already so they can't disconnect for toll and then next year --

COMMISSIONER GARCIA: Well, why? If you mention that that's --

COMMISSIONER CLARK: And then look at what the data shows.

MR. DUNKEL: Yeah.

COMMISSIONER GARCIA: You mention that that is part of the support that is keeping the cost down. Why would we want to do that? I mean part of the revenue that is being generated by that phone, whether it be the individual making the long distance call or the individual receiving the long distance call which is of no cost to the user, basically, why would we want to increment the cost of local basic service if one of the support mechanisms is long distance?

MR. DUNKEL: Sure. Okay. First of all, the real problem is when the LEC is billing for someone else, like MCI or interLATA toll.

COMMISSIONER GARCIA: Right.

MR. DUNKEL: Most of that revenue is not going to the LEC. If they are billing for AT&T and they bill for $10, AT&T gets the $10, and then AT&T pays the LEC something for the switched access charges. It might be $2 or $3.

COMMISSIONER GARCIA: Right.

MR. DUNKEL: So, you know, we are disconnecting for a ten dollar bill, and the LEC is only getting two or $3 of that $10. So, you know, certainly, if we use that argument, we are not getting the full benefit of that $10. We are disconnecting because of the ten, but the LEC is not getting the $10. I would rather see them not disconnect because of the $10 AT&T or MCI bill. They will still -- the IXCs could still get their revenues and the LEC -- well, the LEC would still get an access charge revenue anyway because it collects it from AT&T or MCI. AT&T and MCI would then have to collect from the customer the way any other business does without the threat of disconnecting their local service.

COMMISSIONER DEASON: But isn't there incremental revenue generated by providing that billing service and that if you were --

MR. DUNKEL: Some small amount.

COMMISSIONER DEASON: Yes, but it's a small amount applied to the entire customer base that uses that toll, not just those that disconnect because they didn't pay that toll. And if you take away that option of having the company disconnect service, perhaps the incentive to use them as a billing service goes away, so then you lose that incremental revenue, not for just those that disconnected but for the entire customer base.

MR. DUNKEL: Well, the first answer is the billing and collection is in the FCC deregulated services anyway, so even when you are setting -- I know some companies here are not on cost-based regulation any more, but even when they were on cost-based regulation, those billing and collection revenues were not counted as either interstate revenues or intrastate revenues. They were simply money that the shareholders got and wasn't counted as support for joint or common or anything else, so that was extra money. It's a deregulated service. So, you know, no matter what those revenues are, that doesn't affect your intrastate rates even when you were rate-base regulated.

There are lots of details to this business. It drives you crazy, actually. That's like the inside wire; that is also deregulated. So whatever they make or lose on inside wire doesn't directly show up in the regulated intrastate rates. There can be an allocation of common overhead costs or something like that that happens, but that's about it.

Another thing on affordability is I've heard stories that said, well, cable TV rates are $25 and Internet is $20 and people pay this anyway. I would like you to take a close look at that. The last numbers I saw on cable TV subscription was at around 60 or 65% of the areas where it's available. I don't think charging $25 and having a 60% or 65% subscription rate is a good model for telephone service. If someone doesn't have cable TV and someone is breaking into their house during the middle of the night, it doesn't really matter. If someone doesn't have telephone service and someone is breaking in their house in the middle of the night, it does matter. So please do not use that as a model.

The same with Internet. Internet is maybe $20. The last figures I saw were somewhere between 10 and 20% of the households have Internet. That is not a good model either. We don't want a service that has got 10 or 20% as the model for telephone service. We would like to see --

you know, we are seeing 95 to 98%. We would like to see higher than that because there are some public safety issues involved.

Let me give you another --

COMMISSIONER DEASON: Wait.

MR. DUNKEL: Sure.

COMMISSIONER DEASON: Those low penetration rates for Internet and cable, is that because of the price or some people just don't want it at any price?

MR. DUNKEL: The people that I know who don't have cable TV would probably like to have it, but they think the price is too high, okay?

On telephone service --

COMMISSIONER DEASON: Contrast that to telephone service.

MR. DUNKEL: Okay. Past surveys of telephone -- people who do not have telephone service, 80% of them have said they want telephone service but they can't afford it, and these are the surveys where they asked them why and they said it was the nonrecurring charge and the basic charges that were keeping them off, okay?

COMMISSIONER JACOBS: How do you respond to the position that those customers, and I think particularly low-income customers, who have a high subscription rate to vertical services correlates to the indication that they can't afford a higher rate for basic service?

MR. DUNKEL: Okay. First of all, I would point out that they don't have high a subscription rate as the average consumer, so they are exercising restraint in buying the optional services. The fact that there are some that subscribe is -- you know, that's fine. For them that must be important. They are making a choice to cut back somewhere else to afford call waiting. I think we had the description today that, you know, maybe they wanted -- if they have a potential employer, they don't want to miss that call. That is certainly their choice.

I would point out that if you have to choose between having high call waiting rates or high basic exchange rates, basic exchange service is more important than call waiting to the low-income subscribers. If you have a telephone service without call waiting, you might occasionally miss a call; but if you have call waiting and no telephone service, you are not going to get any calls, okay? So the most important service for emergency use, for getting employment and everything else is basic exchange service, the rest are optional.

Finally, again, going back to this concept that you should put -- or some people put a hundred percent of loop cost in the cost of local service, the federal law, in fact, warned and anticipated what companies would do.

Going back to the railroad model where there is competition some areas, monopolies other areas, they know very well that companies are going to try to shift the cost recovery away from where there is competition to where there is monopoly. So the federal government in the Federal Telecommunications Act, 254-K put a requirement that said local service, universal -- service is important to universal service -- can include no more than a reasonable share of the joint and common costs the facilities used to provide those services. So to have a case where you are putting a hundred percent of those costs in the rate of local service is contrary to the requirements of Section 254-K.

The law that we are dealing with in this case, the state law, also talks about a reasonable share of the joint and common costs as being included in the cost of residential service, not a hundred percent, but a reasonable share. In case someone says, well, a hundred percent is reasonable share in my opinion, the Supreme Court decades ago in what is called Smith versus IBT looked at a case where the telephone company was putting a hundred percent of the loop costs on local service. The Supreme Court said that was improper, it placed an undue burden on the local service and required that an allo -- an apportionment is the term they used -- required an apportionment of those costs be made. So we've got supreme court rulings that say a hundred percent is not a, quote reasonable, unquote, share. It's an unreasonable share.

In conclusion, residential basic is subsidy free. It's reasonably priced. It's above its floor, below its ceilings. Toll and switched access are reasonably priced. They are above their floor, below their ceiling. There is nothing other than using a double cost standard that would lead you to a different conclusion. Only if you look at the ceiling cost of basic exchange and say it's priced below the ceiling do you get a conclusion that there is something wrong with the pricing, that pricing below the ceiling is not wrong. I'm open for questions.

MR. BANAGEE: Mr. Dunkel, good afternoon.

MR. DUNKEL: Hi.

MR. BANAGEE: I am Andy Banagee from National Economic Research Associates.

MR. DUNKEL: Hi, Andy.

MR. BANAGEE: I'm not a lawyer, so I don't believe in cross examination.

MR. DUNKEL: Okay. That's good. Who are you working with, Andy? Who is your client?

MR. BANAGEE: You mentioned William Taylor, he is my boss.

MR. DUNKEL: Okay. Fine.

MR. BANAGEE: And I have in the past worked for a number of local exchange companies.

MR. DUNKEL: Okay. Great.

MR. BANAGEE: My purpose here is just to get some clarifications.

MR. DUNKEL: Sure.

MR. BANAGEE: Help me understand. If there are differences between us, I hope you would indulge me by explaining it to me.

MR. DUNKEL: Sure.

MR. BANAGEE: I heard you talk about the stand-alone cost. Obviously the way you've defined it is TSLRIC plus a hundred percent allocation of shared and common costs.

MR. DUNKEL: That's not the way I defined it.

MR. BANAGEE: Okay. Well --

MR. DUNKEL: The stand-alone cost is the cost you would incur to provide that service by itself.

MR. BANAGEE: Okay.

MR. DUNKEL: Now, for example, if you are providing toll service and no other service, you would have to incur the full cost of the loop among other costs.

MR. BANAGEE: Okay. So we are agreed then that you have to look at the cost of producing something on a stand-alone basis, that is to say, the cost to a firm that produces that service alone or that product alone and nothing else?

MR. DUNKEL: That gives you your ceiling, yes.

MR. BANAGEE: Okay. If that's the case, is it conceivable that there are LECs these days which are widely agreed to be multi-product or multi-service firms? Would you not agree with that characterization?

MR. DUNKEL: Every LEC I know is multi-service because it is more efficient to build a facility and use it for several services than build a separate facility for every service.

MR. BANAGEE: Okay. So is it conceivable that a LEC that provides multiple services and, therefore, over the years configures its network to provide those services would have built its network differently than, say, a LEC that only provides a single service, namely, local exchange service?

MR. DUNKEL: Certainly would build it differently. It would -- If you are doing multi-products, you have to put in whatever investment you need to provide all those products.

MR. BANAGEE: Okay.

MR. DUNKEL: That's fine.

MR. BANAGEE: So the stand-alone cost, which is the cost of the single service network can be very different from any stand-alone cost that you compute for a multi-service network that is built differently?

MR. DUNKEL: What you do in a stand-alone cost is to say: What would it cost to build a network to provide just that service, okay? The TSLRIC, it's the opposite -- Both it and the TSLRIC are theoretical calculations.

MR. BANAGEE: Right.

MR. DUNKEL: TSLRIC you say what cost would I avoid if I got rid of just one service.

MR. BANAGEE: Right.

MR. DUNKEL: Stand-alone you say what cost would I have to incur if I provided only one service.

MR. BANAGEE: That's right. I agree with that.

MR. DUNKEL: They are two theoretical numbers.

MR. BANAGEE: I'm just saying in theory if you have two different networks, one that produces local basic service by itself on a stand-alone basis.

MR. DUNKEL: That's a stand-alone local cost.

MR. BANAGEE: And one which produces local basic service along with every other service that a LEC typically provides.

MR. DUNKEL: Right.

MR. BANAGEE: That if you were to calculate the stand-alone cost you would do so only for the first of the two networks, not for the second, because they could be very different networks, so the cost structures could be very different too, cost levels could be very different.

MR. DUNKEL: You would not calculate the stand-alone cost on the network that is multi-service because stand-alone means you calculate it on a stand-alone basis.

MR. BANAGEE: Right.

MR. DUNKEL: You calculate what it would cost to provide just that one service.

MR. BANAGEE: That's the difficulty I'm having because you have presented your ideas in terms of a range of prices between TSLRIC and stand-alone cost.

MR. DUNKEL: Right.

MR. BANAGEE: If we cannot -- I mean we all know what the TSLRICs are. We can run cost models to find that out.

MR. DUNKEL: Well, that's not true.

MR. BANAGEE: Subject to --

MR. DUNKEL: No. No, no, you do not know what the TSLRICs are.

MR. BANAGEE: Okay. Okay.

MR. DUNKEL: Because all firms are actually multi-product firms.

MR. BANAGEE: Okay.

MR. DUNKEL: You do not know what it would cost to provide service -- all the services excluding local. You don't know what that would cost. You can estimate it, approximate it, hypothetically --

MR. BANAGEE: Whatever.

MR. DUNKEL: -- calculate it, but it's got exactly the same problem you were talking about. The real world, every LEC is multi-product. There is not a stand-alone toll company. There is not a company that does not provide local service, okay? Either one of those two calculations, either one of these two is hypothetical. It's based upon I as a -- or you as a modeler says, all right, if I was building a network only for toll, this is what it would cost. This is the same way. If I was building a network for multi-service and then I took toll out, what cost would I avoid? Neither one of those exist in the real world.

MR. BANAGEE: Okay. So what you are saying is these costs are basically hypothetical and we have to make do with the best knowledge we have of the range between them to see if the prices are free of subsidy and so forth.

MR. DUNKEL: For the tests we are doing here, it's not some fine tuning. If -- you know, the basic costs are about four dollars that you would avoid if someone comes in and says, well, I don't think you handled the cost of printing additional line. You know, you've assumed a cost of printing one more line on the bill is a penny; I think it's two pennies. Fine. I mean that is not going to change your conclusion whatsoever.

MR, BANAGEE: Okay. But, you know, I'm a little confused here because I'm thinking if these are hypothetical costs that is one thing but if you can tell what the TSLRIC is, not what the --

MR. DUNKEL: You can't tell what the TSLRIC is.

MR. BANAGEE: Okay. So --

MR. DUNKEL: Show me one company that provides toll, call forwarding, switched access service, caller ID but doesn't provide local, okay? I mean that is what you have to do.

MR. BANAGEE: Okay. So --

MR. DUNKEL: And it doesn't exist.

MR. BANAGEE: Your position is that you cannot estimate TSLRIC with a hundred percent accuracy?

MR. DUNKEL: You can estimate TSLRIC just as accurately as you can estimate stand-alone.

MR. BANAGEE: Even though the stand-alone cost is not strictly needed to do a cross subsidy test, is it?

MR. DUNKEL: Sure it is. The only way you know if you are producing a subsidy is if you are priced above stand-alone. There is no way -- With TSLRIC, there is no -- you can tell whether you are receiving a subsidy.

There is no way to know if you are paying a subsidy without knowing the stand-alone cost.

MR. BANAGEE: Well, what if I were to tell you that if a firm at least breaks even, okay, at least breaks even, if that firm were to price every service that it provides at or above its respective TSLRIC --

MR. DUNKEL: Okay.

MR. BANAGEE: -- if I were to tell you that, isn't that equivalent to saying that all prices are free of subsidy?

MR. DUNKEL: No.

MR. BANAGEE: Now that is contradicting William Balmoral in his book.

MR. DUNKEL: I don't care. Hang on. Hang on.

MR. BANAGEE: Okay.

MR. DUNKEL: Let's say there is one of those services, its stand-alone cost is here and it's price is up here. They could have gone out -- instead of sharing facilities, they could have gone out and built their own parking lot for a hundred thousand dollars, instead they are sharing a parking lot and they are paying 150 thousand dollars. Even if the firm overall is fine, that service or that customer is being overpriced. They are paying a subsidy.

MR. BANAGEE: So if it's -- if all the prices are at or above their respective TSLRIC, it's still possible for at least one service to be priced above stand-alone cost.

MR. DUNKEL: Sure, priced above -- if you are saying priced above TSLRIC, that could be anywhere. That's all you're saying? I'm somewhere above TSLRIC.

MR. BANAGEE: I meant below stand-alone, above TSLRIC and below stand-alone.

MR. DUNKEL: You just changed it.

MR. BANAGEE: No, I'm qualifying it.

MR. DUNKEL: If you are above TSLRIC and below stand-alone, you are neither producing or receiving a subsidy.

MR. BANAGEE: Right.

MR. DUNKEL: But you have to know TSLRIC, and you have to know stand-alone to know if that's true.

MR. BANAGEE: So without a stand-alone cost estimate, you cannot ever do cross subsidy tests?

MR. DUNKEL: You can test whether you are receiving a subsidy. You cannot test as to whether that price is receiving a subsidy, no.

MR. BANAGEE: But when something is not receiving subsidy, no single service is receiving a subsidy, is it possible that service was providing it?

MR. DUNKEL: If it's above stand-alone, sure. I mean I can explain that very easily. Let's say that you had a million customers, a million services. For one customer their stand-alone price -- or stand-alone cost was ten dollars and you didn't like the customer, you are charging them a thousand, okay? Their -- And they could go out and build their own facility or whatever for $10. If that is only one customer and you have millions of customers, that extra revenue may not be enough to drive the prices for the other million customers below their TSLRIC. You know, they might be -- each would be a penny less than they otherwise would have been, but that's not enough to drive them down. So you can be over charging one customer, charging them above stand-alone, and that makes everybody else's price a little bit lower but if it's not enough to push them below TSLRIC -- You can have everyone above TSLRIC, but somebody actually still being -- paying a subsidy, paying more than they should pay for shared cost because they could build their own cheaper.

MR. BANAGEE: Okay. Let's move on to a different topic.

MR. DUNKEL: Okay.

MR. BANAGEE: I disagree with you on that, but let's move on to a different topic.

MR. DUNKEL: Well, I'm sorry you disagree.

MR. BANAGEE: Because it's a well accepted test that when a firm at least breaks even that if you are pricing all of your services at or above TSLRIC but below stand-alone cost, it doesn't matter whether you know the stand-alone cost or not. If you're at least covering your TSLRIC --

MR. DUNKEL: Well, I'm sorry, if you look in the standard economic textbook, you are going to see exactly what I spelled out here, floor and ceiling.

MR. BANAGEE: Would you just --

MR. DUNKEL: I can give you quotes from the FCC. Sure, I've got quotes in my handout from the FCC that say --

MR. BANAGEE: I would be very happy to take a look at that.

MR. DUNKEL: Okay.

MR. BANAGEE: Because I'm not aware of a test like that.

MR. DUNKEL: I'm sorry. Look at any definition for a stand-alone test.

MR. BANAGEE: You know, I'm willing to be educated.

MR. DUNKEL: Okay. As a matter of fact, I think if you look in our handout -- Can you find that, where it is, the FCC quote? We'll look it up while you move on here.

MR. BANAGEE: One, I think, basic point.

MR. DUNKEL: By the way, this Commission also in a 1997 order also established that same standard. Stand-alone is the ceiling; TSLRIC is the floor.

MR. BANAGEE: I'm just talking economic principles here.

MR. DUNKEL: Okay. Well, I'm talking with the accepted principles.

MR. BANAGEE: Which may not be the economic principles.

MR. DUNKEL: I'm sorry, they are.

MR. BANAGEE: Let me ask you about one basic difference in position that seems to be coming out from this morning's presentations to yours, which is the view of the loop cost. The morning's presentations had the view that the loop cost is entirely contained within the cost of local exchange services, basic local exchange services.

MR. DUNKEL: Okay.

MR. BANAGEE: And the position you've taken is that the loop is a shared facility and, therefore, is a shared cost.

MR. DUNKEL: That's right.

MR. BANAGEE: Now would you say that the two camps, the differences between the two camps or the two points of view hinges completely on this difference in their viewing the cost of the loop? If that difference disappears, then essentially their conclusion should all be the same?

MR. DUNKEL: That is certainly the major difference. There are differences on postage stamps as well, that your companies could do the same thing. If you get a bill that is a bill for toll, call waiting local service, they put the full price of the postage stamp on local although you are billing for three items. So it's the same concept in other areas. Now the loop cost is 55% of BellSouth's total investment, so that's the elephant of all this. There are also little fleas that are wrong too, but this is certainly the big cost.

MR. BANAGEE: So if the loop is -- forget about cost causation and all that. You know, we have been over that ground before. If the loop is a shared facility, has a shared cost, has to be allocated to everything else, then your conclusions are right. If the loop is not a shared cost, it's something that belongs truly within local exchange service because it is the only means that the customer has to gain access to the network and, therefore, is a service that can be demanded in its own right, if that's the case, then the other camp is right?

MR. DUNKEL: Absolutely not. What you just said is that the loop is access service, is a service that can be demanded in its own right. Even if that is true, you are still wrong. Doctor Taylor has talked about something he calls customer access, and he says, as you have just said, that there are -- customers could demand access even if they weren't going to use it. This is a service that could be demanded in its own right. I'm not sure that's true, but let's assume it is.

Even if that's true, that is not the only service that would share the loop facilities. The IXCs also want carrier access. They demand the ability to connect toll traffic to customer's premise, so if there is something called customer access that uses a loop, there is also something called carrier access that uses a loop. There is also toll service that uses a loop. There is also switched access service that uses a loop. So to make up the name for another service that uses a loop and say, all of the costs go to that service is incorrect.

And again, we've handed out a card for cost causation. Let's run the test. This says a cost is caused, if the company does not avoid certain costs in the long run when a service in question is eliminated while holding constant the production of all other services produced by the company, those costs are not caused by the service in question. Let's pretend your company is providing carrier access, toll service and customer access, whatever that is. They drop customer access from the services they provide. Have they now gotten rid of the loop cost? No. They are still providing carrier access. AT&T still wants to connect to their premise. You need a loop to do that. They are still providing toll service. You need a loop to do that. You can call it local service, you can call it customer access, you can make up any name you want to as long as it's not the only service that uses a loop. If you make that service go away, the loop cost does not go away, and that service is not by itself causing the loop cost.

MR. BANAGEE: But if I were to --

MR. DUNKEL: Now it can be one of the family of the services, but to get rid of the loop cost, you have to wipe out the entire family, not just any one of those services; that's the difference.

MR. BANAGEE: You can surely concede that there are individuals who take the loop or the local access -- the access part of the local exchange service without necessarily making toll calls in a given month or using optional services?

MR. DUNKEL: Sure.

MR. BANAGEE: There are those people, right?

MR. DUNKEL: Sure. I had a friend in college, the reason he took telephone service is so he could call his girlfriend, which is a toll call. There are people who take, a few, a tiny percent, who would say make no toll calls. There are a few others on the other extreme who take telephone services because of toll calls. All that tells you are the two extremes. You can use one extreme to get here, the other extreme to get there, but you don't price on the extremes.

MR. BANAGEE: Very interesting, but I quibble with you on your statistic because I've seen subscriber line usage studies consistently demonstrating that a fairly large fraction of customers don't ever make toll calls, interLATA, intraLATA, whatever, 60 to 80%.

MR. DUNKEL: I'm sorry. One of your --

MR. BANAGEE: Sixty to 80%.

MR. DUNKEL: I'm sorry. One of your telephone people had a schedule up here that said 94% of low income make toll.

MR. BANAGEE: That, by the way, is not a telephone study. That was from P&R and Associates who happened to --

MR. DUNKEL: I'm not sure. One of your telephone people sponsored that as evidence.

MR. BANAGEE: No, you're --

MR. DUNKEL: He is saying 94%, and now you are saying what, 20% make toll calls? Come on.

MR. BANAGEE: That is a question that someone else raised. My point is, if it's true that 60 to 80% of people do not make inter or intraLATA toll calls in a month, and -- just if you would indulge me -- if it is also true that they don't use optional services, so all they are doing is calling the local pizza parlor, calling the local car wash, or whatever, making local calls only, for that individual not to be charged the entire cost of being connected to the network, whatever that cost is, in other words, to be asked to pay only half of it or one third of that cost, is it not true that then someone else who is actually making use of toll calls and subscribing to optional services and is also paying prices that incorporate part of the loop cost, isn't it true that those customers end up subsidizing the first customer?

MR. DUNKEL: Absolutely not, for two reasons. First of all, your numbers -- I've seen these studies, and the studies I have seen had a percent of people who made no intraLATA toll calls but they ignored the interLATA toll calls they make. Secondly, even if you make no toll calls, when you receive toll calls, that is a use of your loop for toll traffic and the LECs get paid for that. If a telemarketer calls you at home at suppertime, tries to sell you a credit card, they are using your loop for toll service and the LEC is getting paid for that, and that is not part of local service. You shouldn't pay for the cost of some telemarketer to call and interrupt your supper.

So that's -- First of all, there are other revenues other than local service. Secondly, let's take a -- Let's say there is 1% of the customers who never make a toll call, never receive a toll call, don't have caller ID, don't have anything other than basic exchange service. When you do a cost study and you say their cost is $15, that is not true. That is a result of averaging. The only cost they actually cause -- that you would avoid if you dropped that customer is the cost of their drop and maybe some local usage and a tiny part of the cost. The main cost of putting a loop in is digging a trench, that's about $5 a foot. If you drop a cable in there that is 50-pair, that is a dollar a foot. If you drop a smaller one to avoid these customers you are talking about, that is 50 cents a foot. So you can spend either $6 or 5.50 a foot to serve twice as many customers; that's your choice.

So it's back to the people who go into a restaurant and one person orders a hamburger and water, the other orders all these other things. Both of them are covering the extra cost they cause. The ones that order a lot of service are making a bigger contribution to the rent, sure, but you are not losing money.

If you had a subdivision and you could tell in there is a lake on the subdivision.

MR. DUNKEL: Okay.

COMMISSIONER GARCIA: So the subdivision has lake properties and these lake properties have homes that are half a million a piece.

MR. DUNKEL: Sure. Sure.

COMMISSIONER GARCIA: The rest of the homes are townhouses in this subdivision. They all have, you know, two wires into the home but, you know, you know that the guys on the lake are the ones you are going for so you only serve them. The LEC is then left with the rest of the subdivision who are not big users of -- They are small low income townhouses.

MR. DUNKEL: Okay. If you had an area or a subdivision or whatever where when you counted all the revenues together you still would not cover the cost of serving, that's when you need a universal service fund of some sort or else higher prices for access or something, okay? But that is not -- even if you have lower income people or median income housing, you can't really tell in advance which one is going to make toll calls, et cetera.

COMMISSIONER GARCIA: No, but I'm talking about after. I'm not talking about in advance. I'm talking about after. In other words, I as a competitor arrive, and I'm not even pricing economically. I just know that -- I advance which houses were going to take only basic exchange service and have no other revenues whatsoever, if you were smart, you'd still serve them anyway because all that means is it costs you another two or three dollars a household --

COMMISSIONER GARCIA: What happens when someone does precisely that, when someone looks at residential neighborhood --

MR. DUNKEL: Okay.

COMMISSIONER GARCIA: -- say Coral Gables where you have a median income of 150 thousand.

MR. DUNKEL: Okay.

COMMISSIONER GARCIA: -- so that they feel very comfortable that serving there could be profitable --

MR. DUNKEL: Okay.

COMMISSIONER GARCIA: -- so they then serve that area and then red line everyone else. They are not interested in serving the other areas because they may be losers, doesn't the incumbent carrier then lose?

MR. DUNKEL: Well, his example is if there is individuals that are different. If we have a whole neighborhood --

COMMISSIONER GARCIA: If you want we'll do a subdivision.

MR. DUNKEL: We'll do a subdivision, okay.

COMMISSIONER GARCIA: You have a subdivision, and there is a lake on the subdivision.

MR. DUNKEL: Okay.

COMMISSIONER GARCIA: So the subdivision has lake properties and these lake properties have homes that are half a million a piece.

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COMMISSIONER GARCIA: The rest of the homes are townhouses in this subdivision. They all have, you know, two wires into the home but, you know, you know that the guys on the lake are the ones you are going for so you only serve them. The LEC is then left with the rest of the subdivision who are not big users of -- They are small low income townhouses.

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COMMISSIONER GARCIA: No, but I'm talking about after. I'm not talking about in advance. I'm talking about after. In other words, I as a competitor arrive, and I'm not even pricing economically. I just know that -- I look at the history of consumption, and I say, I want the houses by the lake. Those are the real winners here, the townhouses aren't, and I just serve them.

MR. DUNKEL: Okay.

COMMISSIONER GARCIA: Then overall does not the LEC, the incumbent LEC who is providing service to all of these people, their revenues are obviously going to drop?

MR. DUNKEL: Their revenues would drop. That probably would not be a smart choice for the CLEC because of economies of scale. Most of these things are -- the fixed costs are very high. Digging the trench is the big cost, so if I was digging a five-mile long line out to a subdivision, half the subdivision was on the lake, high income people, the other half was normal, I would still put in a big enough cable to serve all of them. Because once I got within a few hundred feet of these other people, all I've got to do is add a little bit, and I can serve them too, even if they are not as profitable as the other people.

Most of my costs are fixed costs, digging a trench. If I'm going to dig a trench, I want to put as big a cable in there as I can put and I want to serve as many people as I can because, if it cost me $5 a foot, if I have to split that over ten people, that's a pretty big chunk. If I can split it over a hundred people, that's a much smaller number, and that's my big cost. Even if those other people I add aren't as profitable as the first people and are not paying as much of the joint and common, I'm still better off with them than without them. That's the difference. It's like if you go into a restaurant and order hamburger and water they don't throw you out. You are not as profitable as the one that ordered 15 things, but you are still helping to pay the rent.

COMMISSIONER GARCIA: When Publix has a sale on diapers and, you know, they obviously aren't making money on the diapers because they will say limit two bags or two.

MR. DUNKEL: Okay.

COMMISSIONER GARCIA: And they want me to walk in there because they want me to buy formula. They want me to buy --

MR. DUNKEL: Sure. Sure.

COMMISSIONER GARCIA: -- all other stuff, and that is where their profit is. So they limit my takeage because, if they were pricing under cost, I might come in and buy ten cases and, you know, all the way through toddler age I'll buy because they're pricing it under cost. The whole point is to get me in there, and the concept which works, is a line leader, you get the person in, you get them into the service; and you're saying to some degree that's also -- If I'm out there serving, I serve everyone.

The ones that produce more will take care of the other ones, correct? But you're not saying that.

MR. DUNKEL: No, I'm not.

COMMISSIONER GARCIA: You're saying that all of them cover cost.

MR. DUNKEL: All of them cover cost. When you see a cost like $15 a line, that's an average. If you were honest, you'd say my cost is $2 a line for the drop, plus I spent a hundred thousand dollars to dig this trench. If you think of it that way, you've got a better picture of the cost. So then if you can get at least $2 of cost of revenue from that person, you are better off with them than without them. You are still going to spend a hundred thousand dollars to dig that trench out five miles no matter what. So once you are going to dig the trench and it cost you another two bucks to hook up somebody else, you are better off with those other people than without them, unless you have to go, you know, five miles off to the side to get them, then that's a different issue. But if you are close to them or anywhere near them, you are going to spend a hundred thousand bucks for the trench, throw the biggest cable you can throw in there and get as many people on there to split up that hundred thousand dollar cost as you can.

COMMISSIONER JACOBS: One of the positions I think I'm hearing is that if you didn't have to serve everybody you wouldn't. You could figure out some level of investment below the whole universe where you could maximize your profits at a lower level, and I think what I'm hearing you say is that so long as you can carry multiple services over whatever you put in the ground, okay.

MR. DUNKEL: Right.

COMMISSIONER JACOBS: And let's put this in real world, what we are seeing today. What I've heard is that it's the idea that you have to serve everyone who comes to you for service that causes you to incur this huge investment that kind of makes the cost causing factor go towards the basic service, okay?

MR. DUNKEL: Well, yeah, I've heard that argument. Yeah.

COMMISSIONER JACOBS: Okay. So your counter, if I understand it, then you then would look to all the services that go over that, including the 94% who are subscribing to the vertical services, including the 90 some odd percent who make toll services, you would have to look to that same flow of revenues as well; is that a correct statement?

MR. DUNKEL: Exactly. If you were deciding whether to put facilities in or not, it's the total revenues you would look at. If you are saying I have a choice of wiring this subdivision or not, my revenue for basic exchange service is $10 a line, my loop cost is 15, if that's all you looked at, you'd say I'm not going to do it. But if they said, okay, your local revenue is going to be 10, you are going to get the SLC, that is 3.50, you are going to get an average of $5 from caller IDs and call forwarding, you are going to get an average of $5 from intrastate toll and switched access, you are going to get $5 from interstate toll and switched access and that all adds up to $25, now it's a good deal. And any rational decision maker, that's what they are going to do. They are going to say I put in this $15. I can get $25 in revenue. I'm going to do it.

COMMISSIONER JACOBS: And the problem comes up is when I run past this neighborhood where you've got folks who only want the local service.

MR. DUNKEL: Right.

COMMISSIONER JACOBS: They are not going to get any vertical services, and they are not going to make any toll calls.

MR. DUNKEL: Right. There may be areas, usually they are rural areas, pretty low density where when everything is considered it's still not a good area, and that's where you need your universal service funding, okay? But most areas, you know, what they are doing is comparing all the loop cost to basic exchange is just nonsense. You've got to compare -- If you are going to include all of the loop cost, you've got to include all of the revenues; or if you are going to include only part of the revenues, then you can't include the full cost of the loop because it's used for several services. But there are areas, rural areas, whatever, where the total cost, even with everything considered, wouldn't make it an economical investment; and that's what universal service funds are for, those areas. But that certainly is not the average. Residential service on the average is well above the cost it causes.

MR. BANAGEE: Mr. Dunkel, thank you for sharing your perspective with me.

MR. DUNKEL: Sure.

MR. BANAGEE: Just one final request.

MR. DUNKEL: Yeah.

MR. BANAGEE: You had said that you have seen studies which show that customers disconnected because, not because of toll cost problems but cost of local exchange service.

MR. DUNKEL: Sure.

MR. BANAGEE: I wonder if you the can share with me the source or the nature of those studies.

MR. DUNKEL: Sure, why don't you leave me your card. There are three studies I know of. As a matter of fact, one of them was in California, and its conclusion in the California study was the major cause of -- the largest single item of disconnect was actually international toll calling, probably because of the proximity to Mexico. And I've had that used in testimonies against me where they are saying, look, toll calling is what is causing the disconnects, and it turns out it was international toll calling and, you know, I certainly have no reason to believe that is the case here.

MR. BANAGEE: Was that the Field Research Institute study?

MR. DUNKEL: I believe so, yes, but if you -- you know, it's listed as being toll but when you got into their data, it was international toll was the main problem, so you have to look carefully there.

MR. BANAGEE: Were there others?

MR. DUNKEL: Well, the difference it makes -- And we regulate intrastate only. We don't regulate interstate toll. If you lower toll rates, you aren't going lower the interstate toll rates. If you lower toll rates, all you are going to lower is the intrastate toll rates and the intrastate access charges. If people are disconnecting because of international calls, that bill is going to stay exactly the same as it was before, no matter what you do in this Commission because, you know, you are intrastate.

COMMISSIONER CLARK: Well, I thought you had cited that local rates being high was the reason they were disconnecting.

MR. DUNKEL: Right. There are some studies that the LECs use in which they try and use to claim that it is toll, and the Field study is one he referred to. And when you get into them, you find out it's not the intrastate toll that we are talking about here. The few cities that have shown that toll is a problem, when you look at them, the studies are flawed; they are international toll calls.

COMMISSIONER CLARK: I don't see why that makes a difference.

MR. DUNKEL: Okay. What you are being asked to do in this --

COMMISSIONER CLARK: Because we don't --

MR. DUNKEL: Okay. What you are being asked -- Okay, go ahead.

COMMISSIONER CLARK: No, it doesn't make a difference to the -- I thought you were citing the disconnects as being a reason why you wouldn't want to increase local rates.

MR. DUNKEL: Right. Right.

COMMISSIONER CLARK: If you do, you are going to have more disconnects.

MR. DUNKEL: Right.

COMMISSIONER CLARK: And it seemed to me there were other studies that suggests the real reason is not being able to make toll -- being able to meet their toll bill. It doesn't matter if it's international toll. It's the toll bill that is causing it.

MR. DUNKEL: Okay. Those three studies are all sponsored by the LECs. What I'm telling you is to not take them at face value. They are special circumstances that are very unusual. One of them, as I said, was in California where there is a lot of international toll.

COMMISSIONER CLARK: I still don't see why that is a special circumstance that makes it not valuable.

MR. DUNKEL: I doubt that if you did the same study in Florida you would find that international toll was a large part of your customer's bill.

COMMISSIONER CLARK: I would accept that.

MR. DUNKEL: Okay. Therefore --

COMMISSIONER CLARK: It's still toll.

MR. DUNKEL: Okay. Therefore, the conclusion that in a state where international toll is a large part of your bill, that international toll is a problem, is not a conclusion that you can transfer to Florida. The studies that we --

COMMISSIONER CLARK: The conclusion that it is toll is transferable.

MR. DUNKEL: Only if your -- percent of your bills in this state is similar to the percent in that state.

COMMISSIONER CLARK: Okay.

MR. DUNKEL: You know, if you did an analysis of the bills in this state and found out 10% was toll --

COMMISSIONER GARCIA: Didn't you tell us that we should have a rule in Florida that stopped disconnect?

MR. DUNKEL: I would suggest that strongly, yes.

COMMISSIONER GARCIA: But you just said that you're not sure that those studies equate to the disconnect factor because it's international control, and we have no control of that, so --

MR. DUNKEL: You could have control of whether they disconnect local service because of international toll calling. You control local service, and you can pass a rule that says --

COMMISSIONER GARCIA: I understand that.

MR. DUNKEL: -- that you can't disconnect local unless you haven't paid your local, okay?

COMMISSIONER GARCIA: I understand that.

MR. DUNKEL: Back to your question. Let's take hypothetically that if we did a study in Florida and we found ten percent of the problem was toll and they did a study in California and it found 80% of the problem was toll. The fact that they found 80% in California doesn't mean it's 80% here, I mean that's a way of looking at it.

COMMISSIONER CLARK: I would agree with that.

MR. DUNKEL: Okay.

COMMISSIONER CLARK: But it's that percentage that matters, not that it's international toll as opposed to intrastate toll.

MR. DUNKEL: Yes, what that shows is that's an odd circumstance. The California study that the LECs like to rely on is not typical of other states, okay?

MS. CASWELL: Mr. Dunkel, Kim Caswell with GTE.

MR. DUNKEL: Sure.

MS. CASWELL: This is just a follow up to Mr. Banagee's question. I think you mentioned three studies, but you didn't tell us what the two other than California were. If you could just give us the details on those.

MR. DUNKEL: Do you remember those, Tom? We can find those.

MR. REGAN: We can get them to you.

MR. DUNKEL: We can get them. Why don't you leave your card, and we'll get them to you.

MS. CASWELL: And you can get me the studies?

MR. DUNKEL: Right. Right.

MS. CASWELL: Okay. Thank you.

MR. DUNKEL: There is another one the LECs rely on, and as I remember, they interviewed something like five or six households and the LECs put that in the record a lot of times.

MS. CASWELL: So that's one of the studies that you're referring to?

MR. DUNKEL: Right. Again, if you look at the studies that claim to say that toll is a big part of disconnects, they are usually pretty strange.

MS. CASWELL: And do you have any idea what the third one was?

MR. DUNKEL: No, not off the top of my head.

MS. CASWELL: Okay. Thank you.

MR. DUNKEL: Okay. Can you give a card to Tom though?

MS. CASWELL: Yeah, sure thing.

MS. WHITE: Hello.

MR. DUNKEL: Hi.

MS. WHITE: I'm sorry, I'll be quick.

MR. DUNKEL: Sure.

MS. WHITE: I'm just a little confused about this.

MR. DUNKEL: Okay.

MS. WHITE: Nancy White for BellSouth. You stated -- I thought you referenced a survey that said that people who have been disconnected don't reconnect because of installation or connection costs and the rate for basic service. Are the surveys that you are relying the same three you just talked about?

MR. DUNKEL: No. No.

MS. WHITE: Okay. What is that one then?

MR. DUNKEL: There was -- well, there has been several. The one -- There was one done by AARP, AT&T and the Consumer Federation. And we can give you a copy of that one if you like.

MS. WHITE: Okay. If you could give that to Ms. Caswell that would be great.

MR. DUNKEL: Okay.

MS. WHITE: Great. Thank you.

MR. DUNKEL: Okay. Sure.

MS. CASWELL: And I have just one more follow-up because I thought I heard you say earlier that you had seen surveys showing that 80% of the people not on the network say it's because they can't afford the local rate. Did I hear that correctly?

MR. DUNKEL: The local and the nonrecurring. Those are the two key problems that are keeping them off.

MS. CASWELL: So the connection charge?

MR. DUNKEL: Yes, connection and the --

MS. CASWELL: And what studies would those be?

MR. DUNKEL: That's the one we just discussed, the Consumer Federation, AT&T and --

MS. CASWELL: So there is just that one study, it's not more than one survey?

MR. DUNKEL: I'll have to see if we have others in the file that's the most detailed one.

MS. CASWELL: Okay. Thank you.

MR. DUNKEL: Sure.

COMMISSIONER DEASON: So how do we price service, just as long as it's between those two extremes we are okay?

MR. DUNKEL: You really want to get into that. The answer is --

COMMISSIONER DEASON: Just make it short. Just, you know --

MR. DUNKEL: This is subsidy free. The way you price service is to have a reasonable percent of the joint and common cost, including the loop, recovered -- spread among the services it shares.

COMMISSIONER DEASON: How do we spread it?

MR. DUNKEL: Well, I can tell you, I think the law here says proportionate. Okay, let me, first of all, say this: The Supreme Court in its Smith versus IBT said the way of doing this was difficult.

COMMISSIONER CLARK: Let me interrupt you.

MR. DUNKEL: Okay.

COMMISSIONER CLARK: Give me the date of that case, please.

MR. DUNKEL: 1930, okay?

COMMISSIONER CLARK: Okay.

MR. DUNKEL: It's still good law, by the way. The FCC regularly refers to it. It's the basis of separations right now, and there hasn't been any subsequent rule that changed it. It's the applying -- the law that applies right now.

Okay. There is no perfect way. That is one reason you start off with these ranges. You can, with some difficulty, come up with a pretty good number here. With some difficulty come up with a pretty good number for here. Where you go between the allocated cost is -- and that would be an opinion as to whether you should use 50% of the loop in local or 40% or et cetera. The FCC has come out with its interpretation of 254-K, which is a requirement we just read which says no more than a reasonable share can be in a cost of basic. In the cost standard they rely on is the stand-alone cost, but then they say, however, because you know it has these problems we can't rely on cost alone, so they use the stand-alone.

So the one way you can do it is the relative stand-alone cost. You could say, okay, the stand-alone cost of toll is this, the stand-alone cost of basic is this, we'll give them both an equal share of the benefit of sharing facilities, split it 50/50. That's one way to do it.

Pennsylvania in their law, that's actually how they spell it out, they call it the proportionate share, making it proportionate based upon the relative stand-alone. So you calculate what it would cost to provide toll service by itself, what it would cost to provide local service by itself and say, now we are going to build a system that will do both. There is a benefit from that, split it equally based upon the relative stand-alone cost, the cost you would have to incur to provide just that service.

That is one way. There are a dozen other ways. The problem with the loop cost is it's not traffic sensitive. Something like switching equipment where the cost depends upon how much you use it, you know, if you make more calls, you have to add more equipment. There you can say, well, I've measured. 10% of my traffic is this type of traffic, so 10% of my switching equipment cost goes to this service. A loop has to be there. It's like a highway. I mean it has to be there whether one car is going to use or 50 cars are going to use it. So it is really -- It's a fixed overhead or like the rent for a restaurant. It doesn't matter whether you sell five hamburgers and 12 hot dogs or 15 hamburgers and three hot dogs, you have to recover that rent. It's a fixed cost, and it doesn't change based upon your traffic. So you really -- the best way is to look at the stand-alone cost and give everyone a share of the benefit of sharing.

COMMISSIONER DEASON: Even though the loop is a fixed cost, is there any rational basis to allocate based upon minutes of usage?

MR. DUNKEL: No.

COMMISSIONER DEASON: Toll versus local?

MR. DUNKEL: No.

COMMISSIONER DEASON: There's no rationale?

MR. DUNKEL: Nope.

COMMISSIONER DEASON: It's better to look at some arbitrary allocation? 50% is better than trying to look at minutes of use?

MR. DUNKEL: The cost does not vary with traffic at all. It is totally non -- You know, if you had to put in a loop, and you are going to do one toll minute a month, you have to have the loop; or if you are going to do a thousand toll minutes a month, you have to have the same loop.

The cost causation is the need for facilities, and that is really -- that is shown by the stand-alone cost. If you are going to provide toll service on a stand-alone basis, you need a loop cost, so $15 is part of the stand-alone cost of local ser -- of toll service. If you are going to provide local service, you need a $15 loop to provide local service. So if you, instead of putting two separate loops you put in one and share it, then there is no logical reason to do anything other than give them both an equal share of the sharing.

COMMISSIONER DEASON: Well, under that explanation, it's just as reasonable to allocate a hundred percent to one service or the other and say that's fine too.

MR. DUNKEL: Not really because then you are giving one service the benefit of sharing and the other service none of the benefit of sharing.

COMMISSIONER DEASON: Well, it's still going to cost -- If that's the only service you are going to provide, that's what it's going to cost to provide it.

MR. DUNKEL: Okay. Let's say you were an arms length open competition negotiation and you had owned one business, I owned a business, and we are going to build a shared parking lot, and the shared parking lot is going to cost 150 thousand dollars. I said, Here is the deal. You pay the 150 thousand dollars, I'll pay nothing, we'll share the parking lot. Is that -- That's not acceptable. That's not what would happen in a competitive market. In a competitive market, assuming we were both equally good negotiators, we would end up splitting the cost of the parking lot, assuming there is, you know, no other traffic sensitive or anything else.

COMMISSIONER DEASON: I agree with you.

MR. DUNKEL: Yeah.

COMMISSIONER DEASON: It's more -- economically it's more rational to find a way to share cost and operate more efficiently.

MR. DUNKEL: Right. Right. And --

COMMISSIONER DEASON: My question though is why is minutes of use an inappropriate way of allocating that, and your answer seems to be that, well, it's going to cost that much anyway to have a stand-alone network.

MR. DUNKEL: Right.

COMMISSIONER DEASON: So minutes of use has nothing to do with allocating the cost because it's a fixed cost.

MR. DUNKEL: That's my answer.

COMMISSIONER DEASON: But we need to find a way to share it for both toll and local.

MR. DUNKEL: I understand.

COMMISSIONER DEASON: And it looks to me like sharing it, minutes of use shows a way that it's being shared. Your parking lot example, you could say, well, we are going to share it by the number --

MR. DUNKEL: Okay.

COMMISSIONER DEASON: -- of cars that park there that are my customers versus the number of cars --

MR. DUNKEL: All right.

COMMISSIONER DEASON: -- that park there that are your customers.

MR. DUNKEL: Well, let's change my example slightly. Let's say we have a shared driveway that comes a parking lot, and we are talking about the cost of the driveway and it's just one car wide and it's a fixed cost. It costs 10 thousand dollars for that driveway, and we need the driveway, regardless of how many cars -- you know, I need the driveway if I'm going to have one car a month or a hundred cars a month. That's perhaps a better example. And the way reasonable people, you would split that, is say, well, if I build my own driveway and you build your own, here is what it's going to cost us. Let's build one and split the cost. I mean that is what would come out of competitive negotiation because it's non-traffic sensitive.

COMMISSIONER DEASON: Yeah, but if you are going to have ten thousand cars going through that driveway and

I'm going to have one, I'd probably say I'll build my own damn driveway, and I won't have to worry about your cars being there when I want my one car to use that driveway.

COMMISSIONER GARCIA: And then I'll say, What is it that you sell that one car a month comes? And I'll provide that service and close you down.

MR. DUNKEL: Okay. Let me back up. Let me back up. Let's say that driveway was going to cost 10 thousand. Would you really pay 10 thousand for a driveway instead of paying five thousand for your share of a driveway, assuming it is still usable, it provides all the functions you need et cetera? Probably not. You'd probably be happy to spend five thousand if it -- You know, you are saying if it doesn't work right, that is a different thing. Assuming it serves your needs just as well as your own driveway, you would agree to pay five thousand instead of ten thousand. Now getting to the extreme, you know, if one guy says, you know, you pay the ten thousand, I'll pay nothing, then you would say, no, I'm not going to mess with you.

COMMISSIONER DEASON: But the guy that is going to have ten thousand cars on that driveway probably, if it's only going to be one car a month that the other neighbor is going to use, he probably would be happy with 50 dollars, a hundred dollars because at least that much -- it's that much that he is going to have to -- it's a cost that he is going to have to avoid, and he is getting the benefit of ten thousand units of usage per month on that facility.

MR. DUNKEL: Okay. If I was him, if I was one of the businesses and you came to me and said, let's share a driveway, and you can build your own for ten thousand, and instead you pay nine thousand 999, I'd say no; and I would do that as a negotiating tactic because you have the choice of -- you know, that's going to cost you ten thousand dollars if we don't reach an agreement, okay? So you have the same motivation I have, and we are eventually going to reach an agreement that is probably splitting the cost.

COMMISSIONER DEASON: So what are we supposed to do when we go to pricing, try to visualize a toll provider and a local provider sitting down and saying let's build a network and let's negotiate how much you are going to pay for the network and how much I'm going to pay for the network? And our pricing, we are supposed to sit down and try to look into their minds and find out what they would negotiate to build those networks, what each would pay their portion to do it efficiently?

MR. DUNKEL: I would say that would be much better than saying a hundred percent goes on local and zero percent goes on toll, okay? And let me, again, say what the Supreme Court said. This is not a precise activity, okay? But a hundred percent is not reasonable. Zero is not reasonable. It's got to be in the range of reasonableness.

Now -- and I apologize. Everyone who has ever looked at this that tries to come up with the exact percent says it's tough. There is no perfect right answer. But if you think of what you do with cost of money, you don't come up with a perfect answer. You say the range is this. The range is from between nine and a half and 11 and a half, and so we are going to use the middle of the range or something like. There are lots of things in this world that there is not a perfect answer to, but you establish a range of reasonableness and go from there.

The fact that it's difficult or impossible to come up with an exact precise number does not mean you should go to a hundred percent. A hundred percent is an arbitrary allocation and unreasonable. 50% or 60% or 40% might be arbitrary, but it's reasonable. And that's the standard, if you look at the laws, they say reasonable. They don't say perfect. A hundred percent is unreasonable. It violates the standard.

COMMISSIONER DEASON: Well, then I can't understand why you say then minutes of use or some usage is unreasonable.

MR. DUNKEL: Because it's not cost causative.

There is nothing about the cost of the loop that varies based upon the minutes of use.

COMMISSIONER DEASON: So in comparison to minutes of use, 50/50 is more reasonable and is better than minutes of use?

MR. DUNKEL: If it's based on the relative stand-alone, yes. It's a difficult question, I understand that, but a hundred is wrong, I'll tell you that right off the top. Anybody else?

(NO RESPONSE)

MR. DUNKEL: Okay. Thank you very much. I enjoyed it. It was fun.

MS. MARSH: I understand Mr. Regan is going to hold his portion of the presentation until next week. These speakers are actually part of a pair, and they are coming again next week too, so that concludes the scheduled presentations for today.

MR. DUNKEL: And, Anne, thank you very much for the easel and for the help.

MS. MARSH: And thank you for the very exciting presentation.

Before everybody goes, I just want to remind you that we are starting at 8:30 tomorrow, especially for anybody who came in late today and didn't hear that. We are starting at 8:30 tomorrow. Thank you.

(WHEREUPON, THE WORKSHOP WAS ADJOURNED)

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CERTIFICATE

STATE OF FLORIDA)
COUNTY OF LEON)

I, NANCY S. METZKE, Certified Shorthand Reporter and Registered Professional Reporter, certify that I was authorized to and did stenographically report the foregoing proceedings and that the transcript is a true and complete record of my stenographic notes.

DATED this 6th day of October, 1998.

NANCY S. METZKE, CCR, RPR

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