

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
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1 where they may move to over time and the impacts that they
2 will have in conjunction with any changes in a
3 determination about what might be fair and reasonable.
4 Given these interactions and tradeoffs, I'd make the strong
5 recommendation that the report that goes into the
6 legislature include and reflect to as great an extent as
7 possible the scope of these interrelated issues.

8 If we look at background -- and I apologize, the
9 shading here is not that strong, but I'll work with the
10 pointer. If we stand back and look at current rate
11 relationships, what we see quite simply is disorientation.
12 If we look in total, we've got total costs that are covered
13 by the combination of intrastate revenues and interstate
14 revenues. In total, the revenues generated from the
15 provision of service are sufficient to cover costs. If we
16 look beneath that aggregate level analysis and to adopt
17 some terminology that will be used in the upcoming phases,
18 if we look at supported services, those services that will
19 be the object of public policy issues in terms of what
20 might be an affordable level, if we look -- so single line
21 business rates and residential rates. If we look at the
22 rate to cost relationships for those services, what we see
23 is that current revenues cover just a fraction of cost, and
24 there is a shortfall that is produced there. If we look
25 over at unsupported services, those I just mentioned

1 areas, the incentives don't exist today. The costs are
2 high. The prevailing rates are low. There is not a
3 sufficient signal to competitors to enter and compete in
4 the provision of basic access.

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

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

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

25 So the implications that are borne out by the

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

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

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

21 The key message in terms of the current
22 environment is that these implicit subsidies are not
23 sustainable. If we go back two slides to the picture we
24 were looking at, what we can see if we look at supported
25 services here and think about competition in the rural

1 contribution analysis, rate rebalancing to competitive
2 market levels for non-supported services is key. Within
3 that context of rebalancing, fair and reasonable
4 determinations focus on the price for basic service paid by
5 customers; and as I mentioned before, we've got to stay
6 focused on those tradeoffs and take not a focused or narrow
7 view of this but a broader view where we are considering
8 the impacts of rebalancing on all rates.

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

20 It's important to focus on unsupported services
21 as well as supported services. We can look at basic local
22 service in itself, make revenue and cost comparisons, and
23 they are very important and it's insightful to do that. We
24 can also look at all the unsupported services and get a
25 feel for the manner in which the current mechanism is

1 providing for that shortfall between revenues and costs on
2 the local side.

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

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

21 From this data several conclusions emerge. I
22 mean the level of disorientation that exists in rates is
23 confirmed, very consistent with what we saw from Sprint
24 this morning. Revenues from residential service alone fall
25 short of costs by over three hundred million dollars, and

1 to set up some of the linkages with the cost model phase
2 that is upcoming, this shortfall is a conservative estimate
3 of funding requirements for three key reasons: Costs are
4 aggregated to a rate group level -- I'll come back to that
5 in a minute -- local measured service was excluded from the
6 analysis -- just the unlimited use residential service was
7 considered in the cost and charges in the contribution
8 analysis -- and single line business services were included
9 in the contribution analysis, but they are excluded in the
10 calculation of that 328 million shortfall. And, again,
11 single line business would also be considered a supported
12 service. So we want to -- it's important; I'll come back
13 to this -- to keep the differences between what we can use
14 the contribution analysis for and how it relates to the
15 cost model phase.

16 Again, let's kind of restate the goal or the
17 objective here. In the top panel coming across, we've got
18 our current system, and total costs are recovered but
19 through a very disoriented rate schedule where shortfalls
20 on the supported services side are made up for with
21 surpluses on the unsupported services side. The end
22 state, or the goal we are trying to realize here has the
23 costs of supported services covered now through a
24 combination of universal service funds and the revenues
25 paid by customers, and that universal service funding

1 mechanism would in marked contrast to the current set of
2 implicit supports be designed and implemented on a
3 competitively neutral and, therefore, sustainable fashion
4 where all providers of telecommunications services would
5 contribute.

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

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

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

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

25 MR. CALNON: That's right.

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

5 MR. CALNON: If we sort of envision a fully
6 sufficient fund where all implicit subsidies would be
7 removed, then it wouldn't necessarily be equal or
8 proportionate; but to the extent that features are marked
9 well in excess of their costs, they would be rebalanced
10 down as would toll, as would access. So to the extent that
11 there is implicit support in each of those, if you look at
12 the contribution analysis, everything is not at eight or
13 900% now for those services, and 50% of cost for basic.
14 Some markups are higher than others, and so the reductions
15 wouldn't necessarily be proportional to one another but
16 would reflect their current mix.

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

21 MR. CALNON: Well, those services whose margins
22 are greatest today are subject to the greatest levels of
23 competition, features through telephone equipment versus
24 taking them from the supplier, alternatives to switched
25 access and toll bypassed for the multi-line business

1 customers. So in a sense, the rebalancing to more proper
2 cost levels -- I mean to the question that was raised this
3 morning, you know, why would we want to do this since it's
4 establishing proper price signals and encouraging
5 competition? The answer was, it's to stop the bleeding.
6 And so in that sense, I don't know if profit maximizing is
7 the right characteristic or the right description, but it
8 certainly does maximize the preservation of the support
9 mechanism.

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

14 MR. CALNON: Okay.

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

18 MR. CALNON: That's right.

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

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

1 MS. BUTLER: Right.

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

4 MS. BUTLER: Right. I understand that part.

5 MR. CALNON: Okay.

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

9 MR. CALNON: That's right.

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

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

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

25 MR. CALNON: It is most likely the case that

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

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

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

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

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

6 MS. BUTLER: Okay. Thank you.

7 MR. CALNON: Right?

8 MS. BUTLER: Thanks.

9 MR. CALNON: So what our goal is, is to create
10 this transformation from the current set of implicit
11 supports to what for supported services would be a
12 combination of revenues paid by the customer and support
13 drawn from a fund, sufficiency to cover their costs, and
14 then with those implicit burdens off loaded from
15 unsupported services, their prices more closely approximate
16 their costs. And if we go back to the comment I made
17 earlier about an insufficient incentive to enter and
18 compete in the rural areas and the customer impacts and
19 economic development impacts that are associated with that,
20 that problem has been solved in that the portable level of
21 universal service funding and the price paid by customers
22 is now sufficient to cover costs, so rural -- potential
23 entrants for rural areas will see appropriate
24 compensation. We've also eliminated the uneconomic
25 arbitrage opportunities that exist for unsupported

1 services, and so that transformation has preserved or
2 transformed the current level of implicit funding to the
3 explicit fund. So you've got reasonable cost to rate
4 relationships for both unsupported services and supported
5 services.

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

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

20 MR. CALNON: That's correct.

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

24 MR. CALNON: No, not necessarily. If we go
25 back -- Actually the next slide we'll see that. If that's

1 the measure of cost in that wire center, then -- and we'll
2 link to affordability in a minute. What is important is
3 that the combination of the price paid by the customer and
4 whatever level of funding is established, that the sum of
5 those two properly address their costs.

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

8 MR. CALNON: That's right.

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

12 MR. CALNON: As you --

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

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

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

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

24 MR. OCHSHORN: Okay.

25 MR. CALNON: For purposes of addressing universal

1 service and making comparisons to where the prices would
2 tend to be absent a public policy goal with where they are
3 now, it's necessary to bring common costs into those. So
4 I've adjusted the direct-cost-only estimates and included a
5 reasonable allocation of common, and those are reflected
6 here.

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

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

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

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

25 MR. OCHSHORN: So the answer is this calculation

1 does not include revenues from second lines?

2 MR. CALNON: I would need to check that. If they
3 were not included in July 31st, they were not included
4 now. I'm just not sure of whether or not they were in July
5 31st.

6 MR. OCHSHORN: Okay. Thank you.

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

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

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

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

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

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

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

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

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

4 MR. CALNON: That's right.

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

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

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

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

17 COMMISSIONER DEASON: And they should also
18 approach cost?

19 MR. CALNON: That's correct.

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

24 MR. CALNON: Yes, if we can go back one or two
25 slides here. I mean through this chart we are not changing

1 the overall level of costs for the firm. All right, what
2 we are showing is that these surpluses here, right, they
3 migrate to a permanent explicit universal service fund, and
4 then the large revenue column here is rebalanced down.

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

7 MR. CALNON: Yes.

8 COMMISSIONER DEASON: Do we know that as a fact?

9 MR. CALNON: I think current revenues provide --

10 COMMISSIONER DEASON: Are they equal to your
11 cost?

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

13 COMMISSIONER DEASON: Cost plus a reasonable
14 profit.

15 MR. CALNON: Right.

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

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

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

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

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

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

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

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

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

24 MR. OCHSHORN: In a competitive market in which
25 exchange carriers have to file tariffs and then offer the

1 service to whoever applies for it, why wouldn't competitors
2 offer as low a basic rate as they could in order to get
3 subscribers and then make their money on vertical services?

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

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

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

1 able to react and adapt to that.

2 MR. OCHSHORN: Okay. Thank you.

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

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

1 cost.

2 To illustrate some of the interactions I've been
3 talking about, the key message here is not to look in a
4 vacuum, not to approach affordability as an issue of, say,
5 a \$10 rate moving towards \$20, or without looking at the
6 potential offsets and the total bill impact. If we sort of
7 envision an explicit universal service surcharge and
8 consider rebalancing rates that remove the implicit support
9 that exists today -- I've just prepared some hypothetical
10 data to show these interactions, and I'll talk through the
11 first couple of columns. If we assume that basic rates are
12 \$15, the other two assumptions down here in the notes, and
13 I apologize for the quality of this slide, but I've assumed
14 that 50% of the current bill above and beyond the basic
15 connection is rebalanced down; and if you recall the level
16 of the contribution margins from this morning that the
17 other companies have put in, 50% may, in fact, be a
18 conservative level given how much support --

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

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

24 COMMISSIONER GARCIA: Okay.

25 MR. CALNON: And I just want to look at those

1 tradeoffs between two things. A customer who would spend
2 \$15 a month would be in a position to receive no benefits,
3 because they are not consuming toll or access or verticals.
4 If we are in a world where rates are rebalanced and as the
5 second note points out there is, say, a 20% surcharge,
6 universal service surcharge, I just want to come down that
7 column and find the bill impact for that customer whose
8 bill is \$15 on average. So they start out at \$15. They
9 are not consuming any of those things whose prices come
10 down, so there is no benefit realized, yet they are
11 subjected to a 20% tax, the universal service surcharge.

12 COMMISSIONER GARCIA: Got you.

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

23 If we go one more step out with greater levels of
24 usage and feature and long distance, now there is \$10, the
25 difference between 25 and 15 in their consumption bundle,

1 that generates a \$5 credit when those prices are reduced.
2 The surcharge now would be \$4. Their net bill impact is a
3 dollar lower. And so I think the key point here is to
4 recognize that as use increases, for whatever mix it would
5 be, features, long distance, toll. that at reasonable
6 levels of consumption beyond --

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

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

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

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

1 commissions.

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

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

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

24 And, again, these are just hypothetical numbers.
25 I think 50% is, given the level of contributions, is

1 possibly easily realized. The 20% surcharge is important.
2 What is critical, and it ties to this morning's discussion,
3 we want to -- it's very important to understand the
4 customer base that would sit in the low usage categories.
5 Certainly reasonable levels of use and higher will see net
6 benefits from this, so I think the focus is properly placed
7 on the low-use customers in understanding to as great a
8 degree as possible the demographic and socio-economic
9 attributes that those customer would have. A simple
10 example would be, some fraction of that low-use segment
11 would probably be second homes and seasonal homes; and I
12 think it's a much different public policy perspective of
13 that \$3 impact than it would be for an elderly or a
14 low-income or a fixed-income household.

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

24 COMMISSIONER DEASON: Could you backup?

25 MR. CALNON: Sure.

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

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

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

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

16 The 20% number in terms of the level of
17 surcharge, several factors that go into determining what
18 that number would ultimately be, the aggregate level of
19 funding required within the state, if it would be a state
20 level surcharge, and you've also got -- and the reason 20%
21 is less than 50% I think is you've got all
22 telecommunications providers participating in the fund
23 going forward, not just the rates for those services above
24 and beyond basic. So with the broadest possible assessment
25 base that would come in beyond just the local incumbent

1 providers, but long distance, wireless, I mean the full
2 scope of telecommunications services being the base against
3 which the funding needs of the state are assessed. So
4 you've got a lot of details in actually putting substance
5 to those numbers. I just, you know, used illustrative
6 numbers to try and frame the impacts.

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

12 MR. CALNON: Multi-line residential?

13 COMMISSIONER JACOBS: Yeah, separate line and
14 residences.

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

18 COMMISSIONER JACOBS: Okay. That answers my
19 question.

20 MR. CALNON: A couple of comments on the linkages
21 to the cost model phase -- and the cost and charges here
22 I'm referring to the contribution analysis -- just to
23 compare a couple of differences that will be important as
24 the Commission works through. In looking at supported
25 services and unsupported services, for the contribution

1 analysis, we used GTE's ICM model. As we look over into
2 the cost model phase, given the need to use proxy models
3 there, GTE supports the use of the BCPM. So there is a
4 different cost model, and that is looking at supported
5 services. In the cost model phase GTE presents an analysis
6 of the level of funding that exists in rates today. For
7 purposes of identifying that we use the permanent UNE rates
8 that are in place and take those as a statement about the
9 economic costs of the underlying switching and hauling
10 functionality and use those to compare to current retail
11 rates.

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

20 The level of averaging, we are at a rate group in
21 the data presented here with my testimony, and I'm saying
22 here that it includes netting; and a business example will
23 make that clear. If we are in rate group five, there would
24 be a certain relationship. Say, on average revenues cover
25 costs for single line business in a certain rate group, but

1 down at a wire center level, there would be pluses and
2 minuses. There would be wire centers whose revenues would
3 be greater than costs. There would be wire centers whose
4 costs would be greater than revenues. As you go through
5 the cost model phase and start to look at alternative fund
6 sizes, that example is what I mean here netting, net
7 averaging, above cost and below cost, netting in an example
8 to, say, be equal.

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

25 COMMISSIONER DEASON: Well, when you go into the

1 next phase and there is no netting, what does that do to
2 the company's over revenue level?

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

17 COMMISSIONER DEASON: So those --

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

24 Conclusions. From the consumers' perspective, we
25 are looking at affordability in as broad a possible

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

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

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

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

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

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

22 MR. CALNON: Yes, subject to some fairly
23 aggressive assumptions in terms of the network is built, in
24 effect, overnight. It's built to known levels of demand.
25 I think there are some very strong assumptions in there,

1 and the level of inputs into those models are also
2 extremely important to focus on. I think Bert Steele next
3 week can extend that discussion farther.

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

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

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

25 MR. CALNON: I think that's appropriate.

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

8 MR. CALNON: Most definitely. I think --

9 MR. OCHSHORN: I --

10 MR. CALNON: I'm sorry.

11 MR. OCHSHORN: Go ahead.

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

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

18 MR. CALNON: The ability to continue to offer
19 basic service at current rates is predicated currently on
20 the ability to generate the surpluses, if you will, from
21 the other services. As those surpluses are eliminated,
22 pressure will exist for basic rates to go up, potentially,
23 without sufficient action on the universal service front to
24 and through a level that may be determined to be
25 affordable. So I think what is critical is to not wait for

1 competition. That's too late. The competition that exists
2 today is inefficiently, artificially incented, given these
3 high margins, and it's thwarted in the rural areas. So I
4 think it's critical to move to establish the universal
5 service fund. That gets the proper balance.

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

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

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

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

19 MR. CALNON: I think the policy of universal
20 service goes beyond any one company, so I don't know that
21 it's completely solved by that hypothetical. I think, if
22 this is another variation on your question, I think the
23 proposal we heard this morning has a lot of very sound
24 attributes to it. It recognized the link to charge the
25 rate that is determined to be affordable. It put a

1 transition plan out which has a reasonable time horizon
2 probably. Too long, I think, would have jeopardies. The
3 certainty that would be created by a gradual phased-in
4 approach benefits consumers. I think it would provide
5 enough information to entrants to, you know, be able to
6 form and implement their business plans. So I think that
7 sort of straw man and what I was talking about today is the
8 solution.

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

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

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

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

24 MR. OCHSHORN: Oh, okay. The reason I'm asking
25 is that current -- as you know in Florida and I realize you

1 are from out of state, but in 1995, we allowed companies to
2 get out of rate regulation if they wanted to and go to
3 price regulation. And the 1995 law provided that if at any
4 time there was a substantial change in circumstances from
5 when the Act went into effect that a company could petition
6 the Commission and request an increase in rates based upon
7 those changed circumstances, and so that's why I was trying
8 to see whether you felt based on your economist's
9 perspective here whether that remedy would be sufficient or
10 not.

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

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

15 MR. CALNON: Yes, I would think so.

16 MR. OCHSHORN: Okay.

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

21 MR. OCHSHORN: Okay. That's fine, because that
22 is basically our position too at Legal Services. We
23 represent low-income people, and we feel that the remedy
24 that is in the law now is combined with work on these USF
25 issues and seems to be a perfectly adequate way to address

1 any substantial changes in circumstances where you may have
2 to adjust rates due to competitive pressures or whatever,
3 so thank you.

4 MR. CALNON: Thank you.

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

12 COMMISSIONER DEASON: 15 minutes.

13 (BRIEF RECESS TAKEN)

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

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

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

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

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

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

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

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

17 He looked at the coins in his hand, looked at the
18 meter that said \$30, and then he looked in the back of the
19 cab, and there were no more passengers in the cab. At that
20 point he reached underneath his seat and came up with a
21 baseball bat. He said, I heard what the first gentleman
22 said, and it sounded pretty good when he said it. I heard
23 what the second gentleman said, and it sounded pretty good
24 when he said it. I heard what the third gentleman said,
25 you, and it sounded pretty good when you say it, but

1 somebody owes me \$30; and since you are the last one in the
2 cab, I guess it's you. So the moral of the story is, when
3 you are doing incremental pricing, don't be the last one in
4 the cab.

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

14 Competition for utilities is nothing new. Back
15 in the 1800s before railroads were regulated, there were
16 four railroad lines that ran from New York to Chicago. And
17 the prices there were very competitive and, therefore, the
18 prices were very low. There was only one railroad line
19 that ran from New York to Buffalo, New York City to
20 Buffalo. That was a monopoly service. The price there was
21 very high. As a matter of fact, a lot of times it was
22 cheaper to ship something from New York City that went
23 through Buffalo to Chicago than to ship something from New
24 York City that stopped at Buffalo. So a utility
25 unregulated will price competitive services extremely low

1 and monopoly services very high. This is in their
2 interest. It allows them to impede competition, or get an
3 unfair advantage over competition, but it's not in the
4 public interest; and, in fact, it was this discriminatory
5 type of pricing that led to regulation of the utilities.

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

17 Now you'll hear all of us talking about cost loop
18 cost. Let's explain why. BellSouth's investment in loop
19 facilities is 55% of their total investment in anything.
20 That's why everyone talks about the loop cost. A very
21 common technique, if you want to make the cost of a service
22 look low, is to do the cost excluding the loop cost. When
23 you exclude the loop cost, there is not much cost left. If
24 you want to make the cost of a service look high, you do
25 the cost including the loop cost. You'll end up with a big

1 number that way. A very common trick commonly used in
2 presentations to regulators.

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

19 Now there is another extreme. The maximum
20 possible number is a hundred percent of those costs, so you
21 do that, and it's called a stand-alone cost. You price it
22 as to what it would cost to build a system to provide only
23 one service. For example, if you build a system to provide
24 toll service, the cost of that system gives you stand-alone
25 cost of toll. This gives you the ceiling. So you have a

1 floor that includes none of the incremental costs or none
2 of the joint or common costs. You have a ceiling that
3 includes all of the costs of the facility needed to provide
4 that service. The proper price is between those two
5 extremes.

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

12 Now if you would like to perhaps understand a
13 little bit of these theories, let's take an example. Let's
14 say you owned a business and you were going to build a
15 parking lot and the business next to you is also going to
16 build a parking lot and your parking lot would cost you a
17 hundred thousand dollars and this business came over and
18 said, Let's go together and build one parking lot and we'll
19 share it. And they said, I would like your share of that
20 to be a 150 thousand. Now if you can build your own for a
21 hundred thousand, you are certainly not going to go in on a
22 shared lot and pay 150 thousand; that is above your
23 standard cost. If you were offered that, you simply
24 wouldn't do it unless you were trying to subsidize that
25 other person for some reason, it was your brother-in-law or

1 something like that. So the stand-alone cost is the
2 maximum. No one in a free market would pay more than
3 stand-alone because they would simply not share any more;
4 they would build their own system.

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

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

22 Now a lot of people will tell you in a
23 competitive market that prices go to TSLRIC, but that is
24 not true. If you priced your soft drinks and your french
25 fries and your hamburgers all at incremental cost, at the

1 ends of the month you couldn't pay the rent because it's
2 not part of the incremental cost of a hamburger or a soft
3 drink or anything else. So if you did that you would go
4 bankrupt.

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

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

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

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

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

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

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

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

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

13 MS. MARSH: Okay.

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

20 Now let's talk about the stand-alone of toll
21 service. If you were to build a system that was providing
22 only toll service and not shared with any other service,
23 what would you need? Well, if you are going to place a
24 call from a business, you need a loop going from that
25 business to the switching equipment because the business

1 has to pick up their phone and place a call, a toll call.
2 You need the switching company. You need interoffice
3 facilities, and if they are calling a residence, you need a
4 loop from the switching equipment to the residence in order
5 to terminate the toll call.

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

17 Local service is exactly the same story. The
18 stand-alone cost of local service includes the cost of the
19 loops because, if you are going to have local service, you
20 have to have a loop. If you build a system that was only
21 for local, you need the loop cost. The incremental cost of
22 local service does not include the loop because if you
23 build a system that was providing a number of services and
24 stopped providing local while still providing toll, you
25 would not eliminate the need for the loop. You would

1 eliminate some cost of local switching, the local part of
2 local switching costs. You might eliminate a few billing
3 costs, but that is all you would get rid of.

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

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

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

24 Now if you look at this map very carefully, if
25 you wanted to be able to say that residential rates are

1 below costs, can you find something on there that makes
2 that a true statement? Well, sure you can. There is a
3 stand-alone cost. If you look at the stand-alone cost, you
4 can honestly say residential basic rates are below
5 stand-alone costs. You might not -- you might want to drop
6 the word stand-alone and just say residential basic is
7 below cost because the stand-alone might cause someone to
8 go to a dictionary and find out what you are talking about.
9 So if you were trying to convince someone that residential
10 rates were below cost, this is the cost you would refer to.

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

20 So for stand-alone -- or for basic, the cost I
21 talk about is the stand-alone that includes a hundred
22 percent of the loop cost. For toll the cost I talk about
23 is the incremental cost that doesn't include any of the
24 loop costs. I can then make all sorts of graphs and charts
25 and say, you know, this service is priced 50% below its

1 cost, this one is priced two hundred percent above its
2 cost. The only difference is I'm using a different
3 definition of cost. One of them I'm putting all the loop
4 costs in, the other one I'm not. This simple little trick
5 is the basis for many of the filings and documents you'll
6 see in this case. Not my documents, by this way.

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

20 If the cost you are given includes a hundred
21 percent of the loop cost, that's the maximum possible loop
22 cost you can include; that's a ceiling. If the cost
23 includes none of the loop costs, that's the lowest possible
24 allocation you can put in; that's the floor. The
25 reasonable price should be below the ceiling and above the

1 floor. So if someone gives you a cost study that's got a
2 hundred percent of the loop cost, you should immediately
3 think, the right price is below that number. If someone
4 gives you a study that has got zero percent of the loop
5 costs, you should automatically think, the right price is
6 above that number.

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

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

1 calls to and from premises. The cost of the loop is not
2 part of the cost of basic exchange service, not part of
3 the TSLRIC of basic exchange service.

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

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

25 Let's pretend we are all telephone company

1 executives and a subdivider comes in and talks to us, and
2 he offers us the opportunity to provide service in a new
3 subdivision, and we'll assume it's entirely up to us
4 whether we do it or not or whether we let some CLEC do it;
5 and let's just pick some numbers. Let's -- I think we
6 had a witness earlier today that said the average
7 residential total revenues, total telephone revenues were
8 \$62 a month. For my example I'll just use \$30 a month.

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

18 Now if I told you this \$30 in revenue is
19 comprised of \$10 in toll -- or, I'm sorry, \$10 in local,
20 3.50 SLC, \$5 vertical, \$6 state toll and state access and
21 \$6 interstate toll and access, or whatever adds up to 30,
22 that would not change your decision. You would not say,
23 well, I can get \$10 of local revenue and the loop costs 15,
24 therefore, I won't do it. That would be an illogical
25 decision. What you would say is, if I can get \$30 of

1 revenue, 25 after all other costs and the loop costs 15, I
2 will do it. Any rational decision making as to whether to
3 put a loop in or not, looks at all the revenues that would
4 be generated, not just revenues from basic local.

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

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

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

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

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

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

21 COMMISSIONER GARCIA: Okay.

22 MR. DUNKEL: Let's deal with another issue that
23 has come up. Some people say, well, now there is something
24 called an unbundled loop rate, and that means you can no
25 longer talk about recovering or sharing the cost of the

1 loop. That's not true. The customers that subscribe to
2 the unbundled loop rate are the CLECs, not the end users.
3 The unbundled loop rate should cover the full cost of the
4 loop, but then the CLEC uses that loop to provide a family
5 of services; and the CLEC spreads the cost of the unbundled
6 loop over the family of services it provides. It might
7 recover 50% of that loop cost in its basic exchange, 25% in
8 interstate access, et cetera; so it will spread the cost
9 just like everyone else.

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

23 And the fact that your contribution from
24 different customers may vary is also something that exists
25 in the competitive market. There are people that go into a

1 fast food restaurant, buy just a hamburger and a glass of
2 water. They probably made a fairly small contribution to
3 the rents. Someone else that comes in that buys the Big
4 Mac and the big soft drink and the large fries and an apple
5 pie, they make a larger contribution to the rent. The fact
6 that there will be residential or telephone customers, some
7 of who will make a less contribution to rent than others,
8 is not abnormal; that is what exists in competition.

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

15 MR. DUNKEL: Sure.

16 COMMISSIONER JACOBS: How do you handle that?

17 MR. DUNKEL: Okay. Those cost studies are done
18 using the double standard we just talked about. The cost
19 of toll they show you is the cost of toll including no part
20 of the loop cost. The cost of local they show you is the
21 cost of local including a hundred percent of the loop cost.
22 If you do it on the same standard, if you say the cost of
23 local including no part of the loop cost, you are going to
24 have, you know, a hundred, two hundred percent, three
25 hundred percent contribution. If you do vertical services

1 or toll the way they do local and say, okay, your cost is
2 the cost including a hundred percent of the loop, since you
3 share the loop and you need the loop to be provided, you
4 are going to have a negative two thousand percent
5 contribution. Your cost is here (indicates), your revenues
6 are there (indicates).

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

18 Now let's go to the customer who is a basic
19 exchange customer, they make no toll calls. I think we had
20 a slide earlier that said 94% of the people make toll
21 calls, but let's take the extreme. Let's say the person
22 who never makes a toll call. Well, of course they still
23 receive toll calls. A telemarketer will call and try to
24 sell them a credit card, so that's still -- And that
25 generates revenue for the LEC, by the way. When a toll

1 call comes into a premise, the LEC gets a carrier common
2 line charge for incoming traffic as well.

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

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

22 Secondly, in the telephone business, when they
23 tell you the cost of an individual loop is \$15, that is an
24 allocated cost. If you get into what the costs really are.
25 If you are running a wire down the street, cutting the

1 trench costs you something like \$5 a foot. Once you've dug
2 the trench, if you put a 25-pair cable in, that's about 50
3 cents a foot; 50-pair cable, dollar a foot. So the cost of
4 running the trench is the big cost.

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

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

1 going to have to pay the \$5 a foot no matter what.

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

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

1 was established to prevent.

2 The robber barons in the railroad industry in the
3 1800s didn't use the term inelastic or elastic, but they
4 knew if they had monopoly power over somebody, they could
5 extract higher prices. And that's what was in their
6 interest; it's not in the public interest. Calling abuse of
7 monopoly power inelastic pricing doesn't change what it is
8 at all.

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

25 On affordability, I think a fact that is not well

1 known is BellSouth in Florida last year disconnected 230
2 thousand customers, residential customers for non-pay.
3 That's at present rates, so please do not let anyone tell
4 you that present rates are affordable for everyone. 7% of
5 their customers were disconnected for non-pay last year.

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

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

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

24 MR. DUNKEL: It is relevant -- okay, first of
25 all, we have surveys that in the past have asked people who

1 do not have telephone service what kept them off, and the
2 two most common answers are the connection charges and the
3 basic local rates. So the people that don't have phone
4 service, those are the two charges that they worry about
5 the most, that keep them off.

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

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

14 MR. DUNKEL: I understand.

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

17 MR. DUNKEL: I understand.

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

21 MR. DUNKEL: I would hope that this Commission
22 and other commissions would make a service available
23 whereby you could get basic exchange service and not be
24 disconnected for not paying toll; that is my first answer.
25 But second of all, the surveys have said that it's basic

1 exchange rates that is most important to keeping these
2 people off the network. Now --

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

6 MR. DUNKEL: Right. I know.

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

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

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

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

18 MR. DUNKEL: Yeah.

19 COMMISSIONER GARCIA: You mention that that is
20 part of the support that is keeping the cost down. Why
21 would we want to do that? I mean part of the revenue that
22 is being generated by that phone, whether it be the
23 individual making the long distance call or the individual
24 receiving the long distance call which is of no cost to the
25 user, basically, why would we want to increment the cost of

1 local basic service if one of the support mechanisms is
2 long distance?

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

6 COMMISSIONER GARCIA: Right.

7 MR. DUNKEL: Most of that revenue is not going to
8 the LEC. If they are billing for AT&T and they bill for
9 \$10, AT&T gets the \$10, and then AT&T pays the LEC
10 something for the switched access charges. It might be \$2
11 or \$3.

12 COMMISSIONER GARCIA: Right.

13 MR. DUNKEL: So, you know, we are disconnecting
14 for a ten dollar bill, and the LEC is only getting two or
15 \$3 of that \$10. So, you know, certainly, if we use that
16 argument, we are not getting the full benefit of that \$10.
17 We are disconnecting because of the ten, but the LEC is not
18 getting the \$10. I would rather see them not disconnect
19 because of the \$10 AT&T or MCI bill. They will still --
20 the IXCs could still get their revenues and the LEC --
21 well, the LEC would still get an access charge revenue
22 anyway because it collects it from AT&T or MCI. AT&T and
23 MCI would then have to collect from the customer the way
24 any other business does without the threat of disconnecting
25 their local service.

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

4 MR. DUNKEL: Some small amount.

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

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

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

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

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

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

4 Let me give you another --

5 COMMISSIONER DEASON: Wait.

6 MR. DUNKEL: Sure.

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

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

13 On telephone service --

14 COMMISSIONER DEASON: Contrast that to telephone
15 service.

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

22 COMMISSIONER JACOBS: How do you respond to the
23 position that those customers, and I think particularly
24 low-income customers, who have a high subscription rate to
25 vertical services correlates to the indication that they

1 can't afford a higher rate for basic service?

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

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

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

1 Going back to the railroad model where there is competition
2 some areas, monopolies other areas, they know very well
3 that companies are going to try to shift the cost recovery
4 away from where there is competition to where there is
5 monopoly. So the federal government in the Federal
6 Telecommunications Act, 254-K put a requirement that said
7 local service, universal -- service is important to
8 universal service -- can include no more than a reasonable
9 share of the joint and common costs the facilities used to
10 provide those services. So to have a case where you are
11 putting a hundred percent of those costs in the rate of
12 local service is contrary to the requirements of Section
13 254-K.

14 The law that we are dealing with in this case,
15 the state law, also talks about a reasonable share of the
16 joint and common costs as being included in the cost of
17 residential service, not a hundred percent, but a
18 reasonable share. In case someone says, well, a hundred
19 percent is reasonable share in my opinion, the Supreme
20 Court decades ago in what is called Smith versus IBT looked
21 at a case where the telephone company was putting a hundred
22 percent of the loop costs on local service. The Supreme
23 Court said that was improper, it placed an undue burden on
24 the local service and required that an allo -- an
25 apportionment is the term they used -- required an

1 apportionment of those costs be made. So we've got supreme
2 court rulings that say a hundred percent is not a, quote
3 reasonable, unquote, share. It's an unreasonable share.

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

14 MR. BANAGEE: Mr. Dunkel, good afternoon.

15 MR. DUNKEL: Hi.

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

18 MR. DUNKEL: Hi, Andy.

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

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

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

25 MR. DUNKEL: Okay. Fine.

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

3 MR. DUNKEL: Okay. Great.

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

6 MR. DUNKEL: Sure.

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

10 MR. DUNKEL: Sure.

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

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

16 MR. BANAGEE: Okay. Well --

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

19 MR. BANAGEE: Okay.

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

23 MR. BANAGEE: Okay. So we are agreed then that
24 you have to look at the cost of producing something on a
25 stand-alone basis, that is to say, the cost to a firm that

1 produces that service alone or that product alone and
2 nothing else?

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

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

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

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

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

22 MR. BANAGEE: Okay.

23 MR. DUNKEL: That's fine.

24 MR. BANAGEE: So the stand-alone cost, which is
25 the cost of the single service network can be very

1 different from any stand-alone cost that you compute for a
2 multi-service network that is built differently?

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

7 MR. BANAGEE: Right.

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

10 MR. BANAGEE: Right.

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

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

14 MR. DUNKEL: They are two theoretical numbers.

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

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

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

22 MR. DUNKEL: Right.

23 MR. BANAGEE: That if you were to calculate the
24 stand-alone cost you would do so only for the first of the
25 two networks, not for the second, because they could be

1 very different networks, so the cost structures could be
2 very different too, cost levels could be very different.

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

7 MR. BANAGEE: Right.

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

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

13 MR. DUNKEL: Right.

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

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

18 MR. BANAGEE: Subject to --

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

21 MR. BANAGEE: Okay. Okay.

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

24 MR. BANAGEE: Okay.

25 MR. DUNKEL: You do not know what it would cost

1 to provide service -- all the services excluding local.
2 You don't know what that would cost. You can estimate it,
3 approximate it, hypothetically --

4 MR. BANAGEE: Whatever.

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

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

21 MR. DUNKEL: For the tests we are doing here,
22 it's not some fine tuning. If -- you know, the basic costs
23 are about four dollars that you would avoid if someone
24 comes in and says, well, I don't think you handled the cost
25 of printing additional line. You know, you've assumed a

1 cost of printing one more line on the bill is a penny; I
2 think it's two pennies. Fine. I mean that is not going to
3 change your conclusion whatsoever.

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

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

9 MR. BANAGEE: Okay. So --

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

14 MR. BANAGEE: Okay. So --

15 MR. DUNKEL: And it doesn't exist.

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

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

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

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

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

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

7 MR. DUNKEL: Okay.

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

11 MR. DUNKEL: No.

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

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

15 MR. BANAGEE: Okay.

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

25 MR. BANAGEE: So if it's -- if all the prices are

1 at or above their respective TSLRIC, it's still possible
2 for at least one service to be priced above stand-alone
3 cost.

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

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

9 MR. DUNKEL: You just changed it.

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

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

14 MR. BANAGEE: Right.

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

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

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

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

25 MR. DUNKEL: If it's above stand-alone, sure. I

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

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

21 MR. DUNKEL: Okay.

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

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

25 MR. BANAGEE: Because it's a well accepted test

1 that when a firm at least breaks even that if you are
2 pricing all of your services at or above TSLRIC but below
3 stand-alone cost, it doesn't matter whether you know the
4 stand-alone cost or not. If you're at least covering your
5 TSLRIC --

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

9 MR. BANAGEE: Would you just --

10 MR. DUNKEL: I can give you quotes from the FCC.
11 Sure, I've got quotes in my handout from the FCC that say
12 --

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

15 MR. DUNKEL: Okay.

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

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

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

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

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

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

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

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

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

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

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

18 MR. DUNKEL: Okay.

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

22 MR. DUNKEL: That's right.

23 MR. BANAGEE: Now would you say that the two
24 camps, the differences between the two camps or the two
25 points of view hinges completely on this difference in

1 their viewing the cost of the loop? If that difference
2 disappears, then essentially their conclusion should all be
3 the same?

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

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

24 MR. DUNKEL: Absolutely not. What you just said
25 is that the loop is access service, is a service that can

1 be demanded in its own right. Even if that is true, you
2 are still wrong. Doctor Taylor has talked about something
3 he calls customer access, and he says, as you have just
4 said, that there are -- customers could demand access even
5 if they weren't going to use it. This is a service that
6 could be demanded in its own right. I'm not sure that's
7 true, but let's assume it is.

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

18 And again, we've handed out a card for cost
19 causation. Let's run the test. This says a cost is
20 caused, if the company does not avoid certain costs in the
21 long run when a service in question is eliminated while
22 holding constant the production of all other services
23 produced by the company, those costs are not caused by the
24 service in question. Let's pretend your company is
25 providing carrier access, toll service and customer access,

1 whatever that is. They drop customer access from the
2 services they provide. Have they now gotten rid of the
3 loop cost? No. They are still providing carrier access.
4 AT&T still wants to connect to their premise. You need a
5 loop to do that. They are still providing toll service.
6 You need a loop to do that. You can call it local service,
7 you can call it customer access, you can make up any name
8 you want to as long as it's not the only service that uses
9 a loop. If you make that service go away, the loop cost
10 does not go away, and that service is not by itself causing
11 the loop cost.

12 MR. BANAGEE: But if I were to --

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

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

22 MR. DUNKEL: Sure.

23 MR. BANAGEE: There are those people, right?

24 MR. DUNKEL: Sure. I had a friend in college,
25 the reason he took telephone service is so he could call

1 his girlfriend, which is a toll call. There are people who
2 take, a few, a tiny percent, who would say make no toll
3 calls. There are a few others on the other extreme who
4 take telephone services because of toll calls. All that
5 tells you are the two extremes. You can use one extreme to
6 get here, the other extreme to get there, but you don't
7 price on the extremes.

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

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

14 MR. BANAGEE: Sixty to 80%.

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

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

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

23 MR. BANAGEE: No, you're --

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

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

16 MR. DUNKEL: Absolutely not, for two reasons.
17 First of all, your numbers -- I've seen these studies, and
18 the studies I have seen had a percent of people who made no
19 intraLATA toll calls but they ignored the interLATA toll
20 calls they make. Secondly, even if you make no toll calls,
21 when you receive toll calls, that is a use of your loop for
22 toll traffic and the LECs get paid for that. If a
23 telemarketer calls you at home at suppertime, tries to sell
24 you a credit card, they are using your loop for toll
25 service and the LEC is getting paid for that, and that is

1 not part of local service. You shouldn't pay for the cost
2 of some telemarketer to call and interrupt your supper.

3 So that's -- First of all, there are other
4 revenues other than local service. Secondly, let's take
5 a -- Let's say there is 1% of the customers who never make
6 a toll call, never receive a toll call, don't have caller
7 ID, don't have anything other than basic exchange service.
8 When you do a cost study and you say their cost is \$15,
9 that is not true. That is a result of averaging. The only
10 cost they actually cause -- that you would avoid if you
11 dropped that customer is the cost of their drop and maybe
12 some local usage and a tiny part of the cost. The main
13 cost of putting a loop in is digging a trench, that's about
14 \$5 a foot. If you drop a cable in there that is 50-pair,
15 that is a dollar a foot. If you drop a smaller one to
16 avoid these customers you are talking about, that is 50
17 cents a foot. So you can spend either \$6 or 5.50 a foot to
18 serve twice as many customers; that's your choice.

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

25 If you had a subdivision and you could tell in

1 there is a lake on the subdivision.

2 MR. DUNKEL: Okay.

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

6 MR. DUNKEL: Sure. Sure.

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

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

22 COMMISSIONER GARCIA: No, but I'm talking about
23 after. I'm not talking about in advance. I'm talking
24 about after. In other words, I as a competitor arrive, and
25 I'm not even pricing economically. I just know that -- I

1 advance which houses were going to take only basic exchange
2 service and have no other revenues whatsoever, if you were
3 smart, you'd still serve them anyway because all that means
4 is it costs you another two or three dollars a household --

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

8 MR. DUNKEL: Okay.

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

11 MR. DUNKEL: Okay.

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

14 MR. DUNKEL: Okay.

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

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

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

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

25 COMMISSIONER GARCIA: You have a subdivision, and

1 there is a lake on the subdivision.

2 MR. DUNKEL: Okay.

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

6 MR. DUNKEL: Sure. Sure.

7 COMMISSIONER GARCIA: The rest of the homes are
8 townhouses in this subdivision. They all have, you know,
9 two wires into the home but, you know, you know that the
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20 people or median income housing, you can't really tell in
21 advance which one is going to make toll calls, et cetera.

22 COMMISSIONER GARCIA: No, but I'm talking about
23 after. I'm not talking about in advance. I'm talking
24 about after. In other words, I as a competitor arrive, and
25 I'm not even pricing economically. I just know that -- I

1 look at the history of consumption, and I say, I want the
2 houses by the lake. Those are the real winners here, the
3 townhouses aren't, and I just serve them.

4 MR. DUNKEL: Okay.

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

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

20 Most of my costs are fixed costs, digging a
21 trench. If I'm going to dig a trench, I want to put as big
22 a cable in there as I can put and I want to serve as many
23 people as I can because, if it cost me \$5 a foot, if I have
24 to split that over ten people, that's a pretty big chunk.
25 If I can split it over a hundred people, that's a much

1 smaller number, and that's my big cost. Even if those
2 other people I add aren't as profitable as the first people
3 and are not paying as much of the joint and common, I'm
4 still better off with them than without them. That's the
5 difference. It's like if you go into a restaurant and
6 order hamburger and water they don't throw you out. You
7 are not as profitable as the one that ordered 15 things,
8 but you are still helping to pay the rent.

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

12 MR. DUNKEL: Okay.

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

16 MR. DUNKEL: Sure. Sure.

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

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

3 MR. DUNKEL: No, I'm not.

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

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

25 COMMISSIONER JACOBS: One of the positions I

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

8 MR. DUNKEL: Right.

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

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

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

24 MR. DUNKEL: Exactly. If you were deciding
25 whether to put facilities in or not, it's the total

1 revenues you would look at. If you are saying I have a
2 choice of wiring this subdivision or not, my revenue for
3 basic exchange service is \$10 a line, my loop cost is 15,
4 if that's all you looked at, you'd say I'm not going to do
5 it. But if they said, okay, your local revenue is going to
6 be 10, you are going to get the SLC, that is 3.50, you are
7 going to get an average of \$5 from caller IDs and call
8 forwarding, you are going to get an average of \$5 from
9 intrastate toll and switched access, you are going to get
10 \$5 from interstate toll and switched access and that all
11 adds up to \$25, now it's a good deal. And any rational
12 decision maker, that's what they are going to do. They are
13 going to say I put in this \$15. I can get \$25 in revenue.
14 I'm going to do it.

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

18 MR. DUNKEL: Right.

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

22 MR. DUNKEL: Right. There may be areas, usually
23 they are rural areas, pretty low density where when
24 everything is considered it's still not a good area, and
25 that's where you need your universal service funding,

1 okay? But most areas, you know, what they are doing is
2 comparing all the loop cost to basic exchange is just
3 nonsense. You've got to compare -- If you are going to
4 include all of the loop cost, you've got to include all of
5 the revenues; or if you are going to include only part of
6 the revenues, then you can't include the full cost of the
7 loop because it's used for several services. But there are
8 areas, rural areas, whatever, where the total cost, even
9 with everything considered, wouldn't make it an economical
10 investment; and that's what universal service funds are
11 for, those areas. But that certainly is not the average.
12 Residential service on the average is well above the cost
13 it causes.

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

16 MR. DUNKEL: Sure.

17 MR. BANAGEE: Just one final request.

18 MR. DUNKEL: Yeah.

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

23 MR. DUNKEL: Sure.

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

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

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

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

18 MR. BANAGEE: Were there others?

19 MR. DUNKEL: Well, the difference it makes --
20 And we regulate intrastate only. We don't regulate
21 interstate toll. If you lower toll rates, you aren't going
22 lower the interstate toll rates. If you lower toll rates,
23 all you are going to lower is the intrastate toll rates and
24 the intrastate access charges. If people are disconnecting
25 because of international calls, that bill is going to stay

1 exactly the same as it was before, no matter what you do in
2 this Commission because, you know, you are intrastate.

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

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

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

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

17 COMMISSIONER CLARK: Because we don't --

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

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

24 MR. DUNKEL: Right. Right.

25 COMMISSIONER CLARK: If you do, you are going to

1 have more disconnects.

2 MR. DUNKEL: Right.

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

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

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

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

18 COMMISSIONER CLARK: I would accept that.

19 MR. DUNKEL: Okay. Therefore --

20 COMMISSIONER CLARK: It's still toll.

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

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

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

6 COMMISSIONER CLARK: Okay.

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

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

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

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

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

20 COMMISSIONER GARCIA: I understand that.

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

23 COMMISSIONER GARCIA: I understand that.

24 MR. DUNKEL: Back to your question. Let's take
25 hypothetically that if we did a study in Florida and we

1 found ten percent of the problem was toll and they did a
2 study in California and it found 80% of the problem was
3 toll. The fact that they found 80% in California doesn't
4 mean it's 80% here, I mean that's a way of looking at it.

5 COMMISSIONER CLARK: I would agree with that.

6 MR. DUNKEL: Okay.

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

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

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

14 MR. DUNKEL: Sure.

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

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

22 MR. REGAN: We can get them to you.

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

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

1 MR. DUNKEL: Right. Right.

2 MS. CASWELL: Okay. Thank you.

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

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

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

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

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

15 MS. CASWELL: Okay. Thank you.

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

18 MS. CASWELL: Yeah, sure thing.

19 MS. WHITE: Hello.

20 MR. DUNKEL: Hi.

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

22 MR. DUNKEL: Sure.

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

25 MR. DUNKEL: Okay.

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

7 MR. DUNKEL: No. No.

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

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

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

15 MR. DUNKEL: Okay.

16 MS. WHITE: Great. Thank you.

17 MR. DUNKEL: Okay. Sure.

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

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

25 MS. CASWELL: So the connection charge?

1 MR. DUNKEL: Yes, connection and the --

2 MS. CASWELL: And what studies would those be?

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

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

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

9 MS. CASWELL: Okay. Thank you.

10 MR. DUNKEL: Sure.

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

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

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

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

22 COMMISSIONER DEASON: How do we spread it?

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

1 the way of doing this was difficult.

2 COMMISSIONER CLARK: Let me interrupt you.

3 MR. DUNKEL: Okay.

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

6 MR. DUNKEL: 1930, okay?

7 COMMISSIONER CLARK: Okay.

8 MR. DUNKEL: It's still good law, by the way.

9 The FCC regularly refers to it. It's the basis of
10 separations right now, and there hasn't been any subsequent
11 rule that changed it. It's the applying -- the law that
12 applies right now.

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

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

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

17 That is one way. There are a dozen other ways.
18 The problem with the loop cost is it's not traffic
19 sensitive. Something like switching equipment where the
20 cost depends upon how much you use it, you know, if you
21 make more calls, you have to add more equipment. There you
22 can say, well, I've measured. 10% of my traffic is this
23 type of traffic, so 10% of my switching equipment cost goes
24 to this service. A loop has to be there. It's like a
25 highway. I mean it has to be there whether one car is

1 going to use or 50 cars are going to use it. So it is
2 really -- It's a fixed overhead or like the rent for a
3 restaurant. It doesn't matter whether you sell five
4 hamburgers and 12 hot dogs or 15 hamburgers and three hot
5 dogs, you have to recover that rent. It's a fixed cost,
6 and it doesn't change based upon your traffic. So you
7 really -- the best way is to look at the stand-alone cost
8 and give everyone a share of the benefit of sharing.

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

12 MR. DUNKEL: No.

13 COMMISSIONER DEASON: Toll versus local?

14 MR. DUNKEL: No.

15 COMMISSIONER DEASON: There's no rationale?

16 MR. DUNKEL: Nope.

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

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

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

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

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

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

21 MR. DUNKEL: Okay. Let's say you were an arms
22 length open competition negotiation and you had owned one
23 business, I owned a business, and we are going to build a
24 shared parking lot, and the shared parking lot is going to
25 cost 150 thousand dollars. I said, Here is the deal. You

1 pay the 150 thousand dollars, I'll pay nothing, we'll share
2 the parking lot. Is that -- That's not acceptable.
3 That's not what would happen in a competitive market. In a
4 competitive market, assuming we were both equally good
5 negotiators, we would end up splitting the cost of the
6 parking lot, assuming there is, you know, no other traffic
7 sensitive or anything else.

8 COMMISSIONER DEASON: I agree with you.

9 MR. DUNKEL: Yeah.

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

13 MR. DUNKEL: Right. Right. And --

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

18 MR. DUNKEL: Right.

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

22 MR. DUNKEL: That's my answer.

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

25 MR. DUNKEL: I understand.

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

5 MR. DUNKEL: Okay.

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

8 MR. DUNKEL: All right.

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

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

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

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

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

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

20 COMMISSIONER DEASON: But the guy that is going
21 to have ten thousand cars on that driveway probably, if
22 it's only going to be one car a month that the other
23 neighbor is going to use, he probably would be happy with
24 50 dollars, a hundred dollars because at least that much --
25 it's that much that he is going to have to -- it's a cost

1 that he is going to have to avoid, and he is getting the
2 benefit of ten thousand units of usage per month on that
3 facility.

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

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

22 MR. DUNKEL: I would say that would be much
23 better than saying a hundred percent goes on local and zero
24 percent goes on toll, okay? And let me, again, say what
25 the Supreme Court said. This is not a precise activity,

1 okay? But a hundred percent is not reasonable. Zero is
2 not reasonable. It's got to be in the range of
3 reasonableness.

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

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

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

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

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

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

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

10 (NO RESPONSE)

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

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

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

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

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

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6 and Registered Professional Reporter, certify that I was
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