BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

SPECIAL PROJECT
NO. 980000A-SP

In re: Undocketed Special Project No. 980000A-SP, Fair and Reasonable Residential Basic Local Telecommunications Rates.

DAY 2
MORNING SESSION

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| IN RE: | Staff Workshop |
| CONDUCTED BY: | Anne Marsh |
| DATE: | Thursday, October 9, 1998 |
| TIME: | Commenced at 8:30 a.m.<br>Adjourned at 3:40 p.m. |
| PLACE: | Betty Easley Conference Center<br>4075 Esplanade Way<br>Room 148<br>Tallahassee, Florida |
| REPORTED BY: | RAY D. CONVERY, Court Reporter |

P R E S E N T

COMMISSIONERS PARTICIPATING:

J. TERRY DEASON, Commissioner
SUSAN F. CLARK, Commissioner
JOE GARCIA, Commissioner
E. LEON JACOBS, JR., Commissioner

STAFF PARTICIPATING:

MELINDA BUTLER, Aide to Commissioner Jacobs
BETH KEATING, PSC Staff, Legal
WILLIAM B. McNULTY, PSC Staff, AFAD
DAVID DOWDS, PSC Staff, CMU
SALLY SIMMONS, PSC Staff, CMU

OTHERS PARTICIPATING:

GREG FOLLENSBEE, AT&T
WILLIAM DUNKEL, Office of the Attorney General
TOM REGAN, Office of the Attorney General
CHARLES BECK, Office of Public Counsel
JOSEPH GILLAN, FCCA
BEN OCHSHORN, Florida Legal Services
NANCY WHITE, BellSouth
WILLIAM TAYLOR, BellSouth/Sprint
CARL DANNER, GTE
KIM CASWELL, GTE
TOM McCABE, TDS Telecom
JOHN P. FONS, Sprint

PROCEEDINGS

MS. MARSH: Our first speaker is Dr. William Taylor.

DR. TAYLOR: Thank you. It's a pleasure to be here. It's sort of unique in my experience that a regulatory commission takes time out from its busy schedule to actually sit down and -- independent of a docket or a price setting exercise or something like that, sits down and asks what are the basic fundamental economic questions that are in play and tries to get what I have seen to be a fairly dispassionate and academic discussion of what those issues are. And I would like to -- that's unique in my experience and I think it's a good thing and I would like to more or less continue in that spirit.

My agenda is a short one, and I intend to finish on time, and I intend to have lots of questions, so feel free to speak up.

The object of the project for which we're here, according to the legislation, is to determine what fair and reasonable cost-based rates for basic local service might be. I'm here to urge that we adopt economic and costing, pricing principles that enhance economic efficiency, that make possible efficient competition, and that aid and increase social welfare. As a

consequence, such prices will provide subsidies only for targeted consumers.

Now, as you've been listening and I've been listening for the past week, two weeks, there seems to be a big issue of debate. From my perspective as an economist, there are actually two. One is, what are the costs of providing residential basic local service in Florida, including the proportionate share of joint and common costs, which I think is some kind of legal mandate you have; and the second is what value of service or what non-cost considerations should a commission take into account in pricing telecommunications services.

And that comes down to my three particular topics where kind of all of the action is. Should we allocate a loop cost to other services? A byproduct of that is, what is stand-alone cost and what's it doing here? Do we need to do that? And then finally, what about value of service pricing? I'll spend a lot of time on the first and whatever remains on the remainder.

It caught my ear that there seems to be general agreement among probably everybody, and maybe even the economists, on what loop costs are. Not quite their dollar value, I mean, I think we're kind of -- parties are different by maybe a factor of two, but at least

the discussion on what costs are for a loop are -- is a rational one and we know that the Commission can take the results of the models and all of that, apply its particular wisdom moving inputs up or down as it sees fit, and there's a method which will allow those two estimates of what loop costs are to close to something. That's an activity that commissions have done in the past. That's an easy one.

But where economists and public advocates differ most, not by factors of two, but by factors of a hundred, is what you do once you calculate those costs. The debate to my ear seems almost like a religious debate. It reminds me of the old beer commercials, you know, less taste, more filling or whatever it was, with kind of no -- the other way around, I guess -- with no grounding in principle. You wouldn't know how to decide it.

The economists will get up and they'll describe the costs of basic local service, and there will be a loop in there. Mr. Dunkel will get up and will remind us that you need a loop to have toll service and you need a loop to have vertical services. The new Congress will get up and say, well, gee, you need a computer if you want to use software, but the cost of a computer is not part of the cost of software, and

reasons, one of which I'll argue ought to be economic efficiency, but by no means the only one.

Sometimes I think that regulators fear, if they recognize the true economic cost of a loop in basic service, that that commits them to some particular course of pricing. It ought to affect that course of pricing, but it doesn't commit you to a particular price.

One thing that the Legislature to whom you are recommending a decision can't do is the Legislature, despite its powers, cannot legislate how costs are caused. That's a law of physics. I remember a story that went around when I was a high school student in Tennessee where -- taking algebra, everybody was irritated because pi, the ratio of the circumference of a circle to diameter, has got this nasty 3.14159, the 14159 tucked on there, and it made your homework very difficult keeping track of this extra fraction. So the story that I was told in Tennessee was that some backwoods Legislature -- in Tennessee we use Arkansas, I'm sure in Florida high schools, you use some other example, maybe Tennessee -- but at any rate, the story went that the Legislature in Arkansas heard this problem and said, well, we can solve that, we'll set pi equal to three exactly. Great, so you don't have to

carry that fraction along. All your homework is a lot easier, calculations are easier, but circles don't close in Arkansas. You know, you can't legislate that. A three isn't enough to go all the way around.

Similarly, you can legislate, if you like, that the cost of a loop is the common cost of all services, but you can't -- but prices that are set on that basis will not be sustainable in a competitive market. Circles won't close. You can't legislate sort of facts. Okay. That's my sort of preamble. Let me amble.

Should loop costs be allocated? The short answer, of course, is no. Allocation is a word that we try to train our students never to use. Costs can be assigned, that's what you do, but allocation is -- means that you've given up, means that there's no cost causal relationship anymore between the action whose costs you're trying to measure and the costs that you're assigning, and the results that come out are arbitrary. So it's admitting defeat.

Allocation gives rise to a cross-subsidy between local service and other services, and that's not just sort of economic jargon, that's serious; that is, whether something is technically a cross-subsidy or not, it's important for competitive reasons. That is,

if local service is priced below the cost of providing local service, then any firm that is required to provide local service at that price is at a competitive disadvantage relative to other competitors who don't have that requirement. If you're going to use the revenues or the above cost prices from toll service or from vertical services or anywhere else so that a residential customer is attractive to a competitor, you have to put in this underpriced loop, but you've got these overpriced other services that you can sell him. That's fine, that means that people will find it profitable to serve the customer, but it's bad for competition, because any firm that has to provide the loop at this below cost price is at a disadvantage compared to firms that don't.

To pick on AT&T, if they're a CLEC in Florida, they don't have to provide residential local service below cost, but they can provide toll service to that customer at prices above cost, and that's not going to be efficient competition. Ultimately if competition reigns, the ability to price toll above cost to provide the subsidy to basic local service is going to go away, but even if that doesn't happen, even if competition is so slow in toll that it doesn't happen, you're still setting the wrong incentives. The wrong things are

happening. Resulting rates are economically inefficient.

The economic value of that is immense. Whenever the FCC sits down and takes credit for the many, many good things that it has done, I think the one that is highest on its list is the welfare gains from their rate rebalancing that took place in the early 1980s from subscriber line charges and the ultimate reduction in access charges and in toll rates. And well they should, that's a number that's in the hundreds of millions of dollars. That is a net benefit to society. They deserve a great deal of credit for that.

The cost of something is very different from the value of something. For the moment, we keep separate the ideas of what the costs are and how we recover them, so for the moment we're just interested in how -- what costs are.

Costs arise when something that's valuable in some other use is committed to another use. When we use capital, labor and raw materials to build a loop, we don't use them to do something else. A cost is not caused -- well, it's caused if, when you do the activity, if you put the loop in, the cost is incurred. If you take the loop out or if someone else buys the loop from you, the cost is saved. That's the

cost causation standard. That standard doesn't depend at all on how the loop is used, or how the product or service is used, or the benefit or value that's created from that use. I mean, we know that. The value of telecommunications service is immense. It's huge for elderly people, as we heard Dr. Cooper say yesterday. Surely, I agree with that. Particularly for the elderly, the service is worth far more to them than the price that they pay, and even more to them than the -- or not quite as much to them as -- more than the cost that's incurred to provide the service. It's very, very valuable to them, but that has nothing to do with the cost. So the simple fact that many services use the loop has nothing to do with how the cost of the loop is incurred, and has really nothing to do with how the cost of the loop ultimately ought to be recovered.

A distinction which we've been making -- I've been making in fun for the past five years has been between long distance services which use the loop, and somehow we feel that it's kind of unfair that a long distance service should get to use the loop while a local -- for free, quote, close quote, while local service --

COMMISSIONER GARCIA: Let me ask you a question, though.

DR. TAYLOR: Please do.

COMMISSIONER GARCIA: Because I was listening to you upstairs and listening to the comment you made, but other services do have an impact. For example, if we were charging dial tone, and I don't think your -- maybe they do. Isn't that part of -- I mean, isn't everybody getting that, therefore, it's embedded in the cost of that loop, as opposed to calling it an additional service to that loop?

DR. TAYLOR: Sure. You could -- I mean, the way you could break up local service if you wanted to is dial tone. In fact, some states do this. I know Pennsylvania has an element in the tariff is the dial tone line price as separate from usage or from anything else that gets you access -- actually, I don't think you can buy them separately, but the price of the thing is for access and nothing more. You could do that and that's fine. That doesn't invalidate anything that I'm saying.

What that says is -- what that would say, if you had a dial tone line price and all you got for that when you picked up your phone was dial tone, is that the -- that local usage now would be in exactly the same position as long distance usage would be. That is, it would be, quote, using the loop for free if you priced the loop at full price, you know, at full

incremental cost charged to the dial tone line. But that's exactly the right answer, because local usage imposes no cost on the loop. I mean, there are switching costs and all of that, just as there are switching costs and transport costs in long distance, but there are no additional costs on the loop.

And where I was going was to take the example to the opposite extreme that you went to, which was, instead of restricting and looking just at what local service has got, think wider, think of Domino's Pizza. I mean, that's another service which is -- because Domino's is, I think, entirely takeout or pretty close to it, is entirely dependent upon the telephone service, just as AT&T is. AT&T can't make long distance calls, can't serve their customers unless they dial a phone and call AT&T effectively to make a long distance call. The same for Domino's; they can't sell a pizza unless somebody can dial Domino's and call up a pizza. But no one would ever think of trying to recover the cost of the loop from Domino's Pizza because calls to Domino's Pizza don't cause any costs to be incurred. You know, when they start putting pizza through a modem and sending it through the wires, then maybe you're going to have some costs, but, you know, the way it does now, no additional costs are

incurred and no one would think of charging, or trying to charge Domino's or Land's End or L.L. Bean for the cost of the loop, even though you can't have a Domino's pizza without a loop.

So cost from an activity doesn't depend upon how it's used or the benefit that we get when we use it. It just depends upon the costs that are caused when we buy it.

Value, on the other hand, is value. It's the difference between what we would be willing to pay and what we have to pay. A loop -- well, let's try to come as close to agreement among the warring parties and see where we differ. I think everybody agrees that a loop is the same thing, more or less, as subscriber access to the public switched network. You want access to the network, you want to be able to call, you want to be able to receive calls, you have to have a loop.

MR. DUNKEL: Excuse me, Doctor.

DR. TAYLOR: Yes.

MR. DUNKEL: Could we go back to your cost causation slide?

MS. MARSH: Please state your name for the court reporter.

MR. DUNKEL: This is William Dunkel.

DR. TAYLOR: This one?

MR. DUNKEL: Yes. Previously I handed out a little card that was the test for cost causation, and I'd like to read it to you and see if you agree or disagree.

"If a company does not avoid certain costs in the long run when a service in question is eliminated or not offered, while holding constant the production of all of their services produced by the company, those costs are not caused by the provision of the service in question."

DR. TAYLOR: No problem.

MR. DUNKEL: Okay. If you had a telephone network and you stopped or never provided local service, but you provided toll, switched access and vertical service, would you need a facility that could connect to the customer's premise, yes or no?

DR. TAYLOR: Would I need one?

MR. DUNKEL: Yes.

DR. TAYLOR: Yes. Do I cause any costs on it? No. Take an example, AT&T's network is a fine example.

MR. DUNKEL: Let's stay with this.

DR. TAYLOR: Well, let me finish. You get to ask, but I get to answer.

AT&T's network is a fine example of a network which provides, let's be simple, only toll service. It

has no loops. What does it do to reach its customers? It pays local exchange carriers an access charge to reach those customers, but it doesn't -- when it does that, it doesn't cause any additional costs for loops. Local exchange carriers don't have to build more loops, they don't have to condition loops, they don't have congestion on loops, and AT&T, MCI, Sprint, everybody, simply buys access service, but they don't have loops.

MR. DUNKEL: So you would agree a loop facility would be needed, whether you rent it or buy it, a loop facility is needed even if no one provides local basic?

DR. TAYLOR: Needed, yes, but that's not the test for cost causation. That is, I need a computer to run software, but if I'm asking about what the cost of a piece of software is, do I include the computer? No.

MR. DUNKEL: What if you were going to provide a service that needs both a computer and software, you would not include the price of the computer in the cost of that service?

DR. TAYLOR: If I were bundling the two together, sure. But at the same time, there will be other people who are -- since both parts are separable and can be provided separately, there will be people who will be selling one, there will be people who are selling the other, and there's no way, if these two markets are

competitive, that I can price one above cost and the other below cost.

MR. DUNKEL: When AT&T provides toll service, do they bundle it, meaning they provide it to the customer premise, or do they bring it only downtown and you have to go down there and got your toll call? Do they deliver it to the premise?

DR. TAYLOR: Well, it's an end-to-end service.

MR. DUNKEL: So they deliver it --

DR. TAYLOR: But they do not incur costs of loops.

MR. DUNKEL: Okay.

DR. TAYLOR: Unlike your computer example, they don't bundle together, you know, Taylor Software doesn't buy a computer and purchase software, put the two together and sell it to somebody. Taylor Software in that circumstance incurs a loop cost, a computer cost. AT&T does not. That's the difference.

MR. DUNKEL: Do you agree that the cost of the loop would have to be incurred even if local basic service was never provided by anyone?

DR. TAYLOR: It would have to be incurred by the provider of local basic service. The problem is your --

MR. DUNKEL: There is no provider of local basic service.

DR. TAYLOR: Then you've asked me a Zen question. If there is no basic local service, what -- and for me, basic local service is the same as the loop --

MR. DUNKEL: Well, that's not my question. If you are providing only toll, vertical and switched access, no one had ever invented a service called local basic, does someone have to have a facility that connects to the premise, yes or no?

DR. TAYLOR: Oh, all of those services require connection to the premise --

MR. DUNKEL: Thank you.

DR. TAYLOR: -- just like software requires a computer, exactly the same analogy. It has nothing to do with the cost of either the loop or the usage.

Where were we?

COMMISSIONER JACOBS: Excuse me, Doctor.

DR. TAYLOR: Yes.

COMMISSIONER JACOBS: That -- following in that logic, we're seeing now where, and it was spoken of yesterday, where IXCs are looking to basically narrow their customer base by getting -- well, let me not say this -- by taking away the influence of small volume customers.

DR. TAYLOR: By the $3 minimum charge, for example.

COMMISSIONER JACOBS: If you follow your logic, they wouldn't be incurring any costs from those customers if they aren't making any calls.

DR. TAYLOR: Yes, but that's not quite right. They aren't incurring any loop costs, but I think if you ask AT&T, Mr. Gillan will be following, he probably knows, I think in fact he's arguing in this forum that there are customer-specific costs that AT&T incurs when it signs on a customer. In the first place, there used to be 53 cents a month that AT&T had to pay for the universal service fund for a customer that it had. There still are the PICC charges that AT&T today has to pay. There are probably some fixed costs of billing about which we can disagree, but I think those are the costs for which AT&T asserts they need $3 a month to make the customer worth having, not loop costs, because AT&T doesn't pay loop costs. They pay per minute to the access of --

COMMISSIONER JACOBS: So then that customer who is in that circumstance is more in the line of what Commissioner Garcia is saying, he's going to want to rid himself -- I mean, if he doesn't want to make any long distance charges --

DR. TAYLOR: Right.

COMMISSIONER JACOBS: -- he doesn't think that

he's imposing any costs, he's going to want to get to that condition where he only wants to pick up and have a dial tone.

DR. TAYLOR: Oh, that's right. I mean, if such a person never wanted to make a long distance call or to receive one, didn't want to be a customer of a long distance carrier, they'd be better off if they weren't, because the long distance carrier would avoid some of these regulatory charges and then some of their own billing costs and the customer wouldn't have to pay this. Unfortunately, at least for the regulatory costs, that's not a choice. You know, for the PICCs --

COMMISSIONER JACOBS: I understand.

DR. TAYLOR: You know, the customer gets stuck with it even if he doesn't choose a long distance carrier.

Okay. I think the best way to see the main point that I want to make, and we can see this really quickly in this slide, regarding cost causation in the loop is to think today now that we have CLECs and ILECs in competition for different services, ask yourselves what happens when Sprint or BellSouth loses a local exchange customer to a CLEC. The customer goes over to MFS or to AT&T, what costs are saved by BellSouth? Well, supposing that the CLEC has its own facilities, to make

it simple, BellSouth then has one free loop that they didn't have before, and that one free loop -- they're selling one less loop than they did before. So their excess capacity goes up by one loop and the day on which BellSouth has to expand a cable route or something like that in the future to provide for growing demand gets pushed back because they have one less customer and they have one more spare loop. And that fact, that they have to relieve capacity later by a small amount now, in present value is exactly the cost that BellSouth saves when it loses a local customer's loop service, and that's exactly the way all of us folks on both sides of the aisle calculate effectively what the long-run incremental cost of the loop is.

So when BellSouth loses a local exchange customer, its local exchange service, they save the cost of the loop. Conversely, when a new customer comes on the network, or a CLEC customer switches to BellSouth, and they have to put in a loop or they have to use up a loop that's already in spare capacity to serve that customer, the day on which BellSouth has to relieve some facilities is pushed forward in time. That's an increase in cost. And that is exactly the incremental -- long-run incremental cost of the loop. BellSouth

incurs that cost when it loses the customer.

Look at long distance service. BellSouth provides intraLATA long distance service. What happens when a BellSouth customer signs up with AT&T? BellSouth saves all of the usage costs that it has to serve this customer. Does it save any loop costs? The answer is no. It still has its loop, still provides the loop by assumption, it saves no loop costs. The distinction should be clear that when a -- when basic local service changes providers, loop costs change for BellSouth or for Sprint. When toll service or any other service you can think of that's sold separately changes, loop costs do not change. So from the point of view of what's going to happen in competitive markets, it ought to be clear that the loop cost is incremental to basic local exchange service and not to any other service.

MS. BUTLER: Dr. Taylor, can I ask you a question, please?

DR. TAYLOR: Sure.

MS. BUTLER: I'm Melinda Butler.

When you had the example a minute ago to demonstrate that the long distance carrier didn't have loop costs, you were assuming that there was zero long distance usage, right?

DR. TAYLOR: No. I mean, by the customer or by

whom?

MS. BUTLER: Well, you said that it was a usage-sensitive charge to the IXC in terms of, like for instance, when they do terminate or originate, they do pay access --

DR. TAYLOR: Yes, per minute, that's correct.

MS. BUTLER: Could you explain how that doesn't translate into a --

DR. TAYLOR: Into a cost?

MS. BUTLER: Yeah, please.

DR. TAYLOR: Sure. By the definition that we've used of cost causation. Because AT&T pays per minute to originate and terminate traffic, it doesn't save anything if a loop disappears or if loops become more cheap. Well, if a loop disappears, it doesn't save anything. Its costs are entirely -- its costs, AT&T's costs, are entirely determined by the volume of usage which goes down the pipe. And that's correct, just as the Domino's pizza costs don't depend at all on the cost of a local loop. The cost of a pizza, you know, look at Domino's costs, its costs are flour and tomatoes and all that, plus what it has to pay for telephone service.

COMMISSIONER GARCIA: Doctor, let me ask you another question, and maybe it will pull you off, but

it was -- something stuck in my mind and I wanted to use your powerful intellect to help move me away from this position.

The other day we were talking about -- and I think I might have even asked the question, but it's sort of been rolling around. We were talking about mailing and billing, and let's say that it takes 32 cents to bill for the local company --

DR. TAYLOR: Yes.

COMMISSIONER GARCIA: -- the cost of the stamp. Let's add to that, let's say that the total cost of the bill is a dollar, to make up a figure, including postage, paper, everything included. Should -- in that bill, should other services pay for that cost that already has to be made? In other words, if I were -- the company was billing me and I was getting a vertical service, say call waiting, it's just one line. It hasn't added more paper weight, so I don't have to pay more postage. The ink is, I would assume, almost negligible. If you want, we could toss a penny in it.

DR. TAYLOR: No, let's be generous.

COMMISSIONER GARCIA: All right. It's not our money anyway, right?

DR. TAYLOR: That's right.

COMMISSIONER GARCIA: So that said, shouldn't that

service which is dependent on that billing to some degree help pay for that billing, help -- and I don't want to add the long distance, because you're right, that's usage, but you can sort of -- but that vertical service exists primarily because that phone line is there. If that loop wasn't there, it wouldn't exist. It's contingent. Shouldn't then that loop be paid for to some extent by that vertical service, especially if it's a vertical service that the majority has?

DR. TAYLOR: Okay. The answer to the last question I think is no, where I'll go. The answer to the billing question is I think probably yes, and what we are trying to do is distinguish between what costs are common to a set of services, and the bill example is a good example of that, and the loop and even vertical services where I argue that actual cost of the loop is not common. Let's see if we can sort out what the differences are.

For the billing function, if -- and let's simplify the billing one a little bit. Let's just suppose there are two services, usage and subscription, so there are only two. If you can buy usage from somebody else, you know, so the two are not inextricably intertwined --

COMMISSIONER GARCIA: Tell me what you mean by usage, because --

DR. TAYLOR: Oh, local or toll usage, I don't care. Just usage and the loop.

The cost of billing for those two services is a common cost. That is, if I have only one -- if I have only toll service, I incur the 32 cents, if I have only usage service, if I only have the customer for usage service, by assumption I'm going to have to send 32 cents. So the cost doesn't change whether I'm in one business or the other, and it doesn't change -- well, it happens to be proportional to the number of customers I have, but that's okay. That's a common cost. It doesn't change -- under these assumptions, it doesn't change when the mix of services that I provide changes.

Not so for the example -- the second example, that of the loop and you were using vertical services. The loop and basic local service are one and the same from a pricing perspective; that is, you can't buy access to the network, in Florida, you can't buy access without buying basic local service. That's what basic local service is with some usage thrown in. So in this case they are not -- the loop and -- the loop cost is not common between local service and vertical services because we can identify one service, basic local service, which, if you sell it, you incur the cost, if

COMMISSIONER GARCIA: And I can't get a newspaper if I don't pay for it.

DR. TAYLOR: Right.

COMMISSIONER GARCIA: Isn't that similar to the bundle of services that come with a phone? In other words, shouldn't incrementally all those services that make up a phone, some more, some less, but overall -- I mean, some of us buy the newspaper to read the front page and local news and could care less about sports, so we toss it, but it's there as part of the bundle. Others just read the sports page, and so they have to get all this other stuff and they toss that. But it's in -- it's a bundle of services which are essentially part of that loop, that it's all part of it. I mean, we -- shouldn't we then, because it's all part of it, just like the guy who only reads the sports page sort of pays for the rest of it because he knows there --

DR. TAYLOR: Right.

COMMISSIONER GARCIA: Shouldn't then I, who just read the national news, have to pay for those other parts of the paper because that is how this is produced?

DR. TAYLOR: Right. You have a bundle of services in the newspaper example which cannot be separated. They're --

COMMISSIONER GARCIA: Well, they could. They --

DR. TAYLOR: Well, they won't stand on their own.

COMMISSIONER GARCIA: Well, no, but, see, Doctor, that's the problem that we have here. Long distance service will not stand without someone providing a loop. The sports page, as wonderful as it may be, most national sports newspapers fail. They aren't able to find a niche market that can sustain their existence. However, local sports pages are essential to a newspaper.

DR. TAYLOR: By assumption.

COMMISSIONER GARCIA: Well, I don't know for me, but they are as a general rule.

DR. TAYLOR: Yes.

COMMISSIONER GARCIA: So what I'm saying is that shouldn't all those parts pay for that vehicle on which they arrive to you, just the way all of us are willing to understand that concept? Shouldn't local service be that bundle of services? You may pick one of those additional services, it may cost you more or less. For example, in my case, I pay extra in Miami to get the Spanish paper. I don't have to really get that, but I'm charged, and I'm sure that the local paper, and for many years the local paper subsidized that Spanish paper because they had an interest in penetrating and

entering that market, but that's even more complex than I want to get.

DR. TAYLOR: Sure.

COMMISSIONER GARCIA: Let's just stay on the paper. Shouldn't all those parts of the paper, and I'm not -- let's move now to the -- let me get away from the paper. Let's -- shouldn't all those parts of the loop, of --

DR. TAYLOR: Of telephone services.

COMMISSIONER GARCIA: -- telephone services pay for their opportunity to reach you and therefore pay for that loop? In other words, all those who are involved pay for that --

DR. TAYLOR: Okay. The question really is, should, that was the bottom line question, should these other services, and you've restricted it to telephone services, so you've thrown out my pizza, but that's okay. Should they pay for the opportunity to use the loop? The answer is yes, they should, if they cause a cost to be incurred, and no, they shouldn't if they don't.

In the newspaper case, it does cost more to provide other newspaper services. You know, so there are costs involved in producing an additional sports section, an additional advertisement, et cetera, et

cetera. But for the loop and for telephone services, there is no difference in the obligation that AT&T should have because it depends upon the loop to market its service than L.L. Bean should have to the extent that it depends upon the loop to market its services. And the reason for the -- for that is because neither of those parties' services impose any additional costs on the loop. We're jumping between questions of value and benefit and questions of cost, and at least for the moment, when I'm talking about what the cost of the loop is, I want to keep it strictly on cost.

Now, when it comes time to price the sucker, we can talk again, because there are other elements of pricing the loop, basic local service, that come into play, economic efficiency, other public policy objectives where you may want to use dependence of some sort as one your standards, but it's not part of costs. And that's -- I guess that's a very important part of my message. If you want to behave as if all services, when toll service uses the loop, it adds cost and therefore should pay, I think you're making a big mistake, because that's not how costs are incurred. If you want to price basic local service along with universal service and all the other policy parameters you have to play with in order to encourage universal

service or whatever, fine, there are a lot more reasons to do that than simple economic efficiency. But at the moment, it's just cost, and we've got to keep it separate from benefit.

MS. BUTLER: Dr. Taylor, I wanted to follow up on a question about the idea that the IXC isn't incurring any costs of the loop.

DR. TAYLOR: Yes.

MS. BUTLER: I must have misunderstood your answer, because it sounded to me like what you were saying was that the reason why we can't conclude that they're paying any loop costs is because they're paying a nontraffic sensitive charge back to the LEC.

DR. TAYLOR: Oh, well, no, that's -- at least at the FCC, that is a regulatory fiction, I guess, if you like. That is, AT&T is required to pay the carrier common line charge which is derived -- well, it's actually price capped these days and frozen or price capped, but is derived from NTS costs, blah, blah, blah, but that cost is not one that AT&T incurs when it gets another subscriber, when another subscriber comes off the network.

MS. BUTLER: No, but it is incurred with usage.

DR. TAYLOR: It is incurred with usage, that's correct.

MS. BUTLER: And it is a regulatory decision that it's charged that way and a regulator, the FCC, could decide to change the rate design and they could charge enough to front charge.

DR. TAYLOR: Oh, and they are very much acutely aware since Docket 7872 that this is an inefficient way to recover the nontraffic sensitive costs that they were assigned to recover, and it's as busy as it can be trying to reduce those costs.

MS. BUTLER: Okay. So if that's the case then, I don't really understand then how it could be concluded that the IXC doesn't pay any costs of the loop.

DR. TAYLOR: I'm just speaking as an economist. It doesn't pay costs of the loop because when another customer comes on the network, their costs -- AT&T's costs don't changes. When a customer leaves, their costs don't change. When another customer comes on the network, the local exchange carrier's costs go up by the long-run incremental cost of the loop. When it goes away, they go down by a --

MS. BUTLER: Okay, that's fine. Thank you.

DR. TAYLOR: Okay.

MR. DUNKEL: I have one question following up on this question. Part of the confusion is that AT&T uses the same loop that's used for local and used for other

services, is that a correct statement? I mean, they share the same loop with other services.

DR. TAYLOR: Sure.

MR. DUNKEL: Let's say a regulator was bothered by this confusion and so they passed a law that said AT&T can provide only toll service and it cannot share the loop with anyone else. It must build its own facilities. Under that condition, if AT&T was going to be in the toll business, would they have to provide a loop?

DR. TAYLOR: By definition, by law, not by economics.

MR. DUNKEL: Would the cost of that loop then be a part of the cost of toll service?

DR. TAYLOR: It would be a service-specific fixed cost, yes, of toll service by that -- under this legal hypothetical, yes.

MR. DUNKEL: Fine. So now, if instead of building their own loop, they rent a loop or share a loop with other services, your argument is that that cost of toll service now immediately goes to zero? The loop cost of toll service is now zero because they're sharing a loop with other services?

DR. TAYLOR: That's right, because when they get a customer for their toll service, they don't have to buy

a loop anymore, they don't have to build a loop anymore. They can get one for whatever it costs, and it doesn't cost anything to use it.

MR. DUNKEL: And they rent the loop instead of build the loop, is that correct?

DR. TAYLOR: I wouldn't even say they rent the loop. They rent the loop in the same sense that I rent your loop when I call you up at night. You know, the call uses the loop in the same way that my software uses my computer.

MR. DUNKEL: Okay. You agree, if they built the loop, that would be a cost -- if they built the loop for toll, that would be a cost of toll, you agree with that?

DR. TAYLOR: If they were required to, yes.

MR. DUNKEL: But if they rent a loop for toll, that's not a cost of toll?

DR. TAYLOR: If they do not have to -- if they're not required to build a loop whenever they got a toll customer, then the loop is not a cost of toll, that's correct.

MR. DUNKEL: But if they rent a loop for toll, that does not cost as a cost of toll?

DR. TAYLOR: I've already answered -- I've answered it -- that question.

MR. DUNKEL: Thank you very much.

DR. TAYLOR: You're welcome.

Okay. Is everybody crystal clear? And this again is the example that I want to use because it's the one that's relevant for competition. As I said, you could legislate that the loop is a common cost, but the prices that you would end up with under that assumption would not be sustainable in competition. Why would AT&T -- or, let's pick on Sprint. Why would Sprint -- we better not, they're a local company. Why would MCI not -- why would they have an interest in building a loop to reach a customer at a price below cost when they might not be able to overprice toll in a competitive market to recover that?

Conclusions, well, you've heard all that. Lickety split -- I heard yesterday about stand-alone costs from Marvin Kahn, and I'm not sure exactly where Florida is on stand-alone costs. That actually caught me by surprise because I would have said in my years in this business I've never seen a stand-alone cost study, but he seemed to imply that there had been some things that purport to be stand-alone cost studies filed in Florida.

The difficulty -- there are two things about stand-alone costs from my perspective that you need to

know quickly. The first is, you don't need one. You don't need -- I agree with Dr. Kahn. I think all the economists agree that subsidy-free prices are those which fall between stand-alone costs and total service long-run incremental cost. No disagreement there. Why don't you need to know what the upper bound is? Why don't you need to know the stand-alone cost? Well, two reasons. One, what you really care about is cross-subsidy. It's the other side of it. You really care if a price for a regulated firm is being set for a competitive service below the cost of providing that service, because when it is, and if the firm is made whole, other customers of the firm are made worse off. That's a bad thing. A stand-alone -- a price above stand-alone cost means that some service would be providing a subsidy, but the fact that it's above stand-alone cost, if you've done the stand-alone cost study right, means that anybody can come in and provide that service.

Now, I don't care if a natural monopoly or whatever, if it's priced above stand-alone cost, then by definition, I can come in and provide nothing but that service, if I'm as efficient as the LEC is, and compete. So it's not really a problem.

The second reason why it's a dangerous thing is

stand-alone cost studies are sometimes nonsensical to do. Incremental cost studies are fine because they're increments. They change the real world a little bit from where it is and ask what the consequences are. Well, as y'all know from the models that you see, that's a hypothetical world, but it's one in which, you know, our engineers are reasonably competent, they know what it would be like to design a network that would have a little more usage or a little less of something. That's a reasonable thing to ask an engineer to do. To ask an engineer to design the optimal network to provide call waiting -- I mean, try that some time. Go to one of your engineers and say, "What kind of network would you have if you just provided call waiting?" They'd look at you as if you were crazy. That's -- whatever it is, it's going to be far from the network that anybody, AT&T or BellSouth, has today, and to use the results of a study like that to set prices or to determine social welfare is using science fiction in the pursuit of science, I think.

So that's my plea on stand-alone costs. They're not necessary and they're probably not right. And I think that miraculously takes me to the end. Let me close just on a positive note.

We all look at this problem of allocating loop

costs and of trying to get basic residential local service prices right as a terrible problem because it's so politically charged and because we've had a long, long history in the United States of, from my view, mispricing those services, and it's very difficult to change that.

And just two quick things in summary. It isn't that difficult if you do it slowly, and I think the FCC's experience and the experience in Massachusetts, where I come from, has been that. If you ask people if they'd rather pay more than less, they'll tell you they'd rather pay less. That's an obvious one. But if you rebalance rates carefully, not overnight, I think the experience that we've had in the states and at the FCC has been that it's been a phenomenal success as far as economic welfare is concerned. And that's really the second point, too, that there's an awful lot of welfare involved in this. The range of services that are now available on the telephone, which weren't ten years ago when prices last changed in Florida, are immense. If you remember Bob Harris's talk yesterday, the -- what I would learn from that were I a Commissioner would be the danger of essentially taxing usage of the network. We incur all of these big essentially fixed costs, costs of the loops that don't

vary with usage, and then having incurred all of that, we tax usage, we price usage above its incremental cost, which discourages usage to a great extent.

COMMISSIONER JACOBS: Isn't there another aspect of that in that you may not be sending the right price signal on usage?

DR. TAYLOR: Absolutely. It discourages entry -- or, excuse me, encourages inefficient entry as well. That is, if usage is priced way above the cost of providing usage, we may get resellers who may not be efficient firms but who can still come in and serve, but they wouldn't be able to serve if the price were set at -- in a competitive market. So there are all kinds of inefficiencies which come about, and as we move into this sort of Internet data, who-knows-what world coming in the future, if I were going to make a mistake as a regulator, I would make a mistake by underpricing usage and overpricing access rather than the other way around.

COMMISSIONER GARCIA: Let me ask you another question, and I know I'm sort of stuck on this, if you'll forgive me, and I've slowed down your presentation a little bit, but let's use legalisms again.

Let's say that the state, Florida, said we're

going to own basic service. We're going to say we as a state feel that it is essential for every single Floridian to have access to a phone and therefore we're going to eminent domain you, we're going to buy all the local companies and we're going to figure out a price and we're going to pay you all what you've got in the ground, and now we suddenly own this system.

DR. TAYLOR: Okay.

COMMISSIONER GARCIA: And the way we're going to pay for this system, if you had to design it, how would I make -- if I made this decision, how would I make that system pay for itself? Wouldn't I charge those who use the system? All I own is local service, not even vertical services, just a black phone.

DR. TAYLOR: Just the line?

COMMISSIONER GARCIA: Just the line. So --

DR. TAYLOR: Not even the black phone?

COMMISSIONER GARCIA: Not even the black phone, just the line. In that case, how would I then pay for that system as a bureaucrat that has been named chairman of this national company, or this state company? Then, wouldn't it be the most logical way is to say, well, let's let the users pay the system, not the users as in the owners of telephones, we want to take care of them, but wouldn't I then take this system

that I have, this roadway, this network, just like anything else, and just make those who come across it to some degree pay for those who pay for -- have vertical services, those who pay for long distance? Which is in essence what we did, I mean, when we didn't allow the Bell companies to participate in long distance, we said, well, you're going to charge, and that's how we figured out how access worked and therefore that helped pay for this system.

DR. TAYLOR: Your example is very close to the Florida highway system, if you think about it. You guys do own the highways and sometimes you charge tolls and sometimes you collect gas taxes.

COMMISSIONER GARCIA: And, I mean, it costs me very little for a truck to drive as opposed to a car, yet I charge for the trucks to go through it much more than --

DR. TAYLOR: Value of service pricing, exactly. Yes, what is the difference between the problem that you've posed and the problem that nature has dropped on your desk is that in your case you are a monopolist of the local loop, your own one, and you can do anything you damn well please. That is, you can achieve any special policy you like, you can discriminate in favor of these people against those people if you like. You

can recover your costs, since that's your job, in any way you please. I would come in here and beg, as I'm sure economists in transport do, that you please set your rates in an efficient way mirroring costs as best you can, because if you don't, you're going to be screwing up things like whether traffic goes by trucks or whether traffic goes by rail or by canal or barge or whatever.

You have more choices in your world than you do in mine. In my world where people can come in and put in a loop and compete and do so everyday, and not even just a wire line loop, but a wireless loop, you know, of which there are many these days, a degree of freedom has been taken out of your case and bad things can happen if you behave in the telephone example the way you could in the road example.

Mr. Dunkel?

MR. DUNKEL: Let me ask a follow-up question. Let's take the Commissioner's example of a toll road where you're charging -- you charge everyone that uses it something, pickup trucks, cars, you charge them all something. But now let's make it competitive. Let's say there are five toll roads between the same two towns.

DR. TAYLOR: Right.

MR. DUNKEL: Would it be reasonable to expect that in that competitive environment that the long-run pricing would let the pickup trucks ride free but charge all the cars?

DR. TAYLOR: Well, let's see, we have -- let's assume we have nothing but nontraffic sensitive costs. How would, in a competitive market, those nontraffic sensitive costs get recovered from the great body of users? It's going to depend precisely on the price elasticity of demand. That is, if trucks have -- people have alternatives to trucks. Suppose there's a canal going down the --

MR. DUNKEL: Well, let's take pickup trucks.

DR. TAYLOR: Let me finish.

MR. DUNKEL: I know heavy trucks cause more wear, et cetera, let's eliminate that.

DR. TAYLOR: No, no, no, no, no. Oh, no, no, no. It has nothing to do with cost.

MR. DUNKEL: Pickup trucks and vans.

DR. TAYLOR: Hang on, Mr. Dunkel. It has nothing to do with cost. I'm trying to think first how I'm going to recover my costs. And the way I'm going to do it, if you'll let me finish, is going to have to be in competitive markets, I'm going to be driven by market forces. What are those market forces? Well, they

depend upon the alternatives that residential users, motorcycles, bicycles, horses, cows, trucks, have, and if trucks have lots of alternatives, put it another way, if shippers have lots of alternatives, then I'm not going to be able to charge much to trucks. They'll find it more profitable, that is, I'll find it easier to recover my fixed costs if I'm the state of Florida, if I, you know, charge the hell out of the little cars because they have no choice, and charge very little of these fixed costs to a big truck because if I charge any more to the big truck, it's gone and they send the shipment by rail.

MR. DUNKEL: Let's go back to competitive. There's five toll roads --

COMMISSIONER GARCIA: Excuse me, because I -- there's where I have a problem.

DR. TAYLOR: Sure.

COMMISSIONER GARCIA: Now, let's take it to another level. I'm Wayne Huizenga. I mean, I like Mr. Huizenga, nothing against him, but he's a very wealthy man. He's got seven lines at home and he makes tons of long distance calls, and you're a provider. You are probably going to say, well, you know what, you're more than paying for your cost on all the other stuff, so I'm going to give you your service free. And

then I'm the basic service provider, I'm the -- if I'm the poor guy, the guy who is just getting basic service, I'm going to pay.

DR. TAYLOR: Well, be careful. If you're a poor guy, say --

COMMISSIONER GARCIA: I've got no options.

DR. TAYLOR: Right. Take an elderly person who really needs the phone and who makes no calls. What a paradoxical position to be in. Nobody wants to serve such a customer at prices -- loop prices below cost. Is it fair that the -- this elderly, let's not say poor, but this elderly person pay his cost of the loop where your rich man example does not pay his cost of the loop in the price of the loop, but pays for it through whiz-bang services. Fair isn't what I'm good at. Fair is what you're good at. It's inefficient, I can tell you that. That is --

COMMISSIONER GARCIA: Well, maybe that's what we're looking at here, and that's why I'm asking those questions. Fair is part of the issue that we're asked to look at.

DR. TAYLOR: Right. See, the problem, though, when I step one step beyond fair is that high volume users -- there's no way in a market that we can keep high volume users making this contribution to keep the

system whole once you can provide the loop and usage separately. It's just not a choice anymore.

COMMISSIONER DEASON: I have a question.

DR. TAYLOR: Yes, sir.

COMMISSIONER DEASON: It seems to me that a key to this entire analysis is the concept of cost causation.

DR. TAYLOR: Yes.

COMMISSIONER DEASON: And it also appears to me to some extent you almost have to go inside a customer's head and ask the question, when they go to BellSouth or any company and request telephone service, why are they doing that? Because it's that customer's decision to request that service that is causing the cost. Would you agree with that?

DR. TAYLOR: Yes, I agree with that. It's the decision that causes the cost. I would urge you not to go inside his head and ask why.

COMMISSIONER DEASON: Well, I guess that's some of the difficulty I'm having, because if you go to that customer and -- because their expectation when they subscribe to service is that they're going to have local service and access to toll service, and if they so choose, access to vertical services. If you go to that person and ask them that question, they're probably going to say, "I subscribe because I have

these services." But hypothetically if you were to say, "Well, the cost of providing you service in your location is $40 a month, that's what it's going to cost you, $40 a month," and he evaluates that and he says, "Well, $40 a month, but with that I get local service and I can call my son who is in college, which is important to me, and I have access to the toll network, I'm going to pay $40." But if someone were to wave a wand and say, well, no, you no longer have access to the toll, $40 is the cost of providing you local service, and that's what it's going to cost you, and he may say, "Well, that's a lot of money and I'm really not interested in paying that, so I'm just not going to get on the network," now, what does that do?

Well, for all of the IXCs, they have lost a potential customer, because he's required to pay $40 for local service. And if you were to go to an IXC and say, "Look, I know this customer, if he would have subscribed to local service, he would have picked you as his IXC and he would have made $10 a month in long distance calls calling his son. How about you kicking in $3 and let's charge him $37, and everybody's better off?" Now, how do we assess that situation?

DR. TAYLOR: Oh, that's, I think, a situation which can occur and it's probably a good thing that it

can occur in this world where IXCs and local exchange carriers and everybody can compete. You've seen cases I think in Illinois or places where some CLECs -- I think AT&T or MCI might be one of them -- have actually offered free local service, that is, a calling plan where we're not going to charge you extra for local service, but you're going to pay us $40 a month or $50 a month or something like that. We're going to give you toll for eight cents a minute or something like that, and part of that, we're going to throw in local service for free, and that's fine. You know, that gets at the problem that you're looking at.

It's not a problem which has occurred before in the past, because whenever one buys basic local service in Florida in the past, part of that package has been access to every other service, including Domino's Pizza and Land's End, and that's part of the value when -- you're absolutely right. That's how people decide whether to subscribe or not, you look at the value of the service to you, given all the things that you can do with it, you know, given that you have to pay AT&T 12 cents a minute or whatever, but it's worth it to call your son across the country, and there's enough left over after you've done that to make it worth paying for it.

That's the kind of decision in principle people make when they put in a phone. And, you know, in the market that works out just fine. I don't think what it says is that you've got to subsidize for everyone, that we could only have one package, that is, we'll have a package where local -- the local price is $20 so that people will be encouraged to make long distance calls. I think that's the wrong thing. I think IXCs have exactly the right incentives to aim their packages at high volume users and set prices that make sense for their customers, but you wouldn't want to force people, you wouldn't want to have one price, you know, $20, with the expectation that we'll pay for it because, on average, people will be making long distance calls, because then AT&T can come in or -- sorry to keep picking on them -- but any other IXC can come in with a lower per minute price and not give the rebate and make money.

Yes? No?

Thank you for your attention.

MS. MARSH: Thank you, Dr. Taylor.

We'll continue with Joe Gillan.

(Whereupon, a pause was had in the proceedings.)

MR. GILLAN: Before I begin my semiformal presentation, I think I want to make an observation,

because it seems to me in all the years I've been coming to Florida doing work here, this is one of the odder proceedings that I've ever been involved in. You've not actually been asked to make a decision, at least in this one, and it's not really even clear to me what the problem is that the Legislature is preparing to address, and that's what I want to direct my observation to.

On the one hand, there appears to be this is all a foundation to go up to the Legislature and answer the question, should the state of Florida create a governmentally collected, externally imposed subsidy to go give to somebody for some purpose, so we have a question of creating a subsidy fund. In addition, though, or separate from that, or somehow linked to that, there's a separate question about, should the Legislature either authorize through legislation or send back to you a rate restructuring of an incumbent monopoly local telephone company's prices?

And I think there's a lot of blurring between those two questions, because on the one hand, if it's universal service that we're after and we're trying to figure out who needs help and why, and if it's a rate restructuring, I would submit to you and I think I'll go back to this in my comments a couple of times, this

is a very odd time in history to approach BellSouth as a monopoly and try and decide what should be the monopoly rate structure for that company, when the stated objective of the state of Florida and the federal government and everything else is to make them no longer be a monopoly. And if they weren't a monopoly and if in fact you could have competition, then an awful lot of the questions that are being debated here, like what is the great -- the best balance, the optimal balance, between what you charge a customer on a flat monthly basis as opposed to what do you collect from them in the other things you sell them, would be decided by the market. It wouldn't be decided in a regulatory context.

With that as a backdrop -- now, I'll apologize for this next slide, for the spelling. We have a fixed cost d-i-l-e-m-n-a, which is very similar to a dilemma. It shows what happens when you rely on a computer to give you an answer, like whether your slides are correctly spelled. It's probably a lesson you should apply when you look at the cost studies.

I could have phrased this slide in one of two ways. I could either disagree with everybody or agree with everybody, and since, you know, it's Friday, I'll start out by agreeing with everybody. Dr. Taylor is

correct -- and, you know, you'll never hear me say that again -- in a very limited, narrow way. The fixed costs of this network cannot be allocated, okay? I mean, it's ridiculous to sit around and try and talk about allocating those costs to different things as a regulator. The reason is because whatever you do is inherently arbitrary, and to an economist, the concept of arbitrariness is really hated.

Now, to the rest -- I realize it's sort of the organizing principle of the rest of the world, but in terms of an economist's perspective, the notion is, you can't allocate these, and he's absolutely correct.

On the other hand, Mr. Dunkel and everybody else is also correct, just because you can't allocate these fixed costs doesn't mean you pretend they only do one thing. They don't. This -- the whole nature of telecommunications, the whole organizing principle of the market going forward, is all based on this idea that if you win a customer, it's going to cost you something to serve them, that it's going to be independent from all the other things you can sell them and your job as a competitor or as a monopoly today is to figure out, gee, given that, how do I figure out what is the best set of prices to use to attract and win that customer?

Our proposal is a middle ground, but it goes back to, what question are you trying to establish? If the question you're trying to figure out is, gee, should we create a subsidy for BellSouth or for GTE or for one of these other ILECs, our position is, quit defining the problem in a way where there is no solution, quit defining the problem in a way where you either have to allocate these costs or pretend these other services don't exist. What matters to BellSouth and what matters to every competitor is, does all the money I get from this customer at the end of the day -- forget how I get it -- does all that money make that customer profitable to serve? And in fact the only cost that we could all in this room sit down and agree about is what is the cost of providing them that package of things that they buy, that package that has the basic local service, that has the vertical service, that represents the receipt and delivery of long distance phone calls and ECS calls, which is really the greatest category of calls -- revenue-producing calls we're talking about. Look at that total cost and look at the total revenue of that package, because that's going to tell you whether or not customers are profitable.

And, you know, I refuse to submit to you that it's rational in any way, sense or form for the Legislature

or you to create a universal service fund to collect government subsidies to hand to a company to serve customers that are profitable. That doesn't make any sense.

Bell looks at it this way when they sit down, any entrant's going to look at it this way if they ever get into this market. What matters is, does the total check the customer writes at the end of the month cover the total cost to do it?

What do we know from the data we've seen so far? Basically that some -- well, clearly, some packages are profitable, some customers are profitable, others are not. We know that the average residential customer is profitable, which means in terms of a universal service fund, I think the starting point you have to recognize is that yes, there are probably some residential customers out there that aren't profitable to serve. You have to ask yourself two questions: A, should I care? And, B, if I do, how do I find them and give somebody a subsidy to make sure they continue to provide service? But it sure isn't the majority of the residential class.

And, secondly, this has nothing to do, or should have nothing to do with giving BellSouth the ability to reduce business, or any of the other ILECs the ability

to reduce business rates and become revenue neutral through a residential rate restructuring, because the reality is both the average residential customer and, by extension, the residential class is already profitable to serve.

Now, having said that, a big question got raised yesterday that I heard, and that is the question of how do we bring competition to the residential market? Because if what we're talking about is a rate restructuring proposal or a desire for the Legislature to design BellSouth's retail prices, then the reality is that if you put a bunch of carriers into the market, place each with that same problem, then they will go out and figure out different ways to win and attract customers. I don't know, BellSouth doesn't know, Dr. Taylor doesn't know whether or not that competitive process will yield prices that the full cost of the loop is recovered in a recurring, fixed monthly rate with all this other stuff given away for free. My own suspicion is that if we were to get to that point, it would take a decade or more. There's no way you would expect that, going in, that that pricing would change that rapidly.

Look how the -- the long distance industry is a perfect example. There are fixed costs to serving a

customer. In 1982 when MCI first went into the marketplace, it went into the marketplace initially with a rate structure where they had like $5 a month that you had to pay, and then you made cheap long distance calls, and then you had different prices depending on different city pairs you called, because that reflected MCI's cost structure. That rate structure lasted about six months, maybe less. They quickly moved to a rate structure that consumers could understand, even though it didn't reflect their underlying cost structure. It took from '84, equal access, where it says 14 years of long distance competition before we get to the point that AT&T comes in with a flat rate to reflect the fact that there are customer-specific monthly costs, and even then I would submit to you that the only reason we saw it in the time we did is the FCC changed the structure of access charges to impose a PICC, a monthly fee you pay the local telephone company, which today starts out for residential customers, which starts out relatively low, but it's scheduled to ratchet up to be several -- you know, four or five dollars a month.

So, I mean, it's clear that the fixed costs were going to increase for the access charge. That's how we got there. Competition intake is there instantly, or

even, you know, in any short order.

Going back to the slide, will higher prices for entry, and what I hope to explain to you, plead with you, is what type of competition you see in the local market today and why do you see it, and whether that's going to change whether you do anything to residential rates or not.

There are two sort of fundamental types of telecom services out there, what are called design services and the other form actually does haven't a name, but we'll call it mass market.

Design services is the term of art inside the telephone industry to refer to a service that is sufficiently complex that it falls out of whatever provisioning system you're using. It falls out of the RBOC's provisioning system, it falls out -- entrants barely have a provisioning system. It means that whatever it is you're selling this customer is sufficiently complex that it basically has to be manually put together in some way and sold to that customer. Maybe it's a Centrex product, maybe it's a -- it's certainly multi-line, probably has data components to it.

Now, in the design services portion of the market, if I'm an entrant and I've got to put together

everything I sell on a manual basis, the fact that the customer would go through a similar cumbersome system process with the ILEC is not a problem. So I can go into the business market and sell those types of services.

I don't want what I'm telling you to be misconstrued to say that price plays no part. I mean, obviously, one of the reasons you see competition in the business market is because of the fact that the prices are so much higher. But the other reason you see competition in the business market is because the types of services those businesses buy do not represent a fundamental barrier to the entrant. In fact, if you're a small company with only a few customers, you're likely to be able to put together that provision and provision that manual service more efficiently or more quickly than the incumbent whose basic business is handling things on an automated basis.

Mass market is fundamentally different. Mass market, and by that, I would refer to, you know, your typical R-1 customer, your typical B-1 customer. That portion of the market relies -- exists spread out everywhere, and in order to penetrate that portion of the market, you've got to have some way to be able to provision service to them that's very inexpensive on

the front end. It has to be automated, it has to be electronic. Long distance competition took off because you implemented equal access and the cost to convert a customer from Bell to a rival or from AT&T to a rival became a software step costing probably under a dollar, electronically implemented, provisioned all the way through through an automated system. There was no transactions cost here that made it very difficult to provision customers once you won them.

When we look into the local market -- go ahead, Joe -- that is the fundamental barrier keeping carriers out of not only the residential market but the small business market as well. You need to have systems for network element combinations because this was true in '95, it was true in '96, it was true in '97, it's true in '98, it's going to be true for at least five years, maybe ten, that if you want to go into the mass market where you can run an ad and take customers from anywhere, you have to have something that you can provision that's ubiquitous, that has this inexpensive customer migration capability, which means it can be provisioned automatically.

Only one entry strategy in the past four years has been identified as potentially meeting these characteristics, and that's buying both the loop and

the switch capacity and everything you need to provision service from the ILEC. There is no other business strategy out there that will allow you to go there. That's the fundamental barrier, and until you address that barrier, all the rest of this is going to be unneccesary -- the reasons you might want to reprice, but it is not going to bring you residential competition.

And to give you some sense of the scale of this, let me take you through what it would take to serve a typical residential customer, given the things that are available today versus what could be, and put it in the context of how much of a local rate increase would it take to get the same result as just fixing this operational provisioning network element combining issue? If I go to BellSouth today -- and I apologize to BellSouth for always using you as the example, it isn't that the other ones are further along, it's simply that I have access to your data more rapidly -- physically, if I go, and I want to do this in the ways that BellSouth will allow me to combine network elements and actually get into business, I will pay them and them -- just the cost I pay them would be $178 per line. The nonrecurring charge associated with them going into their network, tearing the loop off of this

switch, dragging it over to a co-location arrangement and handing it to me, and the cost of them going over to their switch, tearing the loop off -- or the port off the loop, dragging it over to someplace where I can reconnect them, I pay them $178. In addition to that, I have all the costs associated with my guy, the manual processes for me to be able to recombine them. If that's done in an electronic manner, the Commission's set a nonrecurring charge of $1.45, so the difference between the way they'll let me buy it and an efficient way is $176, which, if you recover it in 12 months, if you try to recover that in the first 12 months of the customer, means that you're paying roughly $15 a month just to get back to the starting point of having those facilities connected.

Said differently, fixing this would give you the same -- more local competition in the residential market than a $15 local rate increase, because they are equivalent. Drop the costs by $15, raise the revenue by $15, it's equivalent. Now, which makes more sense? Fix this and get $15 worth of competitive -- potential competitive benefit, or raise rates by $15 to offset it? I mean, this should not be difficult as a decision of logic.

The other way to look at it is, if you raise local

rates for residential customers or encourage the Legislature to do it or tell them that it would be okay, there are other reasons why you might do it, but don't delude yourself that it's part of a process of creating local competition for residential customers. Rates go up $2, rates go up $4, rates go up $6, all you're going to do is have residential customers pay two, four, six dollars more a month to their incumbent supplier. It is not going to promote competition. That's the barrier. The price isn't the barrier, that's the barrier.

A final comment: I don't want anything to be -- that I've said to actually be interpreted either that there might not be reasons for residential rates to go up, and I'm going to relate to you an experience in my past of the political ramifications of a residential rate increase.

In '83 I was on the staff of the Illinois Commerce Commission when divestiture was first occurring. Illinois had a unique problem in those days. Illinois Bell had actually never used intrastate toll rates to create a subsidy to hand to independent telephone companies. It was embedded actually into their overall rates for local telephone service. So when we had divestiture and we made the policy decision to quit

having -- effectively, Illinois Bell quit subsidizing the independent telephone companies, we had to go through a process of allowing the local rates of the independents to ratchet up as this subsidy ratcheted down.

The two lessons I learned in that process were as follows: One, when we talked about the local rate increases being $2, $4, whatever it was, and so to give you a scale here, the ultimate increase for some of these companies was on the order of twelve to fifteen dollars a month increase in local rates, okay, so we're talking about a very dramatic increase in local rates for these independent telephone companies who predominantly served downstate communities. So, you know, you're really talking -- and this is 1983 dollars. So you're really talking about a significant price change. As long as it was talked about in an even number, everybody knew it was arbitrary and everybody thought -- everybody talked about it as, you know, how dare you raise my rate $2, what is your justification? And part of it was just driven from the fact that because it was a $2 increase, everybody knew you had pulled a number out of thin air. We ultimately made the increases things like $1.67, 7.23, numbers like that, and surprisingly -- I know, Charlie, you

hate this kind of advice -- there's a lot more legitimacy to it. So, you know, while economists may tell you that they hate arbitrariness, it appears to sell well in the public.

The other general lesson is be very cautious with extended transitions. Surprisingly, what we discovered was as you raised people's rates, it wasn't the ultimate rate that was getting them angry, it was the constant increase in the rate. It was that -- we did for some of these companies raise rates by $15, and I can't really recall the actual amount, but over like a five-year period. Near the end of that five years, these people were sick and tired of having their rates go up every damn year. Now, the reason was, they weren't so mad at the $15, but they were mad at, why is this continuous, why is this everlasting? I offer that because I don't want to be perceived necessarily saying that residential rates shouldn't be permitted to increase for a variety of reasons, but what I would say is that you shouldn't allow it to happen until you've solved this problem so that those people can vote with their feet, and therefore, you can allow the market to decide instead of Dr. Taylor's theories or BellSouth as a monopoly what the right combination of a flat rate and all these other optional rates should be. Because

it's not clear to me at all that the competitive market's going to decide that the best answer is $30 a month but you get everything else for free. In fact, I would be shocked if that's what the competitive market comes back with.

We've already seen, you know, Dr. Taylor even referenced it, the competitor in Illinois, they gave local service away for free because they wanted to get you to come to them to buy other things. Now, admittedly I think that was an example in the context of a business customer, but then again, that goes back to this other problem. There is no way to serve residential customers on a mass scale basis. That's been true from before the act and we've made almost no progress since the passage of the act in getting that resolved, and until that's resolved, you can't give the people the protection of voting with their feet, which is the final protection they enjoy, and that concludes my comments.

COMMISSIONER DEASON: I have a question. Could you describe again what you mean by physically disrupted combination and how that amount was calculated?

MR. GILLAN: Yeah. If I today wanted to come into the BellSouth market and run an ad, say, come to me for

local service, the only way that you could do that on any geographically broad basis is if you committed to buying all the things you need to provide the service from the BellSouth network. It's the only one that's out there that would give you that capability. So in essence, I'd have to buy a loop from BellSouth, I would have to buy a port, which would represent switching capacity, from BellSouth, and I would have to then buy the other things that interact with those network elements to provide the service.

COMMISSIONER DEASON: Buy everything from BellSouth?

MR. GILLAN: Buy everything from BellSouth. BellSouth's current -- the way they would currently agree to give it to me -- and bear in mind, at the end of the day what I'm going to want is that port reconnect -- that loop reconnected to that port. I mean, that's the way they go together. The way they would currently provide it to me is they would go and they would tear the loop down from the port, drag it over to a cage. That's manual. You know, they've got to dispatch a technician, you know, this is a manual process. They would then have to do something similar on the switch side to go drag me two wires, again sending -- dispatching a technician. It's all manual.

I would have to connect it. Because of all the manual activities in those steps, I end up paying them a nonrecurring charge of $178. I pay them in essence for tearing apart the network and handing it to me so that I can put it back together again. On top of that, there would be costs for me to put it back together again. If in fact we did this on an electronic basis where they essentially functionally disconnected these elements, handed them to me and I functionally recombined them using an electronic means, the estimated cost is $1.45. So the cost of all that extra unnecessary activity comes out to, you know, about $175 per line, and there's no way in the world that I -- any entrant facing this problem is going to come into a marketplace of average consumers, because even if I'm willing to sort of eat that over 12 months, which really implies that I feel confident that my customer's going to stay with me for 12 months -- you know, we haven't even gotten into how on earth did I win him and what did I sell him and how am I going to profit on him otherwise -- that's like $15 a month in unnecessary costs, and that's just -- in a residential marketplace, that's just a fundamental prohibitive barrier. Now, I realize you have something to add to this.

MS. WHITE: Yes, yes, I do. Nancy White for

BellSouth Telecommunications.

Now, Mr. Gillan, are you familiar with the June 12, 1998, order of this Commission?

MR. GILLAN: Yes. Is that the reconsideration order or the first order?

MS. WHITE: The first order. And it was -- reconsideration was not changed, I believe.

MR. GILLAN: Yes.

MS. WHITE: But didn't the Commission say that in the case of a migration of an existing BellSouth customer to MCI, the price MCI shall pay is the sum of the unbundled network elements for the loop and the switch port?

MR. GILLAN: I believe that there's a tag-on to that, is there not?

MS. WHITE: For example, when an existing BellSouth customer migrates to MCI and MCI orders the loop and port that serves the customer, MCI will receive and pay UNE prices for only those two elements.

MR. GILLAN: All right. My understanding is that the price for any other entrant would tie back to it having to come to you and renegotiate -- and negotiate whether or not that's recreating a service. Let me ask you this: If I walked to you today right now and gave you an order for a loop and a port, would you move the

whole service -- serving arrangement over to me, make me the access provider and charge me $1.45?

MS. WHITE: The whole serving arrangement is more than the loop and the port.

MR. GILLAN: Okay, all right. If that's the game we're playing, okay.

MS. WHITE: No, I'm not playing a game with you.

MR. GILLAN: No, no, no, well, wait a minute. I'm talking about buying something that would allow me to actually provide service. I have taken this $1.45. You and I know that you cannot provide any kind of service buying just a loop and a port. There are other things that I'd have to buy. I'm interpreting that your company would say, before you would permit me to buy all those things, I would have to go down the physically disrupted combination path in order to buy all the things I need to provide service. Is that correct?

MS. WHITE: Well, I believe Bellsouth would ask whether this combination that you want to buy, this list of elements that you want to buy, recreates an existing retail service.

MR. GILLAN: Okay. I don't want to debate the issue with you, I just want to make clear that we do agree that if I were to buy the things I need, you

would force me down this physically disrupted combination path and charge me that nonrecurring charge. Is that correct?

MS. WHITE: I don't have to answer. Thank you.

MR. GILLAN: Oh, all right. Well, I don't think there's a dispute.

COMMISSIONER DEASON: And the next question, when you refer to efficient migration, how is -- where did you --

MR. GILLAN: Get that number?

COMMISSIONER DEASON: -- derive the $1.45?

MR. GILLAN: The Commission did establish the nonrecurring charge that would apply if you converted a loop and a port, which is what Nancy, Ms. White was referring to. That would be all you would actually need to do if it weren't for this continuing legal debate in order to accomplish what an entrant has been seeking in this type of entry arrangement, the ability to migrate those facilities from Bell over to themselves.

COMMISSIONER DEASON: So there's a nonrecurring charge --

MR. GILLAN: So that's the cost of achieving that that the staff calculated doing a cost study.

COMMISSIONER DEASON: That's the nonrecurring

charge for ordering the loop and the port, is that what it is?

MR. GILLAN: For -- actually it's the nonrecurring charge associated with ordering and then provisioning them in an electronic manner. Now, it doesn't do me any -- it's an odd situation, Commissioner, because you ended up setting a price for an activity that doesn't have any usefulness anymore because of other parts of the order, and I'm trying to stay out of the nature of the debate because it's both -- it's very complicated as to where we stand today. But the staff did do a cost study that looked at what would the cost be to migrate these two key facilities over to an entrant.

Now, right now they come with strings. That means that it's not very useful to people, but that -- the cost numbers should no longer -- or at least the cost numbers that the Commission has calculated, and they're consistent, actually, with some numbers I've seen in New York. I don't think Texas -- there's only -- Texas has not established that second nonrecurring charge, the one associated with inefficient migration, yet.

COMMISSIONER DEASON: So you're indicating that if there is a mechanism to acquire a customer, an existing customer, in an efficient manner, that we will see -- we will see competition, because competitors are

competing for the entire revenue stream of that customer?

MR. GILLAN: Yes, basically, very simply is, if an entrant can get the local arrangement that they need as easily as a long distance carrier conversion occurs today, you will see, as you did at the days of long distance competition, people coming into the market broadly, and I feel confident telling you this because there's almost no progress in the southeast region, but in New York, Bell Atlantic is -- for whom admittedly long distance entry is a much more valuable carrot than it is for BellSouth, I think -- is going down a path of trying to make the operational systems to make this arrangement work.

COMMISSIONER JACOBS: So to add a little bit more to Commissioner Deason's summary, without the ability to compete for the broad basket of services in a mass market, just sending price signals won't accomplish --

MR. GILLAN: Won't accomplish anything. It won't accomplish anything in the development of competition, no. As evidence of that, go to Illinois where the prices today look a lot like what the prices they want to charge look like, and ask the Illinois Commission, do you see broad-based residential competition, and the answer's going to be no, or maybe you should ask the

staff. You'll get a fuller answer, at least.

There's been a lot of turnover, and the reason is that this whole process, this whole ability to get into the market, Ameritech will not implement it, and everything's stalled.

MR. McCABE: Tom McCabe for TDS Telecom.

Would you agree that there are some areas that are high cost and some areas that are low cost?

MR. GILLAN: Yeah.

MR. McCABE: Okay. Now, you talk about the entire package -- the entire revenue stream. In those high cost areas, would you believe then it would be best not to allow intraLATA toll competition, which essentially takes away a significant revenue stream?

MR. GILLAN: No.

MR. McCABE: Okay. So then -- but you're saying there's no need for high cost support?

MR. GILLAN: I didn't say that.

MR. McCABE: Well, I believe in your earlier explanation that customers are profitable based on revenue streams and therefore there's no need for a high cost fund.

MR. GILLAN: Yeah. I don't want to be misconstrued. I said that some customers are profitable, some aren't. The question becomes, how

many fall into these two categories?

Now, I had hoped to show you a distribution of BellSouth's residential customer bills, but unfortunately, my file got mugged as it went through the Internet and it became unopenable. And what it showed, at least for BellSouth, was that there was a very small fraction of the people that looked like they bought just basic local service. This distribution did not include even access revenues. But the most were up into an area where they would be attractive to serve, and the reality is, you don't have to get everybody profitable to serve for markets to serve them.

You know, my earlier point about AT&T's recent price change, those cost conditions haven't existed since '83, well, I mean, they existed at the date of divestiture. It took 14 years before they came out with a rate structure that tried to reflect that, and it's being actually driven by some FCC decisions more than anything else. So if you had a situation where, say, 70 percent of the market is profitable, serving 30 percent isn't, that doesn't mean that the 30 percent wouldn't attract customer -- you know, competitors, because nobody finely tunes their marking strategies.

Are there high cost areas? Yes, and we don't -- is there a possibility that we need to go into an

environment where you take money out of low cost areas to ship to high cost areas? Possibly, but actually, I don't hear a lot of that debate really being played out here. This is lot more about preparing for rate rebalancing or trying to legitimize -- in my opinion, trying to legitimize the rate rebalancing.

MR. McCABE: Yeah, I agree. I mean, I think that's the purpose of this proceeding.

MR. GILLAN: Okay.

MR. McCABE: So I don't think, when you were talking about that there's no need for subsidies, a governmentally funded subsidy situation to take care of high cost areas, that there's not a need for it.

MR. GILLAN: I didn't say there was necessarily not a need for it, but even then, it doesn't do anything to correct the competitive problem until companies like yours solve this, too. I mean, I would have an objection to creating a system that handed a high cost company money per access line without telling that company we're going to make this competitively neutral, and you have to make it just as easy for somebody else to come in and use that network to provide service as you, so that there's a quid pro quo here.

MR. McCABE: Okay. I'd like to follow up on

that. Since we're not in that situation and you referred to the fact that interexchange switches are relatively simple today and therefore the cost is not great, why is it that interexchange carriers choose not to go into rural areas, if you say that the cost is low?

MR. GILLAN: Well, when you say interexchange carriers choose not to go into rural areas --

MR. McCABE: Right.

MR. GILLAN: -- what do you mean by that?

MR. McCABE: Well, for example, we had an interexchange carrier issue, an ASR, and said, we want it just for government accounts, we do not want to serve residential customers.

MR. GILLAN: Okay. I mean, was that one single -- are you saying that you have no interexchange carriers?

MR. McCABE: No, we have some.

MR. GILLAN: Okay, but you had one come along that had a particular business plan. I mean, just like in every other world, there are people who -- I mean, Dell Computer is in a highly competitive industry, but it focuses on selling its computers to business customers, but you wouldn't draw that conclusion from that that there's no competition for computers. I just want to make sure we're talking the same language.

You have interexchange carriers competing in your service territory. You just have one who has come along who has a different business plan than the rest, and I can tell you that one of the reasons that interexchange carriers don't all compete in the residential market has nothing to do with the cost of being a long distance carrier. It has exclusively to do with what it's like to market to residential customers. That's the barrier in the long distance market to more residential competition. Residential customers get marketed to through voice and, you know, television and radio ads. Those are relatively expensive, so you've seen a few carriers, AT&T, MCI, Sprint, and more recently LCI, take -- do the business plan of trying to market into them. You've seen another carrier who's been extremely successful in the residential market, Excel Communications, who figured out a way to crack the marketing problem because they use this -- you know, the multi -- the nice word is multi-level marketing. But the notion is it's an Amway type arrangement, but it works. I mean, that's a great way for them to have marketed the service in the residential market and so they're -- I think they're the fourth largest carrier now, and it's almost entirely on residential customers.

MR. McCABE: I've got nothing further.

MR. GILLAN: Okay.

COMMISSIONER DEASON: Let me ask another -- kind of a follow-up to the previous question about IXC entry into the market, and that the -- I think the assertion was that the upfront, the cost of changing a customer for long distance service is relatively low, so you see a lot of competition even in high cost areas?

MR. GILLAN: Yes.

COMMISSIONER DEASON: Okay. Well, I know of one local company in the state that does not provide one plus access for intraLATA, and it's because no company has requested that.

MR. GILLAN: For intraLATA?

COMMISSIONER DEASON: IntraLATA. That's -- that doesn't surprise you?

MR. GILLAN: Well, I guess it surprises me, okay, at one level. At another level --

COMMISSIONER DEASON: It happens to be my local company.

MR. GILLAN: Okay. There is a -- I don't want to make excuses for my clients, but the reality is, since around February of '96, they've been really preoccupied with figuring out ways to get into the local market and the types of things you would have expected to see them

do when their focus was on being a long distance company has changed considerably. They do -- and in fact, quite frankly, I would expect to see less aggressive competition in the residential market in the coming years if we don't solve this problem, simply because if a long distance -- if a national carrier's management feels that it cannot defend its residential customer base because there is no way to get into the residential local market and therefore they expect that they will lose residential customers in dramatic proportion as soon as the local telephone company can provide local exchange service, and if all the evidence suggests that would be, in today's environment, the outcome, then as a manager, I would expect those companies to say, why am I running multi-million dollar advertising campaigns to continue to try and attract and win residential long distance customers if I cannot defend them in, you know, 12 months, whatever the time horizon is for the local company coming into long distance?

So I think, you know, the reality is, until this nut is cracked, you're going to see all kinds of phenomena in the marketplace that nobody wants, but may be unavoidable, and things like what you're describing are sort of a symptom of it. Four years ago if we had

intraLATA, that wouldn't have happened because there would have been so much emphasis inside these companies to make sure that that market opportunity could be exploited. Today most of those people are trying to figure out local business plans of some kind.

COMMISSIONER DEASON: I don't recall when this Commission ordered one plus access for intraLATA, but it's been some time.

MR. GILLAN: Yeah, it has been some time, but my recollection was that the implementation started to overlap into this other -- ascendancy of this other problem. But I'll tell you, I will take back to them this observation.

MS. MARSH: Thank you, Mr. --

MR. GILLAN: I don't even know if there's any intraLATA toll business in the particular market, really, to tell you -- if it's up here, I can't remember the dimension of the LATA here and how much of it is local.

COMMISSIONER DEASON: The company's GT Com. It used to be St. Joe Telephone.

MR. GILLAN: Okay. Isn't that one of those really small LATAs?

COMMISSIONER DEASON: It's a large geographic area.

MR. GILLAN: Okay, I know where it is.

COMMISSIONER DEASON: Population-wise, it's probably low, definitely a high cost area, but there's definitely a lot of toll calling because we have a lot of customers complaining that their local calling area is not sufficient to meet their community of interest's needs.

MR. GILLAN: Is that it?

Thank you for your patience.

MS. MARSH: Thank you, Mr. Gillan.

We'll take a 15-minute break.

(Whereupon, a recess was had in the proceedings.)

MS. MARSH: Our next speaker is Tom Regan.

MR. REGAN: Thank you, Ann.

I'd like to thank you for the opportunity and the privilege to speak with you here today. I'm going to address two issues.

The first deals with the relationship between business and residential basic rates, and when I talk about business and residential basic rates, I mean 1-FB versus 1-FR service.

Now, here in the state of Florida some of the LECs have been complaining that business basic rates are too high compared to residential basic rates. In fact, there have even been prcposals on behalf of the LECs

that we should rebalance these rates by decreasing business basic rates and increasing residential rates to offset that decrease.

Now, the Florida Legislature has directed the Commission to determine fair and reasonable rates on the basis of four specific criteria. These four criteria were affordability, value of service, comparative rates in other states and the cost of providing the service. As I will discuss and, I submit to you, after having considered these four criteria as they relate to business basic exchange service and residence basic exchange service, the current difference between the rates is reasonable and fair in the state of Florida, but first I'll go ahead and list the important factors and explain the difference between business and residence rates in Florida.

First of all, the rate relationship between business and residence is similar to the nationwide average. Secondly, telephone bills are tax deductible for business customers, but not for residence. Third, the business customers receive a valuable Yellow Page listing, which residential customers do not. Fourth, business customers place more local calls per line per month on average than do residential customers. A higher percentage of local business calls are placed

during the peak period of usage than is true for residential calls. And finally, business service receives faster repair than residence service does. I'll go into some of these in a little bit more detail.

On the next slide, I go ahead and show the rate relationship between business and residential in Florida compared to the nationwide average. Now, for business 1-FB service in Florida, the average is about $28. That's the average across BellSouth, Sprint and GTE. And for residential, it's about $11, which works out to a ratio of about 2.55. Now, the nationwide ratio of biz to res is about 2.38, and the nationwide ratio is taken from the FCC's trends in telephone service from July of 1998. So you can see the relationship that exists in Florida is not something unique to the state of Florida. Actually, nationwide there is quite a significant difference between residential and business rates.

Next, telephone bills are tax deductible for business customers, but are generally not for residential customers. If you take that average business 1-FB rate of $28 and you ask yourself, is that tax deductible for the business customer, yes, it is, and if you assume an income tax rate of about 30 percent, the cost after tax, the out-of-pocket expense

really to the business customer is only $19.60, not the $28 dollar tariffed rate. So for business customers, the out-of-pocket expense after taxes is much different, much less than the tariffed rate, but that is not true for residential. As you can see for residential customers, the $11 rate is the same, the $11 after taxes, and because of this tax deductibility difference, the business basic rate is much more affordable than the tariffed rate, but that is not true for residential.

Next, the business basic local service includes a Yellow Page listing worth up to $23.75 for BellSouth in Miami, and GTE and Sprint also offer valuable Yellow Page listings as part of business basic exchange service, 1-FB service. Now, on the previous slide we showed that the difference between business and residence after the tax deductibility issue was only $8.60. As you can see, a Yellow Page listing can easily, by itself, overcompensate for that $8.60 difference in rates. The value of the complimentary Yellow Page listing is a value to the business customer that does not -- is not part of the residential service.

MS. SIMMONS: I'd like to ask a question. Sally Simmons with the staff. And perhaps the LECs can

respond as well, but what you've presented up here, I'm not aware of that to be the case. Now, perhaps the LECs can comment, but --

MR. REGAN: Okay. Let me just clarify the -- what I'm showing up here is the Yellow Page listing worth up to, for example, 23.75 per month. That is the charge BellSouth would charge to a business customer to have an additional listing in the Yellow Pages in Miami that is identical to the one that they provide as part of business basic exchange service. So if you were to buy another listing identical to the one you get free with your service, that would cost you $23.75 per month.

MS. SIMMONS: I guess I'd be interested in knowing, can any of the LECs comment on this? I'm still finding this confusing.

MR. REGAN: I obtained the rates that the LECs would charge for an additional listing in their Yellow Pages directory in Tampa, Tallahassee, and Miami. I called and asked a customer representative, what would it cost me to get an additional listing in your Miami directory if it was exactly the same as the listing I get free, complimentary with my 1-FB service that I bought from you? And they told me 23.75 per month is the charge.

MS. SIMMONS: Okay. I guess maybe we can pursue

it later. I'm just not aware of the complimentary listing, and that's why I was asking for input, but I guess there's no one here that's too sure about this either.

MR. REGAN: Okay. We'll move on. It's fairly common for 1-FB service to include a Yellow Page listing, and that's pretty common throughout the nation.

Next we'll move on to the fact that business customers receive faster repair than residence customers. Now, these were taken from discovery responses we received here in the state of Florida. We asked BellSouth what their average time to repair a business service outage was; they told us 9.9 hours. The average time to repair a residence service was about 14.8 hours, making a difference of about five hours sooner to repair a business service outage than for residence customers. And Sprint's, a similar relationship, about three hours less to repair a business than residence service outage.

Now, I understand that for businesses, time without service could mean lost sales, so it's very important to a business customer to have its service repaired quickly. However, this is a value added feature of business basic service that does not exist

for residential customers. And I'm not complaining that business gets faster repair, but they should pay for that premium added -- value added service, and they do through paying higher rates for basic exchange service.

In addition, there are other differences that justify charging businesses higher rates than residential customers for basic local service. For example, businesses place more calls per line per month than residential customers. They also place a higher percentage of their calls during peak usage periods than is true for residential customers. And most of the LEC studies in this special project have recognized the usage differences in their cost studies, although those relationships are proprietary and so I'll have to speak in general terms for purposes of this presentation.

The conclusion to all this is that business basic local services are properly priced higher than residential rates. Charging higher rates for business basic local service is not improper. There are affordability, value of service and cost of service justifications for charging the rates. The fact is that business basic service is a value added premium service; therefore, it is appropriate, it's fair and

reasonable to charge higher rates for business services compared to residential services. That concludes that issue.

We'll move on to the second issue, and that's the Florida PSC affordability survey, it pertains to that. Last week we heard from a presenter on behalf of the three LECs, GTE, Sprint and BellSouth, Mr. Don Perry. Mr. Perry had done an analysis of the Commission staff's affordability survey and he had presented some results that he said he had taken from an analysis of that survey. The fact is, the analysis did not provide the accurate results of the survey. As a result, Mr. Perry had made some claims that were simply not true. When you look at the actual survey results, it is clear that the claims Mr. Perry was making were simply not reflective of what the actual survey results were telling.

Now I'm going to address two specific claims that the LECs made with respect to the affordability survey.

LEC claim number one was that between 23 and 45 percent of those surveyed said they would discontinue service if basic rate was increased by $2. And I'll explain the difference between the version 2 to 20 and 20 to 2. In the Commission staff's affordability survey, a portion of the respondents were asked a

series of questions of rate increases in an inclining pattern from $2 to $20, and then a portion were asked the questions in a declining pattern from $20 to $2. And you can see from the 2 to 20 respondents, Mr. Perry was claiming that at a $2 increase, 23 percent said they would discontinue service, and of the declining group, 45 percent said that they would discontinue service at a $2 increase. Mr. Perry was saying that this is an unreasonable result. He cited some other studies that showed that it was nowhere near that. He said this was one indication that the survey was unreasonable.

The problem with Mr. Perry's claim, though, is that that is not what the actual survey results show. Below this I show the actual results of the PSC survey. For the combined groups of the 2 to 20 and the 20 to 2, only seven percent of those who were asked said that they would discontinue service at a $2 increase. So seven percent compares to the 23 to 45 percent that Mr. Perry was telling us last week in his presentation.

And on the next slide, I go ahead and give you a summary of the survey responses. There was 1,598 total respondents in the survey. As you can see, 113 of them said that they would discontinue basic local phone

service at a $2 increase. Similarly, 409 said that they would pay the increase and reduce spending in other areas with a $2 increase. There was also some that said they didn't know, data wasn't available, or there was no data provided. All of these survey results add up to the 1,598 total that were attempted respondents in the survey.

If I can move on to the second claim that Mr. Perry made that I'd like to address, the LECs' claim that of those who were asked about the rate increases in the descending order from $20 to $2, more said they would discontinue service at a $2 increase than at a $20 increase, and Mr. Perry was saying this is an unreasonable result. You would expect that at the $2 increase less people would say that they would discontinue basic local service as compared to a much higher rate increase of $20. He was saying that since this is an unreasonable result, then the survey results are flawed. The problem with this claim? That is not what the actual survey results showed.

The actual survey results showed that at a $2 increase, for the people that were asked the descending order, $20 to $2, only five percent of those surveyed said that they would discontinue basic service. And as you can see, that pattern inclined as the rate increase

inclined, opposite of what Mr. Perry was telling us. As you can see, at $2, five percent, but at $20, 22 percent said that they would discontinue local service. So the pattern that Mr. Perry was claiming existed in the survey just does not exist in the actual survey results.

And on the next slide I've went ahead and showed you the summary of the responses of those who were asked those questions in descending order from $20 to $2. At a $2 increase of those that were asked the $20 to $2 descending questions, 46 out of the 840 said that they would discontinue basic local service, at $2, 183 out of the 840 said that they would discontinue local service, so the numbers that Mr. Perry used in his analysis were not the numbers that result in the actual survey results.

Now, to conclude, both of these claims Mr. Perry had made --

COMMISSIONER GARCIA: Were you able to figure out how it is that he arrived at that erroneous conclusion?

MR. REGAN: The simple fact is the results that he provided make no sense anywhere you slice it. Now, we tried, you know, guessing which way he did it, we tried a number of ways trying to guess, and to no avail. The results just do not -- that Mr. Perry provided just do

not coincide with the actual results.

The conclusion is that the LECs have claimed that the Commission's affordability survey is flawed because the results are unreasonable; however, the results the LECs are showing and referring to are not the actual survey results. The actual results show that seven percent of those surveyed said they would discontinue service if basic was increased by $2, not the 23 to 45 Mr. Perry was telling us last week. Again, the actual results show that the number of respondents claiming they would discontinue service increased with higher monthly rate increases. In other words, more people said that they would discontinue service at $20 than they would at $2, regardless of whether they were asked the questions in ascending order from 2 to 20, or descending order from 20 to 2. So both of the claims that Mr. Perry was making were based upon results that were not the actual survey results. When you look at the actual survey results, you find that those claims are just not accurate.

MS. CASWELL: Mr. Regan, this is Kim Caswell from GTE. Can I ask you a question?

MR. REGAN: Sure.

MS. CASWELL: And I'm at a little disadvantage because I don't have Don here with me. I'm not a

the responses were, and then added them up. That was about the extent of the analysis that I had to do to get this.

MS. CASWELL: If somebody dropped out at 2, did you take them out of the set or did you somehow assume they were asked the --

MR. REGAN: Okay. As I said, there was two different groups.

MS. CASWELL: Right. And they're both mixed up here, right?

MR. REGAN: Right, that's the combined.

MS. CASWELL: Okay.

MR. REGAN: That's the overall picture.

MS. CASWELL: So you simply added people up and did a sort of -- is that called a frequency analysis?

MR. REGAN: It's called adding them up and dividing by the total to get the percent of what said what. That's very simple.

MS. CASWELL: Okay. And when you looked at each answer for each question, each subpart, did you analyze six different data groups or just one?

MR. REGAN: I analyzed all the data groups that were included in the survey.

MS. CASWELL: Okay. I understand it was necessary to look at six different data groups for each choice.

MR. REGAN: That's right.

MS. CASWELL: Again, you know, I didn't do it, so -- but that's my understanding.

MR. REGAN: Okay. There was one division -- I'll take it through. There's one division where some customers were asked 20 to 2, descending. There was another group that were asked the ascending, 2 to 20. Now, within those two groups, they had three different choices: Whether you discontinue basic service, whether you pay the increase and you don't adjust any spending, or you pay the increase but you adjust spending in other areas. So that was your three choices. And those were also randomized across customers. So you actually have six different combinations using those three different choices, so those were randomized as well.

So for the 2 to 20 group, they would get asked one of six different combinations of. So maybe one customer, part A would be would you, A, discontinue local service.

MS. CASWELL: Right.

MR. REGAN: But the next person, part A may be would you pay the increase and decrease spending in other areas.

MS. CASWELL: Do you have a chart breaking out the

two groups, or do you just have the combined chart?

MR. REGAN: Okay. I have the combined chart and then I gave you the 20 to 2. I also have the 2 to 20.

MS. CASWELL: Okay.

MR. REGAN: So the combined shows that -- that I show on the previous --

MS. CASWELL: And on page 7 for the 2 to 20 --

MR. REGAN: Okay.

MS. CASWELL: -- if a person said they'd drop out at 2, did you drop them or did you continue to analyze or extrapolate in some fashion?

MR. REGAN: Okay. The way you do that, let's use the example of the 20 to 2. Say you're in the 20 to 2 group, okay? That means the first question you're going to be asked is what do you do when the rate increase is $20, okay? If the person's response is that I will pay the increase and not reduce spending in any way, if that is their response, then there is no reason to ask them what they would do at a lower rate increase.

MS. CASWELL: Do you know if in fact that happened, though, in the survey --

MR. REGAN: That is the way the survey was designed. The survey was designed to, if that was the answer, that they would pay the increase and not adjust

spending in any other area, then you would skip on to the next question, leave the rest of the spaces blank and assume that their response would also be that they would pay the increase and not adjust spending when it's $10, $5, $2.

MS. CASWELL: Do you know in fact if that happened when the survey was conducted, that they were dropped out at 20 and that those other questions weren't asked?

MR. REGAN: That's the way the survey was designed.

MS. CASWELL: It was designed, but do you know if that's what really happened?

MR. REGAN: Because the spaces are left blank in the data disk, you would have no response needed if their response was, I would pay the increase and not adjust --

MS. CASWELL: So you didn't see anything in the results --

COMMISSIONER GARCIA: Maybe staff could answer that question.

MR. McNULTY: Yeah. I think basically you have a series of questions. Actually, you get to the issue of how many people disconnect and so forth like we're looking at now. We had a series of 48 questions because they had to be -- they had to be randomized in

two different ways, so it made it somewhat complex.

But to get to the core issue, if a respondent had the increasing questions, where they were first asked the question, would you disconnect at a $2 increase, and they responded yes, I would disconnect --

MR. REGAN: That would be a skip --

MR. McNULTY: -- then an assumption would be made from that point forward, when they're asked the questions in the increasing pattern of $5, $10 and $20, that it would -- automatically you would have to go back and say that those people who said they would disconnect at 2 are also part of the group that would disconnect at 5, 10 and 20.

MR. REGAN: That is exactly true. And on the data set I had, in that case, if they said they would discontinue at 2, for 5, 10 and 20, there would be no response because the surveyor had already skipped to the next question, would assume that they would disconnect at 5, 10 and 20, too.

So basically the reason why I'm presenting all this is to allow the affordability survey to stand on its merits. Last week we had some data that just was not reflective of the actual survey results, and I just wanted to set the record straight, and I hope I've done that.

MS. CASWELL: I just have one more question. I see the chart from 20 to 2 on page 7. Is there a similar chart from 2 to 20 in here?

MR. REGAN: That's what I was telling you --

MS. CASWELL: That's on page --

MR. REGAN: I was addressing the specific claim that Mr. Perry had made about the 20 to 2, but I do have the data for the 2 to 20 separate, too.

MS. CASWELL: So it's just not in here?

MR. REGAN: It's just not in here. I have it and I can provide that to you.

MS. CASWELL: Okay. Thank you.

MR. DUNKEL: If I might comment, you can also do it by subtraction. You have the total count. There's one table that shows 113, and then this table shows 46, so you can get the other just by subtraction, if you'd like.

MS. CASWELL: Yeah. I think it's not that easy, but we can argue about that later.

MR. DUNKEL: Well, it is that easy. If the total is 113 and one number is 46, and they add the --

MS. CASWELL: I understand your -- I understand your opinion. I think analysis of survey data is a little more complicated than that, but I'm not a market researcher, so --

MR. REGAN: If there are no other questions, I'll thank you very much. I'll turn the microphone over to Mr. Dunkel.

MR. DUNKEL: A lot of the cost studies I've seen in this case remind me of what happened to me when I graduated from college. One of my aunts who has a farm had her sheep sheared and had this wool made into a beautiful but unique material, and the idea was I would have a suit made out of this material. So I went to Tailor Johnson in our town, brought him the material, told him it was very unique, you could not buy any more of it. And I said, "I would like a suit with the wide lapels," which was the style at the time, "a vest and two pair of pants."

Well, Tailor Johnson measured the material and he said, "I'm sorry, there's not enough material here." I said, "All right, well, we'll forget the vest," and he says, "I'm sorry, there's not enough material here." "Well, let's also forget the second pair of pants." He said, "I'm sorry, there's just nowhere near enough material."

"All right. Let's forget the wide lapels, just the suit coat, pair of pants." He said, "I'm sorry, there's not enough material."

Well, I was very sad, so I got back in my car and

I was driving home and saw another tailor shop. This was Tailor Sally. So I decided well, why not, I'll go see what she has to say. So I walked in and I showed her the material and I told her it was very unique, we could not get any more of this material. I would like a suit, just narrow lapels, one pair of pants. She says, "Oh, that's fine." I said, "Well, there's enough material?" She said, "Sure, there's plenty of material here." She said, "Would you like a vest?" I said, "Well, yes, if there's enough material." She said, "There's plenty of material, no problem. Would you like wide lapels," that's the style at the time. I said, "There isn't enough material. She said, "Plenty of material." How about two pair of pants? Sure, plenty of material. Well, so I left the material there.

I came back in a week and she had sewn a beautiful suit, two pairs of pants, vest, wide lapels, everything else.

Well, finally, I say, "You apparently had enough material for all this." She said, "Oh, sure, I even had enough material left over to make an identical suit for my little two-year-old son." Now I just shook my head. I said, "I don't understand. I brought you this material. You had enough material to make a suit, wide

lapels, two pairs of pants, a vest, and an identical suit for your little two-year-old son. But before I came here, I went to Tailor Johnson and he told me there was not enough material. I don't understand." She said, "Oh, that's easy. Tailor Johnson's son is 18 years old."

Unfortunately, a lot of the cost studies you're seeing in this case were done by Tailor Johnson. They have costs in there that shouldn't be in there that are costs that are not caused by that service.

Competition -- in a lot of this, what you're hearing is, they claim is caused by competition. Competition for utility services is not new. Back even before railroads were regulated, there were some routes where they had competition and other routes where they had monopoly power, and what they did that was in their interest before they were regulated is they charged very low, disastrously low prices where they had competition. They charged high rates where they had monopoly power. This was good for the company, but it was not in the public interest. The reason regulation started was to prevent this improper pricing. That is what -- that's why regulators exist, actually.

Next screen.

Now, it's in the utility's interest to charge high

rates where they have monopoly service and low rates where they have competition. This discourages competition. If they charge disastrously low rates where they have competition, either the competition will not even show up in the first place or it will not grow.

Next slide.

This is already occurring in Florida. This is, unfortunately, regulation is supposed to slow this down, but it doesn't stop it. The ARMIS reports for BellSouth from here in Florida show there are deregulated services. Deregulated services are services like voice mail, inside wiring and several others. Their revenues were 169 million last year, their expenses were 187. They lost 19 million, not counting their return on investment. It's actually a negative 28 percent return on things like voice mail.

Now, why voice mail? Voice mail is very competitive. Anybody can get in it. I happen to have a daughter who is a court reporter and she got a piece of equipment that people could call in and leave recordings that she could transcribe, and the salesman sold her this piece of equipment and said it's also good for voice mail. You ought to get in the voice mail business, too. And she tried it and she ran into

this. It's a very tough business to make money in at the prices that are out there, and this discourages competitors, it sends a price signal to competitors. If you're at a stockholders' meeting and you say, "well, we've been providing voice mail in competition with BellSouth and we've been losing our shirt, let's start competing with them somewhere else," somebody's going to stand up and say, "Well, this is not a very good idea. Let's go open a pizza stand or something where we might make some money."

Some of the other services that are fairly competitive and also have either low or negative earnings, we already talked about deregulated services, the Centrex type services. They compete with PBXs, if you look at the rates for Centrex -- this is a service provided to big businesses, and there's lots of names for it, ESSX, Centranet, et cetera. The big businesses do not pay the B-1 rate. When you see the rate is $28 per line for B-1, that's not what big businesses pay. They pay Centrex rates, which are extremely cheap.

And if you look at the contribution analyses, even the ones done by the company, you'll see either low or negative earnings, even accepting their numbers at face value.

Another area where there is competition is for

special access in at least some areas. Now, we've heard talk about why the MSF, the competitive access providers, why you find them in downtown areas. The answer's very simple. Their primary business, the way they got into business, was providing interstate special access service, which is a high capacity service that goes between the IXC's pop and a business, someone that needs high capacity service, which would be a business, usually.

Now, several years ago the LECs, as in their interests, cut the prices greatly for that special access, interstate special access, again, pricing competitors out of the business where there was competition. The FCC had a proceeding and looked at those costs, found what the LECs was doing was called strategic pricing. They were taking real low earnings now to get rid of the competitors. It was in their long-range interest. The FCC prohibited that strategic pricing, made them raise the interstate special access rates up to a reasonable level, and that's why you have caps in business now is because the FCC did not allow the LECs to undercut them drastically and push them out of business.

Now, of course, the caps business plan is they went to -- based on interstate special access -- to get

into other areas as well, because this a volume business. But that's why -- that's why they are in downtown areas, because that is where there is a service that the FCC has not let the LECs drastically undercut them on.

Now, let's stay with this a second. Are they in the downtown area because of the local rates? The answer is no. The local rates they compete with there are Centrex type rates, which are extremely cheap. So that does not make any sense. They would -- if that was true, they would go somewhere else. They would not go into the area where they'd have to face -- where there are some of the lowest LEC local rates that exist, which are the Centrex type rates.

Now, let's see where they don't go. Let's go to the B-1 rates, which are the business rates everybody's talking about in this case. If you had a barber shop that was out three blocks away from anybody else, nobody's going for that market. He's paying $28, but if he pays $28 for his local, even if he has toll and vertical, no one's going to run a line three blocks to pick up that one customer. That's not what they're going for. So there are residential customers that nobody is going to go for by themselves, there are business customers that nobody's going to go for by

themselves.

Next slide here.

All of these that are normal -- let me back up a little bit here. I'm not saying what the utilities is doing is wrong. The utility management has a responsibility to take care of the financial interests of the shareholders. That is their job. That is what they're supposed to do, okay. No problem with that. Part -- having someone come in and take away part of your market is not in the financial interests of your shareholders. You're supposed to prevent that however you can legally. So what they're trying to do is correct for them to pose, but it's not in the public interest.

Next slide.

Now, of course, a LEC doesn't come to you and say, look, I have competition in this area or expect competition, what I'd like to do is make the rate there where it's getting no joint and common cost recovery, I want to run this competitor out of business or hurt him, and I'll make it up in a monopoly area. That's not a very good presentation to a Commission. So they work on the cost studies. They say, well, it so happens this area where I have competition, according to my cost studies, is in a low cost area, so I should

cut the rates there. It so happens the area that I have monopoly power, according to my cost studies, is a high cost area, so I should raise rates there. That's more sellable than saying, "I want to strategic price," which is what they are actually doing and the FCC has found they were doing. And the way they do this is by moving the shared joint costs around.

Next slide.

Now, this, again, this is not a surprise. The Telecom Act -- federal Telecom Act of 1996 knew they would try and do this, and so it put a limitation on there. It said, you cannot charge for the basic services, which includes basic residential exchange, more than a reasonable share of the joint and common cost of facilities used to provide those services. In other words, you can't put 100 percent of the loop cost on there, in plain English.

Next slide.

The Florida House bill that we're dealing with in this case also does not include -- allow 100 percent inclusion of the joint and common costs. When it talks about the cost of residential basic exchange service, it says, "including a proportionate share of the joint and common costs." It doesn't say including 100 percent of the share of the joint and common costs.

Now, the loop is one of the joint and common costs. Now, I know we're going to get people that are coming up with strange definitions, but let's take a look at it.

Do you have the pointer there? Anyway, next screen.

These are the facilities you need to provide a service. At the very top is toll service. To provide toll service you need some interoffice facilities, you need some switching equipment, you need a port. In case you don't know what a port is, it's the piece of the switch that's connected right to a loop. For example, it's the electronics that makes your phone ring or it's the electronics that gives you dial tone. You need a port for either ringing of your telephone or dial tone. And then loop is the facility that goes between your house, your business and the telephone company central office. If you're going to provide telephone service, you need all those things. If you're going to have toll service, you need the phone to ring. If you're going to have toll service, you need some way for the call to get to your house or business.

Vertical service, same thing, you need switching equipment, you need a port, you need a loop. If you

don't have any of those, you're not in the vertical service business.

Switched access, pretty much the same thing. You need all of those and some interexchange, or some connection to the pop.

Basic service, same things, switching, port, loop are all needed.

Now, let's assume that you listened to Dr. Taylor, or you're an executive in a telephone company, and you saw all these studies that we kept shipping to the regulators and you believed them. You believed that basic local exchange service is producing a negative whatever, 200 percent contribution, and switched access and vertical and toll didn't cause a loop cost and they're producing plus 300 percent contribution each. So you say, "I have a brilliant idea. I'm going to start a company. I'm going to go into an area, start a company. I'm going to provide all these profitable services and I'm not going to mess with this loser residential basic." Brilliant idea. "I'm going to make 300 percent contribution on my total company. It's amazing. I don't know why somebody else didn't think of this."

So you do that and you put all this in, and lo and behold, you have not avoided the loop cost, you still

have that loop, and then whether it costs $15 or $20 a line a month, you've got it, you've got the port. The only thing you've avoided is some switching costs. You can put a little bit smaller switch in because you're not going to handle local usage and you might have EAS traffic. In total, you would avoid $3.21 a month in cost. And that's not my figure. One of the LEC witnesses yesterday said that's what you would save on local service, not counting the port and loop. That's all you save, $3.21.

Now, are you making 300 percent profit or whatever? Of course not. You're collecting, you know, four or five dollars from each of those services, paying for the loop, paying for them. You're way in the hole. Now, what would make it better off? It would be better off to go ahead and also provide residential basic. You pick up 3.21 in costs and 14 -- or a dollar or so in additional revenue. Much more profitable.

Now, let's go to cost causation. Everyone agrees what the definition of cost causation is. We've given you little cards, everybody's said that's the -- that's how you tell if a cost is caused by a service. The cost is caused by the service only if that cost goes away when you avoid or delete that service while

continuing to provide all other services. Fine.

Take this group of services, delete residential basic. Does the cost of the loop go away? And you're still going to provide all the others. No, it doesn't. It's not caused by basic exchange service. Anybody that gives you a TSLRIC cost for basic exchange that includes the loop is simply misleading you. The TSLRIC cost of basic is 3.21, using the definition of TSLRIC everyone agrees on. Next slide.

By the way, that 3.21, that may have a cost of money I don't like, et cetera, but it's close to that.

Now, the loop is shared by all of these services. I do have bad news for Dr. Taylor. He doesn't know this yet, but we had some inside information that two years from now he will no longer be working for the LECs. The LECs have decided they're going to hire President Clinton to explain why shared does not mean shared. Sorry about that.

The loop is not part of the direct or incremental cost of any of these services. The loop would still be needed even if residential basic service was not provided while other services continue to be provided. The loop is not caused by basic service. And if you don't believe it, build a system that doesn't provide basic, you've still got the loop cost there.

Next screen.

DR. TAYLOR: Mr. Dunkel?

MR. DUNKEL: Yes.

DR. TAYLOR: Could I ask a question about that previous --

MR. DUNKEL: Sure. You're really not out of work, by the way.

DR. TAYLOR: I know. I have a solid definition of the shared relationship that I will keep to myself.

If I am a local exchange carrier today and I lose a basic local service customer, let's take a customer to whom I supply toll service, let's keep it simple, suppose there's just toll or usage. Let's be even more liberal, just usage and access.

MR. DUNKEL: Okay.

DR. TAYLOR: If I lose that customer to AT&T or to another provider, do I continue to incur the cost of the loop?

MR. DUNKEL: Did you also lose their toll business?

DR. TAYLOR: No, let's say I didn't.

MR. DUNKEL: Okay. If you didn't lose their toll business, you're still going to have to provide a loop.

DR. TAYLOR: Yes, but you didn't answer my question. I agree that to provide toll service one

needs a loop, just like to use software, one needs a computer, but I asked you a different question. I asked you the question that came from your chart on cost causation.

MR. DUNKEL: Well, ask it again, let's try it again.

DR. TAYLOR: If I lose my local customer, keeping his toll business, do I lose the cost of the loop? I do not.

MR. DUNKEL: No, you do not, not if you're going to provide toll. You still have to have a loop and you still have to incur in some manner the cost of the loop.

DR. TAYLOR: No. I don't have a loop that I have to provide anymore, but what I have to do is find some way to terminate and originate traffic. I think we'd agree with that.

MR. DUNKEL: That's called a loop, yes.

DR. TAYLOR: No, let's be really careful here, because originating and terminating traffic incurs no loop cost, right, or that's all usage by definition, and it doesn't add or subtract from the cost of a loop.

MR. DUNKEL: If you're going to provide toll service to that customer, you need some way to get calls to and from his premise. You need a facility.

DR. TAYLOR: You dodged it again. It's not what you need, it's what causes costs, and I think you and I could probably agree to disagree, but I think your definition compels the fact that the loop cost in our simple example here is tied inextricably to the provision of local service.

MR. DUNKEL: Absolutely not. Under your scenario, you've stopped providing local service but you're still providing toll. If you do that -- go back to that slide.

You're at the top right there. The loop cost has to exist, or your other choice is to then send a messenger out there and you'd say, "We have a toll call for you downtown, please come down and get your toll call." That's your other choice.

DR. TAYLOR: I agree with you that we need a loop, but that's different from if I give up the local service of a customer. Do I, the local exchange carrier, incur the nontraffic sensitive cost of the loop? And that is the cost causation question.

MR. DUNKEL: The answer is, when you gave up the local service, you did not get rid of the cost of the loop. It's as simple as that. If you're still giving the toll service, you still need a loop facility; very simple.

Okay. This is the correct analysis, and -- let's back up. Okay. And this is actually what the LECs do for everything except basic. They say, okay, for toll and access, my switching costs and my interoffice costs are $1 a month, my revenue is $6 a month, I've got a very nice contribution to shared and common, not counting the port, not counting the loop cost.

For vertical they say, well, my switching and my programming costs are 50 cents, I get $5 revenue, very nice high percent contribution, not counting any port costs, not counting any loop costs. For local, they say -- well, I'll get into what they say. This is also the correct analysis for local on the same basis as we did the other two. Your local switching, your one line on the bill where you have to pay a penny for the extra printing, that type of thing is about $3. Your revenue is around $14. Again, a very nice contribution, high percent mark-up service, high contribution toward shared and common, as a matter of fact, the highest contribution of any of the services. You're making more towards the joint and common from basic than you are either toll or vertical.

And this is consistent definitions. Each one of these is cost causation. If the cost does not go away when you drop the service, it's not in this cost; i.e.,

the loop does not go away when you drop toll, therefore the loop is not in the toll cost. The loop does not go away when you drop local, it's not in that cost.

Next slide.

COMMISSIONER JACOBS: How do you address the closing of the circle analysis, i.e., if you add up your direct cost column there, do you have all the costs for the local loop there, and if you don't, how are you going to get the rest of it?

MR. DUNKEL: No, and this goes back to how economists like to do these things. They say we don't like to allocate costs for the floor or the TSLRIC, you exclude all of these costs knowing you have excluded them, but that gives you the costs that are directly caused by each service. These are only the costs that would go away if you dropped that service while you kept providing everything else. Loop cost is not in any of these costs, et cetera.

Now, the answer is, you mark all of them up to get a contribution. If you priced each of these at the direct cost, then no one would cover the loop cost. So it's really -- it is not -- on a pure sense you don't allocate the loop cost. You cover your direct costs for each service, but you can't stop there because you've got this other general cost or common or shared

cost you also have to pick up. So you have to mark each of them up above the direct cost, but you're making money on all of these. You're better off with local than without it, you're better off with toll than without it, you're better off with vertical than without it. Each is making a contribution to the joint.

Okay, next slide.

The top is what the LECs have done to you in the contribution analysis in this case. Toll and access, they say, okay, well, our revenues are six bucks, our direct costs are $1, we're making $5 contribution, and that's a correct TSLRIC analysis. Vertical, same thing, correct TSLRIC analysis. But for basic they say, well, you know, our revenues are 10.50, most of them forget about the 3.50 when they do this. Some do, some don't. Our direct costs are $3, but we're also going to take the loop cost and the port cost, throw them 100 percent in there, and, voila, now we're below costs. In other words, local service by itself is not supporting 100 percent of the loop cost. That's a true statement. It's also true toll service by itself is not supporting 100 percent of the loop cost, vertical services by themselves are not supporting 100 percent of the loop cost, nor should they.

What they've actually done for local basic is what's called a stand-alone study. It's the worst-case scenario. What if no other -- there was no other service sharing the facilities, what would it cost? And that would be the cost of local basic, but that's a stand-alone. That gives you the ceiling. TSLRIC where you say forget about all the common and joint, that gives you the floor. When you say include all the common and joint, that gives you the ceiling, and as you've said, you can't price at the floor because that doesn't pick up all the common, you can't price at the ceiling because in the real world you're not providing just one service, you're providing several. The real price and the proper price is between the two.

Just to show you the absurdity of this allocation, at the bottom I've done another analysis -- I don't advocate this. You know, everybody's going to leave here saying Mr. Dunkel wants to put all the loop cost on toll. I don't. This is how -- or just as valid an analysis as the first one. You can do the argument, well, if I'm going to build a system to provide toll, I have to incur the loop costs, I have to incur the port costs, therefore, they are the costs of toll service. You cannot have toll without them. Just as good an argument.

As a matter of fact, I had a friend in college, and his girlfriend lived in another city. The reason he got telephone service was so he could make toll calls. I could do a study on him and say his cost of the loop is really cost of toll, put it all on there. Again, that's an extreme example. You don't price on extremes. That gives you, you know, the maximum this way. You can take the person who makes only local calls and doesn't make or receive toll calls, that's the other extreme. Realty is in between those two extremes.

Next slide.

Again, the LECs include 100 percent loop cost in the cost of basic. They include none of the loop cost in the cost of toll, access and vertical. The bottom is fine if you're doing TSLRIC, but you have to use the same rule for basic. If you use the same rule for basic, you have a cost of around 3.21 as the cost of basic exchange, TSLRIC. And that's the right cost. This Commission has looked at this issue before. This is -- it's an old issue. As a matter of fact, the Supreme Court case that deals with it is back from 1930. So this has been around a long time. This Commission has looked at it, dozens of other commissions have looked at it.

What this Commission said is, they don't buy the argument that the interexchange carrier should ride the loop for free. Contrary -- this would be contrary to common business practices, which is to charge customers for use of fixed cost facilities in the price for goods and services, and that's absolutely true. This is your decision back then. It's valid. If you look at Supreme Court decisions, look at the Telecom Act, look at even the legislation we're dealing with here, some reasonable share being recovered spread among the services that share the facilities is what's appropriate.

Next screen.

This again, loop cost is not caused by any one service, and we just talked about that. If you say it's caused by toll, by local, then get rid of local and see what costs go away. The loop cost does not go away. The proper recovery is that each service that shares the loop cost should recover a portion of the loop cost. Just about -- I think one of the Commissioners was talking about a toll road or a toll bridge, you wouldn't let the trucks ride across it free and charge the cars. As a matter of fact, I think Dr. Taylor said, you know, charge the hell out of the cars. That's not what would happen in competition. If

there are five toll bridges or five toll roads competing, there's no way you could charge the hell out of the cars, because someone else that ran one of the other bridges would say, hey, let's give them a fair price, let's -- you know, in a competitive market, you would collect a little bit from everyone.

The newspaper example is good. If advertisers want to use the newspaper to get a message to you, and you want to buy the newspaper to get information, what happens in a competitive market is they charge the advertisers some of the costs and they charge the end users some of the costs. And that's what happens in telecom markets. That would happen in telecom markets if they really were competitive. If they really were competitive and AT&T went to a company and said, look, you're spending -- you spent a $100 million for loop and you're spending $10 million a year to maintain the loops, how about if I use those loops free to carry my traffic? Free? You'd say no, I'm spending all this money to maintain these loops, if you want to use them, you can use them, you can rent them, but you've got to pay me some money. And that's what would happen in the real world.

Let's go to the next slide.

Again, you are being told that residential basic

is a loser. It is producing the highest contribution of any of the residential services towards the loop cost, assuming only that you don't use a double standard. If you want to calculate the costs of any of these services, including the loop and the port, that's fine. If you want to calculate a cost excluding the loop and the port, that's fine. But don't take one service and say, okay, this is the cost ignoring the loop and the port, which they have to use, for that service. For the next service say, well, this is the cost, but I'm going to include the loop cost in that. That's a double standard. This case boils down to one thing. Will you accept a double standard in costing? If you will not accept a double standard, most of the presentations that have been given to you simply fall apart. There's nothing to them once you eliminate the double standard.

Okay. What portion should be recovered in the residential basic rates, and we're not going to get into the argument that, you know, the economists say, well, you shouldn't allocate costs in the cost. That's fine. TSLRIC includes none of the shared costs. Stand-alone includes all of it. That's fine. But now we've got this problem the Commissioner pointed out. What do we do with the loop cost? If we price at

TSLRIC, we get 3.21 for residential basic, we get 50 cents for vertical, and we've got this $15 loop that nobody's paid for. So what you have to do is price all of them above their incremental costs to cover the loop in total.

Now, how much should you cover of the loop costs from basic exchange? Well, first of all, it must be less than 100 percent. The reason I point out is the LEC studies put 100 percent in, so right off the bat, you know they're wrong if this statement is wrong. In 1930 the U.S. Supreme Court looked at a case where a telephone company was placing all of what we now call the loop costs on the local intrastate service, although it was also being used for interstate toll service. The Supreme Court rejected this. They said this was an undue burden being placed on the intrastate service, it was unreasonable and it had to be -- I think they used the term apportioned. So you can't do 100 percent, and this is the outstanding case that exists today. This has not been overturned or reworked by anybody.

The next point, the FCC allocates 25 percent of the loop costs to the interstate jurisdiction. They recover it in things like the SLC or the PIC they charge the IXCs, or the interstate CCLC charge. So 25

percent of that loop cost is already being picked up in other rates. If you put 100 percent of the loop cost in residential basic intrastate rates and the FCC picks up 25 percent of the cost in the rates it has control over, you've double recovered.

Now, does that mean that 75 percent of loop cost is the cost of intrastate basic exchange service? No, it doesn't. There are other intrastate services that use the loop facility as well, intrastate toll, intrastate switched access, intrastate vertical services. So for the same reason that 25 percent of the cost should go to interstate because there's interstate access and interstate toll sharing the loop, some portion of that cost should also go to vertical services, intrastate toll, intrastate switched access.

So basically I haven't helped you a lot, but now you know the limits. The limits are zero percent allocation is way too low because then you don't pay for the loop costs at all; 75 percent is too high. It's somewhere between those two.

Next screen.

Now, where exactly between those two? Everyone that's looked at it said it's judgmental. The FCC stated -- and this was in implementing their 254(k) requirement which is the requirement that it can be no

more than a reasonable share of joint and common costs. They looked at it and they said, well, if you do a stand-alone cost of one service, that includes the loop; if you do a stand-alone cost of another service, that includes the loop. Obviously, that doesn't help you a lot in determining how much goes from each service. So there are other considerations.

I would point out Dr. Taylor talked about the state of Pennsylvania. Since he brought it up, I'll tell you what the state of Pennsylvania requires. They have, by law, the way you determine what part of the loop cost goes into the dial tone line rate, which is part of the local rate, is by relative stand-alone. So you would do a stand-alone cost study on toll and access, which includes the loop, a stand-alone on local service, which includes the loop, and it's a ratio of those two. If total LEC gives you $40 total cost, then you would do a proportion. If local was 20, then the local -- the 20 divided by the 40 total would be half of it what go to local. So that there are standards out there. That's not your state. Dr. Taylor brought up Pennsylvania. I'd like you to know what does go into that dial tone line rate. It's roughly 50 percent of the costs in Pennsylvania goes into the residential dial tone line rate.

Next slide.

Now, with the FCC's judgment and everyone's judgment, there are considerations other than pure cost because we end up with a range, but not a specific good point in the range. Universal service is one of the key considerations that should be considered. Again, the federal Telecom Act makes the preservation and advancement of universal service one of the major guidelines and major goals.

Now, a lot of people think universal service is something like giving away free electric service; it's not. If you provide universal service, you are benefitting not only the customer that got the service, but also everyone else who has telephone service. If you had electric service and your neighbor did not, you still get the full benefit of electric service. However, if you had telephone service and your neighbor does not, then your telephone service is diminished, because in order for you to call your neighbor, you also need your neighbor to have telephone service. If you are the richest person in the world and you were the only one with telephone service, that would be worthless. You couldn't call anybody. You could put flowers in it, that's all you could do with it. So if you were the only one in the world, the first thing you

would want is someone else to get telephone service.

Universal service is important. It's important for public safety when you hear the break-in to your window at 3:00 a.m. and you need a telephone there to call someone for help. It's also very important for social and family contacts. People who are isolated or older, or anyone, for that matter, likes to have someone to talk to. They like to have friends, they like to have contacts. The telephone is very important for that.

It's important to the economy. If you need to call out your employees because of an emergency, if you need to contact customers -- I get these calls at lunch, suppertime, somebody trying to sell me something, I mean, that's part of the economy and that's a valid use for telephone service, but I certainly hope you don't make me pay for that call. I hope when they use my line -- call in on that line to give me a call, at least the phone company or somebody gets a penny towards the cost of that call, a penny or two.

Next slide.

Now, again, how do we measure the loop cost? Is there some formula we can come up with that says, okay, this is exactly the right number? Well, one that's

sometimes suggested is traffic, measure the relative traffic and use that as an allocator.

Well, the first thing that's wrong with that is the cost is not traffic-sensitive. It's a loop facility. You need a pair of wires, or whatever you're using, regardless of how many calls you're going to make. So measuring the traffic of different services on it doesn't tell you anything about the cost causation at all. Another problem is there is no established way to measure vertical services usage on the loops, so if you look at these measurements that have been made in the past of relative minutes, DIM or SLU or whatever, any vertical service that's using the loop is in there at zero. So what this would amount to is, if you use traffic, you're saying, well, this service shares the loop facility, but we're not going to put any cost recovery on the loop on that service, which again does not make sense.

In addition, you also get some very trivial answers. GTE in response to a staff request -- the staff asked them to allocate, based upon relative usage, allocate the loop based on relative usage. 3.6 percent of the loop wound up in state toll and five percent wound up in state access in the GTE study. You know, if you're looking for something that sounds good,

that results in a trivial allocation of these non-traffic-sensitive costs to other services, you can do this. And by the way, it's also zero for vertical. So you've got very little allocations to any other services except for interstate and they're -- the interstate fed rules said 25 percent, but as far as any intra -- other intrastate services, trivial allocations.

Now, just so you don't misunderstand, the five percent and the three percent is only in a study where the staff asked them to do it. In their own studies, their contribution analysis, GTE puts 100 percent in local, zero percent in toll, vertical, switched access. So I don't want you leaving here with the impression GTE is using usage. They're not, or the other major LECs.

Now, we've talked about the loop, and the reason we talk about the loop is I think for BellSouth over 50 percent of their total investment is the loop investment. So this is the big cost. This is the elephant in cost allocations. But they do the same thing in other areas just as well, though they're not as big a dollars.

The port costs, this is equipment that's connected to the loop. It makes your phone ring, it gives you

dial tone. You need that for any service you're going to have. They put 100 percent of that generally on basic exchange service. At least some of the LECs, and we talked about this earlier with the stamp, if there's a 30 cent stamp and there's a bill in there for five different services, guess what, the 30 cent stamp is a cost of basic, it's not a cost of the toll or vertical or anything else that's being billed for. And they do this with envelopes as well. At least one of the major LECs in the studies that are submitted included the cost of toll switch maintenance entirely as a cost of basic exchange service. It makes no sense to me, but again, it's another way of upping that number senselessly.

Now, let's talk about affordability. Again, this is one of the requirements that the Legislature said we should all look at.

First of all, Florida's percent penetration is below the nationwide average, so it's not like we're out of the woods here. And these are unit penetration, which means they're percent of people that have a telephone in their house.

Next slide.

Now, we've heard people argue, well, they're great for residential basic, it doesn't really matter, it

doesn't have the impact, it's offset by toll, et cetera. Of course, later on they tell you nobody makes toll calls or very few people make toll calls, so how that offsets I am not sure I quite understand, but anyway, that's their argument.

The FCC looked at our same argument and they said there is a correlation between subscription and affordability, and they found that affordable rates are essential in inducing customers to subscribe to telephone service. No surprise, but I just wanted you to know you're not alone in thinking that.

Now, we went through some statistical data. All this is publicly available data. The FCC presents -- they do a survey in which they call various cities or get information from various cities, find out what the basic rate in those cities are. They also show the penetration rates. The states with the five lowest residential basic rates have an average penetration, and this is 1997 data, the most recent annual data we have available, 95.8 percent. The states with the five highest residential basic rates have an average penetration of 92.2 percent, a 3.6 percent difference. Now, you have people in this case urging you to join this group out here, the highest group. I would say that is not in the public interest to go there.

COMMISSIONER GARCIA: Wouldn't that precisely be the case? If we were to take our rates to $20, would we be in the five highest states in the country?

MR. DUNKEL: I believe so. I'll check, though.

The prices that the FCC shows are -- and I believe this includes the SLC charges, the E-911 surcharges -- is $24. So if you went to -- I assume by $20 you're saying the basic rate, not counting SLC and not counting E-911 surcharges. You would definitely be in that range, yes.

Next slide.

Mr. Perry gave you a slide earlier and he said that the rebalance did not hurt in California. I think he had a number that made it look like it was two-tenths of a percent higher after rebalance than before. What he did is there have been three years after the rebalance, and these numbers do bounce around because of statistical variation. Out of the three years since rebalance, he picked the one year that was the highest of the three. It wasn't the year right after rebalance, it was actually two years after the rebalance. So given three numbers, two of which were low and one was high, he picked the high one, and that's the number he used as the after-the-increase number.

If you do it a little more fairer, which is to say, let's look at the average of the three years' data we have after the increase, compare to the average before the increase, you'll see the percent penetration in California is one percent lower after the increase than it was before. And again, this is all FCC data. You can get it publicly available.

COMMISSIONER CLARK: Do you agree that that is -- is that statistically significant?

MR. DUNKEL: The FCC data does -- it gives a table that you can use to tell, and that gets down to saying what you call significant. A lot of people use 95 percent confidence. They have to be 95 percent sure of the answers or else they say it's not significant. Other people use a lower number. So it really depends on whether you want to be 95 percent confident or 50 percent confident or whatever.

COMMISSIONER CLARK: Well, let's assume the 95 percent.

MR. DUNKEL: I do not know -- by averaging three years, I would guess it would, but I haven't done the study. And the smaller sample you get, the greater the variation becomes.

COMMISSIONER CLARK: Is the minus one percent statistically significant in your mind?

MR. DUNKEL: I don't know. I believe it is, but I have not done the math.

MR. OCHSHORN: Just a brief comment. Ben Ochshorn, Florida Legal Services.

I think it's real important to keep in mind the structure of the Lifeline program in California. To my knowledge, it's self-certifying up to a certain income level, and so anyone below that income level, and I can't tell you what it is, who would be affected by higher rates, being charged the full rate could apply to this program. I fear that in Florida a similar rate increase would have a much greater effect on the penetration levels.

MR. DUNKEL: That's possible. What this shows is, even with a very generous Lifeline program, there was still an impact.

Next slide.

Now, who got the benefit of this restructure? Obviously the customers didn't. AT&T's operating margin on their intrastate toll in California is extremely high because the access charges were reduced. This is a quote from Business Week, and a securities analysis was pointing out that in California, AT&T's margins are about 50 percent; elsewhere they're about 25 percent. So I'm sure you

will be told that if you reduce toll and access -- reduce access rates, that will all get flowed through to the customers and the IXCs will get no benefit. That's not what happens in the real world. Some of it sticks to the IXC's fingers. It doesn't all get back to the customers.

Now, why would companies be in favor of this restructure we're talking about today? Here's a very good reason. They make more money out of it. Very simple.

Okay. Now I happen to have been in a case -- this was in Utah -- when I came into the case, we were about here (indicating). They had heard stories just like you're hearing here: "Oh, the loop cost is caused entirely by basic, it won't hurt raising basic rates, people will stay on the line system anyway," et cetera, et cetera. And what they had done when they accepted this answer is their penetration rate did start declining, as you would expect. We talked to the Commission. The Commission realized they had a problem. Their penetration rates were fairly low. They dropped their price very significantly for residential basic, and of course, the LECs were there saying, oh, that won't help, that won't help, that will not change your penetration at all. You're wasting

your money, don't do it. Bingo, it went up and it stayed up.

The Commission in Utah is very happy with what they did. They're very happy they didn't listen to the LECs. It made a noticeable difference. I walked in saying what I'm saying to you today, it matters, trust me, it matters, I know what I'm talking about.

LEC witnesses have made comparisons to other services. They say, well, customers pay about $30 for cable TV, so let's do that for telephone. Penetration rate is about 67 percent in the staff survey. Is that the model we want for telephone? No, we don't want a third of the people not having telephone service. Another thought for you, customer use of cable TV is about seven hours a day. They use telephones about half an hour a day. So if they're willing to pay $30 for something they use seven hours a day, are they going to pay $30 for something they use half an hour a day? Internet: Customers pay about $20 for Internet. So the companies say, well, charge 20 for local basic. Bet you're paying that for Internet. Very low. I've seen different numbers. One number I've seen is 16 percent penetration, somewhere in that area. Is that the model we want to use? Do we want to charge $20 for local basic if that -- and use as a model something

that has a 16 percent penetration? No, we don't. Nobody wants that.

Now, the LECs say there's a great need for this restructure. Vertical services are too high, toll services are too high. You need to cut those rates because the customers want it. This is the LEC's own survey. The four highest value services, value being the customers were happy with that -- the price and the value they got for the price they were paying, these are the four highest. One of them is telephone vertical services, 70 percent satisfaction rate. Long distance rates, at present rates, 67 percent satisfaction rate. Just for comparison, the cable TV satisfaction rate was 55 percent. These are the highest satisfaction rates out of whatever it was, a dozen or so services they asked about. Is there a crying need from the customers, do the customers think vertical services are overpriced? No, they don't. Do the customers think long distance is overpriced? No, they don't. According to the LECs' own survey. And we did not play with these numbers. If you look at Perry's schedule, these are right from Perry's schedule, okay? We don't -- you know, we don't do that. This survey shows there is no perceived need from the customer's point of view to reduce vertical

services, reduce toll, raise local. They don't see a need for that.

Next screen.

The only beneficiary of this would be the IXCs, if you reduce their access charges, because they will get to keep some of that, and the LECs, because to the extent they can reduce prices where they have competition, that makes life hard for their competitors, and if they can make it up where they have monopoly power, they're still okay but their competitor's life is more miserable than it was before, which is in their interests, and they should propose this. They are supposed to take care of their stockholders, they should propose this. But the public interest should not accept it.

Next slide.

This is a different issue. I'd like you to think about this a little while, it's sort of a new one.

Part of the proposal in this case is at least some of the money that would come from the residential increase would go to lower business rates, either business basic rates or business toll rates. Not all of it, but some of it. So let's take an example.

Let's say we're talking about a $10 increase and we go through some math and we find out that $5 of that

increase would not come back to residential customers, it would go to make business rates lower, either business toll or business basic, okay? If you take the $5 per line, I want to you remember that $5 per line as a residential bill is not tax deductible. The $5 per line as a business bill is tax deductible to customers. So it's not a zero sum game. The total tax bill of all taxpayers in Florida would go up over a $100 million.

Just to sort of put this principle in your mind, let's pretend you're a plumber. You have one business line and you have one residential line. Now, the telephone company comes to you and they say, "I want to collect a total of $40 from you. I don't care how I get it. You choose how much I put on your business line and how much I put on the residential line, remembering, however, your business rate is tax deductible." What would you do? I know if it was up to me, I'd put a lot of it on my business line and a little on my residence, because my tax bill would go down. And if you do that across the state, you're looking at a total tax bill of a hundred million dollars less with our present residence/business relationship than you would pay with the proposed residential/business relationship.

Now, what does this mean? It means a hundred million dollars more taken out of the Florida economy with the telephone company getting the same total money, but it's simply you're taking it out in a way that's tax deductible -- or not tax deductible versus taking it in a way that's tax deductible. $100 million more goes out of the economy. There's lower spendable income, lower retail sales, higher unemployment, economic harm for no reason whatsoever.

DR. TAYLOR: Mr. Dunkel?

MR. DUNKEL: Sure.

DR. TAYLOR: Just a quick question. I haven't understood -- it's Bill Taylor -- a lot of what you've said, but is the title of your slide backwards? Am I missing something? Shifting revenue requirement from residence to business is a terrible thing? I think you mean the opposite.

MR. DUNKEL: Okay, I'll agree with that. Thank you. It's the first time we have agreed today, isn't it? Thank you.

MR. GILLAN: Bill?

MR. DUNKEL: Yes.

MR. GILLAN: Joe Gillan. Just so I understand the point, are you saying that $100 million, when it is paid to the federal government, are you equating that

to leaving the state of Florida, or have you tried to net for Florida -- net against this number whatever benefits the state of Florida receives when the federal government -- when the deficit goes down by a hundred million, or they spend a hundred million more? Is it just --

MR. DUNKEL: I think the actual calculation was about 108 million, so I knocked the eight off just for rounding. You know, if you want to presume that if you send 108 million more to the federal government, that we'll --

MR. GILLAN: I'm willing to accept that if we send a hundred million to the federal government, nothing good happens. I just want to make sure I understood the calculation.

MR. DUNKEL: Well, even if we get one-fiftieth of this back, I mean, there's no reason they're going to send it back to Florida specifically. If it -- you know, the federal government has 108 million more, we might get two or three percent of it, we're still in the hole $100 million.

Now, go back a little bit. If you look at the rates across the country, the average residential/ business relationship is about two and a half times -- the business B-1 rate is about two and a half times the

residential rate. This concept is not lost on the rest of the world, and I certainly hope it's not lost on you. That's fine.

Next slide.

The conclusion is, residential basic is producing a high contribution to joint and common. If you dropped residential basic, you'd save about $3.21 in costs, even in the long run. You'd lose the current $11 contribution to joint and common costs that you now get. You will be far worse off without residential basic than with it. Placing 100 percent of the loop costs on residential basic is not only unreasonable allocation, it violates the requirements of the federal act, of the House bill we're working with, and the Supreme Court ruling. The proper way to recover the shared costs, including the loop costs, is to have all the services that benefit from the costs, or if you want to do cost causation, all of the services for whom those costs would have to exist for them to pay a portion of the cost of that facility.

The LEC proposal is anti-competitive. I know they sell it to you as competitive. That's what you want to hear. They're not in the business to increase competition to themselves. That's not the business they're in. They have a responsibility to the

stockholders. Their responsibility to the stockholders is to take care of the stockholders financially. It is to their advantage to inhibit competition against themselves. When you get a proposal from a LEC and they say, we're trying to promote competition against ourselves, I certainly hope some red flags go off.

Now, in addition, this is an abuse of monopoly power. What they have done, in this state it's sort of hidden, I've had other states where the companies were trying to do what they called banding. They were saying, I want to charge a lower rate for various service in this specific geographic area and higher rates in other areas, and the reason I'm doing that is I've done a study and I've figured out where my competition is most likely and I want to charge lower rates in that specific geographic area. I mean, that is the philosophy that is in the telephone company's interests, but what that really does is it undercuts -- it makes competition difficult and it abuses monopoly power by charging higher rates where the competition is not there or not showing up. And I also want to remind you that the competitors get this message. If they come in to one service and they get killed by BellSouth or GTE, they're not going to just, well, let's try another service. If they lose millions of dollars on

that one service, they're going to go away. They're going to go start a pizza chain or something where they've got a chance of making money, not continually lose money.

This proposal would harm the Florida economy. If you collect money in a way -- even if you collect the same total money -- if you collect it in a way that's tax deductible to the customers, your economy's better off than if you collect it in a way that's not tax deductible. But I'm not saying put residential below cost or anything like that. It's still producing a very high margin. All of this is in the LEC's interests, and that makes sense. What else would they propose? But it's not in the public interest.

I'd like to leave you with this. This is the consistent analysis of the contribution from the various services. The only way you cannot believe this is if you will accept a double standard on contribution analysis. If you will say, I'm going to look at the cost of toll and access but ignore the port and the loop cost, I'm going to look at vertical services but ignore the loop cost, I'm going to look at basic service but not ignore the loop cost, if that's the standard you accept, then this is the wrong analysis. If you say, all right, what's the cost excluding the

loop cost, this is your right analysis. Or if you want to do it the other way, if you want to say, what's the cost of all these services including the loop costs, then you get the stand-alone and you'll get a negative number for each one of these. Each one is a negative contribution if you include the loop. Each one is a positive contribution if you exclude the loop.

Is that it? Any questions?

COMMISSIONER DEASON: I have a question.

MR. DUNKEL: Sure.

COMMISSIONER DEASON: You've made an observation that business expenses are tax deductible for income tax purposes, and telephone expense is a legitimate business expense, and then you've indicated that that is a reason to have a differential between residence and business.

MR. DUNKEL: It's an affordability reason.

COMMISSIONER DEASON: If we accept that, would one then conclude that there should be a separate rate for nonprofit organizations which are now currently charged the business rate? They have no income tax. Or is it the rationale since they pay no income taxes, they can pay even more than businesses do? I'm just trying to understand --

MR. DUNKEL: Yeah, I understand. I haven't

proposed that distinction. As a matter of fact, I think if you look at the slide, it says generally tax deductible. I mean, there are exceptions. Somebody might have a business they run out of the home. Of course, they shouldn't use a home rate for that, but there are -- can be exceptions, but this is a general principle. I'm not trying to slice it fine.

Any more?

Thank you.

MS. MARSH: Thank you. We are running about an hour behind schedule, so we're going to go ahead and break now for lunch for one hour and we'll resume at one o'clock with Carl Danner.

(Lunch recess.)

C E R T I F I C A T E

STATE OF FLORIDA )

COUNTY OF LEON )

I, RAY D. CONVERY, Court Reporter at Tallahassee, Florida, do hereby certify as follows:

THAT I correctly reported in shorthand the foregoing proceedings at the time and place stated in the caption hereof;

THAT I later reduced the shorthand notes to typewriting, or under my supervision, and that the foregoing pages 265 through 410 represent a true, correct, and complete transcript of said proceedings;

And I further certify that I am not of kin or counsel to the parties in the case; am not in the regular employ of counsel for any of said parties; nor am I in anywise interested in the result of said case.

Dated this 23rd day of October, 1998.

RAY D. CONVERY
Court Reporter