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EXECUTIVE SUMMARY

1. The major LECs acknowledge that certain of their telephone rates are too high. However, the LECs claim the proceeds of these excessive rates are going to support residential basic exchange service (1FR) rates. The truth is that the proceeds of these excessive rates are supporting excessive earnings by the major LECs. The current rates are producing approximately 19% return on equity for all three major LECs, well above the 12% return on equity the FPSC recently found to be reasonable.

BellSouth is over-earning by over $250 million per year. BellSouth could reduce its toll rates by one-third, reduce its business basic rates by one-third, and reduce its switched access rates by one-third, without increasing rates for any service, and still produce a very reasonable 12% return on equity for its shareholders.

Under the current "price cap" regulation the three major LECs are allowed to lower their prices whenever they want. Therefore, the only reason that some of the LECs' rates are excessive is because the LECs have decided to price those services to produce excess earnings, instead of pricing them to produce reasonable rates.

In the less than three years of price cap regulation, the LECs have increased their return on equity from the previous 12% level to the current level of over 19% return on equity. The LECs' over-earnings are rapidly growing.

Until the start of 1998, the largest LEC, BellSouth was "sharing" price regulated. This "sharing" provided a safety net which prevented the excess earnings from becoming too unreasonable. Under "sharing", the excess earnings are shared between the customers and the shareholders. However, at the start of 1998, the last "sharing" price regulation ceased, and now all three major LECs simply keep all over-earnings that are produced by their excessive rates.

The Florida Legislature should empower the FPSC to incorporate sharing of over-earnings in price regulation. In addition, the level of sharing of over-earnings should be determined by the FPSC after appropriate proceedings. Lastly, the Florida Legislature should allow the Commission access to the LEC information which is reasonably needed for "sharing" price regulation.

2. The LECs propose to raise 1FR rates, in return for reducing the prices of other services. The services to be reduced include some non-basic services. However, if that was done, there is no guarantee that the LECs would not quickly raise the non-basic rates to their previous level or higher. Under price regulation, the LECs are allowed to increase the price cap for non-basic services by 6% or 20% per year, depending upon the exchange. They are not required to even attempt to demonstrate that those increases are appropriate.

corrected contribution analysis is as follows:

ACTUAL DATA FOR SPRINT-FLORIDA
Per line per month

Service Category	Revenue	TSLRIC	Contribution to Shared and Common
Residential Basic Exchange (Including $3.50 EUCL)	$14.23	$3.21	$11.02
Residential Vertical Svs.	3.56	0.29	3.27
Total Residential Local	$17.79	$3.50	$ 14.29
Intrastate IntraLATA Toll	1.35	0.04	1.31
Intrastate Switched Access	6.75	0.50	6.25

As can be seen, 1FR produces a higher contribution than does either toll, switched access, or vertical service. The LECs are much better off providing 1FR than without it. If Sprint dropped 1FR, it would lose $14.23 per line per month of revenue, but avoid only $3.21 of cost, even in the long run. (See Exhibit AG-6 for other LECs).

8. Residential basic exchange service is not being subsidized. The universally accepted test is that a service is subsidized only if it is priced below its TSLRIC. The costs that meet the definition of TSLRIC for Sprint's 1FR total $3.21 per month, based on the cost calculations performed by Sprint themselves. Since the 1FR rate ($14.23 including EULC) is over $3.21, 1FR is not receiving a subsidy. The LECs' claims that 1FR is receiving a "subsidy" is based upon their miscalculating TSLRIC by including 100% of the loop cost in the claimed 1FR "TSLRIC," although the loop costs do not meet the definition of TSLRIC.

9. Since the major LECs mislabel some of their costs, the FPSC should realize that (a) if there are no loop costs included in a cost, that is the minimum or "floor" cost (TSLRIC). (b) However, if 100% of the loop costs is included in a cost, then that is the maximum possible allocation which is a ceiling or "stand alone" cost. It is important to know whether a cost is a "floor" or "ceiling," since the correct price is above the "floor", but below the "ceiling."

10. At present rates, toll, switched access, vertical services, and 1FR services are all "subsidy free"–Each is priced above its TSLRIC "floor" and below its stand alone "ceiling." (Exhibit AG-7)

11. The LECs' inclusion of 100% of the loop costs in the claimed TSLRIC of basic exchange services violates many principles:

a. It violates economic principles, as discussed in Item 6 above.
b. It violates Section 254(k) of the Federal Telecommunications Act of 1996 (TA96), which requires that basic exchange services "bear no more than a reasonable share of the joint and

that one service. The loop costs are properly recovered from the whole family of services that share the loop facility.

e. The LECs claim the loop is dedicated to one service. It is not. When a salesperson calls you long distance, the IXC is the customer who has "rented" from the LEC the loop facility that connects to your home. At that time, the loop to your home is being used to provide switched access service to the IXC.

f. It is not a "fallacy" that shared use implies shared cost. That is how the entire world operates. The Smith vs. IBT Supreme Court ruling requires that principle be used in telecommunications as well.

g. The fact that 100% of all customers do not subscribe to vertical services or use toll services in a given month does not mean revenues from those services can be ignored. A fast food restaurant recovers a portion of their rent in the prices of their french fries and soft drinks, even if 100% of the customers do not buy those products. Two-thirds of BellSouth's residential customers purchase at least one vertical feature. Of course, even 100% of the population does not subscribe to basic exchange service either.

h. Even if a certain customer does not place toll calls, the loop to that premises maybe still used for toll service, because those loops maybe used to receive toll calls, which produces revenue for the LECs.

i. The LECs change the percent of people they claim make toll calls, depending on what argument the LECs are making. When it suits their argument, the LECs claim that 94% of even low income customers make long distance calls. However, in another argument where the opposite number is in the LECs' interest, they claim that 60% to 80% of customers "don't" make toll calls. Whatever the number is, the pricing for a category cannot properly be based on the extreme, but instead is properly based on the norm for that category.

13. At present rates, 1FR is making a very reasonable contribution to the joint and common costs. Sprint's 1FR service is producing a $11.02 per line per month contribution. Residence Local (1FR and vertical services) is producing a $14.29 per line per month contribution. (Ex. AG-5, page 3) For the three major LECs combined, residential local is producing a *** *** per line per month contribution, as shown on Exhibit AG-6. This is a more than reasonable contribution, considering that after analyzing unseparated loop costs, the Commission established $17 as the unbundled loop rate for BellSouth. The Attorney General believes this information indicates that, at present rates, the 1FR contribution to joint and common costs is reasonable.

14. Although the Attorney General does not believe the FPSC has to select a specific loop percent allocation to local, the following information is provided for background:

a. The FCC-State Joint Board rules allocate 25% of the loop cost to interstate. That allocation is mandatory on state commissions.

b. The 75% of the loop cost that is intrastate is shared by several intrastate services (i.e. intrastate toll, intrastate switched access, etc.). Therefore, all of the 75% should not be recovered from 1FR. The FCC recommended a 25%(interstate)/25%(intrastate toll and switched access)/50%(local) split, although only the 25% to interstate is mandatory.

c. Other states which have considered loop allocation percentages, have arrived at allocations to local that are generally between 25% and 50% of the loop costs.
d. The LECs sometimes suggest allocating loop costs based upon traffic measurements because that results in a trivial allocation to intrastate toll and access, and a zero allocation to vertical services. For example, 3.6% of GTE's loop costs would be allocated to state toll, 5.3% to state switched access, and zero to vertical under this method. This is unreasonable. Vertical services do use and share the loop facilities, and therefore should support some portion of the loop facility costs. However, there is no established way to measure the vertical services' "use" of the loop facilities. A measurement of relative traffic cannot be reasonably used to allocate the loop cost, because the loop costs do not vary based upon the level of traffic. In fact, the loops are sometimes referred to as non-traffic sensitive (NTS) costs because of their costs are not sensitive to traffic.

15. The LECs point to a rate rebalancing that occurred in California. However, there are several things wrong with the LECs' claims:
a. After rebalancing, the 1FR rate in California for Pacific Bell was $11.25 per month. Pacific Bell serves 80% of the California customers. $11.25 is a far cry from the $20 (or higher) IFR rate being proposed for Florida. The present 1FR rates in Florida are close to $11.25.
b. The LECs claim the penetration rates increased in California after the rebalancing. However, they had three years of data after rebalancing, and they simply picked the highest of those three years as the "after" number. If they compared the year before to the year after, the penetration rates declined. If they compare the average of the three years "before" to the average of the three years "after", the penetration rates declined almost one percent, which is a statistically significant decline. The LECs are simply gaming the numbers.
c. The switched access reductions did not all flow through to the customers. The IXCs pocket a part of the access charge reductions. AT&T's margins in California are 50%, compared to 25% elsewhere, because of the low access charges in California. These high margins make it obvious as to why the companies are in favor of such restructures, but these restructures are not in the public interest.
d. GTE admitted that the majority of the customers in California did not receive lower total bills as a result of the rate rebalancing.
e. GTE admitted that the California rebalancing hurt older customers with the "worst adverse impact being those over 65, whose bills would increase." Obviously, a rate restructure that harms the elderly is not desirable in Florida, since 30% of Florida households are headed by a person 65 years or older.
f. In California, the business basic rates (1FB) were raised along with the 1FR rates, but in Florida, the LECs propose to raise 1FR and lower 1FB. Therefore, a part of the 1FR increase would be diverted to business services, a diversion that did not occur in California.
g. The penetration decline in California was in spite of the California "self-certified" Lifeline program, under which customers who call and simply claim they are low income automatically become Lifeline customers.

16. The nationwide penetration rate is 93.9%, but in Florida it is 92.8%, over one percent less

to provide) than are 1FR calls.
e. 1FB rates are generally tax deductible to the customers, whereas 1FR rates generally are not.
f. The ratio of business to residence rates in Florida (2.55) is consistent with the nationwide average (2.38).

22. Reducing 1FB rates has nothing to do with competing for large business customers, since the large business customers subscribe to Centrex (ESSX, Centranet, etc.) or PBX. These services are very low priced services.

23. The LECs criticize the CLECs for starting in the downtown business districts, but back when the LECs first started, that is exactly where they started. It is a natural progression to start there, and then over time to expand out.

24. Shifting revenue recovery from residence to business would drain $100 million of additional federal income taxes per year from the Florida taxpayers overall, even if the overall total collected by the telephone companies is unchanged. Assume a customer pays $28 for 1FB and $12 for 1FR. The customer is paying $40 total. Since the $28 1FB is tax deductible, it results in an $8.40 federal income tax savings (30% tax rate x $28). The 1FR is not tax deductible. Now assume the rates are restructured to be $20 for 1FR and $20 for 1FB. This still totals $40. However, the customer's income tax reduction is now only $6 (30% x $20). Therefore, the restructure raised the customer's federal income tax by $2.40 per moth. When taken over the year and the entire Florida economy, this "deductibility effect" would drain over $100 million more per year net overall from the Florida economy, in the form of higher federal income taxes. The "deductibility effect" of the proposed restructure would reduce retail sales, reduce savings, increase unemployment, reduce disposable income levels, and needlessly harm the Florida economy.

25. CONCLUSIONS/RECOMMENDATIONS:
(1) The present 1FR rates are more than fair and reasonable, and meet the criteria for appropriate rates that are being considered in this proceeding.
(2) The Florida Legislature should empower the FPSC to incorporate sharing of over-earnings in price regulation. In addition, the level of sharing of over-earnings should be determined by the FPSC after appropriate proceedings. Lastly, the Florida Legislature should allow the Commission access to the LEC information which is reasonably needed for "sharing" price regulation.

FINAL COMMENTS

I. ANY EXCESSIVE LEC RATES ARE SUPPORTING EXCESSIVE LEC EARNINGS, NOT RESIDENTIAL BASIC EXCHANGE RATES

Some of the major local exchange companies (LECs) in Florida have claimed that certain telephone rates are too high, and claim that these excessive rates are supporting residential basic exchange service. The truth is that some telephone rates are too high, but these excessive rates are supporting excessive earnings by the major LECs. The current rates produced over a 19% overall return on equity for BellSouth's Florida intrastate services in 1997, before refunding excessive earnings. This compares to the 12% return on equity that the Florida Public Service Commission (FPSC) recently found was reasonable for BellSouth.[1] A copy of the page from this recent Order in which the Commission found 12% return on equity was reasonable for BellSouth is attached as Exhibit AG-1. In 1997, BellSouth was required to refund to customers all of its return on equity in excess of 15.11%. As a result of the excessive earnings created by their high rates, BellSouth was required to refund $123 million to its customers in 1997 in order to reduce its return on equity to the 15.11% capped amount.

However, BellSouth's requirement to refund excessive earnings expired at the end of 1997. Therefore, BellSouth's owners are now keeping all the excessive earnings created by the current excessive rates. To show these over-earnings exist, attached as Exhibit AG-2 is a copy of BellSouth's 1997 Earnings Surveillance Report. The $123 million refund is shown on page 2 of

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[1]Page 27, FPSC Order No. PSC-98-0604-FOF-TP, Docket No. 960757-TP, et. al., issued April 29, 1998 in the arbitration proceeding between Metropolitan Fiber Systems, AT&T, MCI and BellSouth.

that Exhibit. That BellSouth's return on equity even after the $123 million in refunds was 15.11% is shown on page 3 of the Exhibit. BellSouth could reduce its rates by $250 million per year, or refund $250 million per year to the customers, and still provides its stockholders with the very reasonable 12% return on equity that the FPSC recently found to be appropriate for BellSouth. BellSouth is trying to convince the Florida Legislature to let it raise its residential basic rates. However, it is unreasonable to raise rates for a company which is already over-earning.

It is obvious that the excessive charges for some services are not being used to make residential rates lower than they should be, because BellSouth had massive over-earnings in 1997, even with the present residential basic exchange service rates. Obviously, if all of the excess earnings from other services were supporting low residential basic exchange service rates, then BellSouth would not have the excess earnings which required them to make a $123 million refund in 1997, and still earned 15.11% on equity, even after that refund. These excess earnings occurred with the present residential basic exchange service rates in place. The major LECs are simply doing the "misdirection" trick that is commonly used by magicians. The high rates are flowing into excess earnings for the shareholders, but the LECs are trying to misdirect everyone's attention by claiming those proceeds are going elsewhere, but they are not.

a. **The $250 million per year excess revenues of BellSouth should be used to reduce excess rates, without increasing residential basic exchange or other rates**

Eliminating the $250 million per year of BellSouth's revenues that are flowing into over-earnings

Some parties have claimed that business basic exchange service rates are priced unreasonably higher than residence basic exchange service. As discussed elsewhere, the Attorney General believes that the existing differences between business and residence basic exchange service are justified for a number of important reasons. (For example, business basic exchange service includes a valuable yellow page listing which residential basic exchange service does not.) However, for illustrative purposes, if BellSouth's current average business one party basic exchange service rate (1FB) of about $28 was reduced by one-third to about $18.75 per month, that would use only about $169 million of the $250 million of excess revenues that are currently flowing into excess earnings for BellSouth. To illustrate the magnitude of the excess earnings (although the Attorney General does not necessarily recommend these specific rate changes), the $250 million in excess revenues that is currently flowing into excess earnings for BellSouth could be used to reduce by one-third all of the following rates: BellSouth intrastate toll by one-third, and BellSouth intrastate switched access rates by one-third, and BellSouth business basic exchange service rates by one-third. Even after all these reductions, without increasing the rates for any other services, the BellSouth shareholders would still be receiving the very reasonable 10% return on equity that the FPSC has recently found was reasonable for BellSouth.

b. It is the LECs' choice to set some of their current rates excessively

BellSouth, GTE, and Sprint are all currently "price cap" regulated.[4] They are allowed to set their prices below those caps with only minimal notice, and without having to provide any justification

[4]Section 364.05 of the Florida Statute.

for pricing below those caps. Therefore, the fact that some of the LECs' rates are excessive is due only to the fact that the LECs have decided to maintain those rates at an excessive level. They have the authority to reduce their own rates whenever they want to under the existing price cap regulation. The only reason certain LEC rates are too high is because the LECs want to price them high to produce excess earnings for their shareholders. There is no other reason.

c. GTE's And Sprint's rates could also be reduced by eliminating their over-earnings

The current GTE and Sprint rates are producing over-earnings similar to BellSouth's over-earnings. A FPSC Staff member has looked at the information that is available, and has estimated that GTE and Sprint are both earning an approximate 19% return on equity in 1998 on intrastate regulated Florida telephone services.[5] GTE's and Sprint's excessive rates could also be reduced, without increasing other rates, by eliminating GTE's and Sprint's current over-earnings. The shareholders would still receive a very reasonable return on investment even after those rate reductions.

The FPSC Staff member had to "estimate" GTE's and Sprint's earnings because the FPSC is no longer allowed access to GTE's, Sprint's, or even BellSouth's accounts, books, records, and papers. None of these companies even have to file an Earnings Surveillance Report (ESR) anymore. Section 364.18 of the Florida Statute empowers the Commission to inspect the accounts, books, records, and papers of any telecommunications company. However, Section

[5]Mr. Dale Mailhot of the Commission's Division of Auditing and Financial Analysis.

364.051 (1)(c) of the Florida Statute provides an exemption to this requirement for telecommunications companies that are price regulated. Since BellSouth, GTE and Sprint are price regulated, this Florida Statute prohibits the Commission from inspecting the earnings of these major telecommunications providers. GTE and Sprint ceased filing ESRs in 1996. BellSouth's requirement to file ESRs ended December 31, 1997.

In this very project, although GTE is asking for much higher residential rates, GTE argued that the Commission, the Florida Legislature, and the public had no right to know how much GTE was currently over-earning.

Prices which produce an excess return on investment are inefficient prices. Paying an excess return on equity is inefficient. Capital is one of the major resources telephone companies utilize. To pay over 19% for capital, when the open market price for capital is 12%, is just as inefficient as is paying too much for any other resource needed to provide telecommunications services.

d. "Non-sharing" price regulation is a failure

The non-sharing price regulated experiment has been a failure. Non-sharing price regulation gave the LECs significant latitude in setting their prices. For example, these LECs are allowed to increase their non-basic rates six percent per year without any demonstration that those increases are appropriate, or 20% per year if there is a competing LEC in the exchange, again without any requirement that they even attempt to demonstrate that these increases are appropriate. The

and the shareholders. Once the shareholders achieved a 15.11% return on equity, all over-earnings above that were credited to customers.

The telephone industry is a declining cost industry. For example, the cost of the electronic equipment, fiber optic equipment, and the cost of money have been rapidly declining. However, that declining cost of service has not resulted in lower rates.

c. Recommendation

In the public interest, the Attorney General recommends that:

1. The Florida Legislature should empower the FPSC to incorporate over-earning sharing in price regulation for all LECs who are under price regulation.
2. The level of sharing of over-earnings should be determined by the FPSC after appropriate proceedings.
3. The Commission should have access to the LEC information which is reasonably needed for sharing price regulation.

II. LOWERING NON-BASIC RATES (IN RETURN FOR INCREASING BASIC RATES) IS NOT A PERMANENT REDUCTION UNDER PRICE REGULATION–THE LECS HAVE THE FREEDOM TO QUICKLY RAISE THE NON-BASIC RATES

Part of what the LECs propose in this case would be to raise residential basic rates, and offset that by reducing the price of certain other rates, some of which are rates for non-basic services

However, if such a trade was accepted, there would be nothing under price cap regulation to prevent the LECs from rapidly raising the non-basic rates back up. Even if the "cap" for the non-basic services was lowered as part of the restructure, that cap goes up 6% to 20% per year. Section 364.051(6)(a) of the Florida Statute states that for non-basic services, the LECs may change their rates with 15 days notice,

> ...except that a price increase for any nonbasic service category shall not exceed 6 percent within a 12-month period until there is another provider providing local telecommunications service in an exchange area at which time the price for any non-basic service category may be increased in an amount not to exceed 20 percent within a 12-month period, and the rate shall be presumptively valid.

However, price regulation for basic exchange service is more limited. For most price regulated LECs, the basic exchange service rates are frozen until January 1, 1999. For BellSouth (a company with more than 3 million lines), the basic exchange rates are frozen until January 1, 2001. After the freeze, basic exchange rates are limited to an increase equal to the change in inflation less one percent.[7] Therefore, if the protection that the price regulation provides to basic exchange service is violated in return for lower non-basic rates, there is nothing to prevent the LECs from running those non-basic rates up at the rate of six percent or twenty percent increases per year. This amounts to trading permanent increases in basic exchange service rates for what could be temporary, short term reductions in non-basic rates.

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[7]Section 364.051(2)(a) and Section 364.051(4) of the Florida Statutue.

III. RAISING RATES ON MONOPOLY SERVICES, EVEN IF LOWERING RATES ON COMPETITIVE SERVICES, IS IN THE LECS' FINANCIAL INTEREST, BUT IT IS NOT IN THE PUBLIC INTEREST

The LECs' proposals in this case, which are to raise rates on their more monopolistic services while lowering rates on their more competitive services, is a technique utilities have used for decades to maintain their excess earnings, even in the face of limited competition.

It is in a utility's financial interest to charge higher rates where it has monopoly power and lower rates where it faces competition. Regulation was first established in the railroad industry to protect the customers of the railroad's monopoly services from this price discrimination:

> "Customers shipping goods from Chicago to New York always pick the route that offers even a few pennies saving. Thus, each of the three or four trunk lines would intermittently undercut the existing rate schedules, until finally a disastrously low level of rates was reached. At the same time, for short hauls where shippers had no alternative, the railroads would jack up the rates, thus creating an anomalous, discriminatory pattern of charges. We have seen that the Interstate Commerce Commission was established in 1887 to regulate railroad rates and earnings and prevent such unstable price conditions."
> (Page 499, Economics, An Introductory Analysis by Paul A. Samuelson)

As the above quotation indicates, one of the reasons utility rates are regulated is because when faced with competition in some areas, the utilities will charge low rates in the areas in which they have competition, but high rates in the areas where they have little or no competition. This rate pattern is a natural self-serving reaction by a utility to competition. This pricing structure is in the utilities' interest, but not in the public interest. By charging lower rates in areas where competition exists, the utilities can discourage competitors from expanding, or even continuing to compete with them. By charging higher rates in areas where little or no competition exists, the utilities can support their low rates for competitive services, and still produce excess earnings

overall.

a. The LECs Admit That Their Goal Is To Mark Up Non-Competitive Services To Fund Rate Reductions For Competitive Services

As an LEC representative stated in the Florida Workshops in October:

> •Since long distance calling is relatively price-sensitive, customer-friendly pricing will minimize mark-ups there.
>
> •Since basic monthly service is almost entirely insensitive to price, it must carry a mark-up to allow other services to be cheaper..[8]

The only services which are "almost entirely insensitive to price" are monopoly services. If there were several competing suppliers, a significant increase in price by one of those suppliers would cause customers to leave that supplier by switching to other suppliers. The more competitive services, such as long distance, are "relatively price-sensitive" because customers react to a price increase by switching to another long distance carrier. The LECs' clearly stated policy is to try to charge higher mark-ups for monopoly ("insensitive to price") services, while "minimizing mark-ups" for competitive services (which are "relatively price-sensitive").

The LECs' proposal in this case is a clear example of the type of discriminatory and anti-competitive pricing that regulation was designed to prevent, in the public interest. Charging higher rates where a company has monopoly power is an abuse of that monopoly power. This is

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[8]Page 23 of Dr. Danner's Presentation Handout Titled "Loop Costs, Universal Service and Pricing Reform" on behalf of GTE, Florida Public Service Commission Workshop, October 9, 1998.

the type of abuse regulation is meant to prevent. Charging extremely low rates where they face competition is anti-competitive because it discourages the competitors.

One reason regulation exists is to prevent the very type of anti-competitive and abusive rates that the LECs are proposing from being implemented.

b. The LECs are already charging anti-competitive low rates for some Florida services where they have competition

In those markets where the LECs already have significant competition, some LECs' are already pricing the services in those markets to produce negative returns on investment. For example, voice mail, inside wire and billing and collection services for interexchange carriers (IXCs) are all services that are considered competitive, and have therefore been "deregulated." For the year 1997, BellSouth's return on all deregulated services combined was -26%[9], as the BellSouth ARMIS Report to the FCC shows:

BellSouth "Deregulated" Competitive Services
Have Negative Returns on Net Investment

	Deregulated (Millions $)
1997 Revenues	$168
1997 Expenses	$187
Net Income	($19)
Total Investment	$197
Total Reserves	$125
Net Investment	$72
Return on Net Investment	-26%

[9]BellSouth 1997 Florida ARMIS Report 43-03.

The source for these figures is BellSouth's 1997 ARMIS Report 43-03, as shown on Exhibit AG-3.

In addition, Centrex-type services (sometimes called CentraNet, ESSX or other names) are services that compete with PBX services. According to GTE's "contribution analysis" submitted in this proceeding, GTE's overall contribution is *** *** on its CentraNet service offering.[10] Although GTE's calculation of the contribution analysis of CentraNet service may contain many flaws, it is clear that under GTE's own cost calculations, CentraNet services are priced to produce a *** *** contribution.

The above shows that charging prices that will produce low or negative returns in areas where they face competition, in order to discourage the competitors, while charging higher rates in areas where they face little or no competition, is a strategy some LECs are already implementing in Florida. The major LECs are trying to expand this improper strategy in their proposals in this very proceeding. This pricing strategy is anti-competitive and it is in the LECs' interest, but not in the public interest.

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[10]While the Attorney General may disagree with some portions of GTE's CentraNet cost study, it is clear that if GTE believes its own cost study, GTE has priced Centranet to produce a *** *** contribution. GTE's response to Division of Communications Data Request 1 (e), Bates Stamp 38-191.

with the LECs, if those competitions are losers. However, as long as the LECs are allowed to fund competitive rate reductions by marking up monopoly service rates, the LECs can continue to force the competitors to lose money.

d. The LECs' proposals would destroy the benefits that competition was supposed to bring

The LECs propose to reduce rates in those areas where they have, or where they expect to, face competition. However, they propose to at least maintain their over 19% return on equity by increasing rates in areas where they have little or no competition. This is not the result that competition was supposed to create. Competition is supposed to lower rates by squeezing excess profits out of the charges. Squeezing excess earnings out of the charges benefits the public interest, and improves efficiency.

However, lowering competitive prices by squeezing out the excess earnings is not what the LECs are proposing. The LECs propose to lower prices in certain competitive markets, but offset those reductions by increasing prices where they have monopoly power, thereby continuing excess earnings. Allowing those price reductions that may be forced by competition to be offset by price increases elsewhere on monopoly services would destroy the expected benefit of competition. This would also be an abuse of the LEC monopoly power

The existence of this LEC strategy can be seen in Florida and in other states. LECs in other states even charge different rates for the same service in different geographic areas based upon how much monopoly power they have in each area. For example, in Utah a witness on behalf of US West Communications, Inc., stated her company:

> Price switched access by zone so that a lower price is charged in zones with high traffic density and high potential for competition.[12] (Emphasis added)

By pricing competitive services to produce little or even negative earnings, the LECs can make the competitors unprofitable, limit their growth, and send a message to the potential competitors that their profits will be low or non-existent wherever it is they choose to compete with the LECs. Some of the LECs are already implementing this strategy in Florida.

IV. THE LEC COST STUDIES ARE DISTORTED IN ORDER TO SUPPORT THE ANTI-COMPETITIVE PRICING WHICH IS IN THE LECS' INTEREST

As previously discussed, it is in the LECs' interest to charge low rates for competitive services in order to discourage competitors. It is also in utilities' interest to charge high rates where they have monopoly power in order to produce high earnings for the company overall, even after supporting their low competitive rates. However, the LECs are smart enough to know the legislators, commissioners, and public would not accept the LEC rate design if the LECs honestly told them their goal was to impede competition, exploit monopoly power, and produce excess earnings for the LECs. Therefore, the major LECs need some way to "sell" these proposals. To

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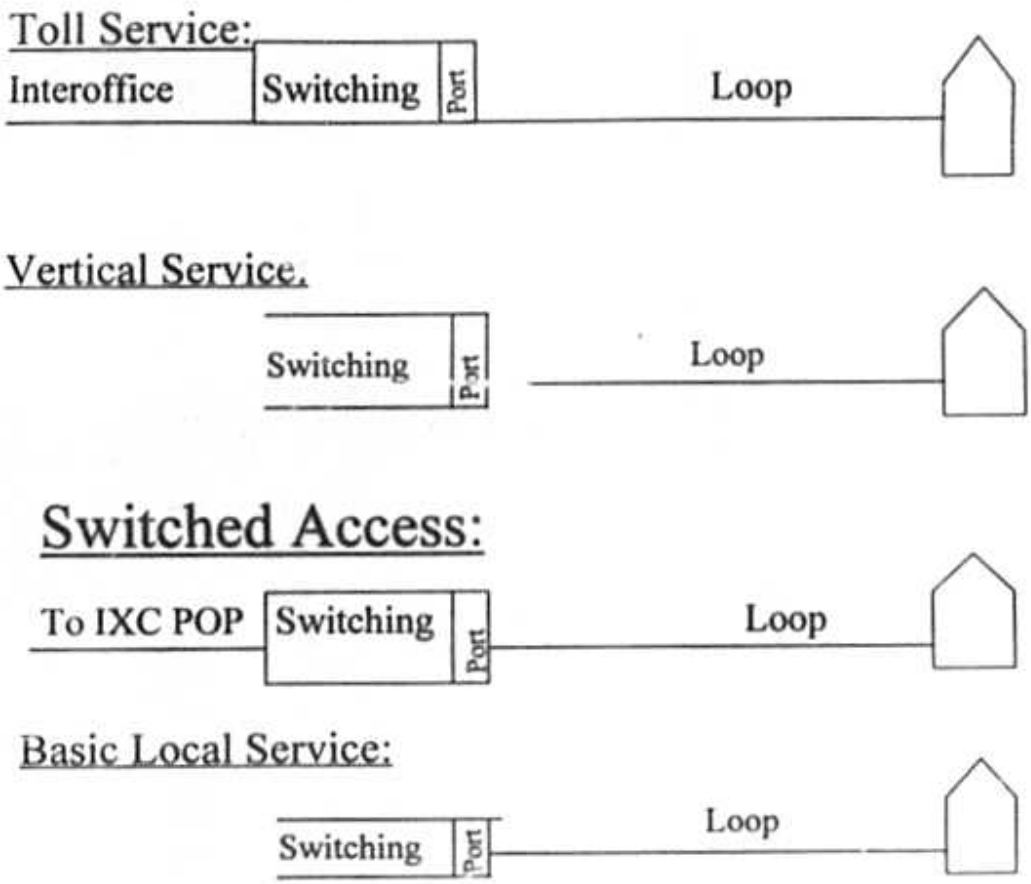
[12]Utah Docket No. 95-049-05, page ii, Barbara Wilcox Direct testimony.



This diagram is attached as Exhibit AG-4.

All of the above services share the same loop facility. The loop facility is needed to provide any or all of the above services. For example, if a company decided not to provide basic local services, but still provided toll, vertical or switched access services, the loop facility would still be needed, even if basic exchange service was not provided.

The major cost mis-allocation in the LECs' cost studies is that the LECs have claimed that the cost of the loop facility is entirely a cost of providing basic exchange service, and have claimed that toll, switched access, and vertical services have no responsibility whatsoever to support any portion of the cost of the loop facility, in spite of the fact that they all share that facility.

The heart of the LECs' argument is that, although they admit the loop facility is shared by several services, they effectively contend that one of the services that shares those facilities should support 100% of the cost of those facilities, while all of the other services that share those facilities should get a "free ride" on those facilities. This argument is unreasonable, has been rejected by the vast majority of regulators who have previously considered it, violates the requirements of the Federal Telecommunications Act of 1996 (TA96), violates the requirements set forth by the Florida Legislature, and violates the relevant U.S. Supreme Court decision.

When the LECs claim that residential basic exchange service is "subsidized", or priced "below cost", what the LECs are really saying is residential basic exchange service is not priced high enough to support a completely free ride on the loop facilities for toll, switched access, and vertical services.

a. The invalid LEC cost study

Shown below is how Sprint calculated the claimed residential basic cost and contribution. Also shown below are Sprint's claimed costs of toll, switched access, and vertical services.

INCORRECT LEC "CONTRIBUTION" ANALYSIS
FOR SPRINT-FLORIDA
Per line per month

Service Category	Revenue	Direct Cost	Loop and Port Cost	Total Cost	Contribution
Residential Basic Exchange (Includes $3.50 EUCL)	$14.23	$3.21	$22.00	$25.21	($15.25)
Residential Vertical Svs.	3.56	0.29	0.00	0.29	3.27
Total Residential Local	$17.79	$3.50	$22.00	$25.50	($7.71)
Intrastate IntraLATA Toll	1.35	0.04	0.00	0.04	1.31
Intrastate Switched Access	6.75	0.50	0.00	0.50	6.25

A more detailed version of this analysis is attached as page 1 of Exhibit AG-5. The claimed basic exchange cost of $25.21 shown in the chart above is the exact residential basic exchange cost that Sprint has claimed in this proceeding.

However, as the above table shows, Sprint included 100% of the cost of the loop facility and port facility in the claimed "cost" of basic exchange service. However, Sprint included none of the loop facility or port facility costs in its claimed cost for toll, access and vertical services, in spite of the fact that they also share the loop and port facilities, as this table shows.

b. Just as valid an analysis

It is important to note that the LECs' claims that residential basic is "subsidized" or priced "below cost" is based entirely on their improper inclusion of 100% of the loop and port costs as

basic exchange service look like it is producing a negative contribution, by overburdening it with all of the loop costs. The LECs are making toll, access, and vertical services look like they are producing high contribution by showing none of the loop costs as being a part of the cost to be recovered from those services.

c. Correct Analysis

The correct way to compare the contribution from all services that share the loop is to treat the loop cost uniformly for each service being analyzed. For toll, switched access, and vertical services, the LECs' analyses do not include any of the loop costs as being a cost of those services. Listed below are the costs and contributions for each of the major residential service categories, uniformly applying that cost standard to all services that share the loop facility.

CORRECT ANALYSIS
USING ACTUAL DATA FOR SPRINT-FLORIDA
Per line per month

Service Category	Revenue	Direct Cost	Contribution to Shared and Common
Residential Basic Exchange (Including $3.50 EUCL)	$14.23	$3.21	$11.02
Residential Vertical Svs.	3.56	0.29	3.27
Total Residential Local	$17.79	$3.50	$ 14.29
Intrastate IntraLATA Toll	1.35	0.04	1.31
Intrastate Switched Access	6.75	0.50	6.25

A more detailed version of this analysis is attached as page 3 of Exhibit AG-5. It should be noted that all of the underlying costs above are the costs as calculated by Sprint.

For example, in the Workshops, Sprint specifically acknowledged that according to their calculations, the cost of residential basic exchange service is $3.21 per line per month, excluding the cost of the loop and port.[14] Sprint also acknowledged that the costs they have calculated for intraLATA toll and access services are the costs which exclude any portion of the line and port.[15] Therefore, the Sprint calculated cost of residential basic exchange service is $3.21 per line per month when the loop and port costs are treated consistent with the way those costs are treated for intraLATA toll, access, and vertical services.

As the above table shows, when the costs are analyzed on a uniform basis for all services that share the loop facility, residential basic exchange service is producing a large contribution to shared and common costs. In fact, residential basic produces a larger contribution to shared and common costs than does any of the other services that shares the loop facility, including toll, switched access, or vertical services. In their analyses, the LECs have made basic exchange service appear to be producing a negative contribution, while making the toll, access and vertical services appear to be producing a positive contribution. This is merely a misrepresentation caused by the LECs placing all of the loop cost on basic exchange service, while placing none of the loop costs on toll, vertical, or switched access services.

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[14]October 8, 1998 Florida Workshop, Transcript page 129.

[15]Ibid. page 129.

services in total, which includes residential basic and residential vertical services, are covering their TSLRIC as well as making a *** *** per month per line contribution to the loop facility and the other joint/shared/common costs. In comparison, intrastate switched access services make only *** *** per line per month contribution to the loop and other joint/shared/common costs and intrastate toll services make only *** *** per line per month contribution.

Although specific figures for other companies are proprietary, as can be seen by looking at this proprietary Exhibit, the average cost of basic exchange service is very close to the $3.21 residential basic exchange service cost of Sprint. This proprietary Exhibit likewise shows that the contribution over direct cost for BellSouth, GTE and Sprint combined is much higher for residential basic than it is for either toll, switched access, or vertical services. The difference between this contribution analysis and the contribution analysis provided by the LECs is that the Attorney General has uniformly treated the loop and port costs in our contribution analysis. Since the LECs exclude the loop and port costs from their claimed costs for toll, access, and vertical services, the Attorney General likewise excluded the loop and port costs when analyzing the contribution for basic exchange service. All of these services share the loop and port facilities.

Since it is in the LECs' financial interest to calculate a very high cost for basic exchange service, the LECs calculate the "cost" of basic exchange service by including all of the costs of the shared loop and port facilities. However, for toll and switched access services, where it is in the LECs'

g. **If The LECs Eliminated Residential Basic Exchange, While Continuing to Provide All Other Services, They Would Avoid Only About $3.21 of Cost, But Would Lose $14.23 In Revenues**

There is an important point to be made in this proceeding–The LECs are much better off with residential basic exchange service than they are without it. For example, if Sprint were to eliminate residential basic exchange service, while continuing to provide all other services, Sprint would lose $14.23 per month in revenues per line, but would avoid only $3.21 per line per month in cost. If the LECs eliminated residential basic exchange service, while continuing to provide all other services, the only costs that would be avoided would be some local and EAS usage costs, as well as some minor other costs. According to Sprint's contribution analysis submitted in this proceeding, these costs are $3.21 per line per month.[16] The loop and the port facilities would still be needed to provide other services, such as toll, switched access and vertical services. Therefore, those costs would not be avoided by the elimination of basic exchange service. In a rate case involving U S WEST (USWC), the Washington Utilities and Transportation Commission reached a similar conclusion:

> If USWC were to exit the local residential exchange market, its revenues would decrease by about $14 per customer, and its costs would decrease by about $4.42 per customer.[17]

The fact of the matter is that the LECs are clearly better off with residential basic exchange

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[16]Page 15, Presentation of Kent Dickerson, Sprint Florida, Inc. Basic Local Service Cost Study, October 8, 1998.

[17]Page 90, Fifteenth Supplemental Order, Docket No. UT-950200 before the Washington Utilities and Transportation Commission, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling, dated April 11, 1996.

cost is not a cost which can be included in the properly calculated TSLRIC for basic exchange service, as can be seen from the above quoted definition of TSLRIC. Therefore, the figures that the major LECs claim to be the TSLRICs of basic exchange service are figures that were calculated in direct and gross violation of the very definition of TSLRIC.

b. The LECs' violation of the TSLRIC definition was "selective"

Although the major LECs violated the definition of TSLRIC for basic exchange service, when they came to toll and switched access services, the LECs did not make that violation. When calculating the TSLRIC of toll and switched access services, the LECs properly excluded the loop costs, since the loop costs would not be avoided if one of these services was discontinued while holding all other products or services offered by the firm constant. The result of this selective violation of the TSLRIC definition by the LECs is to distort beyond recognition the comparison of the relative contributions of the different services. By properly excluding the loop cost from the TSLRIC of toll and switched access, GTE calculated a very low cost and therefore a high contribution. Had the LECs also properly excluded the loop cost from the TSLRIC of basic exchange service, the result would have also been a low TSLRIC and a high contribution for residential basic exchange service. Excluding the loop cost (which is how the LECs calculate the TSLRIC for toll and switched access), the TSLRIC of Sprint's residential basic exchange service is $3.21 per month using the costs exactly as calculated by Sprint.[19]

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[19]Page 15, Florida Workshop presentation handout of Mr. Dickerson, Sprint Florida, Inc. Basic Local Service Cost Study, October 8, 1993.

The residential basic TSLRIC for BellSouth and GTE are very similar to that for Sprint. Using the costs from the information submitted by BellSouth and GTE in this proceeding, the residential basic exchange service TSLRICs are *** *** and *** *** per month respectively.[20]

As Exhibits AG-5 and AG-6 show, residential basic exchange service is producing a large, positive contribution over TSLRIC for all major LECs. The only way the major LECs could claim otherwise is by directly violating the definition of TSLRIC in calculating the claimed TSLRIC for basic exchange service. The major LECs distorted their contribution analyses by "selectively" violating this definition for basic exchange service, but by not violating it for toll and switched access services, resulting in an apples to oranges comparison.

c. **The widely accepted economic principles show that residential basic exchange service is not being subsidized**

It has just been demonstrated that the TSLRIC of basic exchange service is $3.21 for Sprint, and close to that for the other two major LECs. Determining the TSLRIC is important because the TSLRIC is generally accepted as being the "floor" for a proper price. TSLRIC is also the standard for determining whether a service is receiving a subsidy. As BellSouth and Sprint admitted in response to Attorney General's Interrogatory 41(d), a service is not receiving a subsidy if that service is priced equal to or above its properly calculated TSLRIC.

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[20]BellSouth's response to the Division of Communications data request items no.: 1B, 1D, 1H, 1J, 2B, 3B, 4B Section 1, page 5. GTE cost study filing Binder 1, page 2-1 Local Usage *** *** plus DTMF *** ***.

shared in the real world. Mislabeling this cost is a major deception. A proper price is below the stand alone "ceiling," but not below the TSLRIC "floor."

Had an LEC stated that residential basic exchange service was priced below its stand alone "ceiling," that would not have caused any concern, because that is where it should be priced. However, by simply mislabeling the stand alone "ceiling" as the TSLRIC "floor," and then stating the rates were below that cost, the LECs create concern. However, that concern is only because the LECs have mislabeled the "ceiling" as being the "floor." When that mislabeling is corrected, it is clear that basic exchange service is priced above its TSLRIC "floor" and below its stand alone "ceiling," which is appropriate pricing.

e. The test for cost study mislabeling

As previously discussed, a major error that the LECs made in this proceeding was to calculate the stand alone "ceiling" cost, and to improperly label that cost the TSLRIC "floor" for basic service. However, the LECs did not make this mistake for toll and switched access services. For those services, what the LECs called the "floor" was the "floor." Unfortunately, cost mislabeling is a common practice by some companies. Therefore, it is important for a regulator or legislator to be able to determine for his/herself whether a cost figure provided to them is the "ceiling", (which the price should be below), or a "floor" (which the price should be above). The wallet cards that the Attorney General handed out during the October workshops in this proceeding on one side had the following test:

Test for Cost Study Mislabeling:

•If the cost of a service that shares the loop facility includes all of the loop facility cost, that is the maximum allocation. Therefore that is a ceiling cost–regardless of the label provided. The reasonable price should be below that cost.

•If the cost of a service that shares the loop facility includes no portion of the loop facility cost, that is the minimum allocation. Therefore that is a floor cost. The reasonable price should be above that cost.

The Attorney General strongly recommends that the regulators and legislators in this proceeding ignore any label provided to them for a cost. If the cost includes 100% of the loop cost, that is the maximum allocation of the shared loop facility, and therefore is a "ceiling." If the cost includes none of the loop cost, that is the minimum possible inclusion, and therefore is a "floor."

f. Residential basic, switched access, toll and vertical service rates are all subsidy free

It is well recognized economic theory that as long as the price is below (or equal to) its stand alone cost "ceiling", that service is not providing a subsidy. If a service is priced above (or equal to) its TSLRIC "floor," the service is not receiving a subsidy. A price is "subsidy-free" when it is priced above (or equal to) its TSLRIC "floor," but below (or equal to) its stand alone "ceiling." Under these conditions, it is neither producing nor receiving a subsidy. These widely accepted, economic principles are discussed in the following quotation from an FCC Order:

> Economists would say that in order to give incumbent local exchange carriers the proper incentives to build multi-service facilities, where such facilities are economically rational, cost allocated to each individual service or subset of services should be less than the stand-alone cost but greater than the incremental cost. ... These are the upper and lower

TSLRICs use the same cost of money, depreciation rates, and other inputs that the major LECs utilized. The TSLRICs properly do not include the loop or port costs, since those costs would not be avoided if any one service was discontinued while all other services were offered.

The stand alone cost measures the cost of all of the facilities you would need to provide a service if that service were to stand alone, without sharing facilities with any other service. For example, the stand alone cost of toll services includes the cost of the loop, the cost of port facilities, the costs of switching and interoffice transport, and minor other costs. Likewise, the stand alone cost of switched access and local services includes the direct (TSLRIC) plus the full cost of the loop and port facilities, because all these facilities are needed to provide these services.

In the past, the FPSC has properly found that both local and toll rates were "subsidy free" because each was properly priced above its relevant incremental costs and below its stand alone costs. As the FPSC stated:

> We also reject ATT-C's argument that toll service subsidizes local rates. Public Counsel's witness Kahn conducted a stand-alone cost analysis of both local and toll services. Dr. Kahn testified that the results of his analysis showed that the existing rate structure is subsidy-free, and that revenues from local and toll services are above their respective incremental costs and below their respective stand-alone costs. Accordingly, both services benefit from the provision of the other, as neither is provider of nor the recipient of cross-subsidies. U.S. Sprint's witness Cornell stated she "...happen(s) to agree with witness Kahn that anything between incremental and stand-alone is neither subsidizing nor subsidized". We agree.[23]

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[23]87 FPSC 12:447 - 12:448, Florida Docket No. 860984-TP, Order No. 18598, Issued December 24, 1987.

In the Florida workshops in this proceeding, Dr. Kahn provided an update of the above analysis. In his new presentation, Dr. Kahn indicated that the price structure remains subsidy free today. Dr. Kahn noted that the local basic exchange rates have not been changed since the Commission's Order, but the costs of providing local service have actually decreased by 25% since then. In addition, Dr. Kahn pointed out that the toll rates have been reduced by 50% and the switched access rates have been reduced by 60% since the Commission's Order. Therefore, the toll and switched access rates that were found not producing any subsidies in the past could not possibly be producing any subsidies at their drastically reduced prices today.[24]

VI. PLACING 100% OF THE LOOP COST ON BASIC EXCHANGE SERVICE (WHILE PLACING NONE OF IT ON THE OTHER SERVICES THAT SHARE THE LOOP FACILITIES) VIOLATES THE REQUIREMENTS AND FINDINGS OF TA96, THE FLORIDA LEGISLATURE, THE FCC, THE FLORIDA COMMISSION, THE U.S. SUPREME COURT AND THE COMMISSIONS IN THE VAST MAJORITY OF OTHER STATES

a. TA96

The authors of the Federal Telecommunications Act of 1996 (TA96) knew what the utilities would do, and knew how they would do it. The authors of TA96 anticipated that utilities would respond to competition (or the prospect of competition) by attempting to use their non-competitive services to "subsidize" their rates for competitive services. The authors of TA96 also correctly anticipated the LECs would justify this subsidy by allocating "more than a

[24]Page FPA-8, Document entitled "Remarks by Dr. Marvin Kahn", handout provided at Florida Workshop, October 8, 1998.

> Speaker of the House of Representatives its conclusions as to the fair and reasonable Florida residential basic local telecommunications service rate considering affordability, the value of service, comparable residential basic local telecommunications rates in other states, and the cost of providing residential basic local telecommunications service in this state, including the proportionate share of joint and common costs.[25] (Emphasis added)

As discussed elsewhere, the basic local service costs that the LECs have presented in this proceeding have included all of the cost of the shared loop facilities (facilities that are shared by several services), not just a "proportionate share" of them.

c. The FPSC

In its Investigation into NTS Cost Recovery Proceeding, the FPSC properly found that the loop is a common cost, and that services which share the loop should support a portion of its cost. The FPSC specifically found:

> As we stated in Order No. 12265 in response to previous attempts to persuade us to accept the 'no NTS' position, 'The notion that an IXC should pay nothing for the subscriber loop because its use does not impose additional costs on the LEC is ill founded and contrary to common business practice, which is to charge customers for use of fixed cost facilities in the price for goods and services.' It is appropriate that each service provide some contribution toward the fixed costs common to those services."[26]

The Attorney General would like to point out that we do agree with the FPSC that recovery of a fixed cost in the price of goods and services is the common business practice. For example, a fast food restaurant will price their products (i.e. hamburgers, hot dogs, french fries, soft drinks, etc.), so that a contribution to the fixed "rent" cost is collected. Prices in a competitive market

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[25] §364.025, Section 2, (2)(a).

[26] 87 FPSC 12:447, Docket No. 860984-TP, Order No. 18598, Issued December 24, 1987.

recover not only the direct cost of those products, but also make a contribution to cover the fixed costs that must also be incurred in order to provide those products or services.

d. The U.S. Supreme Court

Decades ago, in Smith v. Illinois Bell Telephone, the U.S. Supreme Court reviewed a telephone company cost study which placed all of the loop costs on the intrastate exchange service. The U.S. Supreme Court rejected this, and required that an "apportionment" of these loop costs be made. The Court stated that unless an apportionment is made, an "undue burden" would be placed upon the intrastate exchange services:

> The appellants insist that this method is erroneous, and they point to the indisputable fact that the subscriber's station, and the other facilities of the Illinois Company which are used in connecting with the long distance toll board, are employed in the interstate transmission and reception of messages. While the difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required, only reasonable measures being essential (citations omitted) it is quite another matter to ignore altogether the actual uses to which the property is put. It is obvious that, unless an apportionment is made, the intrastate service to which the exchange property is allocated will bear an undue burden--to what extent is a matter of controversy. We think this subject requires further consideration, to the end that by some practical method the different uses of the property may be recognized and the return properly attributable to the intrastate service may be ascertained accordingly.[27] (Emphasis added)

The Smith vs. IBT ruling is still the Supreme Court ruling in effect on this subject. This ruling is regularly referred to in current orders.[28] The Supreme Court has specifically looked at the cost of

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[27]Smith v. Ill. Bell Tel. Co., 282 U.S. 131, 150-151 (1930).

[28]The FCC, in its recent Access Charge Reform Order dated May 8, 1997, referred to this case in Footnote 23.

the loop facilities, and found that you cannot properly allocate all of those costs to just one of the services that shares that facility, and "ignore altogether the actual uses to which the property is put." This Supreme Court requirement is valid requirement that must be met today.

e. The FCC

The FCC has on numerous occasions stated that the loop facility costs are "common" costs, and not just costs of local service. For example,

> [I]nterstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long-distance services.[29]

f. Federal-State Joint Board

Both the FCC-State Joint Board[30] and the FCC properly concluded that recovery of the cost which includes the loop facilities should be spread over the family of services that share those facilities:

> As the Joint Board recommended, the revenue benchmark should take account not only of the retail price currently charged for local service, but also of other revenues the carrier receives as a result of providing service, including vertical service revenue and interstate

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[29]¶ 237, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262 et al.,adopted December 23, 1996 and released December 24, 1996.

[30]The FCC-State Joint Board is made up of both state commissioners and FCC commissioners

and intrastate access revenues.[31]

> We include revenues from discretionary services in the benchmark for additional reasons. ... Revenues from services in addition to the supported services should, and do, contribute to the joint and common costs they share with the supported services.[32] (Emphasis added)

g. The vast majority of other states

The LECs have pointed out that a few state commissions, such as California, have accepted the concept that all of the loop costs should be considered a cost of basic exchange service. However, these few commission orders that the LECs have cited are clearly the exception. Considering the vast resources of the LECs, it is not surprising that the LECs might prevail in a few locations, but in the vast majority of state commission rulings, the absurdity of the LECs' position has overwhelmed the greater resources that the LECs can utilize to push their position. In addition, even the few state commission decisions that the LECs refer to preceded the requirements of Section 254(k) of TA96, which now prohibits any such over-allocation of the joint and common costs to basic exchange service, as previously discussed.

Numerous state commissions have found that the loop is a shared/joint/common cost, and that it is not a cost of just basic exchange or local service. Here are a few examples:

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[31] ¶200, Report and Orde , CC Docket No. 96-45, FCC 97-157, adopted May 7, 1997, released May 8, 1997 (hereinafter referred to as the *Universal Service Order*).

[32] ¶261, Universal Service Order, FCC 97-157.

> services and, thus, prime candidates for significant price increases. Just coincidentally, the great majority of local service customers demonstrate an inelastic demand for telephone service making them vulnerable to large price increases (TR 83-84). This flaw alone makes the LRIC study unacceptable.[35] (emphasis in original)

In another Order:

> Designating the access line as a separate service and allocating all of its costs to the local service customer continues to be a major problem with U S WEST's LRIC methodology.[36]

The Washington Utilities and Transportation Commission found:

> Finally, the residential cost study contains a basic flaw: USWC improperly allocates 100% of the local loop to residential service, and 0% to services that rely and depend on the use of that facility. The Commission in the past has addressed this issue and found it appropriate to allocate a portion of the loop costs to toll and other services.[37]

The Colorado Public Utilities Commission found:

> The second argument defines the local loop as a system. This system has many different users demanding service, including residential customers; small, medium and large businesses; governmental bodies; resellers; long distance companies; and others. A local loop is required and used by all of these users. Consequently, it has value to all of these users, and all should pay a portion of customer access.[38]

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[35]Northwestern Bell Tel. Co., Docket No. RPU-88-9, Final Decision and Order, p. 10 (IUB Dec. 22, 1989).

[36]US West Communications, Inc., Docket No. RPU-94-1, Final Decision and Order, p. 13 (IUB Nov. 21, 1994).

[37]US West Communications, Inc. Docket No. UT-941464 et al, Fourth Supplemental Order at 39. (WUTC Oct. 1995)

[38]Page 19, Colorado Public Utilities Commission Order, I&S Docket No. 1720, dated March 20, 1987.

VII. ANSWERS TO THE "EXCUSES" THE LECS USE TO ARGUE THAT ALL OF THE SHARED LOOP COSTS SHOULD BE PLACED ON BASIC EXCHANGE SERVICE, WHILE TOLL, ACCESS, AND VERTICAL SERVICES GET A "FREE RIDE" ON THAT FACILITY

The LECs provide enough excuses as to why their miscalculation of the residential cost should be accepted.

a. The loop costs are not "caused" by residential basic exchange service, as can be proven by the "test for cost causation" that BellSouth, GTE, and Sprint all agreed was a valid cost causation test

The major LECs claim that loop costs are "caused" by residential basic exchange service. However, all of the major LECs agreed that the following was the proper test for "cost causation".

> Test for Cost Causation:
>
> If the 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 other services produced by the company, those costs are not "caused" by the provision of the service in question.

In this proceeding, the AG's office distributed wallet sized cards that contained this test for cost causation. In discovery in this proceeding, BellSouth, GTE and Sprint all agreed that this was the accurate test for cost causation.[41] During the workshops, this test for 'cost causation" was read to witnesses. Representatives from all three major LECs agreed that was the correct test for

[41]BellSouth, GTE and Sprint's responses to Attorney General's interrogatory 45(b).

cost causation.[42]

This test undisputedly demonstrates that loop costs are not "caused" by basic exchange service. As Exhibit AG-4 shows, the loop facilities are needed for toll, vertical, and access services. Therefore, under the test for cost causation, if basic exchange was "eliminated", while "holding constant the production of all other services" (including toll, switched access, and vertical services), the cost of the loop facility would not be avoided by the elimination of basic exchange service. The loop facility would still be needed to provide toll, vertical, and switched access services, even if basic exchange service was not offered. Since eliminating basic exchange service does not eliminate the cost of the loop facility, the loop facility cost is not caused by basic exchange service, applying the universally accepted test for "cost causation".

Quite simply, since loop costs must still be incurred even if basic exchange service does not exist, then that loop cost has to be caused by something other than just basic exchange service.

b. BellSouth, GTE and Sprint Have All Admitted that Even If Residential Basic Was Eliminated, A Loop Would Be Needed To Provide Toll and Switched Access Services

In the Florida Workshop, speakers providing presentations on behalf of all the major LECs admitted that the loop facilities would be needed even if residential basic exchange service were

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[42]Dr. Taylor (representing BellSouth and Sprint), transcript page 277 of the October 9, 1998 Florida Workshop; Dr. Danner (representing GTE), transcript page 434 of the October 9, 1998 Florida Workshop.

eliminated, while all the other services continued to be provided.[43] For example, BellSouth's and Sprint's witness Dr. Taylor admitted that a loop facility would be required for toll, vertical services and switched access services, even if there were no local basic service:

> DR. TAYLOR:
>
> If I lose my local customer, keeping his toll business, do I lose the cost of the loop? I do not.[44]
>
> DR. TAYLOR:
>
> ...I agree that to provide toll service one needs a loop ...[45]
>
> MR. DUNKEL:
> 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 –[46]

Dr. Taylor admits that a loop or "connection to the premise" (which is the definition of the loop facility) would continue to be needed to provide other services if residential basic exchange service were eliminated. Since the loop facility would still be needed even if basic exchange service was eliminated, the cost of that loop is not a cost caused by basic exchange service using the universally accepted "test for cost causation."

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[43]Transcript page 435, October 9, 1998 Florida Workshop, Presentation of Dr. Carl Danner.

[44]Transcript page 377, October 9, 1998 Florida Workshop.

[45]Transcript pages 376 and 377, October 9, 1998 Florida Workshop.

[46]Transcript of Dr. Taylor's presentation at the October 9, 1998 Florida Workshop, page 280, lines 4-10.

admitted that if AT&T was to build a loop for toll service, the cost of the loop would be a cost of toll. However, Dr. Taylor claimed that if AT&T rented a loop for toll service, then the cost of renting that loop for toll service would not be a cost of toll service. This absurd position of Dr. Taylor is detailed below. The following exchange is between Mr. Dunkel (representing the Attorney General) and Dr. Taylor (representing BellSouth and Sprint):

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:

Okay. You agree, if they built the loop, that would be a cost -- if they built the loop for

This is incorrect. At the time a residential customer decides to "plug into the network", an existing spare pair is made active. Most of the cost of the loop facilities are investment related costs (i.e. return on investment, related income taxes, and depreciation expense). Therefore, a customer's decision to "plug into the network" has only a small impact on the loop cost. The major loop costs are actually incurred as a result of the facilities installation at the time a developer developed the subdivision. That may have been months, years, or even decades prior to the time when a particular customer decides to "plug into the network." It is not uncommon for a "new customer" who moves into a home to be provided service using a cable pair that is 10, 15, 20, or more years old.

In addition, a telephone company's decision to install loop facilities in a given area is not based just upon the potential basic exchange service revenues. When the loop costs are installed, the company installing those facilities considers all of the revenues of all of the services these loops will provide, not just residential basic exchange revenues. The LECs have admitted to this fact. For example, from the transcript of Dr. Danner's presentation on behalf of GTE at the Florida Workshop:

> MR. DUNKEL:
>
> Is it your testimony that if a competitor was looking at an affluent subdivision such as yours, that the only thing they would look at is the basic exchange revenue, not the total revenue they could collect?
>
> DR. DANNER:

No, I think they'll look at all sorts of opportunities and options.[49]

In addition, Mr. Greg Follensbee, presenting on behalf of AT&T at the Florida workshop indicated that it is the revenues from the total package of services that are relevant to the decision to invest in facilities:

MR. DUNKEL:

Does that mean in your decision-making you would not look at only the basic revenues, basic service revenues, but you would look at the total package in making your decisions?

MR. FOLLENSBEE:

Absolutely, but we would be looking at what customers are buying. In other words, we may be able to design a service for a customer that is only making local calls, or calls within a short area, depending on the cost. We may look at a service based on the fact the customer's calling all over the United States and may not be making very many local calls. It's -- we're going to be, I think, Commissioner Deason, you asked, are we going to have to get into the minds of the consumers? Yes. I think to be able to be successful in the marketplace, we're going to have to know what the consumers are using their telecommunications service for to know what we're going to be able to sell to them.[50]

When the cost of the loop facilities is incurred, the company installing those facilities takes all of the potential revenues into consideration when deciding on the wisdom of the installation of those facilities, not just the revenues from only one service that will be provided using those facilities. The decision to incur the loop cost facilities is based on all of the services that will share that facility, not just one of the services.

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[49]Transcript of Dr. Carl Danner, page 483, lines 8-14, October 9, 1998 Florida Workshop.

[50]Transcript of Mr. Greg Follensbee, beginning at page 498, line18, October 9, 1998 Florida Workshop.

would not mean that the entire loop cost should be recovered from that one service. Instead, that service would be only one of several services that share the loop facilities. The loop facilities would not be caused by that one service, since if you eliminated "subscriber access to the public switched network" service (assuming it ever existed in the first place), that would not eliminate the cost of the loop facility, because the loop facility would still be needed to provide carrier "network access" services, toll services, and vertical services, and all other services that use the loop facility. Quite simply, claiming that there may be one more service in the family of services that shares the loop, does not in any way lead to the conclusion that one service should support all of the loop facility costs, while the other services that share the loop facility support none of those costs.

g. The switched loop is not "dedicated" to one service

The LECs claim that the loop cost should all be recovered from residential basic exchange service because the loop is dedicated to that customer, and not shared by different customers.[52] This is a false argument. The loop to a given premise is not dedicated to one particular service. For example, when a credit card company calls you long distance during dinner to attempt to sell you a credit card, the IXC is the customer that has "rented" the loop facility that connects to your home. The IXCs purchase switched access ("Network Access") from the LECs. Network Access service provides the IXCs with access to the LECs' networks, including the loop facilities which are required to originate and terminate toll calls.

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[52]Page 5 of Dr. Danner's Presentation handout from the October 9, 1998 Florida Workshop.

h. **It is *not* a "fallacy that shared use implies shared cost"**

Dr. Taylor claims it is a "Fallacy that shared use implies shared cost".[53] Dr. Taylor provides no authoritative basis for his claim that this is a "fallacy," other than Dr. Taylor says so.

That shared use implies shared cost is not a "fallacy". Instead, it is required by the U.S. Supreme Court ruling, required by economic principles, and is reflective of how costs are recovered in competitive real world markets. As previously discussed, the U.S. Supreme Court found that "the actual uses to which the property is put" must be considered when apportioning loop costs:

> ...it is quite another matter to ignore altogether the actual uses to which the property is put. It is obvious that, unless an apportionment is made, the intrastate service to which the exchange property is allocated will bear an undue burden ...that by some practical method the different uses of the property may be recognized and the return properly attributable to the intrastate service may be ascertained accordingly.[54] (Emphasis Added)

Quite simply, Dr. Taylor wants this Commission and the Florida Legislature to not only "ignore altogether the actual uses to which the loop facility is put", but to also "ignore altogether" the U.S. Supreme Court Order that previously rejected this concept.

Since Dr. Taylor is an economist, he surely also knows that the "cost causation" principle requires that a cost can only be considered "caused" by a particular service if that cost is avoided when that service is eliminated, while holding constant the production of all other services.

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[53]Initial Comments of Dr. William Taylor, page 28.

[54]Smith v. Ill. Bell Tel. Co., 282 U.S. 131, 150-151 (1930).

Obviously, if more than one service shares the use of a facility, then the cost of that facility cannot be avoided when only one of those services is eliminated. Therefore, the cost of a shared facility is not "caused" by just one of those services. In short, the standard economic "cost causation" theory does relate the treatment of the costs of a facility to whether that facility is shared by more than one service, or dedicated to only one service.

In competitive markets, the sharing of facilities does imply the sharing of costs. For example, if two businesses share a facility, be it a building, driveway, lobby, or any other facility, you can be quite sure that those businesses which share the facility will also be sharing the costs of that facility.

i. The revenue from additional services cannot be ignored, even if 100% of the customers do not subscribe to those services

Some of the LECs argued that none of the loop costs can be recovered from toll or vertical services because not 100% of the customers use toll and vertical services.[55] This argument is nonsense. No rational company anywhere in the world would ignore revenues simply because those revenues were derived from services that were not subscribed to by 100% of the population. For example, if any rational person was considering whether it would be profitable to build a fast food restaurant, the revenues they would consider would include the revenues from their french fries and soft drinks, even if 100% of the customers would not buy those products.

[55]For example, see Transcript page 203 of the October 1, 1998 Florida Workshop, where Mr. Banagee, who works for Dr. Taylor, makes this argument.

Whatever customers do buy those products produce revenues that must properly be considered in any analysis.

In addition, the LECs' theory is based upon the fact that basic exchange service is a monopoly service, and therefore they are effectively arguing they can recover their joint and common costs only from monopoly services. However, the real world proves that is a false theory. If that were true, then all companies that do not have any monopoly services would be bankrupt. All companies have joint and common costs of some type. Therefore, companies in competitive markets must price their competitive products to cover not only their direct costs but also their joint and common costs, or else those companies would be bankrupt. Competitive products and products that are not subscribed to by 100% of the population do carry mark-ups for joint and common costs in the real world.

In addition, of course, even basic exchange service is not subscribed to by 100% of the population. Recent figures from Florida indicate that residential basic exchange service is subscribed to by 92.8% of households.[56] In addition, this market is supposed to become even more competitive, which may mean that the percent of people who subscribe to basic exchange service from the LEC in a given territory may eventually be reduced.

In addition, the vast majority of residential customers do purchase additional services. For example, approximately two-thirds of BellSouth's residential customers purchase at least one

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[56]For 1997, Table 3, FCC Telephone Subscribership Report.

high percent of customers place toll calls, and that is exactly what they claimed.

Quite simply, in an argument in which it is in the LECs' interest to do so, they will claim that 94% of customers do make toll calls, but in a different argument where it is in the LECs' interest to do so, the LECs will claim that 60% to 80% of the customers "don't ever make toll calls."

In addition, if there are some customers who seldom make toll calls, they may still receive toll calls. Therefore, their loop will be used for revenue-producing non-basic service. For example, working people may regularly place toll calls to their retired parents. The working people place the calls because the retired parents are on a fixed income. The retired parents' loop is regularly being used for additional toll revenue producing service, but the retired parents may seldom or never place a toll call.

In addition, even if you single out a particular customer that does not use a loop in a given month to place toll traffic, that does not mean the LEC receives no revenue other than basic local exchange service to contribute toward the recovery of the cost of that loop. Specifically, the FCC is now moving away from the usage based interstate carrier common line charge (CCLC) to a flat per line interstate presubscribed interexchange carrier charge (PICC) for the primary residential line as well as for single line business lines. It is expected that after a several year phase in, that interstate PICC will average $4.10 per month per line for the residential primary line and single line business customers, on a nationwide average. The IXCs will pay this PICC to the LECs for each line for which that IXC is the presubscribed interexchange carrier,

regardless of the level of traffic on each line. Another example is that residential primary lines and single line business lines also pay to the LEC an interstate $3.50 per month per line subscriber line charge (SLC).[61] That charge is paid every month, regardless of the level of interstate usage or intrastate toll usage on any line. Therefore, in addition to the revenues from basic exchange service rates, there is, and in the future will be, significant recovery costs of the loop facility from the services that share those facilities, independent of the level of actual use on any particular line.

In addition, the customers that don't make any toll calls or purchase any vertical services is not the average, typical, or representative scenario for that service category. This is an example of pricing based upon the most extreme case. Proper pricing for a service category cannot be based upon the extreme individual case, but pricing for a category must be based upon the average or typical for that category. For example, some students at college subscribe to telephone service primarily so they can place toll calls to their boyfriends or girlfriends back in their hometown. If that extreme case was utilized, then the logical conclusion would be that the loop cost should all be allocated to toll service. The Attorney General is not recommending this extreme case, but it would be just as logical to use one extreme as the other in pricing.

However, pricing for a category cannot properly be based on just one extreme. Instead, the average or norm for the group of customers to which the price applies must be used.

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[61]The end user common line (EUCL) charge for additional residence lines and multi-line business is even higher.

Residential basic exchange service rates are recovering a reasonable and proportionate share of the joint and common costs at present rates. As Exhibit AG-6 shows, the residential basic exchange and vertical services are contributing *** *** per month to the joint, shared, and common costs. In order to analyze whether this is a reasonable share, it should be kept in mind that this Commission has established $17 as the unbundled loop rate for BellSouth.[62] Therefore, residential local service is clearly making a very significant contribution towards the joint, shared, and common costs. The contribution to joint, shared, and common costs that is being produced by residential basic exchange service at present rates, is clearly within the range of reasonableness for such contribution, and even appears to be on the high side of the range of reasonableness. The Attorney General does not believe that a more specific determination has to be made by the Commission in this proceeding.

Although it is not necessary for the Commission to attempt to determine some specific figure as being the "reasonable" and "proportionate" share of the loop cost to be recovered from local, there are some basic facts that allow us to narrow down the range of possible cost recovery allocations of the loop facility costs to residential basic exchange service.

(1) First of all, in Smith vs. IBT, the U.S. Supreme Court rejected placing all of the loop costs on intrastate local service, therefore the allocation of loop costs to residential basic exchange service must be less than 100% in order to comply with this requirement.

(2) Secondly, the FCC-State Joint Board Part 36 rules allocate 25% of the loop facility costs to

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[62]BellSouth's response to Attorney General Interrogatory 51.

the interstate jurisdiction, and 75% to the intrastate jurisdiction.[63] The Communications Act of 1934 makes the Joint Board separations allocations mandatory on state commissions, as well as on the FCC. Therefore, only 75% of the loop costs can be considered in an intrastate proceeding, such as this.

For example, assume a $17 unseparated loop cost, with even just the 25% interstate costs removed, the highest amount that could be considered the intrastate loop cost would be $12.75 (75%).

It is important to note that in the LEC cost studies, the LECs did not even exclude the 25% of the loop cost that is the interstate costs.

(3) The portion of the loop cost that should be recovered from intrastate local service has to be significantly less than 75%, since other intrastate services share the loop facility (such as intrastate toll, and intrastate switched access services). For the same reason that some portion of the loop cost is allocated to the interstate jurisdiction because interstate toll and switched access services share the loop, some portion of the loop costs must also be allocated to intrastate toll and switched access services, since they also share the loop facilities.

Within these limits, the exact portion of the loop costs that is recovered from residential basic is judgmental. As the FCC has stated:

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[63]Part 36.154(c).

intrastate toll (including intrastate switched access):

[I]n determining the loop costs associated with local service, we propose to assume that those loop costs would be the same percentage of total loop costs for every LEC. Under our current rules, 25 percent of the loop costs are allocated to the interstate jurisdiction. We would assume that an additional 25 percent of each LEC's loop costs would be associated with intrastate toll services. Thus under our proposed allocation method, the remaining fifty percent of each LEC's loop costs would be assumed to represent local service costs.[65]

The FCC-State Joint Board has incorporated the 25% allocation from the above concept into the Part 36 rules. Therefore a 25% allocation to the interstate jurisdiction is mandatory. The FCC's allocation of 25% of the loop costs to the interstate jurisdiction has been upheld by the courts. Although the FCC, for its purposes, considers the remaining 75% to be split 25% to intrastate toll and 50% to local, that split of the intrastate portion of the costs is <u>not</u> mandatory on the state commissions, since the FCC and Joint Board do not have authority to specify the split within the intrastate jurisdictions. The 25% split to interstate is mandatory, but the remainder of that division is only advisory. The FPSC could select a different split of the intrastate portion of the loop costs as it sees fit.

2. In addition, the Washington Utilities and Transportation Commission also found this same allocation to be reasonable:

The Commission adopts an allocation of NTS costs based upon a division of 50 percent to local exchange services, 25 percent to interstate toll and 25 percent to

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[65]CC Docket No. 80-286, Notice of Proposed Rulemaking and Notice of Inquiry at 24, (FCC July 13, 1995).

intrastate toll...[66]

There are good reasons why the above referenced allocations of the loop facility costs are fair and reasonable. There are two major categories of services that share the loop facilities: (1) local services, and (2) toll services.[67] If duplicate loop facilities were installed to provide service to each of these two categories alone, the services in each of these two categories would, by themselves, have to support 100% of their loop costs. However, in the real world these two service categories share the same loops. Both can be priced below their stand alone levels as a result of sharing loop facilities. Both service categories receive equal benefit from that sharing. Giving one service category a greater relative benefit of the sharing of facilities at the direct expense of the other service category which shares those facilities would not be reasonable. Therefore, the local service category should support 50% of shared loop facility cost.[68] Toll service category should support 50% of the shared loop facility cost.

As a second step, the allocation to toll/switched access must be split between interstate and intrastate toll/switched access. The FCC/Joint Board procedures allocate 25% of the

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[66]Eighteenth Supplemental Order, Cause No. U-85-23 et al., at 5. Although establishing 25% as the ultimate goal, the Commission allowed USWC to at least temporarily remain at its prior allocation to intrastate toll of 16.95%. (See page 9 of the Eighteenth Supplemental Order)

[67]By toll services, we are referring to toll and switched access services. Switched access service is the IXCs' toll services being carried over the LECs' facilities.

[68]In fact, because residential basic exchange service is important to universal service, if anything, it should receive a disproportionate portion of the benefit of sharing.

October 28, 1998 considered three different options. The first option would have allocated 50% of the intrastate joint and common costs (including the loop) to the services which are included in the definition of universal service (which includes local basic service). The second option would have allocated 25% of the intrastate joint and common costs (specifically including the loop cost) to the services included in the definition of universal service. The third option would have allocated one-third of the intrastate joint and common costs (including loop) to the intrastate services included in the definition of universal service. The IURC analyzed these allocations specifically in light of the Section 254(k) of TA96 requirement. The IURC chose the third option, which allocated one-third of the intrastate joint and common costs (including loop) to the services included in the definition of universal service (which includes residential basic exchange service), "as the most fair and reasonable resolution of this issue."[72] Following that determination, the IURC did allow certain flexibility to the LECs in this area.

b. **Measurement of the traffic on the loop facilities is not a valid measure of cost causation**

When the LEC concept of allocating all of the loop cost to residential basic exchange service is rejected, the second alternative that the LECs generally propose is that the non-traffic sensitive (NTS) (loop) costs be allocated based upon their measurement of the relative traffic on the loops. The LECs do so because such an allocation results in a trivial allocation of loop costs to toll and access, and none to vertical services. Only 3.6% of GTE's loop costs would be allocated to state

[72]Page 45, IURC Order dated October 28, 1998.

toll services and 5.3% to state switched access services, and none to vertical services,[73] if the loop costs are allocated using relative traffic as measured by the LECs.

If state toll and switched access were unable to share the loop facilities with local and other services, they would require their own loop facilities. In that case, the rates charged for those services would have to be set to recover 100% of the loop facilities that were needed to provide those services. Since these services do share the loops with local and other services, they receive the benefit of a greatly reduced burden of loop cost recovery.

The loop facilities are frequently referred to as "non-traffic sensitive" (NTS) facilities, because the costs of the loop facilities do not vary with the level of traffic. There is no cost causative basis for allocating loop costs to various services based upon each service's level of traffic of the loop facilities. The impropriety of allocating NTS costs based on usage has been addressed by the FCC:

> These costs pose particularly difficult problems for the separations process: The costs of such facilities cannot be allocated on the basis of cost-causation principles because all of the facilities would be required even if they were used only to provide local service or only to provide interstate access services. A significant illustration of this problem is allocating the cost of the local loop, which is needed both to provide local telephone service as well as to originate and terminal long-distance calls. The current separations rules allocate 25 percent of the cost of the local loop to the interstate jurisdiction for recovery through interstate charges.[74]

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[73]Calculated from GTE's response to Division of Auditing and Financial Analysis' Data Request 3, Bates Stamp document 38 289.

[74]¶23, *FCC Access Charge Reform Order*, FCC 97-158.

result in between 50% and 25% of the loop costs being allocated to local service. However, a measurement of traffic is not an appropriate method for allocating the NTS loop costs for the simple reason that the loop costs are non-traffic sensitive.

In this proceeding, the Attorney General does not believe the Commission needs to try to select any particular allocation percentage, since it is obvious that, at present rates, the contribution that residential basic exchange service is making towards the joint and common costs is more than ample, and falls well within the range of reasonableness, for being a reasonable or proportionate share of the costs.

IX. THE "CALIFORNIA EXPERIENCE"

a. Many of the LECs point to the "California experience" as support for their proposals to increase residential basic exchange rates, but the Florida proposals are a far cry from rate changes made in California

The LECs point to the "California experience" in support of their proposals in Florida. However, the rate changes in California were not even close to the rate changes that the LECs are proposing here in the State of Florida. The most critical of these rate differences is the level of the residential basic exchange rates. In California the flat-rate residential basic exchange rates after rebalancing was $11.25 per month for Pacific Bell, which serves the overwhelming majority (about 80%) of residential customers in the State, as Dr. Danner (on behalf of GTE).[76]

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[76]As admitted in Dr. Danner's September 24, 1998 Comments. The residential basic exchange rate of GTE, which serves a relatively small percentage of the residential customers, was

However, the residential basic exchange rates that the LECs have been proposing in their comments and in their presentations in the Florida Workshop are in the range of $20.00 or more per month, not the $11.00 range that occurred for the majority of Californians. Quite simply, for the majority of the California residential customers, the "California Experience" is an $11.25 flat rate for residential basic exchange service, not a rate of $20 or more.

It is interesting to note that the current average residential basic exchange rate in the State of Florida (*** ***[77]) which is very close to the $11.25 rate of Pacific Bell after rebalancing.

b. The major LECs have used misleading information in an attempt to show that the penetration rates were not harmed by rate increases in California.

In his presentation at the Florida Workshop on behalf of the major LECs, Mr. Don Perry claimed that GTE's residential basic exchange rate in California was increased from $9.75 to $17.25. He then used the statewide penetration rates in California to support his position that this rate increase did not hurt penetration.[78] However, Mr. Perry's analysis is very misleading. The penetration rates that Mr. Perry was referring to are the statewide average penetration rates in California. As discussed above, the overwhelming majority of residential customers in the State of California (about 80%) are served by Pacific Bell, not GTE. Therefore, it is the rates of

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increased from $9.75 to $17.25

[77]This is the average residential basic exchange rate charged by BellSouth, GTE and Sprint in the State of Florida. (*** *** with 3.50 EULC).

[78]Slide 29 in Mr. Perry's Florida Workshop presentation handout entitled "Affordability and Value of Local Telephone Service", dated October 2, 1998.

(1996) were the highest of the three years following the increase. The 1996 figure is what Dr. Danner used for his "after" figure. If Dr. Danner had compared the penetration rate for the year before and the year after, the result would have actually been a slight decrease in the penetration rates.[81] Therefore, it is clear that Dr. Danner has "gamed" his penetration numbers to support his position. When the games are removed from Dr. Danner's analysis, it is clear that the increase in rates in the "California Experience" did hurt penetration.

There is now three years' data since the California price change. For the three years after the increase in rates in California (1995 through 1997), the average "unit" penetration rate was 94.6%. However, for the three years prior to the increase in rates in California (1992 through 1994), the average "unit" penetration rate was 95.4%. Therefore, the result of the changes in rates has been a reduction in the average penetration rate by about 0.8%, not an increase. This difference is statistically significant, at a 95% confidence level.

d. The "California experience" does not demonstrate that toll and access rate reductions offset the impact that a residential basic exchange rate increase has on penetration.

The LECs claim that the "California Experience" demonstrates that toll and access rate reductions will offset the negative impact that residential basic exchange rate increases have on penetration. However, there are at least three very important facts that undermine the LECs claim. First of all, as I demonstrated above, the rate "rebalancing" that occurred in California did

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[81]Table 3, Telephone Subscribership In The United States, July, 1998.

hurt penetration. The penetration rates before rebalancing were higher than they were after rebalancing.

Secondly, the residential basic exchange customers did not receive all of the benefit of the access reductions that the LECs are claiming "offset" the basic exchange rate increases in California. Rather, a large portion of the benefit of access reductions was actually pocketed by the IXCs. Instead of using all of the switched access rate reductions to reduce the end-user toll rates, the IXCs used at least part of these reductions to boost profit margins. The fact that the switched access reductions were not all flowed through to the end-users in California is clear from an article in Fortune magazine.

> AT&T reaps its highest profits on the millions of minutes of long-distance calls it carries each year in California. Operating margins there are about 50%, vs. 25% elsewhere, according to Vogel, because the fees AT&T must pay the local telco for handling a call in California are by far the lowest in the country.[82]

Finally, in Florida the LECs are proposing to use at least a portion of the residential basic exchange rate increase to fund a reduction in business basic exchange, toll and other business rates. For residential customers, a reduction in these business rates would do nothing to "offset" the increase in residential basic exchange rates. In the "California Experience", both residential and business basic exchange rates were increased, therefore what the LECs are proposing to do in this Florida proceeding is far worse for the residential customers than the rate structure changes that occurred in California. In California, the increases in both residential and business basic

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[82] "Why Allen's Latest Plan Won't Work", page 30, Fortune magazine, July 30, 1997.

f. **Customers over 65 received the "worst adverse impact" in the "California experience"**

Discussing the impacts on customers of the "California experience", Dr. Danner stated:

> Indeed, the benefits of pricing reform were spread across most subgroups of customers. Only two groups came out behind, with the worst adverse impact being those over 65, whose bills would increase....[84](emphasis added)

As Dr. Danner admitted, GTE's own analysis for California indicated that those over 65 experienced the "worst adverse impact" of the "California Experience", their bills increased. This experience is certainly not something that is needed in Florida. Florida's population has the highest percentage of Senior Citizens of any state in the nation. In fact, according to the U.S. Department of Commerce, about 30% of the households in Florida are headed by a Senior Citizen 65 years or older.[85] Therefore, it would certainly not be a good idea to model Florida after any "experience" that will have the "worst adverse impact" on the population group that accounts for nearly one third of the households in the state.

In addition, as previously discussed, in Florida the LECs' proposal would even have some of the residential basic rate increase diverted to support certain business rate reductions, a diversion that did not occur in California. Therefore, the impact on residential customers in Florida aged 65 or older would be much more adverse than what occurred in California.

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[84]Page 62, lines 1-4, Comments of Carl R. Danner on behalf of GTE Florida Incorporated, September 24, 1998.

[85]Table 73, *Statistical Abstract of the United States* (1997), Bureau of the Census, U.S. Department of Commerce

assistance on the basis of their income. Such programs do help, but in the interest of universal service it is also necessary that the residential basic exchange rates, which are available without requiring the customer to declare and prove that they have low income, should be as reasonably priced as possible.

X. AFFORDABILITY ISSUES

a. Florida has a universal service problem

The current penetration rate in the State of Florida is over a full percentage point below the nationwide average penetration. The 1997 nationwide average "unit" penetration rate is 93.9%, but in Florida it is only 92.8%.[88] Even the "available" penetration rate in Florida is a full percentage point below the national average. The nationwide average "available" penetration rate for 1997 is 95.4%, whereas for Florida it was only 94.0%. The "unit" penetration rate is the measure of households that actually have telephone service, opposed to the "available" penetration rate that measures the percentage of households that either have telephone service or can use telephone service at a friend's or neighbor's house, or somewhere else other than within their household.

Either way, it is clear that Florida has some work to do to promote subscribership if it wants to

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[88]Table 3, 1997 Annual Average, *Telephone Subscribership In The United States*, Industry Analysis Division , Common Carrier Bureau, Federal Communications Commission, Released July 1998.

improve upon its below average penetration rate.

b. Even at the current rates, hundreds of thousands of residential customers are priced off of the network each year.

In 1997, BellSouth alone initiated the disconnection of a staggering 236,000 residential customers for non-payment of their telephone bills.[89] This is over 7% of Bell South residential lines. In addition, GTE initiated over 257,000 "temporary disconnects" and 95,000 "permanent disconnects" of residential customers in 1997.[90] Many residential customers are having trouble paying the phone bill even at current rates. Clearly, increasing the rates for residence basic local exchange service would make these situations even worse. While customers can choose to limit their use of toll and discretionary services to reduce their telecommunications bills, residential customers must pay what the LECs charge for basic local exchange service, or simply do without telephone service.

c. The LECs claim that a residential basic exchange service rate increase will allow rate reductions to be made in toll rates, which will "offset" those basic exchange rate increases

First of all, as I have already discussed, BellSouth and the other LECs can reduce the rates for intrastate toll, intrastate switched access or any other service without having to increase residential basic exchange rates to do it. As discussed, BellSouth is currently earning approximately $250

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[89]BellSouth's response to Attorney General's Interrogatory 18.

[90]GTE's response to Attorney General's Interrogatory 18.

million more on equity than the FPSC found to be appropriate for BellSouth in the State of Florida. Therefore, BellSouth can reduce its revenues by $250 million and still provide a good incentive to attract capital from stockholders. The current price regulation structure gives all three major LECs the ability to reduce their prices without having to justify those reductions to the FPSC, or anyone else. It is the LECs who have chosen to over-price their services to produce excess earnings.

Secondly, the LECs' excuses for increasing residential basic exchange service rates are so unreasonable that it is not uncommon for the rationale behind one of their excuses to contradict the rationale behind another of their excuses. As discussed, in one argument the LECs claim the vast majority (60% to 80%) of customers make no long distance calls, and therefore the LECs claim that long distance services cannot support any portion of the loop cost. However, when the LECs are discussing the so-called benefits of this "rebalance" of rates, the LECs claim the vast majority of customers do place many long distance calls, and therefore reductions in toll rates will offset increases in residential basic exchange service rates. For one argument, the LECs claim the majority of residential customers do not make toll calls, but for another argument the LECs claim that the majority of customers (94%) do make long distance calls, all as previously discussed. Quite simply, the LECs cannot have it both ways. The fair and reasonable method of determining rates for a class of customers is to consider the average characteristics of the whole class of customers.

perceive a need for such a restructure. The fact is that the majority of the customers in Florida are very happy with the existing rate relationships. In fact, Mr. Don Perry, who provided a presentation on behalf of BellSouth, GTE and Sprint in the Florida Workshop, presented the results of an affordability survey that GTE recently conducted in the State of Florida. According to the LECs' own survey, the four services with the highest perceived value by customers were local, long distance, optional services and Internet. LECs' own survey indicate that the customer's perceived value of long distance and local phone service are exactly the same at the existing rates.[93] Customers gave both of these services a 67% value rating. While the LECs would like to create the impression that there is some kind of public outcry to rebalance by reducing long distance and raising basic local rates, the customers' actual perception is that the existing rate relationships are approximate.

f. The price of basic residential service effects penetration

There can be no legitimate dispute to the fact that the price of basic residential basic exchange service has an impact on penetration rates. In fact, studies have found that the two factors that have the greatest impact on a customer's decision to subscribe or not to subscribe to telephone service were:

1. The level of the initial payments, and
2. The rates for basic exchange service.[94]

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[93]Slide 23, Mr. Perry's presentation handout at the Florida Workshop, October 2, 1998.

[94]AT&T/Consumer Federation of America/AARP Joint Telecommunications Project

The FCC has found that affordable rates are needed to promote subscribership:

> We agree with the Joint Board that there is a correlation between subscribership and affordability...(Emphasis Added);

and,

> We recognize that affordable rates are essential to inducing consumers to subscribe to telephone service, and also that increasing the number of people connected to the network increases the value of the telecommunications network.[95] (Emphasis added)

g. Experience in other states shows that the price of residential basic exchange service is the key to penetration

Experience in other states across the nation shows that the price of residential basic exchange service plays a key role in the percent penetration achieved. For example, for the five states that have the lowest residential basic exchange rates, the average "unit" penetration rate is 95.8%, but for the five states with the highest residential basic exchange rates, the "unit" penetration rate drops all the way down to 92.2%[96], a difference of 3.6%.

In addition, Mr Dunkel's first hand experience in the State of Utah tells volumes about the impact that the level of the residential basic exchange rate has on penetration. In the mid to late 1980's,

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[95]¶23 and ¶112, FCC's Report and Order, FCC 97-157, in CC Docket No. 96-45, Federal-State Joint Board on Universal Service, adopted May 7, 1997.

[96]Basic rates for 1997 from Table 1.3 of the FCC's Industry Analysis Division's Reference Book of Rates, Price Indices and Expenditures for Telephone Service, July 1998. The Penetration rates for 1997 are from the FCC's Industry Analysis Division's Telephone Subscribership in the United States, July, 1998.

services, including basic telephone service, to be necessities rather than luxuries, and many would pay high prices instead of doing without those services. The fact that utilities could extract high rates from monopoly services is one of the primary reasons that public utilities are regulated. If the monopoly provider was permitted to charge rates just below the level that would cause most customers to discontinue the service, that provider would generally be able to charge much more than it costs to provide the service.

Of course where there are truly competitive suppliers of an identical product or service, a company generally would not be able to extract monopoly rates from its customers, regardless of how critical the product or service is to an individuals well being. They could charge high rates for their services only because they have monopoly power.

i. **The Florida Commission's Affordability Survey**

The Florida Public Service Commission had the University of Florida's Bureau of Business and Economic Research conduct an affordability survey. Of those respondents, 7% said that if their monthly phone bill increased by $2 they would discontinue basic local phone service[97]. Also 26% said that they would pay the increase of $2, but they would have to reduce spending in other areas[98]. Therefore, a local phone bill increase of $2 would cause a hardship to 33% of the people surveyed.

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[97] 113 of 1,598 respondents.

[98] 409 of 1,598 respondents.

In Dr. Danner's presentation on October 9th he claimed the rate changes that LEC's were proposing would especially benefit minorities.[99] However, the affordability survey conducted for the Florida Commission by the University of Florida showed that any increase in the monthly phone bill would especially cause a hardship on the minority residents of Florida. 10.6% of the "black" respondents said they would discontinue basic local phone service if the local portion of their monthly phone bill increased $2.00. Of the Hispanic respondents, 9.4% said they would discontinue basic local phone service if the local portion of their phone bill increased by $2.00. For comparison, of the "white" respondents, slightly over 5% said that they would discontinue basic local phone service if the local portion of their monthly bill increased by $2.00.

Therefore, according to the results of the Commission's affordability survey, the members of the "black" and Hispanic minority groups in Florida would be more negatively impacted by an increase in basic local service rates than would "white" customers.

j. The LECs Attempted To Discredit The Commission's Affordability Study By Misrepresenting The Study Results

Mr. Don Perry attempted to discredit the Florida Commission's affordability survey on the basis that the study's results, as he interpreted them, did not "make sense".[100] However, the reason that

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[99] Dr. Danner's handout for October 9, 1998 workshop, page 19, under question 5.

[100] Transcript of Don Perry, October 2 Workshop, page 273, lines 6-12.

>Not Available	**23**	**22**	**28**	**34**
>No Data Provided	**16**	**16**	**16**	**16**
Total Surveyed	**1,598**	**1,598**	**1,598**	**1,598**

113 is 7% of 1,598, not 23% to 45% of 1,598.

Secondly, Mr. Perry claimed that of those respondents who were asked about the rate increases in descending order (decreasing from $20 to $2), more said that they would discontinue service at a $2 increase than at a $20 increase. Mr. Perry claimed that it did not "make sense" for more customers to discontinue at a lower rate increase than at a higher rate increase.[103] However, once again, this claim is simply a mis-representation of the actual survey results. The actual survey results indicate that of those who were asked about the rate increases in descending order[104], nearly four times as many respondents indicated that they would discontinue at a $20 increase than at a $2 increase, contrary to Mr. Perry's claim. Shown below is a breakdown of the actual survey results for the 840 respondents that were asked about the rate increases in descending order:

Response	**Basic Local Increase**			
	$2	**$5**	**$10**	**$20**
>Discontinue Basic Local Phone Service	**46**	**72**	**138**	**183**
>Pay Increase & Reduce Spending In Other Areas	**186**	**239**	**302**	**333**
>Pay Increase & Not Reduce Other Spending	**570**	**493**	**361**	**275**
>Don't Know **24**	**23**	**25**	**35**	
>Not Available	**9**	**8**	**9**	**9**

[103]Transcript of Don Perry, October 2 Workshop, page 273, lines 6-12.

[104]840 of the 1,598 surveyed were asked about the rate increases in descending order, and the remaining 758 were asked about the rate increases in ascending order (increasing from $2 to $20).

>No Data Provided	**5**	**5**	**5**	**5**
Total Surveyed	**840**	**840**	**840**	**840**

The survey showed that far more people would discontinue service at a $20 increase than at a $2 increase, which is a reasonable and believable result.

In summary, the criticisms that Mr. Perry has of the Commission's affordability survey are simply mis-representations due to Mr. Perry's errors interpreting the survey results. When the actual survey results are used in the analysis of the Commission's survey, it is evident that the criticisms that Mr. Perry has made are invalid.

k. Some of the LECs have complained that business basic exchange rates are priced unreasonably higher than residential basic exchange rates, but there are a number of factors that explain the existing difference in rates in Florida

Some of the LECs have been complaining that the business basic exchange rates are priced higher than residential basic exchange rates. However, there are many differences between these two services that explain this valid difference between their rates.

First of all, telephone bills are a tax deductible expense for business customers, but they are generally not for residential customers. From an affordability standpoint, the after tax cost to a business customer for basic exchange service is less than the tariff rate, but this is not true for residential customers. Assuming a 30% tax bracket, the after tax cost to a business customer for 1FB service is about $19.60 ($28.00 multiplied by (1 - 30%)). Therefore, after tax deductibility is

Finally, there are other differences between business and residence basic exchange service. For example, businesses average more local calls placed per line per month than do residential customers. According to the usage cost studies submitted by BellSouth in this proceeding, 1FR customers make an average of *** *** local calls per month compared to *** *** local calls for 1FB.[107] In addition, a higher percentage of business local calls are placed during the peak period than is true for residential local calls. For example, BellSouth indicated that a higher percentage of residential local usage occurs during the weekend time period[108] than is true for business. GTE indicated that none of its central offices peak during the weekend time period.[109]

The traffic placed during peak periods is more costly to provide than during off-peak periods, as GTE admitted in response to Attorney General Interrogatory 13. Since the costs are higher during the peak period, the fact that a greater percentage of business basic exchange local traffic is peak usage is another factor that helps explain why the differences in the rates is reasonable.

These valid differences have been recognized in telecommunications pricing throughout the country. The relationship that exists between the business and residence basic rates in Florida is similar to the nationwide relationship. The Florida ratio of business to residence basic exchange

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[107]BellSouth cost study provided in response to Division of Communications Request 1 (d), Section 1, page 10.

[108]BellSouth's response to Attorney General Interrogatory 11.

[109]GTE's response to Attorney General Interrogatory 12.

customers in downtown and metropolitan areas. However, it is a natural progression for telecommunications providers to begin by first providing services in the downtown metropolitan areas and then gradually branch out to serve the suburban and rural areas. In fact, as Dr. Harris admitted in his presentation at the Florida Workshop, back when the incumbent LECs' first began providing telephone services in this country, they started by serving customers in the downtown business districts, and then later branched out to serve residential customers in the suburban and rural areas.[112]

After the LECs built facilities to serve the downtown business district, the LECs branched out to serve the residential and urban areas. This is the natural progression of a telecommunications provider, and the CLECs that are attempting to compete with the LECs in the state of Florida are simply following that natural progression. However, the LECs are trying to stop this natural progression in its initial stage by pricing its competitive services to produce negative returns on investment, and therefore preventing its competitors from being profitable and expanding.

There are several reasons why the downtown business district is the logical starting point for a telecommunications provider. It must be remembered that at the start of competition, the LECs have all customers, and the CLEC has the problem of convincing customers to switch. In order to have a given number of lines switched to the CLEC, if the CLECs concentrate on large business customers, they must convince far fewer decision makers to change what they are now doing than if they concentrate on residential customers. The large businesses located in the downtown areas

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[112] Transcript of Dr. Harris, page 23, October 8, 1998 Florida Workshop.

often subscribe to many lines of service at a particular location, whereas the majority of residential customers subscribe to only one or two lines of service. If the LEC is able to convince one business decision maker to subscribe to its services, that may mean hundreds of lines of service to a single business location. However, if the LEC instead focuses its limited resources on the residential decision makers, winning that customer's service will likely only mean one or two lines of service. Therefore, the LECs initial limited sales resources are best directed toward convincing the large business decision maker to subscribe to the their services, and this is exactly what they do.

Of course, the natural progression is that once the CLECs are established and successful in the large business market, they will expand to other areas.

n. **Shifting revenue recovery from residence to business would substantially harm the Florida economy by over $100 million per year due to the "deductibility effect"**

As already discussed, the LECs have proposed to raise residential basic rates in part to support reductions in business basic exchange and intrastate toll charges. However, business rates are tax deductible and residence rates are not. Therefore, shifting revenue recovery away from business customers and onto residential customers would significantly harm to the Florida economy by drawing millions of dollars of additional Federal income tax payments out of the Florida economy. For example, if $5 per line of a residential rate increase was used to support business rate reductions, over $100 million more in net greater federal income taxes would be removed from the State of Florida each year.

(2)(b) of the Florida Statute, (the cost and charge relationships, affordability, the value of service, comparable residential basic local telecommunications rates in other states, and the cost of providing residential basic exchange service), the Attorney General concludes that the fair and reasonable residential basic exchange service rate is at (or below) the current rates. At the current rates, residential basic exchange service not only covers its relevant direct cost of about $3.21 per line per month, it also makes the largest contribution to joint and common costs of any service that shares those facilities with residential basic exchange service.

The LECs' claims that residential basic exchange service is "subsidized" by high rates for other services or priced "below cost" are based upon blatant and selective violations of standard economic principles, numerous mis-representations and distortions of costing data, and violations of both Federal and State law. When the LECs say that residential basic rates are "subsidized, what they really mean is that residential basic rates are not high enough to support a completely free ride on the loop facilities for toll, switched access, and vertical services.

Some LEC rates may be excessive, but the proceeds of those excessive rates are flowing to over-earnings for the shareholders, not to supporting residential basic exchange rates.

In the less than three years that they have been on price cap regulation, all three major LECs have exploited this regulatory structure to raise their return on equities from 12% to approximately 19%. Due to the expiration of the last "sharing" provision in the price cap regulation at the end of 1997, all excess earnings generated by excess rates now flow entirely to the shareholders, with

none of it being returned to the consumers who are paying the excess rates. The level of over-earning for all three major LECs is rapidly increasing.

Under price cap regulation, only the LECs, not the Commission, have the power to lower the LEC rates. The LECs have chosen to maintain excessive rates in order to generate excessive earnings.

Recommendations:

1. The present IFR rates are more than fair and reasonable, and meet the criteria for appropriate rates that are being considered in this proceeding.
2. The Florida Legislature should empower the FPSC to incorporate sharing of over-earnings in price regulation. In addition, the level of sharing of over-earnings should be determined by the FPSC after appropriate proceedings. Lastly, the Florida Legislature should allow the Commission access to the LEC information which is reasonably needed for "sharing" price regulation.

Addendum:

At the last minute we located another document which shows that the loop is a shared cost. In the past, AT&T's Telecommunications Glossary contained the following definition of the access line:

Access line: The facilities between a serving central office and the customer that are required to provide access to the local and toll switched network. The access line currently includes the non-traffic sensitive central office equipment, the subscriber loop, the drop line, inside wiring and the main jack. Access line costs are considered as joint costs of local and long distance service and not specifically assignable to the direct provision of either service. (Emphasis added)

A copy of this document is attached as Exhibit AG-9.

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition by Metropolitan Fiber Systems of Florida, Inc. for arbitration with BellSouth Telecommunications, Inc. concerning interconnection rates, terms, and conditions, pursuant to the Federal Telecommunications Act of 1996.	DOCKET NO. 960757-TP
In re: Petition by AT&T Communications of the Southern States, Inc. for arbitration of certain terms and conditions of a proposed agreement with BellSouth Telecommunications, Inc. concerning interconnection and resale under the Telecommunications Act of 1996.	DOCKET NO. 960833-TP
In re: Petition by MCI Telecommunications Corporation and MCI Metro Access Transmission Services, Inc. for arbitration of certain terms and conditions of a proposed agreement with BellSouth Telecommunications, Inc. concerning interconnection and resale under tl Telecommunications Act of 1996.	DOCKET NO. 960846-TP ORDER NO. PSC-98-0604-FOF-TP ISSUED: April 29, 1998

The following Commissioners participated in the disposition of this matter:

JULIA L. JOHNSON, Chairman
J. TERRY DEASON
SUSAN F. CLARK
JOE GARCIA
E. LEON JACOBS, JR.

FLORIDA PUBLIC SERVICE COMMISSION

TELEPHONE
EARNINGS SURVEILLANCE REPORT

BELLSOUTH TELECOMMUNICATIONS INC. - FLORIDA

PSC/AFA-15 (12/97)

FLORIDA PUBLIC SERVICE COMMISSION
TELEPHONE EARNINGS SURVEILLANCE REPORT

Page 2A
1 of 3

Company : BellSouth Telecommunications, Inc. - Florida
12 Months Ended : December 31, 1997

ADJUSTMENTS TO NET OPERATING INCOME INTRASTATE OPERATING REVENUE (000)	(1) Basic Local Service Revenue	(2) Inter-Territory Revenue	(3) Intra-Territory Revenue	(4) Misc Revenue	(5) Uncollectible Revenue	(6) Net Booked Revenue
1. Total Intrastate Revenue per Books	$1,840,864	$229,834	$162,101	$83,866	$29,913	$2,286,756
INTRASTATE ADJUSTMENTS						
OUT OF PERIOD ADJUSTMENTS:						
2. Expenses						$0
3. MR & PR Taxes						0
4. Other Out of Period Revenue *	5,317	0	800	240,347	0	246,464
5.						
6. Remove sharing accruals booked	137,267					137,267
7. Sharing Computation	(123,300)					(123,300)
8. Bond Refinancing 1995						0
9. SFAS 116						0
10. Bond Refinancing 1992						0
11. Other Reg/Nonreg Adjustments				(27)		(27)
12. Yellow Page Profits				0	0	0
13. Gains on Sales of Property	1,385				0	1,385
14. Income Related to Temp Cash Inv	177					177
15. Interest Reconciliation						0
16. Interest Imputation						0
17.						
18. Lobbying Expenses						0
19. Corporate Advertising Expense						0
20. Abandoned P[illegible]						0
21. Bellcore Dividends	567					567
22.						
23. Other Regulatory Adjustments						0
24. Total Accounting Adjustments, Intrastate	$41,213	$0	$800	$240,320	$0	$282,333
25. Total Adjusted Intrastate Revenue	$1,882,077	$229,834	$162,901	$324,186	$29,913	$2,569,089

* This adjustment includes the removal of BAPCO as booked under the new contract effective 1/1/96. Also included is an amount for Publishing Fees to reinstate the previous contract for 1997

FLORIDA PUBLIC SERVICE COMMISSION
TELEPHONE EARNINGS SURVEILLANCE REPORT

Company : BellSouth Telecommunications, Inc. - Florida
12 Months Ended : December 31, 1997

AVERAGE CAPITAL(INTRASTATE) ($000)	(1) Average Per Books	(2) Specific Adjustments	(3) Pro Rata Adjustments	(4) Adjusted Amount	(5) % of Total	(6) Cost Rate Sharing	(7) Cost Rate Actual	(8) Cost Rate Ceiling	(9) Weighted Cost Rate Sharing	(10) Weighted Cost Rate Actual	(11) Weighted Cost Rate Ceiling
1. Long Term Debt	1,146,609		(15,896)	$1,130,713	20.83%	6.50%	6.50%		1.97%	1.97%	
2. Short Term Debt	176,972		(3,997)	172,975	4.62%	7.99%	5.59%		0.36%	0.26%	
3. Preferred Stock	0		0	0	0.00%	0.00%	0.00%		0.00%	0.00%	
4. Customer Deposits	14,833		(335)	14,498	0.39%	6.50%	6.50%		0.03%	0.03%	
5. Common Equity	1,888,173	26,541	(43,243)	1,871,471	49.58%	13.11%	15.11%	15.11%	6.50%	7.53%	7.53%
6. Investment Tax Credits	50,349		(1,137)	49,212	1.31%	10.29%	11.91%	11.91%	0.13%	0.16%	0.16%
7. Cost Free Capital	497,204	30,374	(11,915)	515,663	13.77%	0.00%	0.00%		0.00%	0.00%	
8. Total Capital	$3,774,140	$56,915	(186,523)	$3,744,532	100.00%				8.99%	9.97%	9.97%

FINANCIAL RATIO

9. Interstate achieved return on equity — 15.11% @
FPSC Adjusted Basis

See Attachment A to Page 3 for signature

@ This ROE includes sharing for 12 months ending 12/31/97.

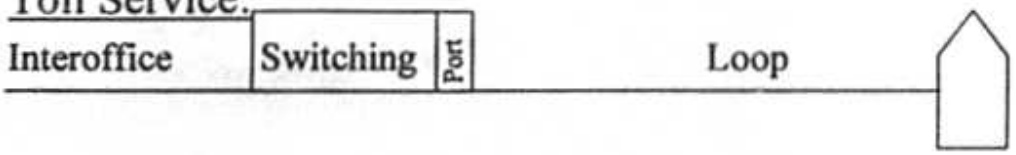
BELLSOUTH "DEREGULATED" COMPETITIVE SERVICES HAVE NEGATIVE RETURNS ON NET INVESTMENT

	DEREGULATED (Millions $)	Source:
1997 Revenues	$168	BellSouth 1997 Florida ARMIS Report 43-03, Column (J), Row 530
1997 Expenses	$187	BellSouth 1997 Florida ARMIS Report 43-03, Column (J), Row 750
Net Income	($19)	Revenues - Expenses
Total Investment	$197	BellSouth 1997 Florida ARMIS Report 43-03, Column (J), Row 370
Total Reserves	$125	BellSouth 1997 Florida ARMIS Report 43-03, Column (J), Row 495
Net Investment	$72	Investment - Reserves
Return on Net Investment	**-26%**	Net Income / Net Investment

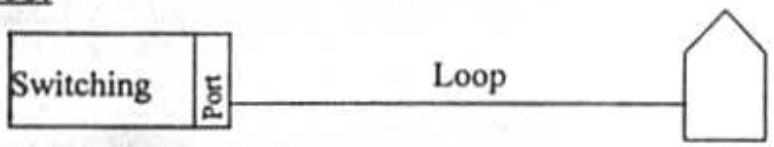
J:\QPRODATA\Florida98\DEREGULATED.wb3

Special Project No. 98000A-SP
Attorney General Final Comments
Exhibit No. AG-3
Page 1 of 1

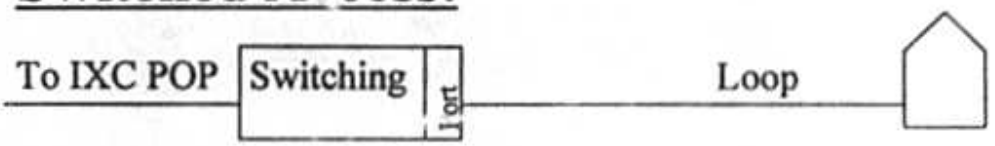
Toll Service:



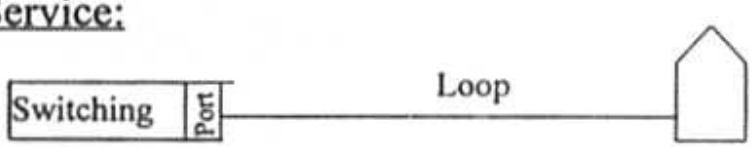
Vertical Service:



Switched Access:



Basic Local Service:



Public Information

INCORRECT LEC "CONTRIBUTION" METHOD

USING ACTUAL DATA FOR SPRINT-FLORIDA

Per Line Per Month

Service Category	(A) Revenue	(B) Direct Cost	(C) Sprint Claimed Loop Cost	(D) Sprint Claimed Port* Cost	(E = B + C + D) Total Cost	(F = A - E) Contribution
Intrastate IntraLATA Toll	$1.35 (3)	$0.04	$0.00	$0.00	$0.04	$1.31
Intrastate Switched Access	$6.75 (3)	$0.50	$0.00	$0.00	$0.50	$6.25
Residential Basic Exchange (Includes $3.50 EUC	$14.23 (1)	$3.21	$21.44	$0.56	$25.21 (1)	($10.98)
Residential Vertical Services	$3.56 (2)	$0.29	$0.00	$0.00	$0.29	$3.27
Total Residential Local	$17.79	$3.50	$21.44	$0.56	$25.50	($7.71)

Sources:

Toll: Sprint's Contribution Analysis and Total Service Long Run Incremental Cost Study, Intra-LATA toll, page 1.
Switched Access: Sprint's Contribution Analysis and Total Service Long Run Incremental Cost Study, Switched Access, page 2.
Residential Basic: Sprint's Contribution Analysis and Total Service Long Run Incremental Cost Study, Residential, page 4 and page 8.
Residential Vertical Services: Sprint's Contribution Analysis and Total Service Long Run Incremental Cost Study, Features, pages 1,4,7,10,13,16,19,22,25,28,31,34,37, and 40.
Loop & Port: Sprint Florida, Inc., Contribution Analysis and Total Service Long Run Incremental Cost Study, Residential, Page 8, Revised October 30, 1998.

Note: Please note that repeating the LEC presented cost does not mean the Attorney General is agreeing with these costs. For example, these LEC costs were calculated using costs of money, depreciation rates, and other inputs that the Attorney General and other parties may not agree with. However, to simplify the presentation and to focus solely on the issue of the mis-allocation of the loop costs, the Attorney General has chosen not to present alternative values of the cost of the loop facility in this presentation.

(1) For residential basic, Sprint had already provided these costs on a per month basis. Sprint Florida, Inc., Contribution Analysis and Total Service Long Run Incremental Cost Study for 980000A-SP: Undocketed Special Project: Fair and Reasonable Rates, August, 1998, Attachment, Page 1, Revised October 30, 1998.

(2) For vertical services, the Sprint provided residential revenues and costs were calculated on a per line basis.

(3) For intraLATA toll and access, the Sprint calculated costs per minute were applied to the Sprint average minutes of user per line per month.

*The port facility is equipment in the central office that is connected to the loop. It provides functions such as providing the dial tone line, and putting the signal on the line that rings the telephone. The port, just like the loop, is needed for all services. For example, in order to provide toll service, you must have the equipment that allows the telephone to ring, even if you do not also provide basic exchange service.

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Special Project No. 980000A-SP
Attorney General Final Comments
Exhibit No. AG-5
Page 1 of 3

CORRECT ANALYSIS

USING ACTUAL DATA FOR SPRINT-FLORIDA

Per Line Per Month

Service Category	(A) Revenue	(B) Direct Cost	(C = A - B) Contribution To Shared & Common
Intrastate IntraLATA Toll	$1.35	$0.04	$1.31
Intrastate Switched Access	$6.75	$0.50	$6.25
Residential Basic Exchange (Includes $3.50 FUCL)	$14.23	$3.21 *	$11.02
Residential Vertical Services	$3.56	$0.29	$3.27
Total Residential Local	$17.79	$3.50	$14.29

*The $3.21 cost is the cost of local switching, EAS switching, and EAS transport exactly as calculated by Sprint. By utilizing this cost in this Exhibit, the Attorney General is not necessarily agreeing with that cost. For example, the Attorney General expects that a lower cost of money or different depreciation rates than used by Sprint in this calculation might be found to be appropriate. The Attorney General is not raising those issues to simplify this discussion. The Attorney General reserves the right to present a more appropriate cost of money, depreciation rates, etc. in other proceedings as appropriate.

Sources: Shown On Previous Page of This Exhibit

THIS EXHIBIT HAS BEEN OMITTED.

IT CONTAINS INFORMATION CLAIMED TO BE

PROPRIETARY BY BELLSOUTH AND GTE.

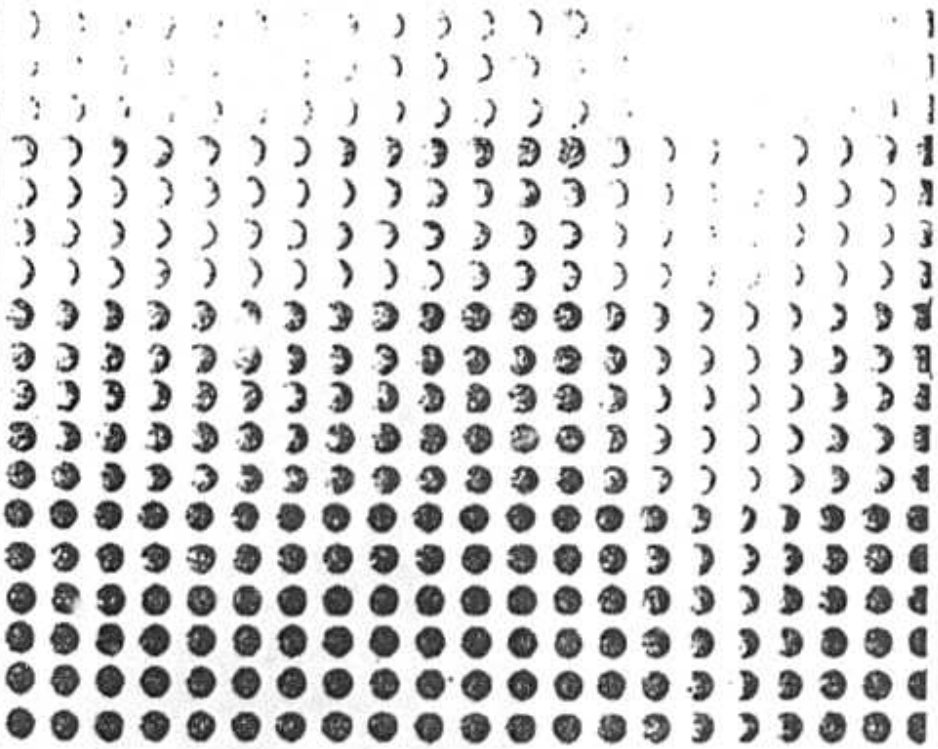
THIS EXHIBIT HAS BEEN OMITTED.

IT CONTAINS INFORMATION CLAIMED TO BE

PROPRIETARY BY BELLSOUTH AND GTE.

AT&T

Telecommunications Glossary



CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of the foregoing has been furnished by hand delivery to those noted (*) and U.S. Mail to all of the following this November 13, 1998:

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(2) The cost of providing local telecommunications service in Florida consists mostly of "joint and common costs," as that term is used in Public Law 98-277, because they support all services provided through local exchange networks. The extent of their allocation to basic residential local service is a public policy question, and would determine the "cost" of that service.

(3) Current rates for basic residential service in Florida were determined based upon a value of service determination. Based upon this factor, basic residential rates in Florida continue to be fair and reasonable.

(4) Florida's rates for basic residential service have been determined in the same way as have rates in other states, and are comparable to them. Differences in rates between the states could not be definitively determined, but appear to be related to differences in costs. Florida has telecommunications cost advantages that result in lower residential and business rates than in other southeastern states.

(5) Current rates for basic residential service in Florida do not appear to impede the spread of competition in telecommunications services; nor do they impair the viability of the state's incumbent local exchange companies or their capacity to respond to competitive challenges.

(6) The incumbent local exchange carriers propose "rebalancing" rates, through raising basic residential rates and lowering other rates. Raises in basic residential rates would appear to make telephone service unaffordable for many Floridians, particularly low-income and elderly persons, based upon a survey of telephone subscribers conducted by the Commission. Lifeline program participation in Florida remains at only about 2% of all residential subscribers of basic service, and has actually declined for the past two years.

(7) Based upon a consideration of the above factors- cost of basic residential service; a value of service review; comparable rates in other states; and affordability- basic residential rates currently charged in Florida are fair and reasonable. Current Florida law provides that the price caps for basic residential rates may be raised by the Commission under price caps based upon a "substantial change in circumstances" since 1995, or the rates may be raised in a rate proceeding. These proceedings afford incumbent local exchange carriers adequate opportunities to implement changes in their rate structure that may be needed in the future to address increases in competition in their markets. The Commission is the appropriate forum to determine the extent, if any, of future rate increases.

In the remainder of this comment, we discuss specific determinations which should reasonably be drawn by the Commission that support these conclusions. We address each of the four factors designated in Public Law 98-277 for the study's consideration. We then discuss the LECs' proposal to raise basic residential rates, its lack of justification, and its devastating effect on the affordability of telephone service; why present rates are "fair and reasonable," taking into consideration the factors specified by the Legislature, and how the factors interrelate; and conclude by pointing out the appropriate remedies available to address the concerns expressed by incumbent local exchange carriers.

(1) The cost data the Commission received from telecommunications carriers for this report consisted not of the actual cost of existing state networks, but rather consisted of the costs of building from scratch maximum technology networks, using the carriers' own depreciation schedules. Carrier estimates of the costs of these hypothetical networks ranged

from below the revenues currently received from basic residential service alone, to several times that amount. No information was presented that the costs of telecommunications networks has increased in recent years, and the Public Counsel's expert is of the opinion that they have decreased. The use of hypothetical data precluded any opportunity to "verify" costs, and the truncated nature of the Commission's review prevented any definitive determinations as to the true costs of providing telecommunications services in Florida.

The cost data submitted by the major incumbent local exchange carriers in Florida, BellSouth, GTE and Sprint, consisted by their own acknowledgment of the costs of building from scratch state-of-the-art telecommunications networks in Florida. The systems they propose are designed to maximize economic benefit to the companies, through increasing the capacity of the companies to offer advanced services, rather than to meet subscribers current needs at least cost. Consistent with their company-oriented perspective, the models allocate network costs only to the basic services for which the companies hope to increase rates, placing upon users of basic service the purported costs of enhancing networks for the benefit of the local service providers.

The companies models do not consider existing telecommunications facilities and equipment. Rather, they divide the state into a hypothetical grid, each segment with its own costs, and estimate costs for providing different services, such as business and residential services, through an entirely new network, by the number of subscribers in each grid segment. The models ignore key aspects of basic service other than hypothetical line cost, such as the advertising provided business subscribers through yellow-page listings; and allocate to vertical services, for which the companies hope to decrease rates through subsidies from basic services, none of the network costs and only part of the switch costs needed to complete execution of particular services. For their calculations, they

used their own depreciation schedules to estimate annual costs, that for many elements of their networks estimate useful lives approximately a third less than the regulatory depreciation standards they had employed prior to their election to leave rate-based regulation in Florida in late 1995.[1]

The incumbent LECs' mapping of the hypothetical costs of their models to individual services is particularly arbitrary. Basic local service is allocated all of the costs of the local loop, in defiance of more than half a century of rate setting practice in this country, save part of the costs of switches needed for long distance and vertical services. Business service is estimated to cost slightly less than residential service, not because of differences in actual costs, but rather because only the cost of hypothetical phone lines are considered, and businesses are slightly more concentrated than residences in concentrated, lower-cost sections of the statewide grid employed by the LECs' costing models.

The cost estimates submitted by the telecommunications carriers vary widely. AT&T estimated that the monthly per-line cost of local networks in total, the "local loops," generally is less than the rates charged for residential basic service alone. The incumbent local exchange carriers, on the other hand, estimated the costs of basic residential service alone, using the allocations of their hypothetical models discussed above, to be over twice the rates charged for residential basic service.

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[1]Consolidated Statements of Income and Notes, in 1998 10-K reports [1997 Annual Reports] of BellSouth Telecommunications (Note M), GTE Florida (Note 2), and Sprint-Florida (Note 8), as filed with the Securities and Exchange Commission.

BellSouth Telecommunications reduced its estimated economic asset lives of its digital switching from 17 to 10 years, and its other circuits from 10.5 years to 9.1 years; of its buried and aerial metallic cable from 20 to 14 years; and its underground metallic cable from 25 to 12 years. GTE Florida reduced its average depreciable lives of copper from 20-30 years to 15 years; of switching from 17-19 years to 10 years; of circuit from 11-13 years to 8 years; and fiber from 25-30 years to 20 years. Sprint-Florida discontinued using regulatory depreciation standards, but did not disclose in its annual report the company's reductions in asset useful lives.

For the more rural exchanges, the models produce cost estimates up to seven times current charges for basic residential service. The Public Counsel and Attorney General produced experts who stated that the rates for basic residential service are between the stand-alone and full-loop costs generated by the companies' models, as they were the last time the Commission looked at this issue, in 1987.

At no point have any of the incumbent local exchange carriers claimed that their costs have increased in recent years, such that these costs would justify considering an increase in the price caps for basic service. Considering that Florida's incumbent local carriers' profit margins continue to be over 30% per year[2], it would be hard for any of them to make this argument. The Public Counsel's expert, Dr. Marvin Kahn, is of the opinion that these costs actually have declined.

FLORIDA LEGAL SERVICES objects strenuously to the use of hypothetical cost models, such as the LECs propose, to estimate costs of basic residential service, rather than the costs of the services actually provided. Such pricing is a huge policy change, that we believe only the Legislature can make. Local telephone service today, and all other regulated utility services, are priced based upon actual cost. Cost data is relevant to residential phone rates only to the extent that they describe the services actually provided.

We do not question the appropriateness of using hypothetical cost models for purposes other than providing service directly to subscribers, such as determining the charges that one provider should pay another for use of network components, or for high-cost universal service support. These uses, which are currently followed, are long-range arrangements that involve indeterminate sources

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[2] - Consolidated Statements of Income and Notes, in 1998 10-K reports [1997 Annual Reports] of BellSouth Telecommunications, GTE Florida, and Sprint-Florida, as filed with the Securities and Exchange Commission. BellSouth Telecommunications pre-tax profits in 1997 were 33.1%. GTE Florida's pre-tax profits in 1997 were 32.5%, and Sprint-Florida's pre-tax profits in 1997 were 31.8%.

of revenues and of opportunity costs. In the case of high-cost support, a measure is sought of what would be the reasonable cost of serving high-cost areas over a future period of time, for which it is appropriate to consider both efficient as well as actual costs, and future as well as current costs. Over the length of time of these provisions, it is reasonable to project that telecommunications networks will be reconfigured through measures such as are specified in these models, and it is reasonable to price long-term access to these networks on this basis. However, when rates for specific consumer services are being determined by regulation due to the presence of monopolies, as occurs for basic residential phone service in Florida, cost calculations that will be used in setting these rates should be based upon actual costs rather than hypothetical costs.

Use of the local exchange carriers' cost data is limited not only by policy considerations, but also by the limited process that the Commission and interveners have had to review the submitted data and studies. The use of hypothetical cost data precluded any opportunity of the Commission or interveners to "verify" the data. The review, although in terms of time limitations as much as the Legislature permitted, was wholly insufficient to arrive at any definite conclusions as to costs, even if the appropriate data had been supplied. There has been only the beginnings of discovery, with disputes over hundreds of initial interrogatories not even resolved, and not enough time to conduct even the limited amount of inquiry that has taken place. There have been none of the features of contested dockets that assure some level of reliability and confidence in the results, such as open issue identification; independent Commission staff aggressively probing company claims; full discovery; findings of fact based upon sworn testimony and cross examination; and specific rate proposals of the LECs for the Commission and public to react to.

costs therefore fall within the "joint and common" category of costs that the Commission has been requested to review by Public Law 98-277.

The manner in which network cost is allocated therefore is one of policy, rather than of physical separateness. One service of the network thus does not subsidize another, to the extent that they each use common facilities. These are well-accepted conclusions that the Florida Public Service Commission has repeatedly drawn in setting telecommunications rates, and that all other states have also drawn in setting their rates. The Federal Communications Commission also views costs of local exchange networks in a similar manner, in its endorsement of the policy that rates for services should be set between the stand-alone and incremental cost of the service.

At least one of the local exchange carriers, GTE, attempted to assert through one of its experts that economic theory supports allocating all the costs of the local loop to basic local service alone. However, economics in fact makes no such point, and there is no support for this view in the decisions of the Commission or of similar regulatory agencies of other states. Very few economists have published thoughts on the issue, and none in the major academic journals of the profession.[3] While some economists, generally those working for local exchange carriers such as one or two of the experts offered by the carriers in this review, have echoed GTE's position, a not much smaller group, such as David Gabel and D. Mark Kennet, cited in GTE's Mr. Danner's comments, have not.

The reason for the silence from economists on this issue is that economics is a behavioral

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[3] - The journals I am including as major academic journals are the leading theortetical journals: the *American Economic Review*; the *Journal of Political Economy*; the *Quarterly Journal of Economics*; the *Journal of Public Economics*; and, for good measure, the *Journal of Law and Economics*. The other major academic economics journals focus on quantitative and econometric articles. The journals cited by the LEC experts are trade journals in the "law and economics" area that do not focus on academic research in economics. For this point, I researched the articles cited by the LECs' experts, including bibliographies, and the articles cited therein, and so on.

rather than an accounting science, and has nothing to say on the *a priori* classification of a cost between different products. Economic analysis begins after the accounting is done, once products have costs assigned to them and markets for the products are externally defined. Economists have not even resolved such basic issues as the extent to which customers make purchases based upon "opportunity costs," i.e., other alternatives available to them, as opposed to external differences in tastes, and they have little inclination to.

Disinterested economists, practicing only their craft, treat local exchange carriers as monopolists that offer one service, access to a switched telecommunications network, and that attempt, as do all monopolists, to segment customers in order to maximize profits, by offering access to the switched features- vertical services- based upon propensity to pay. Regulatory agencies therefore oversee monopolies, in order that the services instead are priced based upon their value to consumers. To an economist, as long as no other companies can replicate local exchange networks or sub-parts thereof, monopolies continue to exist, and there are no separate products. Only when separate competitive markets are created for separate bundles of services, a process which would force telecommunications carriers to make their own, accounting-based division of costs in order to determine product profitability, would economists show interest in product costs, and even then they would be interested only in the behavior of the carriers, rather than in the propriety of the division of costs.

(3) Current rates for basic residential service in Florida were determined based upon a value of service determination. Based upon this factor, basic residential rates in Florida continue to be fair and reasonable.

specialized telecommunications consulting, services and products; and (5) tax deductibility of telephone expenses. Florida has among the lowest rates in the southeast for basic business service. (Table 1.) This is a very good deal for Florida businesses at a reasonable price, and most businesses in Florida gladly take advantage of it.

Basic residential service is priced at the residual needed to assure local exchange carriers a reasonable rate of return. This pricing practice is based upon the public policy of universal service, which recognizes the benefits to the community as a whole of its residents' universal connection to the telecommunications network, through a rate for basic residential service that is universally affordable. Universal service, and the public's support for it, is girded upon several benefits provided to the public at large. First, universal service adds value to the local network for the public at large, including those making incoming calls to subscribers, and businesses that have contact with customers through telephone service. Second, access to the local network also provides an opportunity for companies that sell other telecommunications services to also obtain business, especially long distance companies, and therefore it is reasonable and just for non-basic services to bear part of the cost of the network.

Finally, local network access is today an indispensable link to the world for millions of subscribers, particularly for those who are elderly, disabled, or on limited incomes. The increase in mobility of American society over the past several decades, that has contributed dramatically to our current prosperity, has been integrally facilitated by the capacity of telephone service to continue relationships with geographically separated family members and friends. Modern transportation would be far less developed and attractive to its users without telephones. Suburb living, modern school districts, medical services, communications with employers and businesses, tourism, and

countless consumer services would be severely hampered without telephones. The transformation of our country from a collection of locally-based neighborhoods to a national matrix of people has resulted in a dependence on the telephone for many aspects of daily life.

The information related to the value of basic residential service that the Commission has received indicates that there has been, if anything, a decrease in the value of this service in the past several years, especially in the view of subscribers. This summer, the incumbent local exchange carriers distributed a bill insert designed by the Commission that solicited subscriber comments on current telecommunications rates and charges. Several hundred customers responded, and, in our review of them, not one thought that raising basic residential rates would be justified, or that they were receiving more value than they were paying for in their telecommunications services. In fact, almost all of the respondents felt that they were not receiving adequate value of service at current rates. The great bulk of the public comments received by the Commission this autumn at statewide public hearings echoed this sentiment. The incumbent local exchange companies' service quality review scores, compiled by the Commission and released last year, showed that service quality had slipped alarmingly in the previous year. BellSouth barely received a passing score, and GTE and Sprint scored less than half of a passing score. Complaints about "slamming," the unauthorized switching of carriers; "cramming," placing unauthorized charges on bills; and other consumer complaints about telecommunications service have skyrocketed in recent years.

The incumbent local exchange companies' asserted in this proceeding that the value of residential service has increased in recent years chiefly because of the increased use of phone lines for Internet access. Since Internet users pay for this access through web browsers, though, it is inappropriate to attribute the value of this service primarily to local exchange networks. Further, the

relevant question for value of service review is the relative value of one service to another, and there is no indication that Internet access has benefitted residential subscribers proportionately more than business subscribers. Finally, a very substantial number of households do not access the Internet. Use of the networks for basic telecommunications service does not benefit, and may be impaired by the demands placed upon the system by this new usage.

Use of "value of service" criteria should lead to telecommunications rates at about the current rates for these services. Present rate caps were set based upon a value of service review that reflected state policy, and the relative value of residential service has not increased in recent years. For the Commission to reinterpret the meaning of "value of service" would, in our view, constitute a uncalled for policy-inspired departure from the criteria for the rate study specified by Public Law 98-277.

(4) Florida's rates for basic residential service have been determined in the same way as have rates in other states, and are comparable to them. Differences in rates between the states could not be definitively determined, but appear to be related to differences in costs. Florida has telecommunications cost advantages that result in lower residential and business rates than in other local states.

Florida, like other states, currently prices local phone services based upon value of service. Basic residential service has been priced at the residual needed for a reasonable rate of return for the phone companies, after pricing, according to consumer value, access to long distance, through access charges; residential vertical services; and business services. The other states in the southeast, and, to our knowledge, all other states, have set rates for basic residential service in the same way. For

that reason, rates in other states are similar to those in Florida. Moreover, all of these states' rates demonstrate a state commitment to universal service through low basic rates.

Florida's basic residential service rates are generally similar to those of other states of similar size. (Table 2.) Of the six largest states, all have basic rates in major metropolitan areas that are lower than the $11.81 per month that GTE charges in the Tampa Bay area. Only in New York City and parts of California, where the cost of living is as much as twice that of Florida cities, are basic residential rates significantly higher than in Florida. These states share in common with Florida large concentrated populations that, allowing for cost-of- living differences in prices, offer similar local telecommunications markets.[4]

In the southeast, the metropolitan areas of other states have higher basic residential service rates than Florida, but they also have higher basic business rates as well, and are plausibly explained by higher costs. The basic business rates are steadily about two and a half times as high as the basic residential rates, sometimes a little higher, sometimes a little lower. In Alabama, for example, the residential rate is $16.30, and the business rate is $40.71. The difference in the rates can be attributed to apparent differences in cost. In each of these states, the percentage of residents who live in rural areas is twice as high as in Florida, and the state populations are less than half. Moreover, the differences in rates are proportional to how rural the state is, and how small its population is. (Table 1.) Florida should not give up its comparative cost advantages in telecommunications

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[4] - It is difficult to compare basic residential service rates precisely in other states because of differences in system costs and rate structures. There are differences in the structure of charges, and in the prevalence of unlimited versus measured service. In some metropolitan areas, residential service to new customers now is offered only on a measured service basis. Basic business rates in these states are not comparable to those in Florida because they do not share Florida's requirement that a flat monthly rate be available to businesses.

practice include the pricing of automobiles, computers, cellular phones, no-load mutual funds, "loss leader" grocery items, credit cards, and estimates of competitive services (typically given for free). Based on a review of other markets that are competitive, you would expect that competitive telecommunications markets would function based on offering easy access to the markets through low basic rates. When telephone service was still struggling for customers, competing on a more even plane than today with other forms of communication such as letter writing and personal visits, and before the telephone occupied its present unique role based upon universal service, phone rates indeed were kept low in order to attract subscribers to the network.

It therefore should not be surprising that the competitors to the incumbent LECs in Florida, the Florida Competitive Carriers Association, are opposed to the raising of basic residential rates prior to the presence of competition in local exchange markets. They see correctly that a significant part of the additional revenues the incumbent LECs receive from the rate increases would be used against the competitors to lower the price of other services in order to fend off competition. In their preliminary comment submitted in this proceeding, the Association stated:

> . . . . Significantly, an entrant to the residential local exchange market will similarly view customers by the *total* potential revenue the customer represents. . . . The goal of a competitive entrant is to win customers. To the extent that the prevailing pricing strategy is popular with consumers, the Commission should expect that it will be *mimicked* by entrants (although with lower overall prices).
>
> . . . . [F]undamental to the Association's position, however, is that the incumbent local exchange companies should not be permitted the flexibility to restructure their rates until competitive alternatives exist. No *market-based* rebalancing of rates can occur unless a *market* develops first.

The LECs' focus on the basic residential rate alone as the primary incentive for competitive

into account. (Table 2.)

Competition, for competition sake's alone, is a hollow, empty mantra that deserves no credence from Floridians. Whether we have competition in local exchange networks in Florida should depend entirely upon whether the public overall will benefit. Florida should not give up its natural cost advantages for telecommunications services through higher phone rates, just so that non-incumbent LECs can duplicate services already provided, but at higher rates.

Current pricing of local exchange services in Florida appears to be eminently fair to local exchange carriers. The costs of providing local exchange service do not appear to have increased, and may have decreased, over the past several years. Florida LECs have maintained or increased their substantial profitability over this time.

Each of Florida's three large LECs reported in their 1997 annual reports that their non-depreciation expenses have remained nearly stationary over the past three years; and that they substantially increased their depreciation-related expenses in the fourth quarter of 1995 after opting out of rate regulation earlier that year. The LECs reported that they made the accounting change not because of increased costs, but rather to take advantage of no longer having to follow regulatory guidelines, and thus being able to increase their depreciation allowances, and consequently capital expenditures, in order to better position themselves competitively in subsequent years. The result was that the Florida LECs reduced the estimated useful life of much of their infrastructure (cable, circuits, switches, etc.) by a third or more; took massive extraordinary charges in 1995; and generally increased their depreciation allowances in subsequent years. In spite of these large accounting adjustments, Florida's three large LECs continued to be highly profitable, reporting pre-tax profits

in 1997 of at least 32 percent.[5] Florida LECs may petition the Commission for a rate increase if they believe that "circumstances have changed substantially [since Florida's deregulation of local exchange service in 1995] to justify any increase in the rates for basic local telecommunications services," F.S. §364.051(5), but no such petition has been filed.

(6) The incumbent local exchange carriers propose "rebalancing" rates, through raising basic residential rates and lowering other rates. Raises in basic residential rates would appear to make telephone service unaffordable for many Floridians, particularly low-income and elderly persons, based upon a survey of telephone subscribers conducted by the Commission. Lifeline program participation in Florida remains at only about 2% of all residential subscribers of basic service, and has actually declined for the past two years.

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[5]- Consolidated Statements of Income and Notes, in 1998 10-K reports [1997 Annual Reports] of BellSouth Telecommunications (Note M), GTE Florida (Note 2), and Sprint-Florida (Note 8), as filed with the Securities and Exchange Commission.

BellSouth Telecommunications (BST) reduced its estimated economic asset lives of its digital switching from 17 to 10 years, and its other circuits from 10.5 years to 9.1 years; of its buried and aerial metallic cable from 20 to 14 years; and its underground metallic cable from 25 to 12 years. As a result of the accounting switch, BST posted an extraordinary charge in 1995 of $2,718 million after taxes. BST's depreciation and amortization rose from $3,065 million in 1995 to $3,332 million in 1997, while its other regularly occurring operating expenses rose by two percent. BST's pre-tax profits in 1997 were 33.1%.

GTE Florida reduced its average depreciable lives of copper from 20-30 years to 15 years; of switching from 17-19 years to 10 years; of circuit from 11-13 years to 8 years; and fiber from 25-30 years to 20 years. As a result of the accounting switch, GTE Florida posted an extraordinary charge in 1995 of $374 million after taxes. GTE Florida's depreciation and amortization rose from $285 million in 1995 to $358 million in 1997, while its other operating costs and expenses rose by one percent. GTE Florida's pre-tax profits in 1997 were 32.5%.

Sprint-Florida discontinued using regulatory depreciation standards, but did not disclose in its annual report the company's reductions in asset useful lives. As a result of the accounting switch, Sprint-Florida posted an extraordinary charge in 1995 of $139 million after taxes and other adjustments. Sprint-Florida's depreciation rose from $228 million in 1995 to $247 million in 1997, while its other regularly occurring operating expenses rose by four percent. Sprint-Florida's pre-tax profits in 1997 were 31.8%.

encourages competition, as we have shown; and the cost allocation, contrary to the assertion of at least one of the LECs, GTE, does not have the support of economic theory, as we have also shown.

All phone services, not just basic service, use the local network, and require the functioning of the local network to be operable and of economic value. The local network is built and physically designed to fully facilitate all of these services. It would be inequitable for local exchange companies to build local exchange networks designed to facilitate all of these services, and then to arbitrarily assign almost all of the networks' costs to basic service alone, or to some other service, and to charge customers accordingly.

B. Affordability of LEC Proposal.

The proposal of the LECs to raise basic residential rates would have a devastating effect on the affordability of residential service, and, *ceteris paribus*, would end universal service in Florida. In the Commission's own telephone survey of over 1,500 ratepayers in Florida, over 7% of all subscribers, many of them elderly or low-income, said they would discontinue their basic residential service if the rate were increased just $2. This would lower Florida's telephone subscribership to the lowest percentage in the nation. An additional 20% of the remaining subscribers said that they would discontinue basic service when the rate rose by $10.[7] Regardless of the eventual treatment

[7] - These survey results were reported by both the Attorney General and AARP experts in this proceeding. FPSC staff made available the survey results only in a form that required further extraction by a SAS or equivalent database program, which we do not possess. We corroborated the reported findings by reviewing the spreadsheet runs that had been conducted by AARP expert Mark Cooper. The results reported by the Attorney General and AARP are approximately similar, and both support the conclusions discussed in the text. There are additional analyses of the data that would be relevant to our clients, but, without access to the complete survey results, we were unable to conduct them within the time confines of preparing this comment.

of this survey, it is incumbent upon the Commission, and the Legislature, to listen and act accordingly when so large a percentage of ratepayers say that higher basic residential rates would cause them to disconnect from telephone service.

The factor of "affordability" in the Commission's review of basic residential rates in Florida provides a balancing factor against raising basic rates for other reasons, under which the issue of loss of subscribers, or other customer hardship, caused by rate increases would be weighed against public benefits, if any, obtained through raising basic rates. Consideration of affordability impacts would also involve review of alternative to across-the-board rate increases that would not have these impacts.

By "affordability," FLORIDA LEGAL SERVICES believes that the Legislature intends that the Commission look at how changes in basic service rates, particularly increases, may affect the affordability of the service for customers. We believe that there are three major issues for the Commission to consider in addressing this factor. First, to what extent would basic rate increases lead to customers discontinuing basic residential service, and what would the consequences be of this? Second, how might rises in the basic rate affect customers who are able to retain their service, but with difficulty, and what would be their perception of the changes? And third, how would customers who are relatively unaffected by basic rate increases perceive basic rate increases, and would they too consider the new rates to be "unaffordable?" Judged by these criteria, we believe that increases in basic rates at this time would result in the higher rates being "unaffordable" to many current telecommunications customers.

The current rates for basic residential telecommunications service in Florida, currently about $10 to $12 per month, are affordable to many households, as evidenced by their subscription to basic

residential service. However, many low-income recipients, especially those who would qualify for public assistance, cannot afford telephone service even at these rates. In the only report of which we are aware on public assistance recipients' subscription to telephone service, a 1989 report by the Federal Communications Commission,[8] 31 percent of households that receive food stamps do not have telephone service; 28 percent of households that receive welfare as part of their household income do not have telephone service; and 21 percent of households in public housing, or in receipt of federal energy assistance, LIHEAP, do not have telephone service.

Every dollar rise in the monthly basic residential rate means $12 less in phone customers' annual budgets, and will force some customers to leave. Few low-income households have savings they can draw upon, or unnecessary expenses that they can cut. Some do not have $12 extra per year; more still do not have $24 extra per year; and so on. Those who will pay the increases may buy less medicine for themselves, or less orange juice for their children. Raising basic rates to $20 or more per month, which would cause households to have to pay more than $100 per year extra for telephone service, would cause basic service rates to become unaffordable to many households, and should be expected to cause a widespread exodus of low income households from telephone service.

Rises in basic local telecommunications rates would have devastating effects upon the public. The reasons for this derive from the nature of telephone service itself. Telephone service is absolutely vital to households in today's society. Yet despite the great importance of being connected to the telecommunications network, telephone service is among the more likely candidates for elimination from household budgets should basic rates rise, for two reasons. First, the value of

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[8] - "Telephone penetration and household family characteristics." FCC Docket No. 87-339 (1989). We attach a copy of a recent article on this subject that discusses the results of this FCC report.

telephone service is shared between the telephone customer and those who communicate with the customer through the telephone, so that the total value of telephone service is greater than that derived from the customer alone. The losses associated with termination of phone service borne by relatives who are no longer able to contact the customer; by businesses that lose profits because they are not called; and by communities that suffer from unemployment, lack of school attendance, and health problems fostered by the lack of phone service, are not fully considered by the customer when service is terminated.

Even more importantly, telephone service is used intermittently. It is the most valuable of all consumer goods or services when it is needed most, but at other times may not be used at all. Households that are on very tight budgets must pay for housing, power, water, nourishment and medicine, or perish. Phone service, compared with these expenditures, is not as immediate, and is more easy to terminate, than these other expenditures, and so is more likely to be discontinued if its rates rise. Yet the consequences down the road to a household without telephone service are disastrous. Low-income households without telephone service have difficulties staying employed, keeping children in school, and staying connected with sources of support that can assist them in escaping poverty. They become trapped in unsafe and unhealthy neighborhoods. The ill hurt more, isolated by themselves. The elderly simply die.

Even many households with income several times the poverty level, though, are on very tight monthly budgets. Expenditures for family members, pets, transportation and outstanding debts have accumulated for many households to barely manageable levels, or beyond. The raising of basic telephone rates, to these households, means calling mom less often; foregoing a favorite recreational activity; or putting off needed car repairs. Rises in basic rates must be perceived to be necessary in

of telephone subscribers statewide do. More distressingly, participation in the program has steadily decreased over the past two years. Lifeline definitely is not a viable protection for most persons adversely affected by higher basic residential rates.

We do not have any information on practices of the LECs that may be discouraging Lifeline participation. There are several other reasons for the low participation rate, though. Approximately half of low-income non-participants do not qualify for Lifeline/Link-Up assistance because they do not meet the Florida program requirement of receiving one of a number of public benefits. The remainder are required to initiate their application to the program, and there are many reasons common to nonparticipation in any public benefit program, including lack of knowledge, inability to apply, personal oversight, personal circumstances, and so on, why the remainder of non-participants fail to apply to the Lifeline program. As the Lifeline/Link-Up program is currently structured in Florida, it will be provide insufficiently available relief to low-income customers affected by increases in basic residential service rates.

2. Subscribership rates in neighboring southeast states with higher basic residential rates.

The LECs also assert that the rise of telephone subscribership over the past ten years in neighboring southeastern states which have higher basic residential rates shows that increase in rates will not discourage telephone subscribership in Florida. In none of these states, though, was there a rise in telephone rates that would cause disconnections. When we compared changes in telephone subscribership in these states to changes in real inflation-adjusted median household income over this period, we found, first, that nationally over this period there was a slight increase in telephone subscribership independent of income. Changes in individual states' telephone subscribership rates

be offset through lesser expenditures on vertical services. We have reviewed the sources of information cited by the LECs in support of their assertion, outlined below, and conclude, for the reasons given below, that the data they cite do not show that low-income and Lifeline eligible households would be able to draw protection from increased basic residential rates through decreased purchases of vertical services.

a. FCC expenditure data.

One of the LECs, Sprint, asserted that FCC data on telephone expenditures shows that about half of low-income subscribers' expenditures for local telecommunications service are for non-basic services. The FCC data referred to, contained in the FCC's Reference Book, however, makes no such interpretation. The FCC obtains its information on telephone expenditures from the Census Bureau's consumer expenditure survey. The survey asks for expenditures in a number of broad categories for the purpose of determining whether the categories should be included in the Consumer Price Index. Telecommunications expenditures can include any charges on bills, including past due payments, late charges and penalties, connection charges, etc., and can even include non-billed expenditures such as calls from toll booths. The 1997 Reference Book indicates in footnotes to its consumer expenditure tables that the telephone expenditures include non-billed expenditures, and that the monthly expenditures of households with telephone service include any charge that might be on the bill. The data simply don't isolate whether any of the expenditures are for vertical services.

b. LEC surveys of subscribers.

GTE and Sprint each indicated that they had conducted surveys of their own customers that included a determination of subscription to vertical services, and that these surveys showed that a significant number of low-income subscribers purchased vertical services. The GTE survey, however, differentiated customers not by household income, but rather by residence in a Census area that, almost ten years ago, was considered low-income. Sprint did not know how the survey was conducted, its scope, or what it asked, having commissioned a consulting firm to conduct it, but believed that the survey designated as "low income" households with less than $25,000 annual income. Sprint did not present enough information to allow a credibility evaluation of its results, and most households with income less than $25,000 in Florida are not low income. Neither survey isolated low income subscribers.

GTE also referred to a survey of telephone subscribers conducted in California after the increase of basic rates in that state earlier in this decade, that showed little change in subscribership levels. However, any subscriber in California who was adversely affected by the rate increases could self-certify for inclusion in the state's Lifeline program, and, according to FCC data, subscribers receive a partial rebate of their monthly telephone bills from the state. Such means of lessening the impact of a rate increase are not available in Florida.

c. FPSC staff inquiries of LECs on Lifeline subscribers

Outside of the process for this proceeding, and therefore without the opportunity for interested parties to review the data during the technical workshop for this report, FPSC staff asked LECs to identify the "ancillary services" subscribed to by Lifeline customers. The LECs reported that

subscribership to "ancillary services" was higher than the subscribership levels for vertical services by their entire residential subscribership. When we looked at the questions and responses, though, we are unpersuaded that the subscribership of Lifeline eligible households to vertical services is anything near the reported levels, for the following reasons:

1. The LECs were free to determine what to measure as ancillary services and what to include in ancillary services expenditures. All the LECs supplied were conclusory tabulations, without explanation of their derivation, that would support the policy positions that they are very strongly advocating. BellSouth did attach a list of services it said were included, but the list appears to be out of date and for illustration only, as at least one of listed services, Calling Number Delivery Blocking, is obsolete according to its tariff.

2. Given the GTE and Sprint studies, we do not believe that the LECs actually have data on subscription to vertical services that can be broken down by customer category, and believe that what the LECs actually reported was the incidence and extent of additional charges and services of any kind on Lifeline customers' bills. We regret that the staff survey and its responses could not be openly reviewed in the technical workshop held in this proceeding.

3. The LE responses appear to include participation in toll blocking, a part of the Lifeline program that assures non-disconnection of service, as an "ancillary service." Subscribership in ancillary services was higher than for toll blocking for every reporting LEC. BellSouth's tariff provides that toll-blocking is a vertical service, and that Lifeline subscribers who sign up for it would receive the service, but not be charged for it. When you remove participation in toll blocking from " ancillary service" subscribership, there is a dramatic increase in this subscribership. Other "ancillary services" that might be included in this tabulation, but are not paid for by subscribers in

assistance, such as college students and elderly parents living in assisted living or with their children. In addition, the survey asked, in approximately August of 1998, for "your family's household income . . . in 1997." Typically, slightly more than a quarter of all adults who are poor in one year are not poor in the following year.[9] Another group of persons would have temporarily escaped poverty at the time of the study, but would be considered in poverty for the year 1998. Finally, the confusing wording of the income question, apparently asking for income attributed to either "your," "family," or "household," led to fully one in five of the respondents not being able to answer the question. Taking into account all of these considerations, it is likely one-half of the "low income" responses, under $10,000 income in 1997, actually were not low-income at the time of the survey.

2. Many of the vertical services that were asked about could have legitimately been paid for by respondents on a monthly basis without their subscription to a service likely to benefit from "rate rebalancing." Call forwarding is available for $1 a month in Florida where one specific number, such as for a relative or friend, is designated. Low income persons often regularly rely on such individuals for their own care and for the care of their children. Unlisted numbers are available for less than $1 per month from BellSouth, a valuable service for abuse victims. Three-way calling is available on a per-call basis, for $0.75 per use. Voice message service is an obvious expenditure for households that needs the recording of messages, but cannot afford or otherwise cannot purchase or operate an answering machine.

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[9] - "Dynamics of Economic Well-Being, Poverty 1993-94," *Current Population Reports*, U.S. Bureau of the Census. The study found that 26.8% of all adults who were poor in the first year of the study were not poor in the second.

3. Survey respondents were selected, in part, based upon the ability of surveyors to contact them by telephone. Households with call waiting are easier to contact than other households, and more likely to answer a survey if they are expecting another call. The percentage of households surveyed who indicated that they had call waiting, about 60%, was substantially higher than the percent of households that the LECs indicated in their responses to staff data request 4c receive call waiting, about 42%. We believe that call waiting capability is responsible for most of this disparity, and that households with call waiting capability are also more likely than average to subscribe to other premium services, such as caller ID, whether on an *ala carte* or package basis.

4. Addition of subscriber line charge in the 1980s

Two assertions by LECs, that telephone subscribership is affected very little by increases in basic residential rates, and that the addition of the subscriber line charge in the 1980s did not decrease subscribership, both are based entirely upon data collected by the FCC in the time period 1984 to 1988 in about 500 areas around the country. The data, though, do not support the LECs' assertions. First, the $3.50 access charge was phased in between 1984 and 1989, and during the time period of the data did not exceed an average charge of $2.67. Second, the studies cited by the LECs do not measure significant parts of subscribers' bills over that period that actually decreased, such as charges for many subscribers' purchases of their telephone equipment in 1984 due to regulatory changes, and the reduced use of telephone leasing over that period; and do not account for differences between the places surveyed that may account for differences in subscribership between

In summary, local exchange networks are built and designed to facilitate all telecommunications services, not just basic service. The functioning of all of networks resources is necessary for the operation of each service. Network costs therefore fall within the "joint and common" category of costs that the Commission has been requested to review by Public Law 98-277. Alternatively, current rates for basic residential service are "fair and reasonable" because they fall within the stand-alone and incremental costs of basic residential service, and the rates are set based upon accepted state policy for the setting of such rates, the "value of service" methodology. The manner in which network cost is allocated therefore is one of policy, rather than of physical separateness. One service of the network thus does not subsidize another.

We object to the use of hypothetical cost models, such as the LECs propose, to estimate costs of basic residential service, rather than actual data. When rates for specific consumer services are being determined by regulation due to the presence of monopolies, as occurs for basic residential phone service in Florida, cost calculations that will be used in setting these rates should be based upon actual costs rather than hypothetical costs. We also believe that the process that the Commission and interveners have had to review the submitted data and studies, although in terms of time limitations as much as the Legislature permitted, is wholly insufficient to arrive at any definite conclusions as to costs, even if the appropriate data were supplied.

Florida, like other states, currently prices local phone services based upon value of service. Basic residential service is priced at the historically-determined residual needed for a reasonable rate of return for the phone companies, after pricing, according to consumer value, access to long distance, through access charges; residential vertical services; and business services. Florida's basic residential service rates, and basic business rates, are comparable to those of other states of similar

proposal is inequitable from a functional perspective. All phone services, not just basic service, use the local network, and require the functioning of the local network to be operable and of economic value. The local network is built and physically designed to fully facilitate all of these services. It would be inequitable for local exchange companies to build local networks designed to facilitate all of these services, and then to arbitrarily assign almost all of the networks' costs to basic service alone, and to charge customers accordingly.

The allocation of local exchange costs proposed by the LECs also is unreasonable because it supports unfair monopolistic practices, and does not further legitimate public issues, such as the development of competition in local exchange service in comparison with other states. Pricing basic residential rates based upon the LECs' proposed cost allocations would be an unfair monopolistic practice. Basic residential customers alone still are monopoly customers of local telephone customers, and therefore need continued regulatory protection as is contained in Florida's current price caps on basic residential rates, and on the amounts by which the rates may be increased.

Florida LECs may petition the Commission for a rate increase if they believe that "circumstances have changed substantially [since Florida's deregulation of local exchange service in 1995] to justify any increase in the rates for basic local telecommunications services," F.S. §364.051(5). This offers incumbent local exchange companies an adequate opportunity to obtain rate increases if there is cause for them. No such petition has yet been filed. The Commission is a far more appropriate forum than the Legislature for consideration of such requests to occur, especially because basic residential service subscribers continue to receive service from monopolies that need to be regulated by the state to prevent abuse. One issue the Legislature may wish to consider, in response to the only concern expressed by the LECs that we found to be possibly

legitimate, is whether to change Florida law so that LECs are no longer required to offer businesses flat rate service, so that businesses which contact with non-LECs for vertical services would still, in effect, pay appropriate "rent" for use of the local network through message rate service, rather than through vertical services.

Respectfully submitted,

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TABLE 1

Comparison of Local Service Phone Rates in Southern States Listed in Florida Public Service Commission Flier, by Percent Urban

	Population[1]	Percent of Population Living in Urban/Rural Areas[2]	Range of Monthly Basic Urban Residential Rates Reported[3]	Range of Monthly Basic Urban Business Rates Reported[4]
Florida	14,653,943	84.8% / 15.2%	$10.30 - $11.81	$28.00 - $29.90
Virginia	6,733,996	69.4% / 30.6%	$10.42 - $13.59	$21.96 - $49.33
Louisiana	4,351,769	68.1% / 31.9%	$12.64	$36.76
Georgia	7,486,242	63.2% / 36.8%	$14.85 - $17.45	$30.60 - $46.00
Tennessee	5,368,198	60.9% / 39.1%	$12.15	$39.70
Alabama	4,319,154	60.4% / 39.6%	$16.30	$40.71
South Carolina	3,760,181	54.6% / 45.4%	$14.77	$31.67
Arkansas	2,522,819	53.5% / 46.5%	$14.91 - $20.02	$30.66 - $40.73
Kentucky	3,908,124	51.8% / 48.2%	$17.55	$43.19
North Carolina	7,425,183	50.4% / 49.6%	$10.47 - $12.54	$28.22 - $33.96
Mississippi	2,730,501	47.1% / 52.9%	$17.95	$45.14

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[1] - ST-97-1 *Estimates of the Population of States: July 1, 1997*, U.S. Bureau of the Census.

[2] - Table 16, *1990 Census of Population and Housing*.

[3] - *1998 Reference Book for Telephone Service*, Federal Communications Commission. The basic residential rate is for private line unlimited calling at the minimum available rate. Rate data is from a survey of the telephone rates in 95 U.S. cities in October, 1996.

[4] - *1998 Reference Book for Telephone Service*, Federal Communications Commission. The basic business rate is for private line unlimited calling at the minimum available rate. Rate data is from a survey of the telephone rates in 95 U.S. cities in October, 1996.

TABLE 3

% HOUSEHOLDS WITH TELEPHONE SERVICE AVAILABLE

(Supplements Attachment 9 to Comment of F. Ben Poag (Sprint-Florida, Inc.))

	1988			1997		
	Household Median Income (1997 Dollars)	Telephone in Unit	Telephone Available	Household Median Income (1997 Dollars)	Telephone in Unit	Telephone Available
United States	$36,937	92.7%	94.5%	$37,005	93.9%	95.0%
Florida	34,469	92.7	94.5	32,455	92.8	94.0
Alabama	27,064	87.3	89.6	31,939	92.3	93.6
Georgia	36,043	90.1	92.4	36,663	92.0	93.0
Louisiana	27,809	87.3	91.1	33,260	91.0	93.5
Mississippi	24,646	83.3	88.6	28,499	89.2	93.2
North Carolina	33,124	90.4	92.8	35,840	93.1	94.2
South Carolina	34,641	88.5	91.4	34,262	92.5	93.8
Tennessee	28,296	90.3	93.5	30,636	94.5	96.4

Sources: Annual Averages, Table 3, *Telephone Subscribership in the United States (Data Through March 1998)*, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission (Released July 1998)

Table H-8, "Median Household Income by State: 1984 to 1997" *1998 March Current Population Survey*, U.S. Bureau of the Census.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that the original and fifteen copies of the foregoing Comment of Florida Legal Services was filed with Blanca S. Bayó, Director, Division of Records and Reporting, Florida Public Service Commission, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850; and that a true and correct copy was provided by U.S. Mail this 13 day of November, 1998, to:

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Beyond Universal Service:

Characteristics of Americans without Telephones, 1980-1993

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In a utopian information society, all individuals read and write with sophistication, helpful technological environments abound, and all citizens have access to information necessary for full democratic and economic participation. When envisioning the information super highway, some part of this utopian vision exerts great pull on the popular imagination because it promises a better life. Some version of that utopia lurks within the policy imagination as well. But since policy and the information super highway exist in the real world, utopia's call must be translated. That translation relies on a foundation policy that establishes the expected level of social participation for the information infrastructure as it develops.

For most of the 20th century, universal service has been that foundation information policy. As it came to be understood in the 1950s, universal service offered to everyone communication by telephone from their homes (Mueller 1993). As a new information infrastructure emerges, access to the network is once again on the policy agenda. Yet, while most of the participants in this discussion focus on the technological fog that enshrouds the future, the old question of universal telephone service -- who has it and who doesn't -- remains unsettled.

This paper explores the characteristics of Americans who lack home telephone service. The paper draws on Federal Communications Commission (FCC) and Census data, and covers the period 1980-1993, encompassing the distribution of telephone service before and after the break up of AT&T. More specifically, we focus on the elderly, the poor, women and children, blacks and Hispanics, rural Americans, and renters and home owners -- the primary groups lacking telephone service. We found that members of these groups exhibit both singular and overlapping characteristics. Thus, their lack of telephone service constitutes a challenge to policymakers that goes beyond the economic issues usually associated with universal service. The stakes are high for those without telephone service, because their limitation will soon include isolation from the evolving information society. The paper concludes by presenting policy alternatives that might lead to increased participation by all Americans.

The current telephone penetration rate per household is approximately 94%, generally regarded as evidence of the success of long-term universal service policy.[1] While some concern exists for those who are left out (Gilbert 1987), the weight of opinion believes that existing subsidy programs perform adequately to include all those who can reasonably be connected (Dordick and Wife 1991, Reinking 1985). More recently, new voices have called for a redefinition of universal service in light of the changing technological environment, and the emergence of a new information infrastructure (Williams and Hadden 1991, 1992).

But regardless of point of view all telecommunications researchers accept the assumption that the telephone represents functional membership in the information society. For example, people living without television or radio might appear rebellious, or to be adopting an alternative lifestyle. But people without telephones are seen as truly isolated from basic communication. Consequently, nearly all policy researchers agree that the remaining 6% of households without telephone service (estimated at 5.8 million households, and 15.3 million individuals) involves an excessive number of Americans. 2

The social circumstances surrounding the absence of a telephone in the home reveal a view of American society not easily visible. And they are key to our understanding of the progress of the Information Age. The following section presents findings that partially clarify this picture of society and challenge some conventional wisdom on universal telephone service.

Americans who lack telephone service

Of all American households, an estimated 94% have telephones. An additional 1.3% have a phone available or nearby. However, 4.5% (roughly 4.4 million households and approximately 11.6 million individuals)3 have no phone available (Belinfante 1993, December).4 Despite the recession, the percentage of households without telephone service dropped to 5.8%, or 5.7 million households (Belinfante 1993).5

The elderly

Conventional wisdom holds that the elderly are at special risk because American society does not provide for them as well as comparable European nations do. Yet, when it comes to telephone service, the elderly fair better than young parents with children. Access to telephone service for retired persons at all income levels was at the national average, or better. Only those receiving Supplemental Security income showed a lower penetration of telephones -- between 79.7% and 84.9% (Belinfante 1989).

The effects of low income

Income predicts telephone penetration for most groups (as with the elderly). When households are examined by income, the disparities become clearer (table 1, table 2). For example, 31% of all families receiving food stamps have no telephones. When households on food stamps contain four or more persons, about one-third do not have telephones (Belinfante 1989). Of households on food stamps for one month, 35.9% do without phones, suggesting that in the first shock of unemployment, many families give up telephone service. Although families recover some equilibrium once they adjust to living on food stamps, only a few regain telephone service -- of households receiving food stamps for 12 months or more, 30.6% remain without phone service (Belinfante 1989). The recession has put a range of families -- from farm workers to middle managers -- on food stamps and the effect on telephone penetration appears widespread.

When telephone penetration is viewed through the lens of welfare assistance, a similar pattern emerges. Of households receiving public assistance, 34.7% lack telephones; whereas, 27.9% of households on welfare lack telephones (Belinfante 1989). The penetration rate drops even further, to 43.5%, for households completely dependent on public assistance (Belinfante 1989). Households receiving energy assistance from the local utility company also indicate poverty. In households receiving energy assistance, 21.4% lack telephones (Belinfante 1989).

A fourth, but far less direct, measure of income can be derived from comparing renters with homeowners. Only 2.2% of homeowners live without telephones, compared with 10.7% of renters (U.S. Bureau of the Census 1990) Furthermore, 21.7% of those in public housing are without phones (Belinfante 1989). Finally, Americans living in hotel rooms or boarding houses have the least

20% for unemployed blacks and to 15.3% for unemployed Hispanics (Belinfante 1993).

Blacks and Hispanics experience lower telephone penetration than whites, not surprising since blacks and Hispanics have average lower incomes than whites (table 3). But such thinking is misleading. Figure 5 shows that, even when they share the same level of income, blacks and Hispanics have lower telephone penetration levels than whites. That is, at all levels of income below $40,000, whites have higher levels of telephone penetration. Thus, race and ethnicity appear to confound the impact of income on telephone access.

Why shouldn't blacks, Hispanics, and whites at the same income level, also share the same level of telephone penetration? We acknowledge that racism insinuates itself throughout American society, but telecommunications is supposed to be a neutral technology, so this finding is especially troubling. No hypothesis exists, yet we must pursue an answer with determination. Otherwise, the worthy goal of universal service, along with the exemplary efforts of the telephone companies, will be limited in important social and political ways.

Rural Americans

Among farm households, 5.1% lack telephones -- slightly better than the national average (Belinfante 1989, table 15). However, in America's smaller communities with populations between 50,000 and 250,000, the percentage of households without telephones rises to 7.3%. It is even higher for those living in communities outside of any metropolitan statistical area where the percentage climbs to 9.9% (Belinfante 1989, table 13).

Emergent Themes

The findings synthesized here raise specific questions for further study.

First, how can the strong impact of income on telephone penetration be mitigated, so that those without service can be brought onto the net? The fact that those marginalized from telephone service are also the poorest Americans is not surprising. What demands attention is the persistence of the margin. Telephone penetration surpassed the 90% mark for households in 1970 (series R 1-12, 1975). In the ensuing 24 years, penetration inched up 4 percentage points. In the previous 24 years, penetration grew by 39.1 percentage points. Clearly, reducing the last 10% is difficult; however, without efforts to push penetration further, those at the margin will face enduring isolation.

Second, the vulnerability of women with small children goes beyond simple income effects. How can their families be protected from the compounding effects of isolation and insecurity? The lack of a telephone poses a special risk to a household with small children. Information policymakers should consider the vulnerability of children sufficiently urgent to warrant a universal service policy targeted at this group, among others.

Third, race and ethnicity present this challenge to information policymakers -- is there racism in telecommunications? The social reality of racism in the United States has been reflected in the telecommunications environment; therefore, we should be prepared to address racism as a possible obstacle to the goal of universal service. Much is still unclear, and there is no indication that any of the telephone companies have used discriminatory practices -- quite the contrary. Yet, in the absence of a smoking gun, we are left with unacceptable conditions. Race should not be a factor in telephone access. The anomalous finding calls for more research aimed at uncovering the relationship between race/ethnicity and telephone access. In the meantime, policymakers should consider remedies aimed at tying more blacks and Hispanics onto the net.

The 4.4 million households without telephones in America defy any single characterization beyond lack of service. The questions asked here should be taken as a call for candor and action -- candor because the groups at the margin merit special concern, and action because universal service will not advance without new targeted policies. Universal service still remains an unattained goal.

Universal Service as the Essence of American Information Policy

In its simplest terms, the concept of universal service is that everyone should have the opportunity to interconnect with whomever they wish at a reasonable cost. In principle, this has meant access to a telephone. For most of the 20th century, the idea that every American should enjoy moderately priced telephone service has defined both the telecommunications environment, and citizens' rights to it. So powerful is this belief, it permeates information policy thinking. Less understood are the assumptions underlying that belief.

Universal service derives its significance from a promise: All Americans are ensured equal access to basic channels of communication. The rights to communication embedded in the United States Constitution make the pledge of equal access not only logical, but absolutely necessary. The citizens of a democracy need to communicate in order to get the information necessary to make sound political choices.

To that end, the telephone, and universal service, have contributed to the vision of the information society as a democratic society. As new applications continue to transform the telephone, it makes perfect sense to reconsider the original idea of universal service. Furthermore, new technologies offer new potential that force the rethinking of universal service, which has always been dependent on technology. With the catalytic role played by the computer, and with the arrival of the "information super highway," no wonder that prophets of the information age call for a new universal service.

If one must be informed in order to function successfully in the information society, that means more than a phone connection. Although interconnectivity accelerated the spread of industrial society, it cannot deliver the promise of the information society by itself. For example, if democratic discourse is to be encouraged in the new information environment, then citizens need the answers to their questions, and they must have access to information in digestible form. Similarly, if citizens are to avoid a surveillance state, or a surveillance economy, then access to information about individuals by government or business must be restricted. At the same time, individuals will need full access to information gathered about themselves. Also, in order to fully participate in the information economy as both consumers and producers, Americans must have the opportunity to avail themselves of lifelong learning. In short, the need to redefine universal service may have come from a desire to keep up with technological advances, but the rationale should stem from an obligation to seek the goals of democratic participation and economic growth, no matter how contradictory they might be.

Taking the concept of universal service beyond simple interconnectedness presents challenges. For example, if a redefined universal service stresses information, then which information needs should be met? This is an unanswerable question, because each person's information needs are idiosyncratic and subjective. Thus, solutions must respond to the broader context of citizens as active, individual information seekers.

One approach to meeting information needs is to specify spheres of obligation by differentiating public needs from personal needs. A universal service would then obligate government to meet the demands of the public sphere, while facilitating the opportunities in the private sphere. In the public sphere, citizens need to know how to use government services. They should also have access to channels of communication that provide a public voice. In the private sphere, individuals should enjoy the opportunity to make intelligent economic decisions, and to maintain their privacy. More broadly stated, an informed citizenry is necessary for the ideal of a participatory democracy, and an informed and economically capable public is necessary for a fair and open market economy.

A concept of universal service derived from these principles is not simple. After all, conceptual boundaries are never clear in real life, and, in America, the boundary between the public and private spheres is contested terrain. But that may be an advantage, since the territory is well known and a

socio-legal tradition already exists to show the way. And while there is still no answer to the question of which information needs should be met, the individualistic nature of the question guarantees a continuing public discussion. But if that discourse is to grow and lead the way to enhanced opportunities, then the redefinition of universal service must the first priority. It is fundamental to the progress of the Information Age.

Universal service is so important to the information society that it might better be understood as an information bill of rights. In a democratic society, we might ask what rights to information, and protections from information, belong to all Americans, regardless of their wealth, position, or language. If we direct our energies to answering that question, it should become evident that universal service is not a single policy to be written by a government agency. It is rather a guiding principle of the information society. And, as such, always debated, always tested, always pursued.

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Notes

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1. There is a statistically significant difference between the Current Population Survey of the Bureau of the Census which gives a figure of 93.3% penetration, versus the 1990 Census which gives a figure of 94.8%. The differences result from the questions asked by each survey. We have chosen 94% as an interpolated estimate. See Belinfante 1993, December. Back to document

2. We arrived at the figure of 15.3 million individuals by multiplying the number of households (5.8 million) by 2.64, the average number of individuals per household in the United States according to the 1990 census. Back to document

3. As a point of comparison, 11.6 million is equal to the combined populations of Denmark and Switzerland. Back to document

4. We caution against taking these changes in single percentage points as completely accurate, though they represent the best that can be done statistically. A small rise or fall in penetration may reflect measurement as much as actual change. Back to document

5. 49,961,676 (Belinfante 1989, table 27). Back to document

6. Eleven women were interviewed in California, New Jersey, and Texas, in 1985, 1987, and 1992. Back to document

7. Blacks and Hispanics are grouped together in this article because they are linked in the policy discourse involving telephone penetration. However, it should be noted that, in the Census, black is a racial category while Hispanic is an ethnic category. Therefore, some blacks are also Hispanics, and some Hispanics are also whites. In addition, it should be noted that the use of the term Hispanic reflects the adoption of that term by the Census. Within the cultural communities encompassed by the category "Hispanic," self descriptors such as Latino, Mexican-American, Chicano, Cuban, and Puerto Rican, have greater currency. My point is that one should exert caution when interpreting these categories. They are not mutually exclusive, nor do they capture a monolithic community. At best, the externally imposed categories are tenuously valid. Only the self descriptors have consistent validity, since they capture the self-expressed identity of the various ethnic groups. Back to document

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